

The Bank Policy Institute

Testimony before the Senate Banking Committee

Guidance, Supervisory Expectations, and the Rule of Law: How do the Banking Agencies Regulate and Supervise Institutions?

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My name is Greg Baer, and I am president and CEO of the Bank Policy Institute.¹ I am here to testify about how legal process has broken down in the regulation and examination of banks. I will not today generally discuss the *substance* of post-crisis requirements imposed by the federal banking agencies; instead, my focus will be on a *process* that has prevented stakeholders in banking policy – not only banks but also their customers, academics, and even Members of Congress – from learning what many of those requirements are, and having a say in their content.

In so doing, I bring to bear not only my perspective as CEO of the Bank Policy Institute, a trade association representing America’s leading banks, but also that of a lawyer and sometime law professor. Over time, the laws and regulations I learned, teach, and in some cases wrote have become decreasingly relevant in practice. The procedural rights and protections that those laws provide are generally obsolescent, as regulation and examination have become increasingly subjective, opaque, and unappealable.

So, this hearing is a welcome development, and I thank the Committee for devoting its valuable time to these issues.

In my testimony, I will describe the laws enacted by Congress to govern the regulatory, examination and enforcement process. I will then describe the actual status quo, and how it diverges significantly from the laws as written. Finally, I will describe recent actions by the Government Accountability Office and some of the financial regulators that hold the potential for reform in this area, and some additional steps that could be taken to restore the rule of law as enacted by Congress.

My testimony today describes how examination reports have been effectively turned into enforcement actions, as their mandates – Matters Requiring Attention and Matters Requiring Immediate Attention, or MRAs and MRIAs — are treated as binding regulations or orders. Furthermore, the basis of those MRAs frequently is not a violation of law but rather a “violation” of guidance that under the law is actually non-binding, or of other standards that also have

¹ The Bank Policy Institute (BPI) is a nonpartisan public policy, research and advocacy group, representing the nation’s leading banks. Our members include universal banks, regional banks and the major foreign banks doing business in the United States. Collectively, they employ nearly 2 million Americans, make 72% of all loans and nearly half of the nation’s small business loans and serve as an engine for financial innovation and economic growth.

neither a legal basis nor an evidentiary foundation. Finally, the reason these examination mandates are treated as binding regulations or orders is because a shadow enforcement regime has grown up post-crisis whereby firms with any unresolved MRA are subject to limitations on their growth – limitations never authorized by Congress.

I should note that my testimony generally does not focus on capital and liquidity rules. Clearly, these are the most important components of banking regulation and universally regarded as the core protection for taxpayers and financial stability. And they generally have been adopted in accordance with the Administrative Procedure Act, and are enforced in a transparent, objective way.² Rather, ironically, it is the regulatory requirements that matter the least that are the most opaque and come with the fewest checks and balances – requirements about how banks manage their vendors, minute their meetings, update spreadsheets, structure reporting lines, or monitor transactions. Those requirements, not the core capital and liquidity requirements, are what have built a vast compliance bureaucracy, and it is those requirements that frequently have prevented banks from branching, investing and otherwise serving new customers and offering new products post-crisis. Over the past few years, many banks that met all of the dozens of capital and liquidity requirements to which they are subject have been unable to open a branch because of perceived failures in areas that are immaterial to their safety and soundness.

If I could stress one theme, though, it would be this: the erosion of the rule of law in banking should not be a concern just to lawyers and bankers. Decisions made behind the examination curtain significantly affect the ability of consumers and businesses to access credit and other financial services, and the terms and price of credit and services. They have every right to comment on the currently non-public and sometimes unwritten rules that affect them. So, too, do academics and other policy experts whose views would be helpful in making those rules better. This, of course, is precisely why Congress enacted the Administrative Procedure Act: not as a sop to regulated entities, but rather out of a genuine and well-founded belief that rules are better made when they are informed by an open and public comment process than when they are made in secret, without fear of public scrutiny or challenge.

The Law as Written

Under the law, banks are examined by the federal banking agencies.³ By law, an examination report is not an enforcement action, and is in no way legally binding. Rather, it is a statement of an examiner's views, and the beginning of a dialogue between examiner and banker. To be sure, bankers generally accept examiner criticisms, and strive to resolve any problems identified. But they sometimes disagree.

