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For the Record
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by Jeremy Newell, Executive Managing Director, Head of Regulatory Affairs, and General Counsel, The Clearing House Association

My Perspective
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Contributors

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Norbert Michel

Norbert Michel studies and writes about financial markets and monetary policy, including the reform of Fannie Mae and Freddie Mac. Working in Heritage’s Roe Institute for Economic Policy Studies, Michel also focuses on the best way to address difficulties at large financial companies (the “too big to fail” problem).

Before rejoining Heritage in 2013, Michel was a tenured professor at Nicholls State University’s College of Business, teaching finance, economics, and statistics at the AACSB-accredited school in Thibodaux, La. His earlier stint at Heritage was as a tax policy analyst in the think tank’s Center for Data Analysis from 2002 to 2005.

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Scott is the Director of the Committee on Capital Markets Regulation, a bipartisan nonprofit organization dedicated to enhancing the competitiveness of U.S. capital markets and ensuring the stability of the U.S. financial system via research and advocacy. He is also a member of the Bretton Woods Committee, a member of the Market Monitoring Group of the Institute of International Finance, a past Independent Director of Lazard, Ltd. (2006–2016), a past President of the International Academy of Consumer and Commercial Law, and a past Governor of the American Stock Exchange (2002–2005).
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In this issue of Banking Perspectives, we take stock of the post-crisis bank regulatory framework, with contributions from experts who identify aspects of the framework that merit rethinking. This fresh look at the post-crisis “big picture” seems appropriate, not only because nearly a decade has passed since the worst of the financial crisis abated, but also because of the rapid and fragmented way that picture was painted in the first place. Indeed, it is easy to lose sight of the fact that the post-crisis regulatory framework was not developed in any holistic, systematic way, but rather is an amalgamation of numerous new standards and policies that were individually designed through independent processes, by a wide range of domestic and international regulators, without the benefit of any comprehensive understanding of their collective and cumulative effects.

The capital reforms undertaken by the Basel Committee are perhaps the best example of this phenomenon. Since 2009, the Basel Committee has proposed or finalized a large number of different changes to its capital framework, some of which have established new minimum ratios, some of which have redefined that ratio’s numerator (i.e., the definitions of capital), and many of which have redefined the many subcomponents of that ratio’s denominator (e.g., the separate risk-weighting frameworks for credit risk, market risk, operational risk, etc.). U.S. regulators have generally then taken those standards they negotiated internationally and made them more stringent (which they refer to as “gold plating”) for U.S. banks. All these changes have been pursued separately and iteratively, and the result is a capital adequacy regime that is not coherent in any real sense, but is simply the sum of numerous parts that have each been designed and calibrated in their own vacuum.

That conclusion is not intended to be overly critical – following the most pronounced financial crisis in nearly a century, the
Regulators and supervisors have come to effectively embrace a centrally planned banking system where it is they who do all the planning and define the criteria for compliance.

regulatory community was rightly on a war footing, and the rapid issuance of new regulatory standards was consistent with the urgency of the task of assuring the resilience of the banking system. But – especially now that such resilience undoubtedly is in place – it does seem fair to ask what all of these new regulatory parts add up to, and whether that sum is as coherent and sensible as it could be.

It is precisely this type of “big picture” assessment that is undertaken by this issue’s authors. H. Rodgin Cohen begins this journey by revisiting former New York Fed President Gerald Corrigan’s famous argument regarding the “specialness” of banks as the basis for bank regulation, and highlights the extent to which enforcement of banking regulation seems to have become untethered to the core safety and soundness objective that has traditionally guided it. Professors Julie Andersen Hill and Hal Scott focus on procedural problems in the existing regulatory framework – with Prof. Hill highlighting the ineffectiveness of the existing process by which material supervisory decisions may be reviewed and appealed, and Prof. Scott demonstrating how the Federal Reserve’s stress-testing exercise may run afoul of both the letter and spirit of the Administrative Procedure Act. The Heritage Foundation’s Norbert Michel takes on the broader objectives of bank regulation and explores the link between an expanded federal safety net for banks and greater (and more intrusive) bank regulation – and argues for rollback of both. And finally, Columbia University economist Charles Calomiris assesses the direction of financial regulation through the prism of two regulatory drivers of financial instability – government policies to protect bank losses and encourage real estate lending – and concludes their impact is important and growing.

On a related front, my colleague Greg Baer follows up with some answers to the questions raised in our recent article, “How Supervision Has Lost Its Way.” Increasingly, we hear from banks of all sizes that problems with the generally secret supervisory process are just as significant for their ability to serve their customers as problems with the public regulatory process. We continue our efforts to explain what is going on and how it could be improved.

The subject matter of these articles is diverse, but they all share one trait: a willingness to rethink where the post-crisis reform process has landed. It is our hope that these articles provide ample opportunity for thought as to how to continue to improve and adapt our framework of bank regulation.

To this list of things worth “rethinking,” I would add an observation of my own, which is the emergence of two mutually reinforcing and pernicious trends that cut across nearly all aspects of the new regulatory and supervisory paradigm: a regulatory demand for banking practices that are both standardized and static. Or, to put it more provocatively, regulators and supervisors have come to effectively embrace a centrally planned banking system, where it is they who do all the planning and define the criteria for compliance.

The first of these trends – the overwhelming reliance on standardization of banking practices through regulation – is easier to identify. It is most pronounced in the new framework of “balance sheet” regulation, where the complex and granular nature of new capital and liquidity rules has resulted in an unprecedented level of regulatory prescription around how nearly every aspect of a bank balance sheet should be constructed and managed. That regulatory prescription certainly has its benefits – chief among them, a vastly more resilient profile across the banking industry. But it also gives rise to a world in which bank balance sheets must, as a function of that regulatory nanoengineering, be organized and managed in an increasingly homogeneous and standardized way, with little room to stray from the mostly one-size-fits-all model enshrined in these new rules.

A similar trend toward standardization is observable across many other post-crisis rules: Resolution planning at every bank must meet a single, detailed set of regulatory preferences; leveraged loans must be underwritten, originated, and managed according to practices specified by regulators; all risk-taking must be managed and governed according to the Office of the Comptroller of the Currency’s detailed “three lines of defense” model; vendors must be vetted, approved, and managed according to the agencies’ latest preferences; bank directors must adhere to a hundred pages of precise instructions from regulators on how they must perform their board duties. (On this last point, a recent Federal Reserve proposal gives reason for hope, at least at the holding company level.) The list is seemingly endless.
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And this is to say nothing of all the additional supervisory prescriptions being written by examiners and supervisory policy staff outside of public view. As any banker can now attest, it has become depressingly common for bank supervisors to effectively invent their own standards for how banks should operate, in a process that is not transparent, let alone subject to public comment, and demand conformance to those expectations under penalty of examiner criticism or adverse action. As Greg Baer and I have detailed previously in this journal, the rise of such extralegal (and therefore illegal) banking rules is one of the great untold stories of post-crisis regulatory reform. None of this is to say that the growing standardization of banking practices by regulatory fiat is without some social benefit. But it does mean that, as an overwhelming trend across the post-crisis regime, it likely has some social costs, too. Unfortunately, these social costs have not been much acknowledged by policymakers, let alone analyzed. As with any attempt at central planning, chief among them are the very real potential costs to innovation and efficiency that would seem to come with the regulatory “crowding out” of what ideally ought to be a rich, varied, and competitive marketplace of different ideas and perspectives on how best to run a bank. Also among them is the not immaterial risk that the regulators’ new one-size-fits-all model of bank management and operation may be revealed over time to include one or more deep flaws that endangers the core lending and other functions that banks perform, the stability of our financial system, or both.

The trend toward regulatory standardization in banking is complemented and reinforced by a similarly pronounced regulatory preference for stasis in banking. Simply put, the current supervisory dynamic operates as a substantial barrier to innovation, expansion, or change in the banking industry. On the surface, this trend is less readily apparent than the push for standardization, as it is largely the product of the opaque supervisory environment rather than a transparent regulatory framework. But beneath that surface, the supervisory process has come to impose significant constraints on banks’ ability to make strategic acquisitions, open new branches, or develop and offer new products or services and otherwise meet the growing financial needs of their customers.

In some cases, these constraints are formal – for example, in 2014 the Federal Reserve issued a “supervisory letter,” referred to as SR 14-02, that identified a range of supervisory concerns that as a matter of Federal Reserve practice (as opposed to actual law or regulation) would, if present at a bank, preclude any acquisition or expansion by that bank. There is no requirement therein that the supervisory concern actually relate to, let alone reflect negatively upon, the proposed area of expansion – thus, for example, supervisory scrutiny of anti-money laundering practices in one’s wealth management business could well operate as a total bar on opening a new branch in an underserved community. The net result is a broad supervisory embrace of what might be called the Christmas-tree-lights theory of bank management – if one thing is wrong, then everything must be wrong. And therefore if one thing is wrong somewhere in a bank, then nothing can change anywhere in that bank.

The practical implications of that supervisory approach are predictable and significant – an enormous and systematic bias against innovation and change, both in individual banks and across the industry. Again, this is not to argue against robust and meaningful supervisory checks on banks’ ability to expand and grow – certainly, supervisors can and should be able to prohibit supervised institutions from undertaking acquisitions or activities where they lack the managerial expertise or other resources to do so safely and soundly.

But, ideally, such authority should be clearly articulated and vested in specific and accountable individuals. Unfortunately today’s supervisory dynamic seems quite far from that ideal – instead, it is increasingly the case that the number of individual supervisors that effectively possess a veto right on acquisitions or new activities across the entire supervised organization is not one or two but 10 or 20. We should not be surprised if a supervisory model that imposes such significant and diffuse obstacles to innovation and change should give rise to banking industry that is much less dynamic and adaptable than its customers would otherwise prefer and that international competitiveness demands.
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In 1982, E. Gerald Corrigan wrote "Are Banks Special?", a truly seminal article on bank regulation. He then revisited this subject in a briefer 2000 article, appropriately entitled "Are Banks Special? A Revisitation." Now is the time for a re-revisitation of this work, both because so much has occurred in the financial services industry during the ensuing 17 years and as a tribute to Corrigan’s crucial role in shaping our regulatory structure.

The fundamental conclusion that Corrigan reached — that banks are special — is still true today. As he emphasized, banks are special because they perform unique and indispensable functions in the nation’s economy; there is, in his words, “a long-standing consensus that banking functions are essential to a healthy economy.”

The original article cites, and the subsequent article endorses, three distinguishing functions that banks perform: transaction accounts (which “permit our diverse economic and financial system to work with relative ease and efficiency”); backup source of liquidity for all other companies (for which “all other financial markets and all other classes of institutions are dependent”); and the transmission belt for monetary policy. Moreover, only banks perform the dual functions of both offering transaction accounts (as well as other short-term deposits and liabilities) and then engaging in maturity transformation by utilizing those funds to provide longer-term loans to consumers, businesses of all sizes, and other organizations (which the original article describes as “‘term structure’ risk”). Corrigan posits that, ultimately, “it is the relationship among [these functions] that best captures the essence of what makes banks special.”

Corrigan’s articles also discuss two fundamental questions raised by banks’ special position. First, should they be regulated differently than other companies, even other financial companies? This Banking Perspectives article examines each of these issues in the context of today’s regulatory environment and with the benefit of 17 years of additional experience.

**BANK REGULATION**

As a result of the unique functions that make banks “special,” a wide-reaching legislative and regulatory structure has been developed to ensure the continued availability of these functions. This structure includes the following: (1) a comprehensive scheme of bank regulatory requirements (e.g., capital, liquidity, and stress tests) and restrictions (e.g., powers and loans to affiliates), which are designed to promote bank resilience; and (2) government programs of support (principally, federal deposit insurance and Reserve Bank credit facilities), which are designed to enable banks to incur the risks inherent in their role in the economy. As Corrigan stressed, the predominant objective of this special legislative and regulatory structure is the safety and soundness of individual banks and the banking system. The phrase “safety and soundness” appears at least five times in the original article.

At the same time, however, Corrigan recognized the need for the regulatory structure to be carefully calibrated so that banks are not so constrained as to limit their capacity to fulfill their functions. As he wrote: “If banks are special it would not be in the public interest for the features or functions that make banks special to be eroded by competitive, regulatory or legislative forces.” Corrigan’s concern persists today. Rigidity or undue stringency in the bank regulatory system can prevent prudent risk-taking and create increased costs and friction that drive financial services to less-regulated providers — what is known today as the shadow banking system — that are less capable of dealing with financial or economic stress.

Unchanged since 1982 or 2000 are the functions performed by banks that make them special and the special regulatory structure for banks designed to achieve...
safety and soundness. In terms of functions, banks continue to perform their unique roles of creating maturity transformation, providing transaction accounts, and serving as backup sources of liquidity for the economy. Banks also acted as critical conveyors for monetary policy during the 2008 financial crisis, although the magnitude of the crisis demonstrated the limits of monetary policy.

In terms of continuing special regulation, the numerous bank failures and near failures during the financial crisis, including some of the country’s largest banks, resulted in a considerably more stringent regulatory regime. That regime was a function of both “enhanced prudential supervision” under the Dodd-Frank Act (including higher capital and liquidity requirements, stress tests, living wills, and total loss absorbency capacity requirements) and, perhaps even more so, a more rigorous supervisory approach. It is noteworthy, however, that some of the most consequential failures and near failures during the crisis did not involve banks but other financial services companies, including an insurance company (AIG), two investment banks (Lehman and Bear Stearns), and a money market fund (Reserve Fund). 4

What has changed since 2000 is the evolution of the enforcement approach to certain long-standing bank requirements that are basically unrelated to safety and soundness. This enforcement approach makes banks special in a different way, by singling them out to accomplish certain societal goals and to impose substantial penalties for failure. 5 However laudable these societal goals may be, the severity of this enforcement approach does not advance safety and soundness, and sometimes may actually prove counterproductive.

One principal societal goal is a policing function to detect and prevent money laundering and the underlying criminal activity, including terrorist financing. The cost to the banking industry for assuming this policing role, which is unique in the private sector, extends well beyond the substantial expense of the requisite personnel and technology. A more significant element of cost is the enforcement actions and fines imposed on banks that are deemed by examiners to have failed to adopt and implement effective anti-money laundering programs. These penalties are not reserved just for actual money laundering events but include so-called “program violations,” even though there are not clear and comprehensive regulatory guidelines and regulators’ expectations are constantly evolving.

Perhaps the most serious cost relates to resultant limitations, indeed prohibitions, on expansion, growth, and structure. Banking organizations that are subject to enforcement actions relating to money laundering violations are typically disqualified from engaging in new activities, acquisitions, certain investments, or any other transaction requiring regulatory approval, even if the transaction would promote safety and soundness through greater efficiency, reduced complexity, diversification, or otherwise. The prohibitions include both large and small acquisitions, and even internal reorganizations and de novo branches. The disqualification period can last for years, as the bank must demonstrate not only remediation but “sustainability” over multiple examinations.

A second societal goal is the protection of consumers. Again, this is a laudable objective, which applies to virtually all commercial enterprises, and banks undoubtedly have an obligation to comply with consumer protection laws and, more broadly, to serve the interests of their customers and communities. Moreover, banks that fail to comply should be subject to appropriate penalties, although the enforcement of these laws should take into account the vast array of consumer compliance laws and the evolution of not only regulatory expectations but interpretations. Nonetheless, what is special for banks, as opposed to other companies, is an enforcement approach that directly impinges on a bank’s overall business strategy by imposing the widespread disqualifications discussed in the preceding paragraph. Of course, this has at most a tangential relationship to safety and soundness.

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The divorce between these new enforcement policies and safety and soundness considerations is illustrated by the ratings methodology used by the regulators to prohibit expansion, among other things. For decades, banking organizations have been rated under the so-called CAMELS rating system. The components of this system relate to safety and soundness: C = capital adequacy; A = asset quality; M = management; E = earnings; L = liquidity; and S = sensitivity to risk. A management or capital rating, or a composite rating across the six components, of “unsatisfactory” (“3”) or below precludes expansion.

Notably, there is no component in the CAMELS system for compliance with regulations unrelated to safety and soundness. This is logical because, except in egregious circumstances, failures with respect to such regulations would not detract meaningfully from safety and soundness. Nonetheless, the bank regulatory agencies have, in effect, not only made compliance a component of the CAMELS rating system but an often determinative component. Typically, any significant compliance failure is now deemed by the regulators to reduce the management (M) rating to “unsatisfactory,” and, as indicated, such a rating precludes a broad range of activities and transactions. This result is different from the safety and soundness regulatory regime envisioned in Corrigan’s articles. It remains to be seen whether the Federal Reserve’s proposed new rating system for large banking organizations will change that result.

BANK AFFILIATIONS

In Corrigan’s original article, a central thesis was that the special position of banks made it injudicious for them to affiliate with other companies, including most other financial companies. By the time of the revisitation article, however, the Gramm-Leach-Bliley Act had removed most of the barriers to the affiliation of banks and financial companies, while preserving the fundamental dichotomy between banking and commerce.

Corrigan concluded in 2000 that “to a very considerable degree, GLB seems to acknowledge that banks are special. Indeed, the Act is both powerful and progressive in providing a coherent framework to guide the next phase of the evolution of banking and finance in the United States.” In particular, the act preserved the bank holding company model favored by Corrigan by limiting the conduct of the new financial services activities to the holding company.

With one major exception, the Dodd-Frank Act maintained the basic structure for bank affiliations that existed after Gramm-Leach-Bliley. That exception was the Volcker Rule’s partial rollback of Gramm-Leach-Bliley’s partial repeal of the Glass-Steagall Act. Gramm-Leach-Bliley had removed Glass-Steagall’s “not engaged principally” limitation on investment banking by affiliates of banks (Section 20). The Volcker Rule eliminated the authority of bank affiliates, as well as banks themselves, to engage in proprietary trading and investments in covered funds.

More recent calls for a return to Glass-Steagall have not been couched in terms of preserving the special nature of banks. Indeed, such an argument could not legitimately be made because the Gramm-Leach-Bliley Act left untouched the Glass-Steagall restrictions on the operations of banks themselves. Of even more importance, these proposals are not grounded in an analysis of the 2008 financial crisis, because no evidence has been adduced that the partial repeal of Glass-Steagall in Gramm-Leach-Bliley contributed in any meaningful way to that crisis. This echoes the informed economic analyses of the Glass-Steagall Act itself, where there is no evidence that securities activities of banks or their affiliates were a meaningful contributor to the collapse of the banking system at the onset of the Great Depression.

CONCLUSION

Banks are special, as Corrigan persuasively argued, because of the unique and fundamental role they play in supporting the nation’s economy. For this reason, the scope of regulation of both banks and their affiliates must carefully balance the need for robust safety and soundness standards with the need for sufficient flexibility so that banks are capable of fulfilling that role, which requires carefully calibrated risk-taking. As Corrigan aptly concluded, this balance is crucial so that, given banks’ special role, they must be able to “maintain profitability, attract capital and preserve a de facto monopoly on the transaction account business.”

ENDNOTES

1 Available on the website of the Federal Reserve Bank of Minneapolis: https://www.minneapolisfed.org/publications/annual-reports/are-banks-special
2 Available on the website of the Federal Reserve Bank of Minneapolis: https://www.minneapolisfed.org/publications/annual-reports/are-banks-special
3 Corrigan served as the President of the Federal Reserve Banks of Minneapolis and New York, and also as the closest approximation of an “eighth” Federal Reserve Board Governor.
4 The Dodd-Frank Act did include a provision to subject “systemic” non-bank financial companies to special supervision.
5 The imposition of this much more stringent enforcement regime coincides, at least in time, with a sharp decline in the public perception of banks following the 2008 financial crisis.
6 The Federal Reserve has recently proposed a new rating system for large bank holding companies.
7 Likewise, a Community Reinvestment Act rating of “needs to improve” or below is generally preclusive of expansion.
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Much of the regulation that came out of Dodd-Frank made for a stronger financial services sector. The need and the requirement to stress-test our portfolios make a lot of sense.... But Dodd-Frank has also created some unnecessary complexities, especially around lending.
**Greg Carmichael**, CEO of Fifth Third Bancorp, discusses the effect of regulations on the industry, the relationship between FinTechs and banks, and his thoughts about the future with **Jim Aramanda**, President and CEO of The Clearing House.

**JIM ARAMANDA, TCH**: You have a deep background in technology, including as a CIO. And you have made technology an important part of Fifth Third’s growth strategy. Could you provide us with your perspective, particularly as someone with a technology background, on how you are using technology to grow revenue, manage expenses, and provide new products and services to your customers? Also, I'd welcome your views on how technological innovation and regulation intersect — for instance, is it challenging for banks to effectively innovate due to their regulated nature?

**GREG CARMICHAEL, FIFTH THIRD BANCORP**: First, let me share a couple of general comments on innovation and Project NorthStar, an initiative we launched last year. The overall strategic approach is really about putting the customer at the center of everything we do. It focuses on taking care of the customer, as well as growing revenue and managing expenses, as you mentioned.

Cutting costs just to cut costs, which could hurt our ability to serve our customers, is not acceptable. Project NorthStar puts the emphasis on being customer-centered in all things.

With respect to the question of whether regulation has the effect of holding back banks from creating new products or offerings, here's what I would tell you.

First, there's never just the right amount of regulation. In any amount, regulation will prevent some positive innovations that would help customers. Likewise, even the most stringent regulation will fail to catch some innovations that don't create value and that weaken the stability of our financial systems. Ultimately, it's about balance, and that balance has to be found in each area, each business and each regulation. Understandably, we are not pleased about regulations that prevent us from pursuing innovation that would enable better outcomes for customers. We strongly believe that some regulations should be changed to enable better outcomes for our customers, without risking safety or soundness. At the same time, we recognize and appreciate the very important role that regulations play in protecting customers and ensuring the safety and soundness of the financial system. We appreciate the ongoing dialogue we have with regulators on how best to achieve this balance.

When we put new products or services into the market, we should have an opportunity to learn from the customer experience and the ability to modify that product appropriately. Currently, we are operating in a zero-tolerance regulatory environment.

This environment presents challenges to introducing technologies, products, or services. If we have an issue,
we can't advance the products or services. A zero-tolerance regulatory environment puts constraints on products and services that we may like to get into the marketplace. For instance, small dollar lending has been problematic. As you know, Jim, small-dollar lending is a very important product for our customers. Many customers are regularly going out to payday lenders, title loans, and pawn shops to get short-term access to dollars.

