MEMORANDUM

TO: Federal Financial Analytics Clients

FROM: Karen Petrou

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Earlier today, we released our 2024 regulatory outlook, a nice summary of which may be found on Politico's Morning Money. As I reviewed the draft, I realized how much of what the agencies plan is doomed to do little of what has long been needed to insulate the financial system from repeated shock. This is a most wearisome thought that then prompted the philosophical reflection also to be found in this brief. It asks why lots more bank rules do so little for financial resilience yet are always followed by still more rules and then an even bigger bust. I conclude that financial policy should be founded on Samuel Johnson's observation that, "when a man knows he is to be hanged in a fortnight, it concentrates his mind wonderfully." That is, redesign policy from one focused on endless, ever-more-complex rules spawning still larger bureaucracies into credible, certain, painful resolutions to concentrate each financial institution's mind and that of a market that would no longer be assured of bailout or backstop.

We know in our everyday lives that complex rules backed by empty threats lead to very bad behavior. For example, most parents do not get their kids to brush their teeth by issuing an edict reading something like:

> It has long been demonstrated that brushing your teeth from top to bottom, tooth-by-tooth, flossing hereafter and using toothpaste meeting specifications defined herein will achieve cleaner teeth, a brighter smile, improved public acceptance of the tooth-bearer, and lower cost to the national health system. You are thus to brush your teeth according to these specifications, filing a report back to the parental authority charged with this responsibility under applicable provisions of the parenting agreement at the close of each day along with a signed and certified form (siblings may provide this service) that states the nature of tooth brushing, the wear and tear on toothbrushes, the amount of toothpaste dispensed in compliance with this order, and such other matters as the parent may from time to time prescribe.

Instead, most parents "tailor" tooth-brushing edicts to the age and capabilities of each child prescribed along with express and certain penalties: no candy, more homework, or whatever remedy is most effective with the miscreant. How hard is that? And, it usually works especially when validated or reinforced by a higher authority – the dentist for kids and the market for financial institutions.

The agencies resort to rule as their default crisis response because that's what lawyers like to write and it's how politicians get to feel that they've instituted reform. U.S. banking agencies do not lack for power to enforce meaningful punishment for bad behavior. They don't use this power because they don't trust themselves to do it right and, as history demonstrates, they are in fact not

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trustworthy when it comes to what Congress, for all the rules it wants, has consistently said is the agencies' top priority: close troubled companies without aid to shareholders, management, or the market.

I have said before that the Fed has express source-of-strength authority that forces parent companies to recapitalize or otherwise stabilize a troubled IDI. Its failure to use this power reduces market discipline, encourages executive insouciance, heightens FDIC resolution costs, and stokes moral hazard – see SVB as a grievous case in point.

The FDIC also has broad authority to establish resolution protocols for IDIs regardless of size or parent. Chair Gruenberg acknowledged in 2019 that the agency still didn't know what to do with a troubled regional bank and he and other FDIC board members reaffirmed this in 2021. Still, they did nothing to ensure the FDIC could meet its statutory authority until after the mid-March failures when, instead of enhancing its own capabilities, it along with the FRB and OCC proposed a lot of new long-term debt and resolution standards in part designed to ensure that BHCs and IDIs do the agencies work for them.

Aspects of the resolution proposals make lots of sense, but the agencies had the power to demand them at least since 2010, when the great financial crisis might well have reminded them to do so. Worse, the FDIC is clueless about how to implement one of Dodd-Frank's most critical reforms: the orderly liquidation authority meant to avert both systemic risk and taxpayer bailouts. So much for that too, according to the agency's own Inspector-General.

As with tooth-brushing enforcement, financial-institution resolution works best as meaningful discipline if a culprit is warned and given the chance to remedy bad practice before the noose is tightened. An *American Banker* article Thursday makes clear how little this happens when it comes to banks, including the smallest and simplest. The article talks about how tough the FDIC has gotten via issuance to a $13 million bank of a sell-or-liquidate order. Without comment, it goes on to point out that this little bank has violated major requirements for more than six years – the first public enforcement action is in 2017 and it surely came long after supervisors spotted problems given the wait-and-hope strategy that has long characterized federal oversight – a word with two meanings and where, in this case, the meaning of "failure to see" is more pertinent than over-seer.

After the mid-March failures, Members of Congress failed to hold the Fed responsible for abrogating its source-of-strength power. They generally castigated the FDIC not for its overall inability to handle these cases without bailouts and big-bank consolidation, but rather for the IDI-disposition process. The chaos and, in a couple of cases, the injustice of this process are super-problematic to those involved, but it's only a symptom of the FDIC's inability to do its primary job: shutter failed banks and nonbanks without harm to insured depositors and damage to the financial system.

Housed in a system in which they are told to brush their teeth but the kids who don't brush still get candy, most children will quickly learn that bad behavior gets them the goodies. The current system of bank regulation without financial-system resolution is one sure similarly to fail because there are no near-term consequences for short-term profit maximization. It's hard to see how the latest bout of bank-centric rules in the absence of meaningful FRB and FDIC disciplinary sanctions for banks and nonbanks will turn out any better than all the last bouts of rules followed by crises followed by rules followed by crises.