² One notable exception, however, is the Federal Reserve's stress testing regime. *See, e.g.,* Jeremy Newell, *The Fed's 2018 CCAR Scenarios: A Look at Process*, Underwritings: The BPI Blog (March 2, 2018), <https://bpi.com/the-feds-2018-ccar-scenarios-a-look-at-process/>.

³ *See* 12 U.S.C. § 248(a)(1) (Federal Reserve); 12 U.S.C. § 481 (OCC – national banks); 12 U.S.C. § 1463, 1464 (OCC – federal savings associations); and 12 U.S.C. § 1820(b) and (c) (FDIC). State-chartered banks are also subject to examination by the relevant state banking agency.

In that case, the law is clear. If the agency wishes the bank to conform to its prescriptions, it must initiate an enforcement action. Congress has provided multiple legal mechanisms for doing so. For example:

- Under section 8 of the Federal Deposit Insurance Act, a federal banking agency may issue an order to halt, remediate or penalize a violation of a law, rule, regulation, or final agency order, an “unsafe or unsound practice,” or a breach of fiduciary duty.⁴
- Under section 39 of the FDI Act, each federal banking authority has prescribed safety and soundness standards relating to internal controls, loan documentation, credit underwriting, interest rate exposure, asset growth, compensation, and other topics. If an institution fails to meet the applicable standards, the regulator may issue an order compelling remediation.⁵
- If the issue relates to capital, under section 38 of the FDI Act, the banking agencies may impose sanctions on a banking institution whose capital levels fall below pre-defined levels. Alternatively, a federal banking agency may issue a capital directive to require a bank to maintain a level of capital deemed reasonable by the regulator.⁶
- For individual employees and directors who engage in misconduct, the federal banking regulators have the authority to bar them from a firm (or the industry) and assess monetary penalties.⁷

In each of the above cases, the affected bank or individual has clearly delineated procedural rights, which generally include the right to be notified of the basis of the order, respond on the merits, and ultimately contest it before an Article III court.⁸ Notably, these procedural rights incentivize both regulator and regulated to negotiate an agreement in lieu of litigation.

Another important procedural right was provided by Congress when it required each banking agency to establish a process for administrative appeal of any material adverse supervisory determination – that is, actions for which there was no formal appeal under the law.⁹ This might include a CAMELS rating or a loan classification.

Finally, all of these procedural rights are supplemented by section 706 of the Administrative Procedure Act, which governs the rule-writing process for all federal agencies and gives any affected person the right to seek judicial review of any final agency action.¹⁰ It serves as the ultimate guarantee that the regulations against which banks are being examined are adopted and administered with due process of law.

⁴ 12 U.S.C. § 1818.

⁵ 12 U.S.C. § 1831p-1.

⁶ 12 U.S.C. § 3907(b); *see also* 12 CFR 3.601 *et seq* (OCC); 12 CFR 263.83 (Federal Reserve); and 12 CFR 324.5 (FDIC).

⁷ 12 U.S.C. § 1818.

⁸ *See* 12 U.S.C. § 1818(h).

⁹ 12 U.S.C. § 4806.

¹⁰ 5 U.S.C. § 706.

The System in Practice

Unfortunately, the laws that I have just described, and the procedural rights that Congress provided in them, have become increasingly irrelevant in practice, supplanted by an alternative, non-public examination and enforcement regime where they are unavailable.

The Shift from Regulation to MRAs Based on Guidance and Ad Hoc Mandates

First, the banking agencies have increasingly avoided notice and comment rulemaking, which under the APA requires the agencies to give prior notice of the rule they propose to issue, seek public comment on that proposal, and explain in any final rule why they have disregarded any comment. Instead, they have (i) issued guidance generally without opportunity for public comment or Congressional review or (ii) imposed mandates through the examination process, and then proceeded to treat each examination mandate as binding as a regulation, contrary to law.