We also know that a significant amount of the American population lives paycheck-to-paycheck, and nearly half of the population can't cover an unexpected $400 expense. So, there's a real need for temporary emergency funds to cover situations such as a car breaking down, a refrigerator going out, a roof leaking, or something of that nature.

It's important we get a banking product out to serve this need, and we appreciate that regulators are rightly focused on protecting consumers from potentially unscrupulous lenders. But the guidelines issued to date will prohibit banks from offering a suitable product.

With a limited amount of resources that a bank has to apply to new products, and the limited amount of value that a product of that nature creates for the bank itself – but a huge value for the customer – we can't implement a product that needs to meet significant hurdles to satisfy regulators. The solutions should be simple, efficient, inexpensive and effective for the customers. With overly restrictive rules, it takes as long and as much effort and cost to originate a $500 loan as it does a $1 million loan. Those types of constraints just impede our ability to introduce the right types of products and services to our customers. Instead, these limitations end up leaving the marketplace in the hands of the payday lenders or emerging FinTech start-ups.

Another example is small business loans. We know that small businesses are the primary source of job formation in the economy. They create two out of every three new jobs. Small business loans are thus extremely important. But under Dodd-Frank and under CCAR analysis, because of the nature of a small business loan, typically most of those are leveraged loans and we get penalized. We have to hold more capital for a small business loan than you do for a consumer loan.

When you look at the amount of capital you have to hold, and the underwriting requirements for a small business loan versus a larger loan, the cost is the same. It makes it more difficult to serve small businesses, and you see small business lending by banks being significantly reduced over what you saw pre-crisis.

Once again, a lot of regulation that came out of Dodd-Frank made for a stronger financial services sector. The requirement to stress-test our portfolios makes a lot of sense. We should continue to do that.

But Dodd-Frank has also created some complexities around lending. Likewise, the cost associated with compliance, such as DFAST and CCAR, forces resources to be pulled away from new product introduction.

ARAMANDA: Yes. I think the other TCH member bank CEOs would agree with you and the way you characterize it. While a lot of it makes sense, Dodd-Frank needs to be recalibrated. Its impact on the industry and on the economy also needs to be considered as well.

CARMICHAEL: Agreed.

ARAMANDA: You are one of the select few CIOs who have gone on to become a CEO of a financial company. How do you think your background gives you an advantage when it comes to running a bank?

CARMICHAEL: Jim, I've spent my entire career using technology in a way to solve business problems or to make a company more efficient. When you think about the skills associated with putting in new technology, the preparation, the testing, the disaster planning you have to go through to make sure you can recover from a situation, all of those skills are very helpful when you sit as a CEO of any company.
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In our sector right now, what's really interesting is the pace of change we're experiencing, driven by digital capabilities. The digital capabilities have been enabled by some of the legislation that's been passed in the past few decades. Check 21 enabled banks to transact with a digital image of a check versus the physical check. The new legislation plus the emergence of broadband internet, smartphone technology, and web-based applications all came together to change how we serve our customers, the products we offer, and the channels in which we can offer those products.

A technology background is very helpful with the digital transformation that's occurring now. My approach to problem solving and using technology adds to how I look at my job as CEO.

My technology experience is very helpful in my current role as we work to assess the right type of technology or the right type of partnerships.

We have a clear strategy at Fifth Third when it comes to technology: buy, partner, then build. That mentality of looking out and finding the best partners and the best solutions to solve our problems and implement them quicker, in this day and age, gives a bank an advantage. This strategy is driven by the way our customers want to bank, which is anywhere, anytime. They want simple, easy and fast banking services for day-to-day transactions, and they want a relationship with a trusted advisor.

And to finish answering your question, I'd like to also discuss FinTechs. You know, Jim, I look at FinTechs as a great opportunity. We embrace FinTechs as partners who can help make us better. We have FinTech in our DNA plus more than 150 years of financial services experience. In fact, Fifth Third has a long heritage in the FinTech space. We've been doing FinTech integration and partnerships for the last decade at Fifth Third to introduce new products and services. Examples include bill pay, mobile banking, payment solutions, etc.

Fifth Third was the first bank to introduce a network ATM infrastructure back in the late '70s. We've been innovative for a long time. We built Vantiv Corporation, which is now a very large FinTech company. All in all, I look at FinTech as an opportunity to better serve our customers and to differentiate ourselves. FinTech is not something that I view as a threat.

ARAMANDA: Yes, I think FinTechs are a threat if you don't understand what they can do to help drive solutions to the market. While we're on that topic, can you talk about Fifth Third's partnership with private equity?

CARMICHAEL: Absolutely. We are extremely excited and proud of our partnership with QED Investors. QED is a small boutique private equity firm focused on the FinTech space. It's a great company with tremendous leadership. QED takes a hands-on approach to its investments premised on deep operational experience in financial services. They work with over 50 different FinTech entities in startup phase. Our partnership with QED enables Fifth Third to get the first look at those businesses and determine if there's an opportunity for us to invest directly, partner, or, in some cases, acquire those entities at an early stage.

This partnership has already helped us form relationships with companies like GreenSky, ApplePie Capital, Transactis, and AvidXchange. This has enabled Fifth Third to accelerate our innovation in those different areas, whether it is unsecured lending, small business franchise lending, or accounts payable automation.

Working with QED accelerates our ability to evaluate FinTech companies, and then, where appropriate, make
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an investment that creates a strategic relationship. And, most important, our FinTech strategy, of which QED is an critical part, allows us to accelerate the pace at which we bring new and better products, services and experiences to our customers.

ARAMANDA: Do you have any concerns about the FinTech industry and products and services they offer? For instance, do you have concerns over potential liabilities it may create for Fifth Third or your customers? Also, what kind of touch do you think the regulators should have on the FinTech market?

ARAMANDA: As you mentioned earlier, it’s important to partner with a FinTech to make sure safety and soundness is addressed. If banks don’t do that, these newer companies will go out and build products that tend to disintermediate banks from their customers, and the banks may risk becoming a utility.

CARMICHAEL: Yes, I think the regulators should be involved. Banks are held accountable to protect our customers and make sure that there’s safety and soundness in what the banks are doing. The regulators need to balance the need for customer protection and systemic safety and soundness on the one hand with innovation and customer value on the other. They need to create an environment that provides the same safeguards in the FinTech space that banks have to adhere to when introducing new products and services to customers.

I am concerned about emerging entities that do a lot of screen-scraping, which puts pressure on our networks and our systems to support their business.

And, of course, there is the customer service aspect. When customers have an issue or a problem, they don’t contact the FinTech company, they go to the bank. I’m aware and concerned about this, and my hope is that the regulators will evaluate these FinTech companies in the same manner in which they evaluate and regulate Fifth Third Bank.

We know how to compete in this environment, and we desire what I’ll call a level regulatory playing field for all participants.

CARMICHAEL: Well, the interesting thing with FinTechs is that most of them need a bank as a partner to be successful.

GreenSky doesn’t exist, Lending Club doesn’t exist, OnDeck doesn’t exist without liquidity and the safe harbor banks provide for the asset. Partnerships between a bank and a FinTechs are a potential strong win for our customers and a win for our banking shareholders because we’re more efficient in how we deliver innovative products and services.

ARAMANDA: Well said. Moving on to the next topic, the banking industry, as we all know, over the last eight or nine years has undergone more regulatory change than any time in the history of banking. With a new administration in the White House, there’s plenty of talk of regulatory reform. What areas of the bank regulatory framework do you think need to be recalibrated?

CARMICHAEL: I think it’s appropriate to revisit certain aspects of Dodd-Frank, especially when you think about the traditional regional banks like Fifth Third. There’s an opportunity to more appropriately tailor prudential standards by tying the type of business that a traditional regional bank has to the systemic risk it poses to the financial services sector, rather than the single measurement of asset size.

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Fifth Third and most of its regional peers are not Wall Street banks. We’re Main Street banks. We’re more similar to large community banks with a bigger balance sheet, but we do not do a lot of the types of high-risk transactions or have the international exposure that many trillionaire banks have.

There’s an opportunity to tailor Dodd-Frank more appropriately to the risk that banks create for the financial services sector. That will allow us to do a better job of serving our customers, quite frankly, and deploying our capital more strategically, while reducing our cost to serve customers.

Regulation should be tailored based on business factors, such as interconnectivity, global activity, and complexity. All those things should be considered when you think about the risk a bank or a financial services entity creates for the financial services sector. There is certainly an opportunity to right-size some aspects of regulation.

ARAMANDA: Yes. And I think there’s the appetite in Washington to do that.

CARMICHAEL: There is a need to revisit some of the regulations and how restrictive they are, and assess the applicability of those regulations to where we’re at today. Generally speaking, banks are well capitalized. We are holding significantly more capital than we had going into the Great Recession. We need to maintain a significant capital position to absorb losses in the event of an economic downturn. But we also need to be able to deploy some of that capital differently than we have in the past for strategic opportunities.

ARAMANDA: Switching gears, you’ve been expanding in wealth management and insurance. Can you talk about the opportunities you see in those areas and why Fifth Third is investing in those segments?

CARMICHAEL: Wealth management and insurance are businesses that create a lot of stickiness to the relationship that we have with our customers. Once you become their wealth partner, and they’re part of our Private Bank, it creates a very different relationship because we’re focused on long-term financial wealth creation, retirement planning services, and how to protect their wealth over time.

We become their strategic wealth partner, and that creates a different bond with those customers. In addition to that, Jim, as you know, the population is aging and unprecedented numbers are approaching retirement. People are very concerned about having enough financial resources to be financially successful through retirement. We want to be there to help them do that.

That’s why we acquired a company called Retirement Corporation of America and we’re investing heavily into our insurance capabilities. Our wealth planning platform, called Life 360, is a secure and convenient web-based platform that specifically meets the complex needs of our Private Bank customers. It provides a digitally integrated view of all a customer’s assets across all of their financial relationships, whether they are at Fifth Third or at another financial institution. Life 360 includes an electronic “vault” storage feature that is an outstanding platform to save and share important documents with family members or financial managers. It also allows customers to create projections and offers other tools to enable our Private Bank customers to plan better for their future.

Wealth management and insurance have been strong growth areas over the last five years because of the investments that we made. They are very important services to our customers.

ARAMANDA: What concerns you about what you are seeing in the different markets that Fifth Third services? What sectors are still lagging? Are there some that are overheating? And, maybe, what geographic regions would you hope should have better growth prospects than they’ve been experiencing?

CARMICHAEL: As you know, Jim, we’re in the third-longest economic expansion in the history of the U.S. Broadly speaking, one of the concerns I have is that the length of the recovery suggests that we’re in the latter
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innings, potentially, of the cycle. That's something we're very mindful of going forward.

GDP growth remains slow. I think the latest reading was around 1.2% annualized. There's also a lot of concern and lack of clarity around the timing and magnitude of reforms, which creates headwinds for our business. Are we going to get corporate tax reform? Are we going to see a different healthcare structure put in place and the repeal of Obamacare? Are we going to get fiscal stimulus in the form of infrastructure investments, defense investments, which would bode well for a lot of our customers? Are we going to see that materialize this year? We don't know that, and nor do our customers.

That creates some challenges from a growth perspective and for companies to make decisions. If you're going to sell your company or acquire a company, you may be more attracted to a 20% tax structure than a 35% tax structure. So it may impact your decision making. That's just reality.

On the positive side, I would tell you credit losses are at an all-time low for most banks right now. For Fifth Third, our credit losses are below pre-crisis levels. Our forward metrics are very positive and strong. Credit continues to be a positive in the current cycle, but once again, we're in the latter end of the cycle.

To answer your question about areas/sectors that are lagging, I would tell you we're seeing the same thing that you are seeing. From a sector perspective, we see broader weakness in the brick-and-mortar retail space for traditional clothing and the electronic retailers. That should be no surprise as they're getting pressure from companies like Amazon or eBay, and they really have to rethink their business model.

In addition, the energy sector has rebounded a little off its lows in February 2016, but not where it was nor is it in a healthy state. We don't have a large exposure there, but it's one we watch carefully.

From a geographical perspective, we have seen fairly balanced growth within our footprint. We believe that our footprint, which extends from the Midwest down to the Southeast, has a very diverse mix of businesses in both manufacturing, technology, and the service industry. We're very similar to the rest of the United States with respect to the type of companies that we bank across our footprint. We're not heavily concentrated in any one area.

ARAMANDA: Looking ahead, do you see any fundamental shifts taking place that will affect the overall economy in the years to come?

CARMICHAEL: I think there's a lot. It's difficult to say five years from now what the economy is going to look like, to be honest with you.

There are concerns around the administration's ability to introduce their policies and get them into production, so to speak, whether tax reform, fiscal stimulus, or healthcare reform. I don't know how they're going to play out.

I think those will have far-reaching consequences. If we don't get corporate tax reform, I think that's going to be a setback. If we don't see some type of regulatory relief for corporations, especially financial services, I think we're going to continue to be challenged to grow. While there are concerns, we are focused on the things we can control and what we can do to better serve our customers.

ARAMANDA: Finally, can you speak about Fifth Third's community commitment?

CARMICHAEL: With pleasure, Jim. Fifth Third has always been a strong contributor to all the communities in which we serve. I am a firm believer that you can't build a strong bank without having strong communities. We're very, very focused on serving our communities, and are making that commitment more visible with respect to how much we are doing to help them be successful.

In November 2016, we announced a $30 billion, five-year community development plan over 10 states where we have a retail banking presence. This is the largest
community development plan made by a single regional bank in recent history. We partnered with the National Community Reinvestment Coalition (NCRC), to make sure that we’re doing the right things to create the greatest value in each community we serve. The NCRC is working with over 145 member organizations, and has been a tremendous partner to Fifth Third Bank.

Our $30 billion community commitment focuses on supporting low- to moderate-income borrowers. $11 billion of our five-year commitment is dedicated to mortgage lending; $10 billion is for small business lending; and $9 billion is for community development lending and investments.

We also are committing almost $155 million over five years in philanthropic investments, housing-related investments, small business-related investments, branch and staffing commitments in low-to moderate-income areas, inclusion and diversity and financial literacy.

The NCRC’s President and CEO John Taylor has been a great partner to Fifth Third. In our joint press conference, he declared that “Banks are our neighborhoods’ best hope” and I could not agree more. Our commitment has been well received, and I think it’s really helping the communities see that banks are, indeed, their best hope. We have to stand behind those words by the actions that we’re taking and the investments that we’re making. We’re now in year two of this commitment. In year one, we delivered $7.8 billion. This includes $3.2 billion in mortgage lending, $1.6 billion in small business lending, $2.6 billion in community development lending, and $19 million in philanthropic donations. This represents 26% of the total commitment. I believe that we’ll exceed our overall commitment over the next years, and I could not be more proud of the contribution we are making to our communities. It feels just right and it feels good.

ARAMANDA: Greg, thank you for your time. ■
FINANCIAL REGULATIONS SHOULD NOT PROTECT PEOPLE FROM BUSINESS OR FINANCIAL RISK THAT THEY KNOWINGLY CHOOSE TO ACCEPT. REFORM SHOULD START FROM THIS PRINCIPLE: FIRMS THAT ABSORB MORE OF THEIR OWN LOSSES DO NOT NEED TO BE HEAVILY REGULATED.

BY NORBERT MICHEL
THE HERITAGE FOUNDATION
FOR AT LEAST A CENTURY, the U.S. regulatory framework has increasingly hindered the financial intermediation process, particularly in the banking industry. The current regulatory regime is counterproductive for many reasons, including the fact that there are too many regulators with redundant authority. Unlike non-financial companies, banks endure countless activity restrictions that substitute regulators’ judgments for those of owners and managers. These restrictions are justified as necessary to protect taxpayers, but they undermine that purpose by creating a false sense of security and increasing moral hazard.

These restrictions thus feed into a self-reinforcing cycle in which policymakers expand the scope of losses that U.S. taxpayers absorb as well as the size and scope of restrictions that banks face. Fixing this framework requires rolling back both government regulations and taxpayer backing of financial losses, making it possible for private citizens to build a stronger financial system that efficiently directs capital to its most-valued uses. This article provides an overview of where banking regulation has gone wrong, what a better approach
would look like, and what type of reforms are most likely to occur in the near future.

**RECENT REGULATORY CHANGES SHOULD NOT BOLSTER CONFIDENCE**

History provides more than enough evidence that policymakers have been playing a whack-a-mole game with bank safety and soundness. As government interventions – particularly central banking, deposit insurance, and loan guarantees – became more widespread internationally, banking crises have occurred relatively more frequently.1 Perhaps surprisingly, the U.S. has had one of the worst experiences, with 15 banking crises since 1837.2 This total ranks among the highest of all developed countries, and the U.S. is one of only three developed nations that experienced at least two banking crises between 1970 and 2010.3 While the Federal Reserve was created (in 1913) specifically to stem crises and the resulting spillovers to the broader economy, it has clearly failed to fulfill that promise.

Multiple U.S. financial regulators implemented stringent regulations and price controls in response to the Great Depression, but these rules imploded when high inflation exposed their weaknesses in the 1970s. After the Basel I rules were implemented in the late 1980s, regulators developed their supposedly superior version, the Basel II rules. While these new rules were being implemented in several countries, the 2008 financial crisis hit, causing regulators to get to work on Basel III before Basel II could be fully implemented. Now, regulators are finalizing the Basel III rules and making the same promises as before – that banks are now safer and stronger because of the new rules. Even a cursory look at what regulators said prior to the implosion of earlier frameworks raises serious doubt about how much faith people should place in the new rules.

In 2007, New York Federal Reserve President Timothy Geithner praised “the depth and liquidity of our world-class financial markets and a record of stability in macroeconomic policy.”4 He also praised global regulators and noted, “Financial markets outside the United States are now deeper and more liquid than they used to be, making it easier for companies to raise capital domestically at reasonable cost.”5 In hindsight, Geithner surely held a different view, but his speech is eerily similar to the 1984 congressional testimony of Comptroller Todd Conover.6 In both cases, a high-ranking federal regulator effectively assured the public that the financial system was on solid footing due to stronger capital. On page 219 of the committee report, Conover appeals directly to the benefits of higher capital requirements:

> Under regulations proposed by the OCC and the FDIC, all banks, regardless of size, would be required to maintain a minimum ratio of primary capital to total assets of 5.5 percent. The implementation of this regulation will require over 200 national banks to raise a total of over $5 billion in new capital. The Federal Reserve has proposed similar guidelines on capital.

> Stricter regulatory capital requirements will strengthen the trend towards stronger capitalization of the nation’s largest banks. For example, in the first quarter of 1984 the average ratio of primary capital to total assets stood at 5.67 percent for the holding companies of the 11 multinational banks supervised by the OCC. This is almost 16 percent higher than the average level at those banks two years ago.

There is no doubt that higher equity funding enables banks to better absorb losses, if all else remains constant. But even without the caveat, it does not follow that forcing banks to meet higher equity ratios is a good policy solution for improving safety and soundness. Regulatory capital requirements are arbitrarily designed based on losses in previous financial crises, and their engineers simply cannot know for certain what problems will unfold in the future or how large losses will be. Proponents of the latest round of Basel rules and the systemic regulations in the Dodd-Frank

Though many **pundits blame previous crises on deregulation** and a lack of rules, banks have been **subject to extensive restrictions** on their activities, capital, and asset composition for decades.
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Rather than focusing on providing customers with the best possible service, banks have to worry about satisfying sociopolitical goals, even when pursuing such policies conflicts with sound banking practices.

Act insist that this time will be different, because now the rules are focused on systemic problems, whereas previously they were concerned with individual banks. This concept has been grossly oversold, as systemic problems were contemplated by previous iterations of the Basel rules.

Indeed, the subheading of Conover’s 1984 testimony was “The Supervisor’s Role is to Maintain Systemic Soundness.” He also provided the following specific examples:

“Our supervision of banks of all sizes has been enhanced by the establishment of an Industry Review Program. This program includes a computerized information system to collect data on industry concentrations in individual bank portfolios and the banking system as a whole.”

“In addition to the more frequent examinations we have undertaken, the examiners will also monitor trends and developments in the banks between examinations. This new approach results in near-constant supervision of each of our large banks.

“We are now better able to identify and devote attention to items of supervisory concern in individual large banks and significant practices emerging in the large bank population as a whole.”

Conover’s testimony is far from an isolated incident. For instance, systemic-risk concerns were discussed by a Fed Governor’s testimony before the House Subcommittee on Economic Stabilization in 1991, just after the Basel I accords were implemented. In 1996, the Fed explicitly accounted for system-wide risk in its bank supervisory rating system. Prior to the change, the Fed used a CAMEL rating, but it converted to a CAMELS rating, where the “S” stood for “sensitivity to market risk.” It may be comforting to think that the new rules will keep banks safe and avoid future crises, but history suggests such hopes should be tempered.

Though many pundits blame previous crises on deregulation and a lack of rules, banks have been subject to extensive restrictions on their activities, capital, and asset composition for decades. Most often, these rules and regulations have created bad incentives and resulted in unintended consequences. Glass-Steagall restrictions, price controls, and stringent rules on real estate lending have all weakened banks’ balance sheets in the past, sometimes severely so. The risk-weighted Basel capital requirements are the latest example of such failures: regulators required lower capital charges against assets they blessed as safe, thus biasing the banking system toward more uniform balance sheets filled with those assets. In hindsight, of course, those risk assessments were wrong, and many banks held large amounts of what turned out to be very risky assets.

For the most part, the new macro-prudential tools are nothing more than reworked versions of the same old liquidity and capital requirements. Though some of these tools are not as risk-based, they give regulators discretion to add extra layers of capital as they deem necessary. This approach is highly flawed for the same reasons that the earlier framework was defective. It assumes that regulators can design and mandate a safe financial system where banks still take financial risks, and it ignores that market participants have much stronger incentives – a profit-loss motive – than regulators to discipline inefficient and overly risky firms. Nonetheless, rules have continued to grow in number and complexity based on the notion that they will prevent systemic crises.

A SAMPLE OF EXISTING REGULATIONS AND RESTRICTIONS

Banks’ activities are highly regulated by both state and federal regulators, more so than most types of businesses. They face restrictions on capital, liquidity, mergers, acquisitions, and earnings distributions, among other activities. Regulators routinely examine banks’ records to ensure that they are following the rules, and sometimes
use these examinations to implement changes to the rules. Banks tend to comply even with regulators’ informal suggestions because failure to do so can bring additional regulatory scrutiny or formal enforcement actions, and there is essentially no appeals process for this type of regulation by supervision.

Policymakers generally justify this extensive system of regulation as necessary to protect taxpayers, particularly from losses to the federal deposit insurance fund, but no part of the framework is ideal. This approach, though well intentioned, has demonstrably failed and has given rise to the too-big-to-fail problem. It also provides the public with a false sense of security because the government confers an aura of safety (during normal conditions) on all firms that play by the rules, and it prevents banks from evolving to meet the changing needs of customers.

This regulatory approach is bound to fail for at least three reasons: (1) People take on more risk than they would in the absence of such rules; (2) people have lower incentives to monitor financial risks than they would otherwise; and (3) compared to other actors in the market, regulators do not have superior knowledge of future risks. The logic driving this system – protecting people from the consequences of financial decisions – also creates an ever-expanding need for more government rules to replace market competition. Banks are now highly regulated and severely limited in the types of financial intermediation they can provide, thus further weakening the financial system.

In practice, as Congress and regulators expand the rules, banks end up in roles for which they are ill suited, such as policing money launderers and pursuing affordable housing goals. Rather than focusing on providing customers with the best possible service at the best possible price, banks have to worry about satisfying sociopolitical goals, even when pursuing such policies conflicts with sound banking practices. For all of these reasons, statutory and regulatory restrictions now go well beyond simple capital and liquidity ratios. The following list provides a brief overview:

- All bank holding companies with assets of more than $50 billion are subject to heightened supervision by the Fed, as required by the Dodd-Frank Act. These special standards apply to banks’ leverage, liquidity, and capital requirements, as well as overall risk management and resolution processes.

- Federal regulators now impose a wide array of risk-weighted minimum capital requirements, as well a liquidity coverage ratio, a net stable funding ratio, a supplementary leverage ratio, and a wide array of monitoring tools designed to monitor banks’ liquidity and risk profiles.

- The Federal Reserve, as the primary regulator of all bank holding companies, regulates the “financial condition and operations, management, and intercompany relationships of the bank holding company and its subsidiaries, and related matters.”

- Federal law limits how much money a bank can lend to any one customer or to a group of related customers, and banks are subject to lending limits (and other restrictions) on loans they can provide to insiders (such as officers, directors, and certain significant shareholders), as well as to affiliate institutions.

- Regulation E covers rules for electronic funds transfers, Regulation C covers home mortgage disclosure rules, and Regulation Z (Truth in Lending) prescribes uniform rules for “computing the cost of credit, for disclosing credit terms, and for resolving errors on certain types of credit accounts.”

- Regulation BB implements the Community Reinvestment Act (CRA), a law that Congress passed in 1977 because politicians were unhappy with banks’ provisioning of credit, particularly with regard to low-income neighborhoods.

- Banks are subject to the Equal Credit Opportunity Act, a 1974 law passed to promote adequate disclosure of information and to shield protected classes of consumers from discrimination when applying for.
credit. The law is now part of the framework used to prove disparate impact, whereby regulators can prohibit activities because of a disproportionately negative impact, even in the absence of intentional discrimination.

• Banks are required to comply with complex anti-money laundering (AML) statutes and regulations, such as “know your customer” requirements primarily administered by the Treasury Department’s Financial Crimes Enforcement Network (FinCEN). These rules have effectively turned banks into quasi law enforcement agencies. Federal regulators also require financial institutions to institute formal compliance programs for the AML rules, and regulators heavily micromanage this process.

• Section 619 of the Dodd-Frank Act imposed the Volcker rule, a restriction that prohibits banks from making certain risky investments (trades) solely for their own profit, a practice known as proprietary trading. This complex rule is one of the clearest examples of a government regulation that limits the types of financial intermediation banks can provide, thus further weakening the financial system.

In many of these (and other) cases, banks are subject to the compliance regimes of more than one federal regulator and even those imposed under state law. Thus, in practice, both state and federally chartered banks are subject to state laws governing the basic transactions in which they engage with their customers. The Uniform Commercial Code, for instance, governs (among other things) transactions in commercial paper and promissory notes, bank deposits, funds transfers, secured transactions, and contracts. While the Dodd-Frank Act did not create this problem, it certainly worsened it.

Dodd-Frank created a consumer watchdog agency for the financial industry, the CFPB, increased the responsibilities of several federal regulators, and included a new systemic-risk mandate for the Federal Reserve. Dodd-Frank also gave the Fed supervisory authority over other entities, such as savings-and-loan holding companies (which previously had been overseen by the OTS, which was eliminated by Dodd-Frank), securities holding companies, and systemically important financial institutions. To fix bank regulation and improve financial intermediation, Congress should reduce taxpayer backing of financial losses, pare back restrictions so that banks can expand their activities, and restructure the agencies that write and enforce regulations.

THE OVERABUNDANCE OF REGULATORY AGENCIES

The U.S. banking regulatory structure is overly complex, with responsibilities fragmented among many different federal and state regulators. The list of possible regulators at the federal level includes (but is not limited to): (1) the Federal Reserve, (2) the Federal Deposit Insurance Corporation (FDIC), (3) the Securities and Exchange Commission, (4) the Commodity Futures Trading Commission, (5) the Consumer Financial Protection Bureau, (6) the National Credit Union Administration (NCUA), and various agencies within the U.S. Treasury Department. Besides the Office of the Comptroller of the Currency (OCC), FinCEN and the Internal Revenue Service impose a wide variety of information-reporting and due-diligence requirements on financial institutions. Furthermore, Title I of Dodd-Frank created the Financial Stability Oversight Council (FSOC), a council that consists of the heads of many of the above-mentioned regulatory agencies, and tasked it with several broad responsibilities, including developing activity restrictions.

The FDIC has backup supervisory authority over all banks and thrifts that are federally insured, and this responsibility overlaps with supervisory authorities of the Federal Reserve and the OCC. The NCUA supervises only federally chartered credit unions, but it is the deposit insurer for both federal credit unions and most state-chartered credit unions, so its authorities overlap with state credit union regulators. The Fed has consolidated supervisory authority over most holding companies that own or control a bank or thrift and their subsidiaries, so it overlaps with the supervisory authority of banks’ primary federal regulators.

Coordination among agencies requires considerable effort that could be directed toward more productive activities, and the multiregulator approach has a long history of creating inefficiencies and inconsistencies in
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regulatory processes. There simply is no need for so many regulators, and the existing framework creates an uncertain operating environment for regulated entities and regulators. Some of the best-known historical examples of these inefficiencies and inconsistencies include the following:

- Differences in examination scope, frequency, documentation, guidance, and rules among the FDIC, OCC, and the Fed
- Inconsistent methods for assessing loan loss reserves
- Inconsistent guidance and terminology for Bank Secrecy Act examinations and compliance
- Inconsistencies with oversight and compliance of federal consumer financial protection laws (such as fair lending laws)
- Duplication in the examinations of financial holding companies, despite the OCC’s and the Fed’s efforts to coordinate

Proponents of the multiregulator system argue that it allows regulators’ performance to be measured against the record of other regulators, and that it confines mistakes to limited jurisdictions. Similarly, they argue that competition among regulators reduces the likelihood that a given agency might refrain from raising too many objections about the entities they regulate. The problem with these arguments is that they assume a degree of competition and diversity between regulators that simply does not exist.¹⁴ Bank regulatory reforms should include major structural changes because there are too many federal banking regulators with too many overlapping authorities.

**HOW BANK REGULATION SHOULD BE REFORMED**

Congress should fix the structural problems in the current system by creating one federal banking regulator and one capital markets regulator. This approach would improve efficiency and effectiveness while guarding against the dangers of having a single bank-centric super-regulator. It is critical that this realignment removes the Federal Reserve from financial regulation. As the U.S. central bank, the Federal Reserve’s primary role is monetary policy, which dictates that it should focus on providing system-wide liquidity. Allowing the same entity to exercise regulatory and monetary functions gives rise to unnecessary and potentially dangerous conflicts of interest, and the Fed’s regulatory and supervisory responsibilities are simply unnecessary for conducting monetary policy.

To create the single banking regulator, the OCC, FDIC, and NCUA should be merged. Then, the Fed’s regulatory responsibilities would be shifted to this merged entity. Merging the CFTC and the SEC would give the U.S. a single capital markets regulator, but other reforms would still be necessary. In particular, the CFPB should be dismantled. Consumer protection law predates Dodd-Frank, and there is absolutely no reason that state regulators, along with the Federal Trade Commission and the Department of Justice, cannot police financial markets to guard against fraud and criminal behavior.¹⁵

Optimally, banking applications would no longer be approved based on a regulator’s assessment of the company’s risk profile, the owners’ ability to attract and maintain community support, or whether the agency believes the company can remain profitable. A good reform tool would be to provide an optional federal financial charter, with no chartering restrictions beyond ensuring the suitability of management and directors through standard background checks. This charter could provide an opt-out of countless activity restrictions in return for meeting a higher equity ratio and agreeing to a prohibition on receiving federal assistance.¹⁶
Ultimately, to eliminate the need for activity restrictions, the federal safety net has to be pared back. Congress can provide more market discipline and move toward such a framework by lowering the amount of FDIC deposit insurance coverage to (at least) the pre-Dodd-Frank limit of $100,000 per account. Even lowering the value to the pre-1980 limit of $40,000 per account would insure a level nearly 10 times the average transaction-account balance of approximately $4,000. Congress should also amend the coverage limits so that they apply on a per-person basis and that they cover only retail deposit customers.17

Activity restrictions could then be all but eliminated, and banks would be allowed to operate with relatively few regulatory requirements. Policymakers could easily justify jettisoning, for example, regulatory stress-testing and Basel capital and liquidity rules, and they should go so far as to eliminate the remaining sections of the Glass-Steagall Act so that banks can underwrite and deal in securities. Regardless of how far Congress moves in this direction, they should reform AML and Bank Secrecy Act (BSA) rules so that banks no longer serve law enforcement roles. At a bare minimum, Congress should streamline the AML/BSA reporting process and adjust the thresholds for inflation from $10,000 (where they were set in 1970) to $60,000. It makes little sense to criminalize the use of cash and to continue collecting millions of reports on lawful transactions.

Federal rules should focus on mitigating fraud and promoting disclosure of relevant information rather than narrowly defining and restricting the ways in which banks can employ capital. Policymakers should implement these types of reforms because they are the best way to introduce more market discipline into the system, and because they are the best way to allow financial intermediaries to evolve to meet changing customer needs. While this new approach does not guarantee a stable banking system and macroeconomy, neither does the extensive and overly complex web of federal rules and regulations. Both theory and evidence suggest that the banking system will perform better when banks’ capital suppliers face more market discipline.18 Laws that mandate disclosure and enhance enforcement through civil liability rules have a more positive impact than activity restrictions, and evidence suggests that this type of disclosure and private monitoring would work well even in the banking sector.19

Reforms Most Likely to Be Enacted by the 115th Congress

In Washington, wholesale reforms of any type are much rarer than changes that mildly alter the status quo, and financial regulation is surely not the exception to this rule. So the near-term prospects of a complete transformation of bank regulation, such as the one described in the previous section, are quite dim. However, Chairman Jeb Hensarling’s Financial CHOICE Act, the only major reform bill to pass either chamber of Congress since the Dodd-Frank Act was enacted, does include several major improvements to the current system, including a capital off-ramp provision.

The CHOICE Act would convert the FSOC into an information-sharing working group, end systemically important financial institution designations, and repeal Title VIII of Dodd-Frank, which created a new framework for assessing the systemic risk associated with financial institutions and financial market utilities involved in clearing activities for financial transactions. It would replace Dodd-Frank’s orderly liquidation authority (OLA) with new bankruptcy code provisions, and replace the CFPB with an enforcement-only agency that looks nothing like the powerful rulemaking agency created by Title X of Dodd-Frank. The CHOICE Act would also make many other regulatory reforms, such as repeal the Volcker rule and make all financial regulatory agencies go through the regular appropriations process, thus increasing their accountability to Congress.

As of this writing, there is no Senate companion legislation to the CHOICE Act, but the Trump administration has signaled its willingness to replace large parts of the Dodd-Frank Act. Executive Order 13772, signed in February, made it official administration policy to regulate financial markets consistent with seven core principles. These principles are largely compatible with the ideas behind CHOICE Act reforms, suggesting the Trump administration would be agreeable to major financial regulatory improvements. Several of these principles are as follows:

- Empower Americans to make independent financial decisions and informed choices in the marketplace, save for retirement, and build individual wealth
Structural Limitations and Activity Restrictions

- Prevent taxpayer-funded bailouts
- Foster economic growth and vibrant financial markets through more rigorous regulatory impact analysis that addresses systemic risk and market failures, such as moral hazard and information asymmetry
- Make regulation efficient, effective, and appropriately tailored
- Restore public accountability within federal financial regulatory agencies and rationalize the federal financial regulatory framework.

In fulfillment of the executive order, Treasury has released a report on depository institution regulation, and it includes many specific ideas that are either in or consistent with those in the CHOICE Act.20 For instance, the report calls for making the CFPB’s director removable at will, eliminating the Bureau’s supervisory authority, funding the Bureau through the regular appropriations process, and subjecting it to Office of Management and Budget apportionment. These changes very closely mirror those that Title VII of the CHOICE Act makes to the Bureau.21

Though legislation that restructures the CFPB in this manner is unlikely to garner 60 votes in the Senate, it doesn’t have to because the Congressional Budget Office (CBO) scored this component of the CHOICE Act as providing budgetary savings. In fact, the CBO also reported that repeal of Dodd-Frank’s OLA, as done in Title I of the CHOICE Act, would provide budgetary savings.22 Thus, a simple majority vote in the Senate during the budget reconciliation process would be enough to enact at least two major U.S. banking crises have already originated with predominantly smaller financial institutions. Nonetheless, it is much easier to gain political support for tweaking the existing system in this manner, so these types of small adjustments are likely on the near-term horizon.

The Treasury report also recommends that Congress reduce fragmentation, overlap, and duplication from the financial regulatory framework and suggests that such reforms “could include consolidating regulators with similar missions and more clearly defining regulatory mandates.”25 Yet the report recommends broadening the FSOC’s statutory mandate so that it can play an increased role in coordinating regulation among the various agencies. If history is any guide, broadening the role of the FSOC in this manner will not improve the regulatory process, and consolidating the financial regulators would eliminate the need for the FSOC. As with other biases toward the status quo, consolidating regulatory agencies has always been politically problematic, while gently expanding the role of existing regulators is much easier to sell.

Overall, the report suggests that Treasury has done its best to support as many allies for reform as possible, which increases the likelihood that popular changes such as higher thresholds for supervisory stress testing, comprehensive capital analysis review, and single counterparty credit limits are in the near future. These
types of reforms tend to garner more widespread support because they provide regulatory relief to smaller banks, but they represent tweaks to the current system rather than wholesale reforms. Because most major reforms will require congressional action, unless reform-minded conservatives make major gains in the midterm elections, the U.S. is more likely to enact these types of small changes rather than sweeping financial regulatory reforms. As of this writing, the two major reforms with the best chance of passing into law are the CFPB reforms and OLA repeal in the CHOICE Act.

CONCLUSION

For decades, U.S. financial regulation has failed because it micromanages people’s financial risk, substituting regulators’ judgments for those of the investing public. Government rules that profess to guarantee the safety of the banking system create a false sense of security, lower private incentives to monitor risk, increase institutions’ financial risk, and protect incumbent firms from new competitors. It is important to reverse these trends because competition in markets drives innovation, lowers prices, prevents excessive risk taking, and allows people to invest their savings in the best investment opportunities.

Financial regulation should not protect people from business or financial risk that they knowingly choose to accept. Instead, financial regulations should focus on punishing and deterring fraud and fostering the disclosure of information that is material to saving and investment decisions. It should start from the following principle: Firms that absorb more of their own losses do not need to be heavily regulated. A major shortcoming of the existing system is that it narrowly defines the activities that banks can perform, and restricts the ways in which they can employ capital, thus making it very difficult to evolve to meet changing customer needs. Wholesale reforms are needed to help strengthen the banking and financial system in the U.S., but implementing these reforms at once will be very difficult to accomplish given the current political environment.

ENDNOTES

3 Ibid.
5 Ibid.
7 Conover, p. 214.
8 Conover, p. 216.
12 12 CFR 226.
17 The optional charter approach should explicitly forbid the use of federal deposit insurance, as well as all forms of government loans and assistance. See Dwyer and Michel.
18 White, Eugene N. “To Establish a More Effective Supervision of Banking”: How the Birth of the Fed
23 In May 2017, the Congressional Budget Office (CBO) reported that enacting the CHOICE Act would reduce federal deficits by $24.1 billion, and that the biggest budgetary savings would come from those provisions that repeal Dodd-Frank’s Orderly Liquidation Authority (OLA) and restructure the CFPB. Treasury has decided to release a separate report on OLA. As of this writing, the study is incomplete.
IN THE Q2 2017 EDITION of Banking Perspectives, Jeremy Newell and I wrote “How Supervision Has Lost Its Way.” That article garnered a lot of interest and triggered an outpouring of calls from bankers who felt that we had captured the strange, secret supervisory world they are attempting to navigate. The article concluded with a promise of proposed solutions in a future issue, and here they come.

To be clear, the focus here is (1) safety and soundness supervision, (2) of banks (as opposed to their holding companies or non-bank affiliates), and (3) large banks in particular. That is not to say that safety and soundness supervision should not be rethought for non-bank affiliates of large banks, or for community banks, but they are not the focus of this article. (Indeed, as we go to press, the Federal Reserve Board has just proposed a new rating system for bank holding companies.)

To begin, here are principles that could guide a thoughtful re-evaluation of how safety and soundness supervision of large banks should be conducted.

PRINCIPLES FOR REFORM

SAFETY AND SOUNDNESS SHOULD BE EXAMINED AND EVALUATED INDEPENDENTLY FROM COMPLIANCE

Prior to the last seven or so years, banking supervision generally separated safety and soundness from consumer
BANKS SHOULD BE MONITORED FOR SAFETY AND SOUNDNESS, AS WELL AS FOR CONSUMER COMPLIANCE. HOWEVER, THE TWO SHOULD BE REVIEWED SEPARATELY AND THE PROCESSES, GUIDELINES, AND REGULATIONS NEED CONSIDERABLE REFORMS.

compliance. Indeed, the CAMELS rating system was adopted in 1978 and followed in 1979 by a separate consumer rating system. There are two reasons for supervisors to bifurcate: (1) it’s a good idea, and (2) it’s the law.

It’s a good idea to separate safety and soundness from consumer compliance because they are two different functions with very different goals. Thus, a bank with strong capital and earnings should be evaluated for consumer compliance purposes in the same way as one with weak capital and earnings. Conversely, a bank that commits a violation of a consumer law should be evaluated for safety and soundness purposes in the same way as one that does not. While the first proposition these days seems uncontested, the latter has been implicitly rejected by at least some bank examiners.

Indeed, much of “How Supervision Lost Its Way” detailed the problems that arise when examiners contort to treat healthy banks as having soundness problems based on compliance violations or immaterial process fouls and use that supposed unsoundness as grounds for blocking expansion.

The law is crystal clear. On the consumer compliance side, Section 1011 of Dodd-Frank provides that the CFPB “shall regulate the offering and provision of consumer financial products or services under the Federal consumer financial laws.” The Bureau is
granted clear and exclusive rulemaking authority.\(^1\) With respect to banks with more than $10 billion in assets, “The Bureau shall have exclusive authority to require reports and conduct examinations … (a) for purposes of – (A) assessing compliance with the requirements of Federal consumer financial laws; (B) obtaining information about the activities subject to such laws and the associated compliance systems or procedures of such persons; and (C) detecting and assessing associated risks to consumers and to markets for consumer financial products and services.” Note: “exclusive.”

As any banker could tell you, however, the federal banking agencies have increased their supervision of consumer financial laws since being divested of it. How could that be? On to our next principle.

**“REPUTATIONAL RISK” IS RARELY, AND LIKELY NEVER, A SAFETY AND SOUNDNESS RISK**

In using compliance problems to block bank expansion, regulators often default to the following syllogism: (1) Compliance problems (including legal violations and alleged deficiencies in process that could lead to a legal violation) create “reputational risk” – that is, the risk that a violation of law could damage a bank’s reputation.\(^2\) (2) Damage to the bank’s reputation could lead to serious financial harm, imperiling the bank’s solvency. (3) Therefore, any compliance problem is also a safety and soundness problem.

Key question: How often has damage to a bank’s reputation led to serious financial harm that imperiled a bank’s solvency? Ever?

Let’s consider the recent case of Wells Fargo. Regardless of how one views the merits of the charges brought against it, Wells Fargo has unquestionably suffered reputational damage as a result of alleged consumer compliance problems.

And what has been the effect of this reputational damage?

Let’s look at its credit default swap (CDS) spreads – the best measure of its perceived chance of insolvency, and thereby defaulting on its debt (see Figure 1). Over the past 10 years, Wells Fargo’s spreads, like those of other companies, have varied based on economic and financial conditions. However, the “reputational risk” of the current scandal clearly has proven immaterial to those spreads. At all points since issues first came to light on September 8, 2016, however, spreads have remained significantly below their 10-year average. Indeed, they remain near their 10-year lows.

Thus, Wells Fargo appears to put the lie to the notion that consumer compliance risk is a safety and soundness risk.

The ramifications of the truth are significant for banking supervision. Banks can safely be permitted to manage their own reputations rather than having examiners manage their reputations for them. And safety and soundness supervision can go back to focusing on safety and soundness. For example, many are surprised to learn that in the wake of the clear and wholesale transfer of regulation, supervision, and enforcement over the consumer compliance laws from the banking agencies to the CFPB, the banking agencies have by all accounts increased the scope and severity of their supervision and enforcement in this area.