MRAs and MRIAs

A Matter Requiring Attention, or MRA, is the vernacular by which bank examiners communicate criticisms to a bank's management or (increasingly) to the board of directors. MRAs and MRIAs have no basis in law – there is no reference to them in any statute – and they are unenforceable as a legal matter (in contrast to agency *orders*, which are enforceable and subject to due process). In essence, MRAs create a to-do list for the bank that comes at the end of examination report.

Make no mistake, however: the banking agencies take the position that MRAs must be remediated.¹¹ And ask any banker whether remediation of MRAs or MRIAs is optional, and the answer will be no.¹² But you really *can't* ask any banker, because MRAs and MRIAs are included in an examination report, which the banking agencies consider Confidential Supervisory Information; therefore, it is a federal crime for a banker to complain publicly about an MRA.

¹¹ The bank enforcement section of the OCC's Policies and Procedures Manual states that an examination report may contain "concerns," which are expressed in an MRA. It then states: "The actions that the board and management take or agree to take in response to violations and concerns are factors in the OCC's decision to pursue a bank enforcement action... A bank's board and management *must* correct deficiencies in a timely manner." See Office of the Comptroller of the Currency, *Policies and Procedures Manual*, PPM 5310-3 (Nov. 13, 2018) at 3 (emphasis added), available at <https://www.occ.treas.gov/news-issuances/bulletins/2017/ppm-5310-3.pdf>. Similarly, in its *Supervision and Regulation Report*, the Fed states: "In the event that holding companies do not address MRAs in a timely or complete manner, examiners may determine that the related weaknesses represent a significant threat to the safety and soundness of the company or its ability to operate in compliance with the law and may recommend further action." Federal Reserve, *Supervision and Examination Report* (Nov. 9, 2018) at 16, available at <https://www.federalreserve.gov/publications/supervision-and-regulation-report.htm>. The Federal Reserve also states, "MRIAs are matters of significant importance and urgency that the Federal Reserve *requires* banking organizations to address *immediately*." *Id.* at Appendix A (emphasis added).

¹² Greg Baer & Jeremy Newell, *The MRA is the core of supervision, but common standards and practices are MIA*, Underwritings: The BPI Blog (Feb. 8, 2018), <https://bpi.com/the-mra-is-the-core-of-supervision-but-common-standards-and-practices-are-mia/>.

Consider the number of MRAs they are prohibited from talking about:

Approximate Number of Open MRAs at the Federal Reserve and OCC

Year	OCC	Federal Reserve
2008	6,100	
2009	7,900	
2010	8,200	
2011	8,400	
2012	9,500	
2013	7,900	9,120
2014	4,900	7,400
2015	4,600	6,700
2016	4,100	5,890
2017	3,900	5,850
2018	3,700	5,400

Note: All figures are approximate as they were sourced from publicly available graphs released by the agencies.¹³

Consider, in contrast, the use of the enforcement mandates actually prescribed by statute and described above. For the Federal Reserve and the OCC over the past *ten years*:

- The Federal Reserve has issued 34 safety and soundness orders; the OCC has issued *zero*.
- The Federal Reserve has issued only 20 prompt corrective action orders; the OCC has issued 34.
- The Federal Reserve has issued 211 capital directives; the OCC issued 9.
- The Federal Reserve has issued 75 removal actions against individuals; the OCC issued 246.

The case of safety and soundness orders is particularly telling. These are orders that specifically relate not to capital or liquidity levels but rather exactly to the sorts of issues examiners consider during an examination – risk management, credit underwriting, etc. Over the past ten years, the OCC has not issued a single such order, but it has issued tens of thousands of MRAs.

What, then, are the bases for the thousands of MRAs and MRIs being issued to banks?