**THE AGENCIES SHOULD ASSESS COMMUNITY REINVESTMENT WHEN EVALUATING COMPLIANCE WITH THE COMMUNITY REINVESTMENT ACT**

Aside from being improperly treated as “reputational risk,” consumer compliance has also been contorted into an assessment factor under the Community Reinvestment Act (CRA). So, consumer compliance factors are again transformed into a brake on expansion because CRA compliance is a statutory factor with regard to certain applications.

The purpose of the CRA was to require “private financial institutions [to] play the ‘leading role’ in providing the capital required for ‘local’ housing and economic development needs.”\(^3\) Thus, under the CRA, the ratings are defined as an “outstanding [or satisfactory, needs to improve, or unsatisfactory] record of meeting community credit needs.”\(^4\) The statute directs the agencies to “assess the institution’s record of meeting the credit needs of its entire community, including low- and moderate-income neighborhoods.”\(^5\)
Notwithstanding the fact that the CRA statute and the three assessment factors included in its implementing regulation clearly focus on credit availability, regulators have increasingly included in their assessments other criteria, particularly consumer compliance or other issues outside the scope of the CRA.

**BANKS CAN PERFORM MULTIPLE FUNCTIONS AT THE SAME TIME**

Improperly treating compliance issues as safety and soundness problems and CRA failures would be – to borrow a legal phrase – a “harmless error” if doing so did not have significant consequences for banks’ ability to manage themselves efficiently and serve their customers. But it does. Here we see the relevance of the Federal Reserve’s Supervisory Letter 14-02, issued in 2014, without notice and comment. (The OCC by all accounts maintains a similar policy but has not reflected it in writing.) That letter effectively states that except in rare cases, the Federal Reserve will not approve any application for expansion if, among other things, a subsidiary bank has a CAMELS rating of “3” or below, a component Management rating of “3” or below, or a Needs to Improve or Unsatisfactory CRA rating.

For perspective, consider how odd such an approach looks in the context of other industries. If Pfizer experiences a problem with one of its drugs, the FDA does not prohibit it from developing new ones until the troubled drug is fixed. If General Motors produces deficient ignition switches, the Department of Transportation does not prohibit it from developing new vehicles or opening new dealerships until all the switches are recalled and repaired. If Target suffers a data breach, the FTC does not prohibit it from opening new stores until the FTC is satisfied with its cybersecurity. Rather, the FDA presumes that one group of researchers can fix the problem with one drug while other researchers work on other drugs; DoT presumes that different people at General Motors fix ignition

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**FIGURE 1: WELLS FARGO 5-YEAR CREDIT DEFAULT SWAP SPREAD**

![Graph showing Wells Fargo 5-year credit default swap spread from 2007 to 2017. The average is indicated by a dashed line. The chart shows fluctuations in the spread with notable peaks and troughs. The source is Bloomberg.]
switches and design cars and open dealerships; and
the FTC makes the same presumption with regard to
store openings and cybersecurity. In short, all of them
presume that senior management can manage multiple
projects at once. Only bank regulators – and only
recently – presume differently. And they do so without
legal basis: Neither 12 U.S.C. 1818 nor any other bank
enforcement statute lists among its prescribed penalties
a freeze on branching, investment, or merger.

The puzzlement is that banking regulators have less
need than any other type of regulator to contort the law
to enforce the law. As noted, banking regulators have
extraordinary enforcement tools at their disposal – a
panoply of civil money penalties, disgorgements, and
debarments that can be issued for any violation of law.

The Federal Reserve’s Supervisory Letter does not
appear to link its policies to the statutory standards
the Board is directed to apply – for example, how an
isolated, years-old problem in one of these areas could
rise to the level of a finding that the bank lacked sufficient
managerial resources (a statutory standard) to conduct an
acquisition or offer a new product.

One hint is a statement that any firm seeking an
exception to the general rule against expansion by
“3”-rated banks must “convincingly demonstrat[e]
that the proposal would not distract management from
addressing the existing problems of the organization or
further exacerbate these problems.” That statement is far
more extraordinary than it first appears. We are talking
about banking organizations with tens of thousands,
some with hundreds of thousands, of employees. It is
very difficult to imagine how senior management could
not simultaneously oversee, for example, one group of
employees mailing reimbursement checks to consumers
under a consumer compliance settlement and another
group of employees opening a branch in Philadelphia or
buying an asset manager in Los Angeles.

SUPERVISION SHOULD IGNORE IMMATERIAL
“OPERATIONAL” RISKS THAT ARE NOW
THE PREDOMINANT FOCUS OF CURRENT
EXAMINATIONS

Leaving the world of compliance and looking at how
safety and soundness itself is examined, let’s consider
the diminished role of materiality in that examination.
Consider, for example, vendor management, which
has been turned by the banking agencies into a cottage
industry, requiring the retention of thousands of
people to draft policies and procedures for practically
any interaction with a vendor, and to document
compliance with those policies on an ongoing basis. The
requirements are absurdly detailed, contain no concept
of materiality, and generally add nothing to safety and
soundness, while generating massive costs, many of
which are passed onto borrowers and other customers.

Thus, the OCC in 2013 issued a voluminous bulletin
(which itself referenced and reinforced over 50 previous
bulletins, advisory letters, and banking circulars)
describing how banks should deal with their vendors and
contractors. For example, the 2013 OCC guidance requires
a bank, for any vendor or contractor it hires, to:

Review the third party’s program to train and hold
employees accountable for compliance with policies
and procedures. Review the third party’s succession
and redundancy planning for key management and
support personnel. Review training programs to
ensure that the third party’s staff is knowledgeable
about changes in laws, regulations, technology, risk,
and other factors that may affect the quality of the
activities provided.”

It is worth noting that this guidance requires a bank
to effectively evaluate and monitor not merely its own
training programs and succession plans, but those of
multiple third parties. In addition, for subcontractors, the
bank must, among other things, “evaluate the volume and
types of subcontracted activities and the subcontractors’
geographic locations.”

Has damage to a bank’s reputation
led to serious financial harm that
imperiled a bank’s solvency? How often has
this happened with reputational risk? Ever?
We help our clients navigate today’s markets with an eye for what lies ahead. Morgan Lewis is always on—marshaling our global resources and precise insight to build your future. We have industry-leading teams working in offices across North America, Asia, Europe, and the Middle East.
Key question: When was the last time a bank failed because of poor vendor management? Because its vendor’s board did not have a good succession plan for the vendor’s CEO? Because the vendor chose its geographic locations unwisely? Clearly, banks these days should be very careful about cybersecurity, but (1) banks understand that fact well, (2) this guidance extends to vendors of far less importance than those presenting material cybersecurity risk, and (3) this guidance requires inquiry into matters that are not relevant to any actual risk that is presented.

It gets worse. In its latest Semi-Annual Risk Report, the OCC observes, “Consolidation among service providers has increased third-party concentration risk, where a limited number of providers service large segments of the banking industry for certain products and services.” Of course, the principal cause of concentration risk is the OCC's own vendor management guidance, which gives banks overwhelming incentives to reduce the number of vendors they employ (and therefore on which they must conduct OCC-mandated due diligence) and employ only large companies that have the resources to manage the rigors of that vendor management due diligence. Small businesses need no longer apply.

Vendor management is only the tip of an operational risk iceberg here, in terms of immaterial risks that supervision micromanages. Examiners often dictate the composition of board and management committees and how minutes of meetings are kept; they monitor minutes of meetings to ensure that board members and risk or compliance personnel are providing “credible challenge” (another concept with no legal basis); they mandate reporting lines. And they do so without evidence that doing it a different way presents material risks or even presents greater risk.

**“HORIZONTAL REVIEW” AND “BEST PRACTICE” ARE RECENT INVENTIONS THAT ARE A POOR BASIS FOR SUPERVISION AND SHOULD BE PURGED FROM THE SUPERVISORY LEXICON**

On what basis, then, do examiners tell banks how to manage themselves? The terms “horizontal review” and “best practice” do not appear in banking statute or regulation, and yet they now drive much of bank supervision. Just as “reputational risk” is code for “something we don't like,” so “horizontal review” and “best practice” are code for “we have looked at how other banks are managing a given risk, prefer at least one of your competitors' practices to yours, and expect you to change.” This mandate comes through a confidential supervisory communication about which the bank is legally prohibited from complaining publicly and is rarely if ever accompanied by any demonstration that contrary practices constitute a material risk to the Deposit Insurance Fund, reflects moral hazard, or are in any way a concern of the taxpayer.

We recently met with a midsized bank that had used the same credit underwriting regime for 30 years. It had produced dependable returns, and the bank had not lost money in any quarter of the financial crisis. Recently, however, it was subjected to a “horizontal review” and directed to abandon its credit underwriting system and create a new one that corresponded to what examiners perceived as the industry norm, or “best practice.” The bank is convinced that its new system is not as good the old one. But a failure to comply would have resulted in a downgrade of the bank’s management rating, and a freeze on expansion.

Competition in banking is universally recognized as good. Ultimately, for the consumer, that competition occurs in innovation and in pricing, but there will be less competition in innovation and pricing if banks are required to measure risk in the same way, and manage themselves in the same, examiner-mandated way. Of course, at a higher level, no financial crisis has ever resulted from a financial institution taking an idiosyncratic view of risk; all financial crises result from...
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many financial institutions taking the same view of risk – in other words, adopting the same “best practice.”

“Competition in banking is universally recognized as good. But there will be less competition ... if banks are required to measure risk in the same way and manager themselves in the same, examiner-mandated way.”

It is important to note that there is a phrase akin to “best practice” that does appear in banking law and regulation: “unsafe or unsound practice.” Congress has authorized banking regulators to proscribe practices that are found – after notice and an opportunity for a hearing – to constitute an unsafe or unsound practice, generally understood to mean a practice that imperils the safety and soundness of the institution. In effect, Congress has said that banks are free to develop different and competing practices, so long as they do not rise to the level of unsafe or unsound. But “unsafe and unsound” is a high bar from an evidentiary perspective, and due process can be a bother, so bank supervision has shifted from these concepts to “best practices” enforced by MRAs (Matters Requiring Attention) that are effectively unappealable.

“SANCTITY OF THE CHARTER” IS ANOTHER CONCEPT WITH NO BASIS IN LAW, AND NO CLEAR LOGIC BEHIND IT

This phrase, again rootless in law or regulation, has become another touchstone for OCC regulation. It is used to require independent management of a bank in numerous ways, without analysis of whether the costs of duplicating functions managed enterprise-wide at the holding company level exceed the benefits. Think: separate auditor, CFO, compliance, legal, and other functions. Certainly, one can debate the extent to which an insured depository institution should be managed independently of its parent, but that is a question that should be the subject of notice and comment rulemaking and the product of serious analysis.

NON-BANK AFFILIATES SHOULD BE RECOGNIZED AS REDUCING, NOT INCREASING, RISK TO THE DEPOSIT INSURANCE FUND

One of the least noticed changes in Dodd-Frank was the codification of the source-of-strength doctrine. Also routinely underappreciated is the impact of the Federal Reserve’s total loss absorbing capacity (TLAC) rule when coupled with the single-point-of-entry resolution strategy that is now the norm for banks with large non-bank affiliates. Those two changes unequivocally put holding company bondholders in a second-loss position behind equity holders (and ahead of the FDIC as insurer of any subsidiary bank.) These changes should have – but certainly have not – caused a complete rethinking of the relationship between bank and non-bank affiliate.

When I worked at the Federal Reserve Board, the holding company affiliate was perceived as a danger to the bank, and sections 23A and 23B of the Federal Reserve Act were rigorously enforced to prevent a bank from supporting a troubled affiliate and assuming its losses. Even then, there were concerns when an affiliate became large in relation to its affiliated bank. Today, with sections 23A and 23B still in place, affiliate assets are at least arguably a significant benefit to the bank and ultimately the Deposit Insurance Fund and the banks that fund it. In recovery or resolution, all of their assets are available to protect the bank, which need assume none of their liabilities.

THE PRIMARY JUSTIFICATION FOR STRINGENT BANK REGULATION IS OBSOLESCENT

One of the most overlooked events of the financial crisis was this: at the depth of the crisis in 2009, banks paid $51.2 billion in special assessments to replenish the Deposit Insurance Fund, the overwhelming majority of which was paid by the largest banks. As a result, the Fund never required a call on the taxpayer guarantee. Thus, if the question is “Who really pays if a bank’s failure depletes the Fund?” the answer is: surviving banks, and predominantly large ones. Indeed, it is fair to say that while the Treasury retains a contingent liability, it is so far down the waterfall that one could say that the Deposit Insurance Fund has been effectively collectivized and thereby privatized. Of course, the taxpayer still retains a tail risk, but that tail has gotten significantly longer, and some supervisory consequence should seem to follow from that fact.
In other words, in the modern regulatory regime of heightened resiliency and resolvability and deposit insurance funding, how necessary is it for a bank examiner to review and effectively approve a bank’s vendor management process? Or compensation practices? Or determine whether the head of compliance should report to the chief risk officer or the chief operating officer? Or similar processes? Leaving aside the question of whether that review has any value, and stipulating that it does, what is the taxpayer interest in each bank having the same, ideal vendor management or compensation practice, rather than competing in their ability to manage those risks? As noted above, it seems very difficult to argue that this risk is material to the safety and soundness of the bank. Given how resolution and TLAC are structured to bail-in bondholders, and how the Deposit Insurance Fund is financed through assessments on other banks, it seems beyond difficult to argue that these types of risk are material to the taxpayer. And it is impossible to argue that these are systemic risks.

THE APPLICATION PROCESS AND THE PROCESS FOR DECIDING AND LIFTING ENFORCEMENT ACTIONS MUST BE REFORMED

Currently, the process for a bank to apply to merge, branch, invest – anything, really – is opaque, extended, and not subject to accountability within the banking agencies. Numerous people throughout the agencies can delay or derail an application for innumerable reasons, but it seems that no one can expedite it or call the question. Banks frequently are encouraged to withdraw applications once someone in the process indicates an unwillingness to proceed; in many cases, applications are withdrawn because the strategic opportunity prompting the application has been lost to time. The process is at times more akin to congressional “holds” than the one laid out in statute.

Notably, among the factors that can lead to an application being frozen is the pendency of an investigation. Such investigations can be pending for years. Thus, the bank is punished with a severe sanction (limitation on growth) that could be inappropriately severe even if found guilty, even before it has been charged. In many such cases, the bank is never charged.

In numerous discussions with executives from banks of all sizes, a frequent and loud lament is not just that they cannot expand to meet the needs of their customers but that they don’t even know who at a given agency needs to give his or her approval, why it is being withheld, and how they can change the outcome. This is not a policy problem; it is a management problem.

HOW TO MODERNIZE AND RATIONALIZE SUPERVISION

Applying the principles above, here are some discrete steps that could be taken to rationalize supervision.

1. REGULATORS SHOULD RETURN TO THE PRACTICE OF ISSUING INDEPENDENT SAFETY AND SOUNDNESS AND COMPLIANCE RATINGS. Absent clear, documented evidence that consumer compliance problems can have a material impact on safety and soundness, federal banking agencies should leave that work to the CFPB and the Department of Justice, and instead focus exclusively on safety and soundness.11 Any decision to invoke a consumer compliance issue as a justification for sanction under a banking agency’s supervisory authority should require approval at the highest level of the relevant agency.

2. A ZERO-BASED REVIEW OF THE APPLICATION PROCESS SHOULD BE UNDERTAKEN BY EACH BANKING AGENCY. Pending such a review, the Federal Reserve should rescind its SR Letter 14-02 (establishing a series of ultra vires rules for bank expansion) and return to applying statutory standards for branching, merger, and investment applications. The OCC, which has acted similarly but without issuing public guidance to that effect, should do likewise. Any resulting application process should emphasize transparency and accountability. For example, the Governors of the Federal Reserve Board, the Comptroller, and the Directors of the FDIC should receive regular reports on applications that have been pending for more than a given period – say, 75 days – along with the reason for the delay. The pendency of an investigation should
not constitute grounds for delay absent extraordinary circumstances.

3. **HORIZONTAL REVIEWS SHOULD BE USED SOLELY TO INFORM AGENCY REGULATIONS, PUBLISHED FOR NOTICE AND COMMENT, AFTER A COGENT EXPLANATION OF WHY ONE PRACTICE ALONE SHOULD BE ALLOWED TO PERSIST.** Horizontal reviews should never result in ad hoc mandates to banks to change their practices.

4. **“BEST PRACTICES” SHOULD BE REDEFINED TO AS “AGENCY-REQUIRED PRACTICES” AND ADOPTED SOLELY THROUGH REGULATION.** And they should only be adopted when necessary to mitigate a material risk to safety and soundness.

5. **MRAS AND MRIAS SHOULD BE CONSIDERED JUST THAT, AND NOT CONSENT ORDERS WITH PENALTIES FOR NONCOMPLIANCE.** Examiners should raise failures to remediate an MRA or MRIA to senior management or in some cases to the board of directors, but those failures should not form the basis of a halt on expansion or other sanction. If the agency believes that MRAs or MRIAs, either individually or collectively, rise to the level of an unsafe or unsound practice, it should proceed on that basis, with due notice and opportunity for the bank to be heard.

6. **A ZERO-BASED REVIEW OF AGENCY GUIDANCE SHOULD BE UNDERTAKEN.** Post-crisis, agency guidance in various forms has proliferated. The banking agencies should determine which guidance they believe should be retained. The Federal Reserve’s recent proposal on guidance applicable to boards of directors is a very thoughtful step in this direction.

7. **VIOLATIONS OF GUIDANCE SHOULD NOT BE THE BASIS, DIRECTLY OR INDIRECTLY, FOR ANY RATINGS DOWNGRADE, BRAKE ON EXPANSION, OR OTHER SANCTION.** If an agency wishes to enforce guidance as a binding requirement, it should either (1) publish it for notice and comment under the Administrative Procedure Act, or (2) make the case that the violation of guidance constitutes an unsafe or unsound practice under 12 U.S.C. 1818. Doing otherwise is not only unwise but improper. Post-crisis, agency guidance in various forms has proliferated. The banking agencies should determine which guidance they believe should be retained. The Federal Reserve’s recent proposal on guidance applicable to boards of directors is a very thoughtful step in this direction.

8. **RATINGS SHOULD BE RETHought ENTIRELY.** The Federal Reserve Board has recently proposed a significant rethinking of holding company ratings, and the banking agencies/FFIEC should do likewise. Such a review should emphasize the benefits of objective, transparent, consistent standards over subjective, opaque, and ad hoc standards. In particular, as noted in our earlier article, a management component, if retained, should not be a highly subjective wild card that can be used to deem a bank with solid capital, liquidity, and earnings to be unsafe and unsound, and

A frequent and loud lament from bankers is not just that they cannot expand to meet the needs of their customers, but that they don’t even know who at a given agency needs to give his or her approval, why it is being withheld, and how they can change the outcome.
thereby subject to an expansion ban. Any assessment of management should focus on financial management. A meaningful appeals process should be instituted.

9. MORE BROADLY, SUPERVISION OF A BANK VERSUS A NON-BANK AFFILIATE SHOULD BE RETHUGHT, BASED ON FUNDAMENTAL CHANGES MADE BY POST-CRISIS REGULATION. Perhaps this topic could be addressed in a future edition of this magazine, but in any event, regulators should devote study to what TLAC and single-point-of-entry resolution means for the place of a bank in a holding company structure and how it should be regulated.

ENDNOTES

1 Dodd-Frank Act, Section 1022, Rulemaking Authority.
2 The Federal Reserve issued supervisory guidance in 1995 that identified the six primary risks that remain the focus of its supervisory program, one of which is “reputational risk.” SR Letter 95-51 (November 14, 1995) available at: https://www. federalreserve.gov/boarddocs/srletters/1995/w9551.htm. See Remarks by Federal Reserve Governor Sarah Bloom Raskin, “Reflections on Reputation and Its Consequences,” at the 2013 Banking Outlook Conference at the Federal Reserve Bank of Atlanta, Atlanta, Georgia (February 28, 2013), in which she states that “… supervisors have a duty to see that all risks are fully understood, even those risks that, like reputational risk, are unquantifiable or have not fully emerged. I believe this is an area where supervision can add value. To the extent possible, supervision can unveil hidden loss exposures that may be building up through the accumulation of reputational risk elements.” Available at https://www.federalreserve.gov/newsreleases/srletters/2013/sr130228a.htm. The OCC’s Comptroller’s Handbook for Large Bank Supervision provides that “The OCC has defined eight categories of risk for bank supervision purposes: credit, interest rate, liquidity, price, operational, compliance, strategic, and reputation [sic].” Reputational risk, like the other risks, is evaluated by examiners during examinations, and “examiners are required to judge, based on the review of ‘core assessment factors,’ whether the risk is low, moderate, or high.” See Comptroller’s Handbook for Large Bank Supervision (January 2010). Available at https://www.occ.gov/publications/publications-by-type/comptrollers-handbook/pub-ch-ep-lbs. pdf. The OCC’s 2014 Heightened Standards for Large Financial Institutions establishes “minimum standards for the design and implementation of a risk governance framework” that is required to cover “credit risk, interest rate risk, liquidity risk, price risk, operational risk, compliance risk, strategic risk, and reputation [sic] risk.” Available at https://www.occ.gov/news-issuances/news-releases/2014/nr-occ-2014-117a.pdf


6 Indeed, John Taylor, the head of the National Community Reinvestment Coalition and a staunch proponent of the CRA, recently criticized the regulators’ expansion beyond the original purpose of the CRA to encourage lending in underserved communities. Mr Taylor stated, “I don’t want the message to the banks to be, ‘it doesn’t matter how good you do on the lending, if you do something wrong in another area, you could fail’… I think it’s a better idea to ding them, downgrade them, but don’t totally ignore the positive performance. You want to support that.” See Politico Morning Money (March 30, 2017), available at http://www.politico.com/tipsheets/morning-money/2017/03/brexit-has-broken-219500
9 For example, the OCC has stated that it is one of the primary fiduciary duties of an institution’s board of directors’ to preserve the sanctity of the charter, which it describes as the board’s duty “to ensure that the institution operates in a safe and sound manner … and to ensure that the bank does not function simply as a booking entity for its parent and that parent company decisions do not jeopardize the safety and soundness of the bank.” See The OCC’s 2014 Heightened Standards for Large Financial Institutions, available at https://www.occ.gov/news-issuances/news-releases/2014/nr-occ-2014-117a.pdf. Former Comptroller Curry explained that “We also want boards and management to fulfill their fiduciary responsibility to preserve the sanctity of the federal bank charter. When I refer to the sanctity of the charter, I have something very specific in mind. We want to be sure that national banks and federal thrifts are not just treated as booking entities for the holding company. The federal bank charter is a special corporate franchise that provides a gateway to federal deposit insurance and access to the discount window, and the highest fiduciary duty of management and independent directors is to ensure the safety and soundness of the national bank or federal thrift.” See Remarks by Thomas J. Curry, Comptroller of the Currency, Before the 49th Annual Conference on Bank Structure and Competition, Chicago, Illinois (May 9, 2013), available at https://www.occ.gov/news-issuances/speeches/2013/pub-speech-2013-82.pdf
10 See section 616 of the Dodd-Frank Act, 12 USC § 1831o–1.
11 The banking agencies do retain authority over the Community Reinvestment Act, which they would continue to exercise. Even now, though, as noted above, CRA compliance should not be conflated with consumer compliance. Similarly, section 1092 of the Dodd-Frank Act divested the Federal Reserve Board of regulatory authority under section 5 of the FTC Act, and granted the CFPB new authority to prescribe regulations on a standard similar to section 5. While the banking agencies do retain enforcement authority under section 5 of the FTC Act, that law grants neither the FTC nor the banking agencies examination authority. Thus, the FTC Act would not appear sufficient basis for the banking agencies to retain duplicative compliance examination functions in the wake of the transfer of broader authority – including, explicitly, examination authority over consumer laws – to the CFPB.
SINCE THE FINANCIAL CRISIS ENDED, the authority of banking regulators, particularly the Federal Reserve, has greatly expanded to include the power to disapprove of distributions to shareholders under the Fed’s annual stress tests and to break up large banks if their living wills are deemed to be not credible. The proper exercise of such powers requires that the Fed adopt and implement rules that govern these decisions.

In general, when federal agencies adopt rules, the Administrative Procedure Act of 1946 (APA) requires that agencies: (1) provide the public notice of proposed rules and an opportunity to comment on them (“notice-and-comment procedures”); (2) publish their final rules; and (3) have their actions be subject to judicial review and reversal if they fail to comply with APA procedural requirements or are otherwise arbitrary and capricious.

Fed compliance with these procedural requirements is of great importance in the context of the annual quantitative stress tests it conducts as part of its Comprehensive Capital Analysis and Review (CCAR). The stress tests quantify whether a bank can maintain sufficient capital to meet regulatory minimums under hypothetical future adverse conditions. Importantly, as the Treasury stated in its June 2017 report to the president on
financial reform, the stress tests act as a *de facto* binding capital constraint, particularly for large banks.⁵

That’s because if a bank fails to maintain adequate capital under the stress tests’ projections, then the Fed can prevent the bank from returning cash to shareholders through dividends and stock repurchases, and the amount of capital necessary to survive these tests will be greater than that necessary to comply with the U.S. Basel capital requirements.

In my view, the Fed has not complied with the APA’s procedural requirements in adopting key aspects of the stress tests, even though doing so would reduce the threat of legal challenge to the Fed’s actions and result in better public policy outcomes. In this article, I will (1) describe the Fed’s stress test process; (2) explain how that process likely fails to comply with APA procedural requirements; and (3) make recommendations on how to improve the process to restore compliance with the APA, including that key components of the stress tests be subject to public notice and comment.

I. THE FED’S STRESS TESTS

A. OVERVIEW

The Fed runs its own quantitative stress tests of bank holding companies with total consolidated assets...
equal to or greater than $50 billion and non-financial companies supervised by the Fed. The stress tests serve “as a means for assuring that large, complex financial institutions have sufficient capital to allow them to remain viable intermediaries even under highly stressful conditions.” Banks subject to the tests hold approximately 75% of U.S. banking assets. Adoption of the Treasury Department’s recommendation that the threshold be tailored to apply only to certain banks based on factors such as business models and organizational complexity would reduce the burden the tests impose, particularly on smaller banks that are primarily engaged in commercial banking activities.

The stress test process occurs over a full year. The Fed gathers historical bank-specific information throughout the year, discloses the hypothetical adverse economic scenarios it will apply in the tests by mid-February, and collects the banks’ capital plans describing each bank’s planned stock and debt repurchases and issuance, as well as dividend payments, in early April. Using this information, including detailed bank-specific data on loans, investments, revenues, operational risks, trading activities, net interest income, and assets, the Fed runs its own internal models to project a bank’s regulatory capital ratios under the hypothetical adverse economic conditions and releases the results by June 30 each year.

The Fed compares the projected capital ratios of each bank to the regulatory minimum capital ratios based on Basel standards and will object to a bank’s planned dividends and stock repurchases if the projected capital ratio falls below the regulatory minimum capital ratio in any of the four calendar quarters immediately following the release of the results.

There are three key aspects of the tests: (1) assumptions on economic and financial market conditions; (2) models projecting incomes (which must predict losses); and (3) minimum capital ratios.

B. STRESS TEST ASSUMPTIONS

The Fed must decide what stressful economic and financial market conditions banks might encounter and so must develop assumptions about these conditions. These assumptions include estimates of future gross domestic product (GDP), interest rates, unemployment rates, and dozens of other macroeconomic and financial market variables. The assumptions are applied consistently among the banks subject to the stress tests. For example, in the 2017 tests, the Fed’s worst-case scenario assumed the growth rate of GDP would decline 10.6 percentage points from the fourth quarter of 2016 to the second quarter of 2017 and the unemployment rate would hit 10% by mid-2017. Those are extreme assumptions compared to the current GDP growth rate of 2% and an unemployment rate of less than 5%.

The Fed develops three sets of assumptions that are referred to as “baseline,” “adverse,” and “severely adverse” scenarios. The severely adverse assumptions are the harshest and are therefore the most important because banks must meet the minimum regulatory capital ratios in projections made under all three sets of assumptions. The Treasury’s proposal to eliminate the adverse scenario makes sense because it has no real consequences.

Despite the importance of the economic scenarios to the stress tests, they have not been subject to a notice-and-comment rulemaking procedure. And although the Fed has published a scenario design paper outlining its general approach to developing the assumed economic and financial market conditions, it does not provide details about each year’s assumptions as they are being developed and does not seek public comment on the assumptions. Instead, the assumptions are disclosed to the public as a fait accompli and are required to be applied to the banks.

C. STRESS TEST MODELS

With set assumptions and bank-specific data in hand, the Fed determines how each bank’s capital regulatory ratios would fare. To do so, the Fed applies its own internally developed projection models. It does so in a secretive and opaque manner.

The Fed’s models fall into five broad categories: (1) models to project losses on loans held in the accrual loan portfolio; (2) models to project other types of losses, including those from changes in the fair value of loans held for sale, losses on securities, trading, and counterparty exposure, and losses related to operational risk events; (3) models to project the components of pre-provision net
revenue; (4) models to project balance sheet items and risk-weighted assets; and (5) calculations to project capital ratios given projections of pre-tax net income and provisions for the allowance for loan and lease losses.26

The Fed has never released the models to the public either, before the stress tests are conducted or after the results are released. While the Fed makes some effort to provide transparency by including a high-level summary of its modeling approach in the release of the stress test results, such disclosures do not provide specific details about the models.27 And although a Model Validation Council currently made up of six outside academics evaluates the models each year, the Fed does not disclose the feedback it receives from that body.28

Fed officials have justified the secrecy surrounding the models by contending that disclosure of the models would allow banks to “game” the tests29 – presumably by, among other things, accumulating assets after disclosure of the models that perform well on the test and then changing the portfolio composition after the test is over.

D. CAPITAL RATIOS

The final step in the stress test is for the Fed to compare a bank’s projected capital ratios with the required regulatory minimums. Unlike the assumptions and models, the applicable capital ratios are set forth in Fed rules that have been subject to notice-and-comment procedures.30 The applicable ratios are the tier 1 leverage ratio, the supplementary leverage ratio (added in the 2017 stress tests), the common equity tier 1 ratio, the tier 1 risk-based capital ratio, and the total risk-based capital ratio.31 On at least six occasions, the Fed has objected to a bank’s capital plan because at least one of its projected capital ratios fell below the regulatory minimum.32 Currently, the Fed is considering adding the global systemically important bank (G-SIB) surcharge to the capital required of the eight G-SIB banks.33

II. THE FED’S STRESS TESTS AND COMPLIANCE WITH THE APA

The Fed-developed assumptions and models are central to the stress-testing process, but they’re not subject to input from the public or the firms affected by them. That failure to seek public input likely violates the notice-and-comment procedural requirements of the APA because the assumptions and models constitute rulemakings that are not subject to a valid exemption.

A. THE FED’S ASSUMPTIONS AND MODELS ARE RULEMAKINGS

The APA divides agency actions into two categories: rulemakings and adjudications. Critically, rules are generally subject to the APA’s notice-and-comment procedures and adjudications are not.34 The Fed has not complied with the APA’s procedural requirements in adopting key aspects of the stress tests, even though doing so would reduce the threat of legal challenge to the Fed’s actions.

The key distinction between rules and adjudications is that rules relate to policy considerations and have future effect, whereas adjudications are backward looking and usually resolve disputed facts in a specific case.35 The assumptions and models are best categorized as rules for at least two reasons. First, the assumptions about economic conditions and models on the predicted responses to those conditions are applied to all U.S. banks with assets over $50 billion and therefore have policy implications as they establish the de facto minimum capital requirement for 75% of the U.S. banking system. Second, the assumptions and models have future effect through their significant influence over whether banks will be allowed to make future capital distributions.

The Fed, however, could argue that the assumptions and models are part of an adjudication – a bank-by-bank assessment of whether an individual bank is well capitalized enough to make planned capital distributions. It could point to the Supreme Court’s 1974 case NLRB v. Bell Aerospace, in which the Court held that, in an adjudication about whether to certify a union, the NLRB could determine who was a “managerial employee,” a question central to the certification determination, even if the definition would subsequently apply more broadly in the future to other employers.36
However, that case is easily distinguishable. In *Bell Aerospace*, the NLRB had not pre-defined the term “managerial employee” and had to apply a definition to reach a judgment in the case. In the Fed’s review of a bank’s capital adequacy, however, the assumptions and models are developed in advance of and separately from the conclusion about the capital adequacy of an individual bank. The assumptions and models are criteria that function as rules that the Fed has already developed and that it consistently applies across banks. Indeed, the assumptions and models function no less as rules than the capital ratio requirements, which the Fed treats as rules.

B. EXCEPTIONS TO THE APA’S NOTICE-AND-COMMENT PROCEDURES DO NOT APPLY

If the assumptions and models are rulemakings, then the APA notice-and-comment procedures govern unless one of three relevant exceptions apply: (1) they are merely guidance; (2) they are “interpretative” rules; or (3) the Fed demonstrated that the notice-and-comment procedures are unnecessary, impractical, or contrary to the public interest (the “good cause exception”).

1. The Exceptions Do Not Apply to the Assumptions

First, the guidance exception does not apply to the assumptions because they are treated by the Fed as binding. The D.C. Circuit has held that guidance cannot be treated by the agency as binding. The Fed applies the assumptions uniformly across all of the banks and provides no process whereby a bank can discuss with the Fed why a particular assumption should not be applied to it or why a different assumption might be more relevant.

Second, the assumptions do not meet the D.C. Circuit’s definition of an “interpretative” rule, which is one that “merely interprets” and “does not itself purport to impose new obligations or requirements on regulated parties.” The Fed’s assumptions are not based on an interpretation of an existing rulemaking and the Fed’s assumptions impose new obligations on regulated parties because they significantly affect the amount of capital a bank needs to hold in a given year.

Finally, the good cause exception is narrowly construed by courts and inapplicable. The D.C. Circuit has explained that the three conditions for the good cause exception are as follows: It is (1) impractical for an agency to follow notice-and-comment procedures when an agency finds that due and timely execution of its functions would be impeded by following the procedures; (2) unnecessary to follow procedures if the rule is routine in determination, insignificant in nature and impact, and inconsequential to the industry and public; and (3) contrary to the public interest if the public interest would be defeated by compliance with the procedural requirements.

There is no apparent reason why the good cause exception would apply. The Fed can develop proposed assumptions with sufficient time for the Fed to incorporate public comments prior to issuing the final assumptions. Moreover, for reasons already discussed, the assumptions are not insignificant or inconsequential. Finally, public participation through notice-and-comment procedures would be in the public interest because it would allow the public to provide informational feedback to the Fed, thus enhancing the quality of the assumptions.

2. The Exceptions Do Not Appear to Apply to the Models

In regard to the models, the exceptions for guidance and interpretative rules do not apply because the models are binding, do not simply interpret an existing rulemaking, and impose substantive new obligations to hold capital based on the design of the models themselves. However, there is possibly some basis to conclude that the good cause exception may apply.

There is a dearth of case law directly on this point, but two 40-year-old cases from a now-defunct court of appeals held that notice-and-comment procedures...
could be bypassed where pre-announcing changes to the price of regulated oil prices would have undermined the aims of the rules. 42 Likewise, if the stress test models can be “gamed” then disclosing them prior to the tests could arguably undermine the Fed’s ability to accurately predict how banks would truly be affected by stressful conditions.

That argument has serious problems. First, it is unclear how big of a concern gaming really is. For example, it would be highly costly and impractical for a bank to significantly change risk exposures in its banking book in a matter of months. Second, the Fed could address gaming by adopting and enforcing a good faith or anti-evasion principle.

The Fed also has to contend with the separate requirement that final rules be published once finalized (a requirement the Fed does not satisfy with respect to the models). The good cause exception for notice-and-comment procedures is distinct from the requirement that final rules be published, so even if the good cause exception applied, the models would need to be published when they’re final.

### III. ENHANCING COMPLIANCE WITH THE APA

The Fed should comply with the APA’s notice-and-comment procedures in adopting the economic and financial market assumptions used in the annual stress tests and in the models it uses to make its projections.

Doing so would allow the public to provide valuable information and insight, which will help promote quality decision making when it comes to determining the appropriate assumptions. 43 Additionally, it would alleviate the concern raised by the Treasury that “[t]he lack of transparency ... can make it difficult for firms to efficiently allocate capital across products and exposures.” 44 Finally, it would reduce the threat of legal challenge to Fed actions taken in reliance on the stress tests, including the rejection of a bank’s capital plan.

It is crucially important that development of both the assumptions and models involve public input because any substantive changes made to the assumptions could be offset by changes to the secret models. The Treasury has proposed conducting the tests once every two years, and doing so could give the Fed adequate time to comply with the APA.

Moreover, although I have focused on the quantitative aspect of the stress test in this article, the Fed also qualitatively reviews banks’ capital planning abilities and can object to shareholder distributions on qualitative grounds. 45 That review process is also very opaque, and I agree with the Treasury Department that such a review should be conducted as part of the normal supervisory process rather than the review and approval of capital distributions. 46

**If regulators are using pre-existing criteria to judge the credibility of living wills that have not been made public and subject to notice-and-comment procedures, then those criteria should be treated as rules and subject to notice-and-comment procedures.**

More generally, the Fed should be diligent to ensure that it is complying with the APA when engaged in other supervisory activities, such as supervising the “living wills” process. If regulators are using pre-existing criteria to judge the credibility of living wills that have not been made public and subject to notice-and-comment procedures, as the GAO has found, 47 then those criteria should be treated as rules and subject to notice-and-comment procedures.

Complying with the APA is not only the law, it is good public policy. It promotes transparency and accountability, increases the quality of agency decision making, and reduces uncertainty about the lawfulness of agency actions.

**Editor’s Note:** See citations on p.68.
WHAT HAPPENS WHEN a bank examiner makes a mistake? Perhaps the examiner gave the bank a composite CAMELS rating of 4 when comparable banks typically receive a 2. Perhaps the examiner incorrectly concluded that the bank had inadequate reserves for loan losses. Perhaps the examiner concluded that the bank needs to improve its compliance with the Community Reinvestment Act. Under federal law, each of these decisions is a “material supervisory determination.”

To guard against erroneous material supervisory determinations, Congress in 1994 enacted a statute requiring that federal financial regulators provide an “independent intra-agency appellate process ... to review material supervisory determinations made at depository institutions.” The Office of the Comptroller of the Currency (OCC), the Federal Reserve, the Federal Deposit Insurance Corporation (FDIC), and the National Credit Union Administration (NCUA) each adopted different procedures for handling these appeals.

Although it has been roughly two decades since regulators adopted the material supervisory determination appeals processes, little has been done to analyze their effectiveness. I decided to undertake this task. In addition to scrutinizing each regulator’s policies and guidelines, I reviewed every available appeal. Only the OCC and FDIC publicly provide summary or redacted appeals decisions. When decisions were not generally available, I made Freedom of Information Act (FOIA) requests. The NCUA provided redacted decisions from
its independent intra-agency panel. However, I did not convince the Federal Reserve to provide summary or redacted opinions. Instead, the Federal Reserve provided a table showing brief descriptions and resolutions for some appeals. With the data in hand, I interviewed present and past OCC and NCUA appeals officials.

Based on this review, I found three significant shortcomings of the material supervisory determinations appeals processes. First, there are few appeals. Any appeals process is unhelpful if it is never used. Second, regulators differ significantly in the type of review that they provide. Each regulator sets its own standard of review. This means that some financial institutions are entitled to a more thorough review of their appeals than others. Some regulators’ standards of review are so opaque that it is difficult to determine whether a bank is entitled to a meaningful review. Finally, material supervisory determinations are shrouded in secrecy. This makes it difficult for financial institutions and regulators to learn from past appeals. It is also difficult to determine if similarly situated institutions are treated similarly.

After describing these problems in more detail, I propose three changes to strengthen the material supervisory determination appeal processes. First, once a regulator issues a determination, financial institutions should have direct access to a dedicated appellate authority outside of the examination function. Second, the appellate authority should engage in a robust review employing a clear and rigorous standard of review. Third, regulators should release detailed information about each decision reached by the appellate authority.

I. FEW APPEALS

The first problem is that few appeals are heard by the congressionally mandated “independent intra-agency” review authority. Before reporting data, some background on the appeals processes is helpful. Each bank or credit union may appeal a material supervisory determination to the regulator who made the determination.

Each regulator has its own multistage process for handling material supervisory determination appeals (Figure 1). The FDIC and NCUA both require a financial institution to appeal to an official within the examination function. At the FDIC, banks must appeal to the appropriate division or office director. At the NCUA, the credit union must “contact” the NCUA’s regional office that oversees the credit union. If an FDIC- or NCUA-regulated institution is unhappy with the initial official’s decision, the institution can then appeal to an independent intra-agency panel.
to the regional Federal Reserve Bank president and then to the Federal Reserve Board. The OCC is unique because financial institutions can choose whether to address their appeals to the Deputy Comptroller overseeing the exam or to the OCC Ombudsman. The Ombudsman is independent and reports directly to the OCC's Comptroller.

So how often did financial institutions avail themselves of that independent intra-agency appeal that Congress requires? Not very often (Figure 2). In fact, between 1995 and 2012, the NCUA Supervisory Review Committee issued only six decisions.

Perhaps these numbers would not be troubling if evidence suggested that appeals are being resolved at earlier stages in the appeals processes. However, confirming or disproving that the exam process is adequately handling disputes is difficult because none of the regulators regularly release information about early-stage appeals. Through FOIA, I requested information about early-stage appeals. Only the NCUA reported a significant number of appeals that were resolved at early stages in favor of the financial institution. The NCUA provided a summary table showing 140 “regional contacts” between 2005 and 2012. Twenty-five of those made a change to the initial material supervisory determination. Thus, even considering appeals resolved before reaching the independent review authority, the number of appeals is not large.

Admittedly, it is hard to decide how many appeals should have been filed, but there are reasons to suspect there should have been more. There are nearly 14,000 financial institutions (about 7,000 banks and 7,000 credit unions). Most of these are examined every year. Yet only a tiny number used the appeals process. Financial institution surveys conducted by the Alliance of Bankers Associations in 2011 and the Credit Union National Association in 2010 found that at least one-fourth of survey respondents were unhappy with their most recent examination and results. One-fifth of credit unions responding to the survey indicated that they wanted to appeal. Even if the surveys overstate dissatisfaction, the gulf between the reported dissatisfaction and actual number of appeals is huge.

Why don’t more banks appeal? The Credit Union National Association found that “[t]wo-thirds of the credit unions that wanted to appeal indicated they did not appeal for fear of retaliation by examination staff. Nearly the same number indicated they did not appeal because they did not believe it would make a difference in outcome.”

The survey respondents are probably right about the likelihood of winning an appeal (Figure 3). Here I considered the rate of success of all appeals, not just those that make it to each regulator’s independent authority. During the time periods for which the data is reasonably complete, the FDIC and the Federal Reserve adjusted the material supervisory determination in five cases each.

II. LIMITED AND INCONSISTENT STANDARDS OF REVIEW

This leads to the second problem: Regulators differ significantly in the type of review they provide. Regulators often do not engage in a robust review of appealed material supervisory determinations. One limiting factor in these regimes is the “standard of review” that is applied in the appellate process – the

<table>
<thead>
<tr>
<th>APPELLATE AUTHORITY</th>
<th>YEARS DATA AVAILABLE</th>
<th>NUMBER OF APPEALS</th>
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<tbody>
<tr>
<td>OCC Ombudsman</td>
<td>1994–2012</td>
<td>157</td>
</tr>
<tr>
<td>FDIC Supervision Appeals Review Committee</td>
<td>1995–2012</td>
<td>65</td>
</tr>
<tr>
<td>NCUA Supervisory Review Committee</td>
<td>1995–2012</td>
<td>6</td>
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level of deference the appellate authority gives the earlier decision maker. Possible standards of review range from the deferential “abuse of discretion” standard to the nondeferential “de novo” standard. Because changing the standard of review adjusts the deference given to the earlier determination, the standard of review makes a difference in the outcome. Institutions appealing under a nondeferential standard have a better chance of success than those appealing under a deferential standard. The legislation requiring the regulators to provide an appeals process did not specify a standard of review. Without direction, regulators have adopted differing (and sometime opaque) standards.