“Guidance”

Post-crisis, there has been issuance of a massive volume of “guidance” in the form of supervisory letters, bulletins and circulars. Guidance also includes examination handbooks (which previously were designed for examiners, not banks) and even enforcement actions (where

¹³ Data taken from the Federal Reserve’s Supervision and Regulation Report dated November 2018, available at <https://www.federalreserve.gov/publications/files/201811-supervision-and-regulation-report.pdf> and OCC’s 2018 Annual Report, available at <https://www.occ.gov/annual-report/download-the-full-report/2018-annual-report.pdf>. Federal Reserve data includes MRAs for BHCs, SLHCs, and FBOs. Figures for 2018 are as of the end of Q2 2018. OCC data includes MRAs for national banks and federal savings associations. Figures for 2018 are as of the end of Q3 2018.

the standards enforced on one bank through a consent order have at times been treated as binding on all banks).¹⁴

The volume of guidance is in some ways inestimable, as it takes so many forms. By one estimate, since 2013, the OCC has issued 330 pieces of OCC-only or interagency guidance in the form of bulletins; the Federal Reserve has issued 103 pieces of Federal Reserve-only or interagency guidance in the form of Supervision and Regulation (SR) letters.¹⁵ But this dramatically understates the volume, because the agencies (and therefore bank compliance teams) treat numerous other agency statements as binding.

Consider, as an example, vendor management. The OCC in 2013 issued a voluminous bulletin, which itself referenced and reinforced over 50 previous bulletins, advisory letters, and banking circulars, that describes how federally chartered banks should deal with their vendors and contractors.¹⁶ It applies to a wide range of vendor- and many other types of business relationships (other than customer relationships) – everything from key IT vendors to corporate wellness vendors – and its expectations are granular and prescriptive. The result has been a cottage industry, requiring the retention of large teams of people, both internal and consultants, to act as gatekeepers to any contract with a third party and to draft policies and procedures for practically any interaction with a third party, and to document compliance with those policies on an ongoing basis.¹⁷ (Unfortunately, but not surprisingly, one effective means to compliance is to concentrate one’s most critical vendor relationships with fewer, larger firms that are able to handle the associated compliance burdens, at the expense of small businesses who cannot.)¹⁸

Banks generally treat all of those utterances as legally binding because a “violation” of any of them can form the basis for an MRA. And these guidance documents not only impose meaningful restrictions on banks internal operations but also proscribe or circumscribe specific products and offerings (e.g., small-dollar credit or leveraged lending).

To be sure, recent pronouncements by the GAO and statements by the agencies have sent a message that guidance is not to be treated as binding. One could read a recent interagency statement as stating as much, though it does not include a specific reference to MRAs and rather refers to agency “citations,” which has prompted confusion. This area therefore appears to be one where, as suggested later in my testimony, clarity is required.

¹⁴ This stance is contrary to Supreme Court precedent. *United States v. Armour & Co.*, 402 U.S. 673 (1971); *Local No. 93, Int’l Ass’n of Firefighters v. City of Cleveland*, 478 U.S. 501 (1986) (holding that settled cases have no precedential effect).

¹⁵ The Federal Reserve Bank of St. Louis maintains a public compendium of these and other agency issues at <https://www.stlouisfed.org/federal-banking-regulations/>.

¹⁶ OCC Bulletin 2013-29.

¹⁷ This consultant-industrial complex frequently includes retention of former regulators.

¹⁸ In a 2017 Semi-Annual Risk Report, the OCC itself observed that “[c]onsolidation 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.” See <https://www.occ.gov/publications/publications-by-type/semiannual-risk-perspective/pub-semiannual-risk-perspective-spring-2017.pdf>.

“Safety and Soundness”

In some cases, MRAs are based not on any law, regulation or even written guidance, but simply on examiner preference. In some cases, they take the form of “industry MRAs,” which are identical examination mandates issued to multiple banks – basically, an *ultra vires* regulation without the process required by the APA. Increasingly those preferences derive from “horizontal reviews,” where examiners review practices across a variety of banks, decide which one they prefer, and then require the remainder to adopt what examiners have determined to be best practice. (A primary source of many such reviews is the Federal Reserve’s Large Institution Supervision Coordinating Committee (LISCC), a supervisory committee it uses to oversee the supervision of large banks. Notwithstanding the LISCC’s significance, the Federal Reserve has never established a process or meaningful criteria for how firms become subject to (or exit from) LISCC designation and its requirements. Yet LISCC designation triggers a wide range of heightened requirements related to capital adequacy and capital planning, liquidity sufficiency, corporate governance, and recovery and resolution. (In turn, these significant requirements generally flow from guidance, not law or regulation.)

Asked for the legal basis for such actions, examiners often cite “safety and soundness.” Indeed, they are doing so increasingly, as the law has become clearer that guidance is non-binding and cannot serve as the basis for an MRA.

But “safety and soundness” is not a magical phrase. Rather, it is shorthand for an “unsafe and unsound banking practice” that the banking agencies are authorized (after appropriate procedural process) to prohibit under 12 U.S.C. 1818. And that phrase has a well-defined legal meaning. As explained by the D.C. Circuit Court of Appeals, an unsafe or unsound practice for purposes of section 1818 “refers only to practices that threaten the financial integrity of the institution.” *Johnson v. OTS*, 81 F.3d 195, 204 (D.C. Cir. 1996); see also *Gulf Federal Savings & Loan Association v. Federal Home Loan Bank Board*, 651 F.2d 259 (5th Cir. 1981) (“The breadth of the ‘unsafe or unsound practice’ formula is restricted by its limitation to practices with a reasonably direct effect on an association’s financial soundness.”); *Seidman v. Office of Thrift Supervision*, 37 F.3d 911 (3d Cir. 1994) (“The imprudent act must pose an abnormal risk to the financial stability of the banking institution.... Contingent, remote harms that could ultimately result in ‘minor financial loss’ to the institution are insufficient to pose the danger that warrants cease and desist proceedings.”); *Hoffman v. FDIC*, 912 F.2d 1172, 1174 (9th Cir. 1990) (requiring “abnormal risk or loss or damage to an institution, its shareholders, or the agencies administering the insurance funds”).¹⁹

¹⁹ There is a minority of circuits that has a somewhat lower standard for what constitutes an unsafe and unsound practice, but even there the bar is still extremely high. These circuits primarily endorse the so-called Horne standard – named after the Federal Home Loan Bank Board Chairman who, in material provided to Congress in 1966 in support of the legislation that employed the term, described it as: “any action, or lack of action, which is contrary to generally accepted standards of prudent operation, the possible consequences of which, if continued, would be abnormal risk or loss or damage to an institution, its shareholders, or the agencies administering the insurance funds.” *See, e.g., First National Bank of Eden v. Department of the Treasury*, 568 F.2d 610 (8th Cir.

Clearly, given the sheer number of MRAs it seems highly unlikely that all or even most of them meet that standard. The fact that they come at a time when the vast majority of banks are in compliance with all relevant capital and liquidity requirements makes it still more unlikely. Indeed, I wish that I could provide the Committee examples of MRAs that deal with matters that are beyond immateriality to the point of irrelevancy. Again, however, the banking agencies take the position that doing so is a criminal violation, so I cannot. The Committee itself would need to investigate the extent to which banking agency MRAs meet this standard – perhaps by requesting a sample of anonymized MRAs from exam reports issued over the past five years. Furthermore, it is deeply unfortunate that, other than reporting the total number, the agencies report no aggregate or anonymized data on the subject of those MRAs – reporting that no reading of the law would prohibit.

Examination Versus Supervision

The breakdown in legal process goes hand in hand with a broader trend. By law, the job of the regulatory agencies is to establish *ex ante* regulations, and then to examine the books and records of banks to ensure that they are operating in accordance with those regulations and that they are not engaged in practices that pose the risk of a substantial loss to the firm – that is, losses that could materially erode their capital and liquidity position. It is a system of *regulation and examination*.

Notably, the word *supervision* does not appear in the authorizing statutes for the examination process. There is a large difference between examining a firm and supervising it. Congress authorized the former, but the current system is all about the latter. It is less and less about protecting taxpayers – that goal is primarily served through capital and liquidity requirements – and more about protecting shareholders by attempting to co-manage the firm. Thus, we see constant references to “reputational risk” – another term that does not appear in law or regulation, but which has become shorthand for a practice that is legal and creates no material financial risk but which is disfavored by examiners. And as I will now describe, there is now a shadow enforcement regime that allows regulators to “supervise” without due process.

The Shadow Enforcement Regime

At this point, one should wonder: if all the MRAs are legally unenforceable and, moreover, based on unenforceable guidance and vague references to safety and soundness, why are they treated as binding rules by banks, and particularly their compliance teams? Why are they diverting extraordinary resources to comply with mandates that are often immaterial to their safety and soundness and in many cases against their better judgment?