In the early years of the appeals process, the OCC’s Ombudsman reviewed appeals de novo and often visited the appealing bank. As a former OCC Ombudsman Samuel Golden explained: “[I]f I want to know how you live, I’m going to go to your house. You can tell me about how you live, and then I go to your house and it’s junky as hell. ... If you want to know the real facts you literally go [to the bank].” Now, the OCC’s Ombudsman uses a more limited review asking whether the “examiners appropriately applied agency policies and standards.” The current OCC Ombudsman does not typically visit the appealing bank. Neither do the other regulators.
The Federal Reserve Board has not adopted an agency-wide standard of review for material supervisory determination appeals. Left to their own judgments, the regional Federal Reserve Banks provide a potpourri of standards of review – from de novo at the Federal Reserve Bank of New York,9 to ad hoc (but probably not de novo) at the Federal Reserve Bank of Kansas City,7 to “findings and conclusions were based on sufficient evidence and were consistent with . . . policy” at the Federal Reserve Bank of Minneapolis, to no stated standard at other Reserve Banks.8

The FDIC’s Supervision Appeals Review Committee “review[s] the appeal for consistency with the policies, practices and mission of the FDIC and the overall reasonableness of, and the support offered for, the positions advanced.”9

NCUA policy statements do not provide a standard of review. Joy K. Lee, the NCUA’s Ombudsman and Chair of the NCUA’s Supervisory Review Committee, explained that she viewed herself “as a completely independent party.”10 However, she avoided using language that could easily be classified as a standard of review.

In sum, at present, three regulators (the OCC, some regional Federal Reserve Banks, and the FDIC) check to see if the material supervisory determination is consistent with regulatory policies and standards. This check is important; examiner decisions should be consistent with the law and previous regulatory pronouncements. However, it is not sufficient to ensure that examiner decisions are consistent. While some appeals may simply require the straightforward application of law or written policy, other appeals might present different issues.

Some appeals may involve questions of fact. For example, in rating the quality of a loan, one factor regulators consider is the value of the collateral securing the loan. The financial institution and the regulator may have differing conclusions about the value of that collateral. The examiner (or bank) may have properly classified the loan according to policy but nevertheless arrived at the wrong classification because the factual assessment of the value of the collateral was incorrect. A “consistent with agency policy” standard is also problematic when existing law and written policy do not cover the issue raised by the financial institution.

Given the confusing hodgepodge of standards of review and the low success rate, it is unsurprising that financial institutions believe that appealing a material supervisory determination will be unproductive.

Material supervisory determinations are shrouded in secrecy. This makes it difficult for financial institutions and regulators to learn from past appeals.

III. LITTLE TRANSPARENCY

The third problem with the material supervisory determination appeals processes is that they are not transparent. As I found out firsthand, it is challenging to get information about appeals decisions.

Written and regularly disseminated decisions serve several functions. First, written decisions can be a learning tool for regulators. If decisions are public, all regulators can review the decisions and compare them with their current practices. How can regulators be expected to achieve any measure of consistency (either within an agency or across agencies) if regulators have no idea what others within its own agency or at other agencies are doing? Second, written decisions act as guideposts for financial institutions. Institutions are better able to comply with regulator expectations when they understand what the regulators expect. Third, written decisions give the public a way to evaluate the material supervisory determination appeals processes and the examination function overall. The lack of transparency stands as a barrier to consistency and confidence in the examination process.

IV. IMPROVING MATERIAL SUPERVISORY DETERMINATION APPEALS

How could we make the process better? First, once examiners issue a material supervisory determination,
financial institutions should have direct access to an appellate authority outside of the examination function. Second, the appellate authority should employ a clear and rigorous standard of review. The standard of review should be consistent across regulators. Third, regulators should release detailed information about each decision.

A. STRENGTHENED INDEPENDENCE OF REVIEW
   
   First, once examiners issue a material supervisory determination, financial institutions should have direct access to a dedicated appellate authority outside of the examination function. The OCC is the only regulator to provide this access; OCC-regulated banks can appeal directly to the Ombudsman. FDIC-regulated banks and credit unions first address an appeal to an official who oversees the examination function. Federal Reserve-regulated institutions first address an appeal to an ad hoc committee that changes with each appeal. I propose that FDIC-regulated banks be allowed to appeal directly to the Supervision Appeals Review Committee and credit unions be allowed to appeal directly to the Supervisory Review Committee. I also propose that the Federal Reserve create an independent appellate authority. The appellate authority should consist of people who are not part of the examination function. Moreover, members of the appellate authority should not change with each appeal.

   The benefits of direct access to a dedicated appellate authority outside the examination function are threefold. First, consistent decisions are more likely to come from a single appellate authority (whether consisting of an individual or a small group) than from a number of different individuals who do not deliberate together (as is the case when appeals are first routed through division, region, or office directors).

   Second, a single appellate authority promotes transparency. Regulators do not regularly release any information about early-stage appeals that are routed to a division, region, or office director. Perhaps this is partly because these officials are so connected with the examination function, a non-public process, that they presume complete secrecy is preferable. Allowing appeals to instead begin with a dedicated appellate authority outside the examination function may facilitate public release of summary or redacted opinions. A dedicated appellate authority outside the examination function may be better able to balance protection of information that could lead to banking runs with disclosure of information that could improve the examination function. Indeed, the OCC Ombudsman and FDIC Supervision Appeals Review Committee (appellate authorities outside the examination function) already strike a reasonable balance when they release their decisions.

   Third, a more independent appellate authority may increase bank confidence in the material supervisory determination appeals processes. Financial institutions that disagree with a determination may view the regulator’s examination function with suspicion. Assigning the first step of the examination function to examination officials does little to assuage this concern. Institutions would likely view a dedicated appellate authority outside the examination function as more independent, particularly if that authority publicly disclosed its decisions.

   How often do financial institutions avail themselves of the independent intra-agency appeal that Congress requires? Not very often.

   The OCC gives its banks the choice of filing with the Ombudsman or the Deputy Comptroller of the supervisory district that oversees the bank. Current Ombudsman Larry Hattix estimates that about 80% start directly with the Comptroller. This suggests most banks prefer the appellate authority outside the examination function.

B. CLEAR & CONSISTENT STANDARD OF REVIEW
   
   Second, regulators should adopt a clear and robust standard of review. The bar is low here – nearly any clear and consistent standard would be an improvement. The scope of review that a financial institution receives should not depend on its charter type, membership in the Federal Reserve, or location. Choosing the appropriate level of deference is more
difficult. I favor a de novo review because it would allow each independent appellate authority to correct a wider swath of erroneous decisions.

When I spoke with regulators, some worried that de novo review would encourage financial institutions to “sandbag” examination staff. Rather than raising relevant facts or concerns with examiners, financial institutions might remain silent and then seek to have material supervisory determinations overturned through the appeals process. This, however, seems unlikely for a variety of reasons. First, the appeals process cannot be used to stall enforcement actions. Financial institutions must comply with examiner instructions while any appeal is pending. Second, financial institutions are repeat regulatory players. It is not in their interest to antagonize regulators. Third, the historic success rate for material supervisory determination appeals suggests it would be foolhardy for a financial institution to think that winning an appeal is a foregone conclusion. Even if reforms strengthen the appeals process, financial institutions will face risks when using the process.

C. TRANSPARENCY

Finally, and perhaps most obviously, each appellate authority should provide summary or redacted decisions. The information provided should include (1) the reason the appealing financial institution believes the examiner erred; (2) the applicable law, regulation, or agency guidance; and (3) the decision and accompanying reasoning.

Regulators’ primary objection to releasing decisions appears to be that the appeals concern confidential information from bank examinations. While secrecy may be warranted with respect to the examination report itself, there is no need to extend complete secrecy to material supervisory determination appeals decisions. The OCC and FDIC have managed to strike a balance between releasing meaningful information and protecting sensitive information.

The bottom line is that it shouldn’t take a law professor with a fondness for the Freedom of Information Act to get access to basic information about material supervisory determination appeals.

Given the confusing hodgepodge of standards of review and the low success rate, it is unsurprising that financial institutions believe that appealing a material supervisory determination will be unproductive.

CONCLUSION

When Congress mandated that each federal financial regulator must provide “an independent intra-agency appellate process ... to review material supervisory determinations made at insured depository institutions,” it hoped the processes would “provide an avenue of redress ... from uneven treatment by examiners.”

Now, two decades later, the processes adopted pursuant to this mandate have hardly been used. Regulators differ significantly in the standards they use to evaluate appeals. And even finding basic information about appeals decisions can be difficult. In short, the existing material supervisory appeals processes do not provide a meaningful avenue for correcting uneven regulatory treatment.

To achieve Congress’s goal, regulators must strengthen their appeals processes. Financial institutions should have direct access to a dedicated appellate authority outside of the examination function. Regulators should employ a clear and rigorous standard of review. Finally, regulators should release appeals decisions in summary or redacted form.

I am hopeful that improvements can be made. The NCUA is already considering changes to its appeals process. The banking regulators should follow suit. To err is human; to correct, divine.

Editor’s Note: See citations on p.68.
Continued from p. 67 “Improving Appeals of Material Supervisory Determinations” Endnotes
4 The Credit Union National Association performed a second survey about the examination process in 2012. While it did not specifically ask about the appeals process, it did ask about credit unions’ agreement with examination results. That survey found that 25% of respondents were unhappy with their most recent examination and results. Credit Union Nat’l Ass’n, 2012, Credit Union Exams Survey (on file with author) (N=1531, 10% very dissatisfied, 15% somewhat dissatisfied, 15% neutral, 39% satisfied, 21% very satisfied).
10 Lee Interview, supra note 6.

Continued from p. 59 “Stress Tests: Restore Compliance with the APA” Endnotes
1 This article, which is derived from a report published by the Committee on Capital Markets Regulation entitled “The Administrative Procedure Act and Federal Reserve Stress Tests,” primarily focuses on the Fed’s stress tests’ compliance with federal administrative law.
3 Id. § 552(a)(1)(D).
4 Id. § 706(2).
6 12 CFR § 225.8(b).
9 U.S. Department of the Treasury, supra note 5, at 12.
11 12 CFR § 225.42(b).
12 Id. § 225.8(e).
13 Id. § 225.8(f)(2)(v).
15 Hirtle, Beverly, and Andreas Lehner, Supervisory Stress Tests, Federal Reserve Bank of New York Staff Reports, No. 696 at 18. 2014.
18 Scott, supra note 8.
19 12 CFR § 252.42(a), (b), (e), & (o).
20 Id. § 252.44(a) (stating that severely adverse conditions are more severe than the adverse assumptions).
21 Id. § 252.8(f)(2)(i)(G).
22 U.S. Department of the Treasury, supra note 5, at 17.
24 12 CFR § 252.44(b).
25 CCAR 2016, supra note 14, at 8, 11.
27 E.g., CCAR 2016, supra note 14, at 53-67.
30 12 CFR § 252.42(m).
32 Scott, supra note 8.
37 Gen. Elec. Co. v. EPA, 290 F.3d 377, 382-83 (D.C. Cir. 2002) (stating that guidance cannot be binding and that an agency pronouncement is binding “if it either appears on its face to be binding or is applied by the agency in a way that indicates that it is binding”).
38 Nat’l Mining Ass’n v. McCarthy, 759 F.3d 243, 252 (D.C. Cir. 2014).
43 U.S. Department of the Treasury, supra note 5.
45 U.S. Department of the Treasury, supra note 5, at 12, 141.
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Banks’ Own Models
Should Play a Key Role in the U.S. Supervisory Stress Tests
INCLUDING BANKS’ OWN MODELS IN SUPERVISORY STRESS TESTS WOULD REDUCE THE UNCERTAINTY AROUND CAPITAL PLANNING, INCREASE EFFICIENCY, AND EXPAND CREDIT AVAILABILITY.

BY FRANCISCO COVAS
THE CLEARING HOUSE

THE ROLE OF SUPERVISORY STRESS TESTS in banking supervision has increased dramatically since the aftermath of the 2007–2009 financial crisis. In particular, the Federal Reserve’s stress tests are a key driver of large U.S. banks’ capital requirements and play a crucial role in determining their ability to return capital to shareholders.1 In the stress-testing exercise, the Fed staff projects the loan losses and revenues of each bank in a severe recession to determine their post-stress regulatory capital ratios.2

Banks’ own models are used only in the qualitative assessment portion of the stress tests. This regime gives banks an incentive to manage their own capital according to the results of the Fed’s models, which may decrease the efficiency of the financial system if the projections generated by those models are inaccurate. Alternatively, this process could increase systemic risk if the Fed’s models are vulnerable to a particular source of risk. That the Fed’s models are inaccurate with respect to individual banks is a real possibility, because those models generally are not estimated to best fit each individual bank’s stressed projection, while banks’ models are more granular and fine-tuned to their own business models.3

The opaqueness and imprecision of the Fed’s models lead to uncertainty among institutions as to what level of capital they will be required to hold, and thus may cause banks to reduce credit availability or prevent them from making...
loans in anticipation of knowing the results of the stress tests. Therefore, the efficient allocation of credit in the U.S. financial system could be improved significantly by having banks’ own models play a greater role in determining banks’ post-stress regulatory capital ratios and having the Fed’s models used only to ensure the consistency of stress-test results across banks, similar to the current approach employed by the Bank of England (BoE).

The U.S. supervisory stress tests have the reputation of being **tougher compared to the stress tests conducted in other advanced economies’ jurisdictions**, such as those administered in the United Kingdom.

**PROBLEMS WITH USING THE FED’S MODELS**

The U.S. supervisory stress tests have the reputation of being tougher compared to the stress tests conducted in other advanced economies’ jurisdictions, such as those administered in the United Kingdom and the European Union. The key drivers of the toughness of U.S. stress tests are the stringency of the supervisory scenarios, the assumption that banks’ balance sheets expand under stress, and the requirement that equity distributions be prefunded as if economic conditions were normal. Yet another unique feature of the U.S. supervisory stress tests is that they rely almost exclusively on the Fed’s own models to generate the projections of banks’ post-stress regulatory capital ratios. In contrast, in the stress tests conducted by the BoE and the European Banking Authority, banks’ own models play a key role in generating the projections of stressed loan losses and net revenues, which are key inputs required to calculate banks’ post-stress regulatory capital ratios.

There are several problems that arise when a banking regulator relies exclusively on the projections provided by supervisory models in stress tests. First, if the projections generated using the Fed’s models are overly pessimistic, capital requirements are excessively tight and, as a result, bank credit is too expensive and likely to be unavailable to riskier borrowers (i.e., those loans that require banks to hold relatively more capital). As shown in our own research, the Fed’s supervisory stress tests impose dramatically higher capital requirements for small business loans, residential mortgage loans, and trading assets relative to the capital the banks’ own internal models and the Basel standardized approach would require. Conversely, if the Fed’s models underestimate a particular source of risk and banks manage their own capital according to the results of the Fed’s models, the whole U.S. financial system could be undercapitalized during a time of stress. This scenario unfolded during the crisis, as the Fed’s models underestimated the risks inherent in private-label residential mortgage-backed securities.

Second, it is very difficult to validate the Fed’s models against banks’ own loss experiences because the Fed’s models take a “one-size-fits-all” approach. The use of a common set of models across all banks participating in the stress tests requires the Fed to make important simplifying assumptions, such as glossing over variations in bank-specific business practices, which leads to inaccurate projections for loan losses, and stressed revenues, as described below:

- With respect to loan losses, the Fed does not incorporate **bank-specific effects** in its projections, because there will be unique characteristics of each bank’s loan portfolio that cannot be captured using the variables included in the Fed’s models. For example, it’s almost impossible for the Fed to project expected losses of loans extended to borrowers in foreign jurisdictions because the Fed lacks the default and loss data required to develop accurate models for these portfolios. In contrast, banks have data on the historical performance of their own loan portfolios, which lets them develop more accurate models for such portfolios. In addition, almost none of the simplifying assumptions made by the Fed are publicly disclosed, which makes it impossible to evaluate their appropriateness or compare them in any detail to banks’ own models.
With respect to stressed revenues, the Fed projects pre-provision net revenue using models that link the subcomponents of revenues and expenses to macroeconomic variables. All subcomponents of revenues and expenses are taken from the regulatory reports. However, to model bank profitability accurately requires a bank-specific approach, and the reliance on the limited level of granularity available on regulatory reports poses considerable challenges. For example, the net income subcomponents available on the regulatory reports are not sufficiently granular to capture the diversity of business activities of a given bank. Also, other revenue items that are known to move in opposite directions in response to macro shocks are reported in the same line item on the regulatory reports (most notably, fees from mortgage prepayments are reported in the same line item as interest income). This leads to inaccurate bank-specific projections of stressed revenues because it hides important differences in banks’ revenue sensitivities to the stress scenarios.

In contrast, banks’ internal models are much more granular than those reported in the regulatory reports categories and are likely to yield higher-quality models for net interest income and subcomponents of non-interest income compared with the Fed’s models.

The third problem that arises when a banking regulator relies exclusively on the projections provided by supervisory models in stress tests is the lack of transparency. Without this transparency, banks have a very limited ability to compare their loan loss projections across loan products or geography to the Fed’s because the Fed publishes only loss rates for major loan portfolios. The Fed could provide greater transparency by providing additional detail regarding the statistical specifications of loss and revenue models, and also if it disclosed the results of statistical tests on the performance of its own models. The Fed also could improve transparency, albeit to a lesser degree, by reporting loss rates of U.S. versus non-U.S. portfolios, loan loss provisions by portfolio type, and stress revenues for each of its major subcomponents.

Banks have data on the historical performance of their own loan portfolios, which lets them develop accurate models for such portfolios.

ADVANTAGES OF USING BANKS’ MODELS

Moving to a regime where banks’ own models play a key role in U.S. supervisory stress tests would improve the accuracy of bank-specific projections for loan losses, stressed revenues, and balance sheet and post-stress capital ratios. But why is accuracy so important? One reason is because it reduces uncertainty in post-stress regulatory capital ratios and allows banks to make better choices on how to allocate their capital across business lines.

In a seminal academic paper, Ben Bernanke was one of the first to formally analyze the impact of uncertainty on business investment. The paper showed that an increase in uncertainty depresses current investment, especially for investment projects that are long-lived and that are economically costly to reverse. Because the capital requirements of the majority of large banks are effectively determined by the supervisory stress tests, uncertainty about banks’ post-stress regulatory capital ratios caused by the lack of accuracy of the Fed’s models is expected to lead to an underinvestment in lending activities. Note that banks’ main role is to transform short-term liquid investments such as deposits into long-term illiquid assets such as loans. Banks’ maturity transformation role is by definition a “long-lived investment project” that is illiquid, so uncertainty induced by the U.S. stress tests is likely to depress bank lending. The use of banks’ own models in stress tests would reduce uncertainty regarding banks’ post-stress regulatory capital ratios and, according to the academic literature, boost lending, improve banking efficiency, and lead to a better allocation of capital.

Allowing banks’ to use their own models would also give banks an incentive to continue to invest additional resources to improve the gathering of internal data on loan defaults and recoveries and to continue to develop their own internal risk models, which would further stimulate innovation in risk management at banks.
At the same time, it would also reduce the systemic risk that arises in the current single-model regime, wherein all banks have the incentive to increase their exposure to the types of assets that have lower capital requirements under the Fed’s models, which creates significant one-way risk. Similarly, banks’ use of their own models would also motivate them to develop robust stress scenarios more tailored to their own business models, as the development of a bank-specific scenario is a mandatory requirement in the U.S. stress tests. Ultimately, the Fed wants banks to run effective stress tests, and in order for the banks to anticipate which challenges lie ahead for their bespoke portfolios, they need to run their own models.

**CHALLENGES OF RELYING ON BANKS’ OWN MODELS**

A common argument in defense of the use of the Fed’s models in the supervisory stress tests is that the use of common models provides a level playing field and consistency of stress-test results across banks. In particular, it allows investors to compare results across banks in terms of the risk they’re taking. If banks were allowed to use their own models, the concern is that differences in post-stress regulatory capital ratios would also be driven by differences in modeling approaches. Hence, if a new regime in which banks’ own models play a key role in stress tests is implemented, the Fed should ensure some degree of consistency in the post-stress capital ratios and maintain a level playing field across banks, as discussed below.

Another popular argument is that allowing banks to use their own models in stress tests encourages bad behavior because banks would have an incentive to make more optimistic assumptions in order to increase equity distributions to its shareholders. Although we can’t rule out this possibility, banks’ own projections are not necessarily more optimistic than those obtained using the Fed’s models in past stress-testing exercises. As shown by the yellow bars in Figure 1, banks’ own projections of pre-tax net losses cumulatively over the planning horizon are 20% and 80% higher than those obtained under the Fed’s models in the Dodd-Frank Act Stress Test (DFAST) for 2016 and 2017, respectively. Conversely, for DFAST 2013 through 2015, the projections obtained using the Fed’s models were more pessimistic than those obtained using banks’ own models. This evidence suggests that the concern that banks’ always will arrive at less-pessimistic results than those obtained using the Fed’s models could be somewhat exaggerated.

Lastly, there is also the possibility that the Fed will increase significantly examination efforts to approve banks’ own models for stress tests. Currently, as part of the qualitative review of the stress tests, the Fed’s examiners extensively review banks’ own models but as if they were refereeing an academic paper submitted for publication in a scholarly journal and not so concerned in ensuring that all assumptions in banks’ own models are conservative. Moving to a stress-testing regime where banks’ own models play a key role could give examiners an incentive to demand that more conservative assumptions be embedded in banks’ models. Moreover, examination teams can have a sizable impact on model outcomes, and there is also a concern that different exam teams’ approaches to modeling could lead to disparate capital requirements across banks. More broadly, the biggest concern of moving to a regime where banks’ own models play a key role in stress tests is that the Fed will micromanage banks’ models. For instance, under the Advanced Approaches framework, large, internationally active banks already are allowed to use internal models to calculate their point-in-time capital requirements; however, banks’ own models are so altered in response to requests from bank examiners that
they have reportedly become unusable for internal risk management purposes. Such an outcome in supervisory stress testing models would negate the purpose of using banks’ own models in the first place.

The U.S. is the only advanced economy in which post-stress regulatory capital ratios are exclusively determined using supervisory models. However, some of the challenges presented by allowing banks to use their own models in stress testing are currently being tackled in other jurisdictions. For instance, the Bank of England uses its own models to do peer-benchmarking and ensure a level playing field and consistency of stress-test results across banks. The BoE does not request that banks change their own models; rather, it lets the banks know how much capital they need to hold above minimum requirements. Banks can infer if their projections are excessively optimistic or pessimistic by comparing their own estimates with the BoE’s results. This is a great incentive mechanism for banks to be realistic, as opposed to overly optimistic, in their loss and stressed revenue projections. Assuming that banks try to avoid uncertainty, they have an incentive to hew closely to the BoE’s results to determine with certainty whether and how much they can make equity distributions to their shareholders. Similarly, in the EU-wide stress tests, banks estimate the impact of the supervisory scenarios on risk-based capital ratios using their own internal models, which must be prepared in accordance with a common set of assumptions and an analytical framework that are specified by the European Banking Authority in cooperation with the European Systemic Risk Board, the European Central Bank, and the European Commission.

CONCLUSION

Given the problems associated with the use of the Fed’s models outlined in this article, the Fed should seriously consider moving to a regime where banks’ own models play a key role in the supervisory stress tests. This would significantly reduce the uncertainty around capital planning at each bank, increase efficiency, and expand credit availability to bank-dependent borrowers. The Fed’s models would still be important in supervisory stress tests to conduct peer benchmarking and ensure consistency and a level playing field across participating banks. This approach would also improve financial stability by eliminating the risk of the industry coalescing around the same models as those used by the Fed, and it would require the Fed’s examiners to focus their efforts on portfolios where the differences between the Fed’s models and banks’ models are the greatest.

ENDNOTES

1 Broadly, there are two types of U.S. stress tests – Dodd-Frank Act stress tests (DFAST) and comprehensive capital assessment review (CCAR). Under DFAST, both Federal Reserve’s and banks’ own models are used, while CCAR uses only Federal Reserve’s own models. This article is about the use of the Fed’s models in stress tests, so it refers to both DFAST and CCAR. See The Clearing House, “The Capital Allocation Inherent in the Federal reserve’s Capital Stress Test,” January 2017 for additional details. Available at https://www.theclearinghouse.org/-/media/tch/documents/tch%20weekly/2017/20170130_tch_research_noteimplicit_risk_weights_in_ccar-final.pdf?la=en


ECONOMIC EXPLANATIONS for why banking crises occur focus on two influences: macroeconomic shocks that cause banks’ loans to become riskier, and banks’ tendency to fund themselves with large proportions of demandable debt or other very short-term debts. An adverse macroeconomic shock that raises the riskiness of bank debt leads risk-intolerant depositors to demand repayment. As banks reduce their lending to fund withdrawals, economic prospects of borrowers worsen and bank losses rise further, producing a substantial further increase in borrower and bank insolvency risk.

This simple explanation has a lot going for it; there has almost never been a major banking crisis that did
not begin with a shock to the value of bank loans, and there is substantial evidence that banks have raised funds primarily in the form of risk-intolerant, short-term debt since commercial banking began about 2,600 years ago in ancient Athens. But there is a problem with this story: It does not do a good job of explaining why some places and some eras witness a large number of banking crises while others do not.

Take an obvious point of comparison: the history of banking crises in Canada and the United States since 1837. Canada has had no banking crises during this 180-year period, while the United States has averaged about one every 12 years. Canada has a more volatile economy (hence bigger shocks), and has a higher average ratio of bank loans to gross domestic product (GDP). Banks in Canada, like those in the U.S., finance themselves primarily from short-term debt. A simple explanation about shocks and bank funding structure would suggest that Canada should have experienced more shocks than the U.S., but the opposite is the case.

A GLOBAL PANDEMIC

When you look at variation in the frequency and severity of banking crises worldwide over time, it's striking how much the frequency has increased during the past four decades. Indeed, we are currently living through a global pandemic of banking crises unlike any the world has seen before. Compared to the period 1874 through 1913 – a time of significant macroeconomic...
volatility and heavy reliance on bank credit – the period of the same length from 1970 through 2009 saw 10 times as many banking crises (defined as episodes of significant bank failure and/or times of sudden system-wide withdrawal of deposits), and banking crises were five times as severe (measuring severity as the negative net worth of failed banks relative to GDP).

Could it be that variation in the way banks are regulated can explain differences across countries and over time in the degree of banking instability? That is certainly true. Regulation defines how banks are created, what they’re permitted to do, what they’re required to do, and how much protection they expect to receive from taxpayers, and these have important consequences for risk-taking. The consequences of regulatory differences across countries and over time are important drivers of the recent pandemic of banking instability. The two most important regulatory contributors to risk are the recent increase in the extent to which taxpayers around the world protect banks from loss, and the encouragement of banks’ involvement in real estate lending. These two policy choices could be called the two “800-pound gorillas in the room” of banking system risk.

In theory, more protection of banks could either increase or decrease systemic risk. On the one hand, protection insulates banks from withdrawal risk by supplying them with funds as needed, and this reduces the potential for bank illiquidity to magnify the shocks that produce banking crises. On the other hand, protecting banks may lead them to undertake more risk, thereby making the financial system more vulnerable to shocks. A large empirical literature has shown that the second influence outweighs the first: Overall, protection substantially raises financial system risk.

It’s accepted that the encouragement of real estate lending by banks unambiguously increases systemic risk. Real estate lending is not a natural niche for commercial banks. Real estate prices tend to be correlated with each other and move closely with the business cycle, making it hard to diversify a loan portfolio dominated by real estate loans. Furthermore, real estate assets have unique properties that make them illiquid (not easy to sell quickly for their fair value). Loans backed by real estate may, therefore, be particularly challenging to liquidate during a crisis as banks that face withdrawal pressures seek to reduce their lending. For these reasons, it isn’t natural for banks funded by short-term debts to specialize in real estate lending, and for the most part, historically, banking systems avoided doing so.

However, if a government wishes to subsidize real estate lending, it often finds that the most convenient way to do so is through banking regulation, despite the adverse consequences for systemic risk. The reason is simple: banks are among the most important entities that are chartered and controlled closely by governments.

These observations about the “two gorillas” of systemic risk raise deeper questions: Why are recent regulatory choices so different from those of the past? Why are so many societies now willing to tolerate banking regulations that predictably produce instability by protecting banks or encouraging banks to make real estate loans? The answers to those questions require political insight. My 2014 book with Stephen Haber, Fragile by Design: The Political Origins of Banking Crises and Scarce Credit, explores why and how political coalitions that produce banking regulations that cause instability have been formed in some times and places but not in others. In particular, we ask why coalitions in control of regulatory outcomes in the United States have been so much more willing to tolerate instability as part of their winning political bargains, and why the two gorillas of taxpayer protection of banks and subsidization of real estate lending risks have become more important recently than they were in the past.

When asking questions about the political influence on banking regulation, it is helpful to begin by...
recognizing that banking coalitions aren’t just about the interests of bankers. This makes the political economy of banking regulation a bit different from that of other industries. Political economy theories of regulation often focus on the “capture” of regulation by firms in the regulated industry. Because consumers of particular products tend not to organize as a group politically but producers within a particular industry can and do organize in pursuit of their collective interests, producers often are able to influence the regulation of their industry to favor their interests at the expense of consumers.

But this logic does not apply to banks. Banks’ customers – especially borrowers – often organize themselves politically. In the United States, the agrarian populist movement (which played a major role in financial regulation from the beginning of the republic until the latter half of the 20th century) largely reflected the interests of agricultural borrowers. Those borrowers successfully promoted particular bank regulatory policies – most importantly, “unit banking” laws that limited the establishment of branching banks – that they believed improved their access to local agriculture-related credit. Beginning in the 20th century, urban mortgage borrowers became an organized interest group (assisted by various real estate industry special interests) and used their political influence to push banking regulation (and other financial regulatory policies) to subsidize the risks of mortgage lending.

Why didn’t Canadian borrowers succeed in forming winning political coalitions to control the structure of Canada’s banking system, as their neighbors to the south had done? It was not for lack of trying. For example, in the 19th century, agrarian interests tried to abolish the branch banking system of Canada and replace it with a U.S.-style unit banking system. They also attempted to pass financial assistance packages for rural borrowers similar to those in the U.S., but those efforts failed.

As Stephen Haber and I explain in chapter 9 of *Fragile by Design*, the structure of the Canadian government (the centralization of regulatory rule-making and the powerful role of its unelected Senate) made it impossible for rural borrowers to succeed. Government structure matters in determining which political coalitions win in the struggle over control of the banking system.

**A LOBBYING CONNECTION**

Interestingly, U.S. history shows a connection between regulatory lobbying to protect banks and the subsidization of particular classes of loans. Rural borrowers were a crucial force pushing for deposit insurance to be enacted in individual states, and later at the national level in 1933, as a means of expanding their access to credit. Protection of bank deposits created value for protected banks, which regulation forced them to share with bank borrowers in the form of more favorable credit terms for rural credit.

"Government structure matters in determining which political coalitions win in the struggle over control of the banking system."

The same sorts of rent-sharing arrangements from protection occurred in U.S. mortgage market and banking regulation during the 1990s and 2000s, and such protection was a major means of government subsidization of mortgage lending risk. Deposit insurance, implicit protection of other liabilities of too-big-to-fail banks, and implicit guarantees of the debts of the government-sponsored enterprises (GSEs) Fannie Mae and Freddie Mac created protection rents that banks and GSEs were forced to share in the form of mortgage risk subsidization (as described in detail in chapters 7 and 8 of *Fragile by Design*).

Lax prudential regulation of banks and GSEs was part of the creation of rent from protection. Lax regulation permitted increased risk of default, which increased the size of the transfer from the government to the coalition receiving it.
Recent U.S. banking history, therefore, has been a prominent example of the marriage between the two gorillas of systemic risk: real estate lending risk subsidization and government protection of banks. Unfortunately, this unholy union has become a global pattern over the past four decades. Indeed, the mutually reinforcing systemic risks produced by marriages of these two gorillas around the world can explain the current pandemic of crises that have been so destructive to banking systems.

Deposit insurance by governments and other ad hoc protections of bank liabilities by governments were relatively rare prior to 1980. As Figure 1 shows, however, protection of bank debts expanded dramatically in recent years. A 2008 study by Demirgüç-Kunt, Kane, and Laeven shows that both domestic and international political pressures played a role in explaining the recent wave of expanded protection of banks. Internationally, the International Monetary Fund, the World Bank, and the European Union all encouraged the expansion of safety nets for banks. In part, that advocacy likely reflected the desire to solve short-term banking system problems by using insurance to give banks breathing room. However, the long-term consequences for increasing system risk have been extremely debilitating.

A 2015 study by Jordà, Schularick, and Taylor shows that the proportion of real estate lending in bank portfolios in the countries in their sample has grown dramatically since 1980, from about 40% of loans to nearly 60%. In a new study, Sophia Chen and I analyze the extent to which the expansion of government protection of banks and the creation of protection rents for banks that this implies help to explain the increase in bank involvement in real estate lending. We find strong evidence that exogenous increases in bank protection will lead to resulting increases in mortgage lending.

Not only has the subsidization of real estate lending risk helped to promote a wave of severe banking crises around the world, it has also reduced economic growth.
To identify causality properly, it is necessary to identify exogenous changes in protection – that is, changes that are not themselves a consequence of local banks’ condition or related political responses to their condition. We use Demirgüç-Kunt, Kane, and Laeven evidence that international political pressures – which cannot plausibly be explained by the developments in the countries adopting or expanding protection – explain much of the adoption and expansion of protection. Formally speaking, our econometric analysis occurs in two stages: First, we show that external political factors explain the expansion of protection; second, we show that changes in protection that can be traced to those factors also result in significant expansion of bank mortgage lending. As in the case of the U.S. as described above, protection of banks creates rents that political coalitions direct toward risky real estate lending.

Not only has the subsidization of real estate lending risk helped to promote a wave of severe banking crises around the world, it has also reduced economic growth. A 2015 study by Cournède and Denk shows that the growth in bank consumer lending (which is mainly mortgage lending) has been associated with an economic growth-reducing expansion of bank lending.6

CONCLUSION

Together, these various studies show that the current pandemic of banking crises, with their unprecedented costs to taxpayers and adverse consequences for economic stability and growth, should be viewed from a broad political economic, rather than a narrow economic, perspective. Banking crises are not an inevitable consequence of business cycles or the structure of banks. Countries that make political choices that eschew government protection of banks and government subsidization of real estate lending risk can avoid the costly systemic risk increases that plague the world’s banking system today. Of course, that doesn’t mean that it’s easy to reduce systemic risk that arises from the two gorillas; it is easier to identify politically driven problems that to organize political coalitions to correct them. ■

ENDNOTES

2 Id. Chapter 1.
A number of commentators and U.S. regulators have begun pointing to the need to reset the regulatory and supervisory approach to bank board governance by more precisely differentiating between the role of the bank board (oversight and guidance) and that of management (day-to-day execution). Calls for reviewing and updating expectations and requirements to clarify this important distinction coincide with rapid change and transformation in the banking industry.

Increasing cyberthreats and other developments such as growing competition from and alliances with technology firms, as well as increasing use of technology to improve and enhance customer offerings (e.g., mobile banking) and operations (e.g., the use of blockchain or artificial intelligence to change the way banks collect, access, and analyze data), present new opportunities and risks. As technology-related issues requiring board attention have expanded, some industry experts have argued that regulators should consider changes in requirements or expectations with respect to the role and composition of the bank board. Some in this camp believe that boards and individual directors should become more specialized by including experts in technical fields (e.g., in IT security). In effect, some have argued that the role of the board should be refashioned in order to carry out highly technical responsibilities.
As regulators continue to reassess and better tailor the balance between the roles of the board and management, an appropriate approach would be to recognize and re-emphasize that the fundamental nature of the board’s role should not fundamentally change even as the industry is reshaped through advances in technology and changes in the marketplace. In other words, as applied in the context of today’s rapidly changing world of banking, while boards will appropriately place an increasing focus on technology-related issues and risks, the responsibilities of the board and the basic approach to board oversight – which are spelled out in The Clearing House’s “The Role of the Board of Directors in Promoting Effective Governance and Safety and Soundness for Large U.S. Banking Organizations” (the “2016 TCH Role of the Board Report”) – should largely remain consistent.

Indeed, especially in times of rapid transformation, both the regulatory community and industry should be alert to the hazards of blurring the lines between the role of the board and management and rigid regulatory mandates around board compliance responsibilities and board composition. Forthcoming regulatory reviews of both (i) the regulatory burdens imposed on bank boards, and (ii) the adequacy of certain existing regulations and guidance in the face of transformational changes and related risks provide important opportunities in this regard.
As in any rapidly changing environment, boards of directors that stay abreast of marketplace developments and adopt an “informed and active” approach to carry out their oversight functions as described below should be well-positioned to help guide their institutions through transformational changes.

This article discusses recent statements by regulators and policymakers (and TCH’s Committee on Bank Governance’s dialogue with them) and summarizes a framework for regulators to consider as they navigate the complex supervisory and regulatory implications of technological and business transformations and as boards oversee new forms of risks.

I. RECENT REGULATORY FOCUS ON CLARIFYING THE ROLE OF THE BOARD VS. THAT OF MANAGEMENT

Although certain regulatory requirements appropriately serve to direct board focus toward fundamental safety and soundness issues, a number also extend beyond core board functions, requiring or potentially setting expectations of board involvement that could divert from these core board functions. The maintenance of the separate roles of the board and management is essential for boards to perform their unique oversight function. When requirements are imposed in a prescriptive way or include ambiguous language that could be interpreted as recasting this separation, they can make it challenging for boards to concentrate on satisfying their larger role of focusing on strategy and emerging risks and trends.

Two reports issued by international organizations in 2015 raised awareness of this issue at international and U.S. levels and spurred additional dialogue.

• 2015 INTERNATIONAL MONETARY FUND REPORT: An IMF review of the U.S. bank supervisory framework points to the concern that U.S. bank regulations and guidance often do not clearly distinguish between the board and senior management, leading to possible confusion between the roles. The IMF noted that there were numerous examples in both U.S. regulations and actual supervision where the term “board and senior management” was used where good practices would dictate that only one of the two be responsible for the task in question. For example, this formulation creates risks that too much day-to-day decision-making will be assigned to the board of directors.

• 2015 BASEL CORPORATE GOVERNANCE PRINCIPLES: In July 2015, the Basel Committee on Banking Supervision issued revised guidelines on corporate governance principles for banks. Much of the industry-supervisor dialogue during the consultative process related to the appropriate demarcation between the duties of the board of directors versus senior management. Earlier versions of the guidelines conflated the role of the board and management by requiring the board to “ensure” certain results. An important change to the final version of the document was the general use of the term “oversee and be satisfied with” when referring to board responsibilities.

Recently, Federal Reserve Governor Jerome Powell, the Chair of the Federal Reserve Board Committee on Supervision and Regulation, said that U.S. supervisory expectations should be reviewed to ensure boards can continue to be effective in their role in setting the overall strategic direction of the banking institution, while overseeing and holding senior management accountable for operating the business profitably, safely, soundly, and in compliance with applicable laws. The Federal Reserve has launched an effort to reassess whether Federal Reserve supervisory expectations for boards need to change to ensure that these principles, and not an ever-increasing checklist, are the basis of supervisory work related to bank holding company boards.

In addition, the June 2017 U.S. Treasury Report entitled “A Financial System That Creates Economic Opportunities: Banks and Credit Unions” (the “Treasury Report”) articulated concerns regarding the blurred lines between director oversight and the role of management and overburdening of the board with compliance responsibilities. The Treasury Report recommended an “inter-agency [bank regulatory] review of the collective requirements imposed on Boards in order to reassess and better tailor these aggregate

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expectations and restore balance in the relationship between regulators, Boards, and bank management.

We applaud recent reports and statements by public sector officials such as these as well as efforts by regulators to deepen their understanding of these critical points through retrospective reviews of existing guidance and policy statements.

In addition to retrospective reviews of requirements imposed on the board, future regulatory pronouncements imposing responsibilities on or conveying expectations with respect to bank boards should also reflect, embrace, and emphasize the performance of core board functions. In TCH’s view, and as described in the 2016 TCH Role of the Board Report, these functions are:

- **Function 1:** Reviewing and approving the strategic objectives and plans

- **Function 2:** Monitoring financial performance and condition

- **Function 3:** Talent management for the CEO and other senior executives

- **Function 4:** Overseeing the risk management and internal control frameworks, including top-tier policies and plans in fundamental areas

- **Function 5:** Reinforcing, demonstrating, and communicating the “tone at the top” for the values and culture of the organization and overseeing enterprise-wide approaches/programs intended to promote organizational values, culture, and reputation

In this regard, there is a real opportunity to clarify the important distinction between the role of the board and that of management as U.S. bank prudential regulatory authorities undertake to review and, in some cases, modify guidance in various areas to take into account emerging technologies and new marketplace trends and risks.

- For example, a specific opportunity exists in the area of outsourcing to third-party providers and partnering with financial-technology (FinTech) firms. U.S. federal banking agency officials have recently noted that they are actively reviewing third-party risk management guidance to determine whether any adjustments or clarifications may be appropriate in view of developments such as those brought about by FinTech and FinTech partnerships with banking institutions.

The maintenance of the separate roles of the board and management is essential for boards to perform their unique oversight function.

- Bank boards oversee certain third-party risk management processes in order to have appropriate line of sight into, e.g., operational, reputational, and strategic risks arising from strategically and/or operationally important relationships. Several aspects of existing third-party risk management guidance, however, do not clearly distinguish between the role of the board and the role of management. Other aspects of the guidance (e.g., that the board should “approve” a number of operational standards, methodologies, and agreements) are so granular and operational in nature that they risk diverting board focus and attention from critical oversight functions (i.e., the five core board functions cited above).

There is no question about the importance of understanding and effectively managing risk in a rapidly evolving environment. The problem is how to do so in a way that does not blur the distinction between oversight and management and that preserves a board’s ability to exercise its oversight in an independent fashion.

We encourage regulators to specifically recognize in future updates and “modernization” of guidance
the authority, and utility of the board designating – whether formally or informally – senior management and/or management committees to address tasks that do not warrant board time or approval.

II. INFORMED AND ACTIVE BOARD OVERSIGHT

Over the past several years, representatives of TCH’s Committee on Corporate Governance have engaged in a constructive dialogue with regulators and thought leaders in the U.S. and Europe around bank governance and the role of the bank board.

During these conversations, we regularly discuss what it means for a board to be “effective” and “engaged.” As TCH’s “Guiding Principles for Enhancing U.S. Banking Organization Corporate Governance” (2015) (the “GPs”) and the 2016 TCH Role of the Board Report note, effective corporate governance is determined by the quality, skills, expertise, and judgment, individually and collectively, of the members of the board. Further, an informed and actively engaged board is a core element of effective governance.

Boards should make a meaningful commitment to carrying out their oversight functions in a strong, independent, and proactive manner – i.e., oversight isn't passive.

Although the approaches taken by individual boards and board committees will appropriately vary, the following are illustrations of how boards may perform an active oversight role in three aspects of a board’s playbook. Various considerations, including the board’s assessment of management’s capabilities and its confidence in the openness with which management approaches issues, may be relevant to how boards opt to apply these aspects of the “playbook” in the context of their own institutions.

1. THE OVERSIGHT DELEGATION-REPORTING FEEDBACK LOOP: The oversight feedback loop (where the board delegates responsibility to management, management reports back to the board, and the board provides feedback to management on reports) becomes particularly important where the risk landscape changes rapidly. Active oversight may be exhibited through actions, including directors who do the following:

   • Convey expectations to management relating to ongoing (e.g., periodic updates) and special reporting to the board on what the board believes it needs to know for effective oversight (generally, timely, well-presented, and understandable information that a nonspecialist can understand on the material risks and areas where corrective action is required), and a “no-surprises” approach to escalation that addresses what the potential problems are (not just what is going right).

   • Provide feedback to management on the format and content of information presented to the board.

   • Engage in discussions outside of the formal board meeting to gain additional perspectives on the views of management and other personnel. As an example, if the board becomes aware of material deficiencies or opportunities for enhancements in management’s operation
of the business, in reporting or compliance systems, in risk management or otherwise, this approach provides a flexible framework for the board to be informed of management’s planned responses and for periodic progress updates in the course of its oversight of the company. If progress lags, the board has the opportunity for more frequent and/or deeper involvement, as it determines appropriate.

2. PROCEDURAL CHECKS, REVIEWS, AND INTERNAL AND EXTERNAL “CHALLENGE” OF NEW INITIATIVES/RISK MANAGEMENT OF EMERGING RISKS: In an environment where risks continue to evolve quickly, boards may find it useful to understand and oversee the use of independent assessments and/or industry benchmarking to vet and inform new managerial initiatives, recommendations, and findings presented to the board. Active oversight may be exhibited through actions, including that directors do the following:

- Ask informed, probing questions of management regarding the institution’s use of internal and/or third-party assessments (i) of risk management programs addressing new sources of risk as well as examination findings and resources being dedicated to risk management, and (ii) important initiatives.

- Articulate an approach to assure that there is appropriate coverage of developing risks (e.g., adequate internal and/or external expertise) to provide a level of comfort that the bank is organized appropriately and prepared to address potential threats.

3. PERIODIC REVIEW AND EVALUATION OF WHETHER THE BOARD IS USING ITS TIME AND RESOURCES MOST EFFECTIVELY: Especially in times of technological and business model transformation, directors may periodically ask themselves (e.g., through an assessment process), whether they are using their time and resources most effectively. Active oversight may be exhibited through actions, including that directors do the following:

- Articulate an approach for determining what matters should be addressed at the board and committee level.

- Allow time for “deeper dives” focused on new initiatives and sources of risk.

- Consider the need for updated, refocused, and/or expanded board education/training.

Boards and regulators have an important function to carry out in a rapidly changing and complex environment.

There continues to be an ongoing debate over whether bank boards need directors with greater technical expertise in the “digital age.” The debate sometimes misses the point that “experts” may not have other critical experience or capabilities complementing skill needs/gaps for the board on a collective basis. An assessment of the collective capabilities of the board and how the board works together is more meaningful than an assessment of individual skills. Accordingly, boards themselves should make their own determinations on how best to ensure an appropriately knowledgeable perspective on technology-related matters for purposes of carrying out their oversight responsibilities – i.e., whether for (i) one or more board member(s) to have particular expertise, (ii) the board to retain external experts for briefings or guidance or education (e.g., for board members to be brought up-to-date on key developments and, more generally, maintain an appropriately knowledgeable perspective and awareness on technology-related issues), and/or (iii) the board to rely on their access to the financial institution’s own resources or staff with such expertise, as well as assessments by third parties engaged by management.
The board’s role should be to provide informed oversight, and the board should have the flexibility to choose which source(s) to draw upon, in light of the facts and circumstances, to ensure it has an appropriately knowledgeable perspective to do so.

III. CONCLUSION

Boards and regulators have an important function to carry out in a rapidly changing and complex environment. We are encouraged to see continued discourse around the need to clearly distinguish the role of the board versus that of management at a time when board stewardship and strategic guidance has never been more important for the banking industry.

There is perhaps a natural temptation to consider new risks as somehow different from existing ones—requiring new structural approaches or prescriptive solutions such as a fundamentally different approach to board governance. Experience has shown that the hot topics on the board agenda today may change over time, but the distinction between the role of the board versus that of management remains a core precept for effective governance.

ENDNOTES

1 See, e.g., “Spring 2017 OCC Semi-Annual Risk Perspective.” “Strategic planning remains important for all banks as they adopt and implement innovative products, services, and processes in response to the evolving demands for financial services and the entrance of new competitors, such as out-of-market banks and nonbanks. Boards of directors and management should comprehensively understand the benefits and risks of strategic changes before implementation.”

2 As described in greater detail in Note 5 below, on August 3, the Federal Reserve issued proposed guidance intended to “better distinguish” between the roles and responsibilities of the board of a banking institution and senior management.


4 See, e.g., Tracy, R., Wall Street Journal, p. B10 (August 3, 2017) (according to Federal Reserve Governor Powell, “The [objective] is not at all to lighten the workload of directors or make their life easier . . . our expectations are very high . . . It is an attempt to get [boards] out of the weeds and put them focusing on the big issues.”). See also Governor Powell, Brief Remarks at the Global Finance Forum (“For example, we need to allow boards of directors and management to spend a smaller portion of their time on technical compliance exercises and more time focusing on the activities that support sustainable economic growth”) (April 20, 2017).

5 On August 3, 2017, the Federal Reserve took an important step with respect to this initiative by issuing for public comment a proposal consisting of the following three parts: (1) proposed guidance on supervisory expectations for boards of directors of bank holding companies with at least $50 billion in assets, (2) a proposal to eliminate or amend certain existing Federal Reserve guidance for boards that contains redundant, outdated, or irrelevant supervisory expectations, and (3) proposed guidance to clarify expectations for communicating supervisory findings to the board and senior management. (The Federal Reserve’s three part proposal is available at: https://www.federalreserve.gov/newsevents/pressreleases/files/bcreg20170803a1.pdf.) The Federal Reserve indicated that the proposed guidance is intended to “better distinguish” between the roles and responsibilities of the board of a banking institution and senior management. The Federal Reserve also indicated that it will continue its review of guidance (including, interagency guidance) and Federal Reserve regulations, and make revisions thereto as it considers appropriate, in order to better align regulatory requirements or expectations with appropriate board responsibilities. This is a significant step in recognizing a key issue for boards. We anticipate that thoughtful public comments will assist the Federal Reserve in fashioning its final guidance and continuing its efforts to support the ability of boards to focus on their core board functions.

6 The Treasury Report cited to the 2016 TCH Report on the Role of the Board noting that according to the TCH Report “blurring of this distinction [between the role of the board and senior management] detracts from effective governance by potentially reducing the Board’s ability to focus on its core oversight functions, and therefore impairing the Board’s ability to perform its critical oversight role, and creating uncertainty as to roles and responsibilities.”

7 See, e.g., Governor Lael Brainard, “The Opportunities and Challenges of Fintech” (December 2, 2016).

8 By way of illustration, Federal Reserve guidance prescribes that “The board of directors and senior management of a financial institution should determine whether proposed limitations [of contractual liability in service provider contracts] are reasonable when compared to the risks to the institution if a service provider fails to perform.” (FRB, Guidance on Managing Outsourcing Risk, SR 13-19 (December 5, 2013)). In addition, OCC guidance prescribes that: “The OCC expects the bank’s board of directors and management to: develop appropriate alternative ways to analyze . . . critical third-party service providers, establish risk-mitigating controls, be prepared to address interruptions in delivery . . . retain appropriate documentation of all their efforts to obtain information and related decisions, ensure that contracts meet the bank’s needs” (emphasis added), (OCC, FAQs to Supplement OCC Bulletin 2013-29 (June 7, 2017)).

9 By way of illustration, OCC guidance prescribes that the board of directors “approve[s] contracts with third parties that involve critical activities” (OCC Bulletin 2013-29 (October 30, 2013)). OCC supplemental examination procedures also suggest that board minutes should generally indicate that the board “reviews and approves” third-party risk management due diligence results and various methodologies, contracts and management plans. (The OCC Supplemental Examination Procedures for Risk Management of Third-Party Relationships (January 2017)).

10 The TCH GPs and the 2016 TCH Role of the Board Report collectively provide a more comprehensive discussion on how banking organization boards may approach carrying out their core board functions.

11 As a practical matter, most board engagement will be with senior management, although directors may find it useful to periodically meet with and/or receive information from other members of management/personnel, risk officers, internal auditors, outside advisers and consultants, and bank examiners.

12 See GPs (Commentary to Section 7(a)) for a discussion regarding board composition and the merits of having a board with a diversity of experiences and perspectives to draw upon.

13 Many institutions employ teams of professionals who are highly knowledgeable in technical areas such as IT security. As noted above, board members may well want to understand the processes for periodic third-party assessments (or benchmarking) of the institution’s approach even in cases where internal teams are at the frontier of knowledge in a given area.
The regulatory landscape is evolving before our eyes.

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Anticipate tomorrow. Deliver today.
As shown in Exhibit 1, The Clearing House Bank Conditions Index (TCHBCI) in the first quarter of 2017 had the highest level of resiliency since the start of the index in the first quarter of 1996. The index provides a quantitative assessment of the resiliency of the U.S. banking sector and is constructed using a wide range of common indicators of bank condition. The aggregate index and all of the subindexes take values between 0 and 100 to allow for a straightforward comparison of each category over time. A value of the index close to 100 corresponds to a banking sector that is the least vulnerable it has ever been since the first quarter of 1996, the first available data point of the index. In contrast, a value close to 0 implies that the U.S. banking sector is as vulnerable as it has ever been over that interval.

As shown in Exhibit 2, the increase in resiliency in TCHBCI relative to the fourth quarter of last year was widespread across all categories of the index. Specifically, the categories that experienced the most notable increases were risk aversion, profitability, interconnectedness, and asset quality. The increase in the level of banks’ risk aversion is in most part driven by the decline in the ratio of loans to GDP. In particular, the pace of growth in loans and leases slowed markedly, from 2.7% in the fourth quarter of last year to -0.3% in the first quarter of 2017. The decline in loans and leases on banks’ books in the first quarter is likely attributable to the recent increase in both short-term and long-term interest rates. On the business side, in response to the rise of short-term rates and the expectation that the Federal Reserve will increase short-term interest rates further this year, corporations turned to the bond market to secure funding at what are still relatively low interest rates, and have used some of those proceeds to pay down some of their outstanding C&I loans. On the residential real estate side, higher longer-term interest rates also caused a noticeable decline in mortgage refinancing applications. That said, regulatory headwinds arising from tighter banking regulations have likely continued to put downward pressure on loan growth.

The other categories of the index also shifted toward levels consistent with greater bank resilience. Banks recover from adverse shocks primarily by rebuilding capital through retained earnings, so a more profitable banking system is more resilient. Although bank profitability is still low by historical standards, it rose in the first quarter of 2017, mainly because of a rise in non-interest income as net interest margins were about unchanged. Moreover, bank interconnectedness continued to decline (consistent with an increase in resilience) due importantly to a reduction in the conditional value at risk, or CoVaR, a market-based measure of systemic risk that we added to the index this quarter as an additional measure of interconnectedness. The CoVaR estimates the losses the financial system would incur if one of the U.S. globally systemically important banks were to be in distress. On the asset quality side, all the subcomponents improved over the quarter with the exception of net charge-offs.
which were about unchanged. Among the remaining categories of the index, capital and liquidity rose further, driven by increases in risk-based regulatory capital ratios and holdings of high-quality liquid assets, respectively. On the liquidity side, although the gap between the maturity of assets and liabilities continued to rise, banks’ dependence on short-term wholesale funding remains at very low levels.

Finally, Exhibit 3 provides the readings on each of the six categories that make up TCHBCI at two different points in time: (i) the end of 2008, the nadir of the past crisis, and (ii) the most recent quarter. Points plotted near the center of the chart indicate a high degree of vulnerability in that category while points plotted near the rim indicate high resiliency. As shown by the red line, in the fourth quarter of 2008 (the quarter immediately after the failure of Lehman Brothers), almost all categories of the aggregate index were at very low levels, indicating the presence of acute vulnerabilities. Over the years since the crisis, almost all categories of the index have improved considerably, as shown by the blue line, especially the capital and liquidity positions of U.S. banks. These improvements largely reflect the efforts of commercial banks to increase their capital and liquidity following the financial crisis, the more stringent capital and liquidity requirements that are part of Basel III, and the U.S. stress tests. ■

1 See the research note and accompanying materials available at theclearinghouse.org/research/tch-bank-conditions-index
Research from Around the Industry: ACADEMICS, THINK TANKS, AND REGULATORS

Research Rundown provides an overview of the most groundbreaking and noteworthy research on critical banking and payments issues and seeks to capture insights from academics, think tanks, and regulators that may well influence the design and implementation of the industry’s regulatory architecture.
The authors evaluate the economic costs and benefits of bank capital in the U.S., accounting for the impact of liquidity and resolution-related regulations on the probability of a crisis. Analysis reveals that increases in the banks’ cost of funding are transferred to borrowers, thus hindering economic output. They find that levels of bank capital between 13% and 26% maximize net benefits.

This paper compares regulatory capital requirements under the Dodd-Frank Act with those under the proposed Financial CHOICE Act. They find that most banks would not qualify for the 10% leverage ratio option unless they add considerable amounts of capital. However, most large banks are actually very close to the proposed leverage threshold and are more likely to gain from this regulatory relief. The paper also indicates that banks are likely to increase risk-taking while trying to qualify for the “off-ramp” option.

This paper studies optimal bank capital requirements in an economy where bank losses have financial spillovers. The spillovers amplify the effects of shocks, making the banking system and the economy less stable. The spillovers increase with banks’ financial distortions, which in turn increase with banks’ credit risk. Higher capital requirements dampen the current supply of banks’ credit, but mitigate banks’ future financial distortions. Thus, this paper argues that capital requirements should be raised in response to both an expansion of banks’ credit supply and an increase in expected credit losses. They should be lowered close to one-to-one in response to an increase in realized bank losses.

The paper conducts an econometric analysis on the long- and short-run implications of the Basel III/CRD IV reforms on U.K. banking activity. The paper finds that in response to an increase in capital requirements, banks increase credit spreads to nonfinancial corporate borrowers before households in order to reduce exposures to riskier borrowers with shorter maturity to maximize the reduction in risk-weighted assets. Over the long run, banks increase lending spreads across both sectors to recover the increase in funding costs.
**LIQUIDITY AND LENDING**

**BIS WORKING PAPER: THE SHIFTING DRIVERS OF GLOBAL LIQUIDITY**  
(Avdjiev, Gambacorta, Goldberg & Schiaffi)

The post-crisis period has seen a considerable shift in the composition and drivers of international bank lending and international bond issuance, the two main components of global liquidity. The paper analyses the shifting sensitivities of both types of flows since the crisis to drivers including: U.S. monetary policy, global risk conditions, changes in country composition of lending banking systems, and changes in the behaviors of creditors involved in international financial flows.

**NBER WORKING PAPER: INTERNAL CAPITAL MARKETS IN TIMES OF CRISIS: THE BENEFIT OF GROUP AFFILIATION IN ITALY**  
(Santioni, Schiantarelli & Strahan)

This paper shows that in Italy, firms in business groups have been more likely to survive the challenging environment following the global financial crisis and the euro crisis compared to unaffiliated firms. Better performance stems from access to an internal capital market; actual internal capital transfers increased during the crisis, and these transfers move funds from cash-rich to cash-poor firms and also to those with more favorable investment opportunities. The paper’s results highlight the benefits of internal capital markets when external capital markets are tight or distressed.

**FRB PHILADELPHIA WORKING PAPER: FINTECH LENDING: FINANCIAL INCLUSION, RISK PRICING, AND ALTERNATIVE INFORMATION**  
(Jagtiani & Lemieux)

The authors explore advantages and disadvantages of loans made by the Lending Club versus those originated through traditional banking. The authors find that the use of alternative information has allowed borrowers that would traditionally be classified as subprime to get better loan grades and therefore lower credit costs from the Lending Club. In addition to penetrating more underserved areas, consumers pay smaller spreads on loans with the same risk of default through the Lending Club. The findings imply that FinTech can provide wider access to credit at a lower cost due the differences in the way these lending channels are regulated and suggest that banks could benefit partnering with FinTech for access to alternative data sources and big data.

**FRB OF KANSAS CITY: LENDING IMPLICATIONS OF U.S. BANK STRESS TESTS: COSTS OR BENEFITS?**  
(Acharya, Berger & Roman)

While the U.S. bank stress tests aim to improve financial system stability, they may also affect bank credit supply. Testing a number of hypotheses, the paper’s results are consistent with the Risk Management Hypothesis, under which stress-tested banks reduce credit supply – particularly to relatively risky borrowers – to decrease their credit risk. The findings do not support the Moral Hazard Hypothesis, in which these banks expand credit supply – particularly to relatively risky borrowers that pay high spreads – increasing their risk.

**NBER WORKING PAPER: THE DECLINE OF BIG-BANK LENDING TO SMALL BUSINESS: DYNAMIC IMPACTS ON LOCAL CREDIT AND LABOR MARKETS**  
(Chen, Hanson & Stein)

Small business lending by the four largest U.S. banks fell sharply relative to other banks beginning in 2008 and remained depressed through 2014. This paper explores the consequences of this credit supply shock, finding that in high Top 4 counties, the aggregate flow of small business credit fell and interest rates rose from 2006 to 2010. In this period, fewer businesses expanded employment, the unemployment rate rose, and wages fell. Exploring how high Top 4 counties adjusted to this shock from 2010 to 2014, the authors find that the flow of small business credit has slowly recovered in affected counties, as smaller banks, non-bank finance companies, and online lenders have filled the void left by the Top 4 banks. However, loan interest rates remain elevated, suggesting that credit conditions are still tighter in these areas.
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MACROPRUDENTIAL POLICY

IMF WORKING PAPER: MACROPRUDENTIAL POLICY SPILLOVERS: A QUANTITATIVE ANALYSIS (Kang, Vitek, et al.)

Using event study and panel regression analyses, the authors present evidence that liquidity and macroprudential policy measures have small but regionally concentrated credit and output spillovers to cross-border banking activities worldwide while interventions focused on capital do not. Adjustments to the countercyclical capital buffer were also found to have the potential to generate spillovers affecting countries and their largest counterparties.

FRBNY STAFF REPORT: MACROPRUDENTIAL POLICY AND THE REVOLVING DOOR OF RISK: LESSONS FROM LEVERAGED LENDING GUIDANCE (Kim, Plosser & Santos)

The authors studied interagency guidance on leveraged lending and revealed that guidance was most effective on large, closely supervised banks that were given clear directives. This interagency guidance also triggered a migration of leveraged lending to nonbanks that have less-stringent lending policies. The authors concluded that non-banks increased their borrowing following the issuance of guidance to grow their leveraged lending. While this guidance reduced the leveraged lending activity of the banks, it is unclear whether it actually reduced the risk that these loans pose for greater financial stability.

BIS WORKING PAPER: MACROPRUDENTIAL POLICY AND BANK RISK (Altunbas, Binici & Gambacorta)

This paper investigates the effects of macroprudential policies on bank risk through a panel of banks operating in 61 advanced and emerging market economies. First, the authors find evidence suggesting that macroprudential tools have a significant impact on bank risk. Second, bank responses to changes in macroprudential tools differ depending on their specific balance sheet characteristics. In particular, smaller, weakly capitalized banks and those more dependent on wholesale funding react more strongly to changes in macroprudential tools. Third, controlling for bank-specific characteristics, macroprudential policies are more effective when tightened than when eased.

FRB BOSTON WORKING PAPER: BANK’S SEARCH FOR YIELD IN THE LOW INTEREST RATE ENVIRONMENT: A TALE OF REGULATORY ADAPTATION (Wang)

This paper examines whether the low interest rate environment that has prevailed since the Great Recession has compelled banks to reach for yield, focusing on a bank’s exposure to interest rate risk through the maturity mismatch between its assets and liabilities. It finds evidence that the banks that faced less enhanced regulation after the financial crisis took on assets with longer maturities or prepayment risk, while those banks designated as systematically important and thus subjected to expanded post-crisis regulations have substantially shortened the average maturity of their assets since the crisis. There is some evidence that greater maturity mismatch is slightly more associated with a higher net interest margin during the post-crisis years. After the taper tantrum in 2013, these two groups of banks also adjusted their securities holdings in different ways, consistent with the differential regulatory accounting treatment.

NBER WORKING PAPER: SUPPLY AND DEMAND-SIDE FACTORS IN GLOBAL BANKING (Amiti, McGuire & Weinstein)

This paper addresses a question crucial to understanding international transmission of financial shocks: What is the role for supply and demand forces in determining movements in international banking flows? The authors find that during non-crisis years, bank flows are well-explained by a common global factor and a local demand factor. But during times of crisis, flows are affected by idiosyncratic supply shocks to a borrower country’s creditor banks. This has important implications for why standard models break down during crises.
REAL-TIME ACROSS THE UNITED STATES

...the time is now

We believe that sustainable economies are powered by easy access to and movement of money.

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“Notice and choice” has been a mainstay of policies designed to safeguard consumer privacy. Using field experiment data from the MIT digital currency experiment, this paper investigates distortions in consumer behavior when faced with notice and choice, which may limit the ability of consumers to safeguard privacy. First, the authors find that small incentives may explain the privacy paradox: While people say they care about privacy, they are willing to relinquish private data quite easily when given an incentive to do so. Second, small navigation costs have a tangible effect on how privacy-protective consumers’ choices are, often in sharp contrast with individual stated preferences. Third, the introduction of irrelevant but reassuring information about privacy protection makes consumers less likely to avoid surveillance, regardless of their stated privacy preferences.

This paper presents trends for regulators to consider as they move toward regulating new entrants into the FinTech industry. The author points out that encouraging entry, leveraging innovation, and shaping development of new systems might be the best way to solve the remaining challenges of financial regulation.

The authors use a data set of retail transactions at a national chain bank to examine the influence of location, day of the week, day of the month, and long-term trends on the consumer’s choice of transaction. Some highlights include the finding that as consumers’ payment behavior changed with transaction size, so did the dispersion of that behavior across locations; namely, the use of cash varied widely from location to location. The authors also note that the overall use of cash is declining in favor of debit or credit card transactions, especially for higher value transactions.

The authors use data from U.S. bank acquisitions from 1986 to 2014 to determine whether the predeal geographic reach of bank branches and subsidiaries have any effect on mergers or merger outcomes. They find that (1) banks with greater network overlap before a merger have an increased likelihood of merging in the future, and (2) there are higher cumulative abnormal returns to the acquirer, target, and combined banks. They also find that this network overlap is associated with larger labor cost reductions, managerial turnover, loan quality improvements, and revenue enhancements at target banks.

Following a regulation that capped debit card interchange fees in the U.S., this paper empirically investigates the link between interchange fees and granular deposit account prices. The authors’ results show that banks subject to the cap raised checking account prices by decreasing the availability of free accounts, raising monthly fees, and increasing minimum balance requirements, with different adjustments across account types. They also find that banks exempt from the cap adjusted prices as a competitive response to price changes made by regulated banks. Not accounting for such competitive responses underestimates the policy’s impact on the market, for both banks subject to the cap and those exempt from it.
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