1978). That said, the law of the D.C. Circuit is effectively dispositive, given that the defendant in any action under 12 U.S.C. 1818 has the option of appealing to the D.C. Circuit, in addition to the relevant circuit for traditional venue purposes. Thus, a bank seeking to challenge an action can do no worse than the law of the D.C. Circuit.

The answer is: because a new, shadow enforcement regime has grown up post-crisis. It relies on growth and investment restrictions never authorized by Congress in place of written agreements, formal orders, and capital directives that were so authorized. Those restrictions are immediately effective, effectively unreviewable and therefore practically uncontestable by the bank. It is why those tens of thousands of MRAs should not be viewed as examination findings but rather as *de facto* enforcement actions.

Shadow Growth Restrictions

Thus, the Federal Reserve’s Supervisory Letter 14-02, issued in 2014, describes factors the Federal Reserve will consider in acting upon bank applications to engage in a wide range of proposed transactions, including mergers, acquisitions, asset purchases, investments, new activities, and branching.²⁰ SR 14-2 states that banking organizations that are rated below “satisfactory”, that are subject to any enforcement action, or that have any significant consumer compliance issues or other “outstanding supervisory issues” should not even file an application until they resolve their supervisory issues. Although the literal terms of SR 14-2 suggest that various of these prohibitory conditions can be overcome, the general prohibitions have been virtually absolute in practice. Yet none of them is articulated in the relevant governing statutes. And, for good measure, SR 14-02 itself was never published for notice and comment or submitted for Congressional review under the Congressional Review Act. By all accounts, the practices at the other Federal banking agencies have generally been similar, though generally not codified in writing.²¹

For perspective on how odd this new enforcement regime is, consider that we routinely see serious compliance violations across a wide range of American industries. Those companies are subjected to enforcement proceedings and are required to pay fines and remediate their practices, but no one ever suggests that while those proceedings are pending they should be stopped from opening new franchises, building new plants, developing new drugs, designing new cars, or launching new apps. Yet in banking, regulators often prohibit any type of expansion by the bank as a reaction to any compliance failure.

Thus, SR 14-02 states that covered banks seeking to expand must “convincingly demonstrat[e] that the proposal would not distract management from addressing the existing problems of the organization or further exacerbate these problems.” Again, 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

²⁰ SR 14-2/CA14-1: “Enhancing Transparency in the Federal Reserve’s Applications Process” (Feb. 24, 2014). Most large transactions involve a Federal Reserve review and therefore SR 14-2 may well directly affect many bank-level (in addition to bank holding company level) applications in that context.

²¹ Applicable OCC and FDIC guidance – which like SR 14-2 have never been subject to public comment – differ from 14-2 in some respects and are less detailed. The OCC’s Comptroller’s Manual, Business Combinations (July 2018) states that in the context of MRAs and program deficiencies, the OCC assesses the nature and duration of the issues, the institution’s progress in remediating identified program deficiencies, and whether the proposed combination would detract from the remediation, exacerbate existing problems, or create new problems for the resulting institutions. In the context of an enforcement action, the Manual simply states that in these circumstances the bank should consult with its supervisory office and Licensing Division before pursuing any plans for a transaction. See *Comptroller’s Manual* at 7-8. The FDIC’s 1998 *Statement of Policy on Bank Merger Transactions* simply provides that “[a]dverse finding may warrant correction of identified problems before consent is granted, or the imposition of conditions.”

another group of employees opening a branch in Philadelphia or buying an asset manager in Los Angeles. In other industries, one presumes that a retailer with a data breach can still open new stores, or that an auto company with a fatal defect in its ignition switch can still open new dealerships. Yet over the past ten years, a contrary illogic has significantly impaired the ability of banks to invest and expand to serve their customers better.

The unique reliance on growth restrictions in banking is even more remarkable when one realizes that banks already are subject to more potential penalties, imposed by more potential regulators, than practically any other industry. The inability to open a new branch is not necessary as a deterrent.

Thus, under agency practice, any unresolved consumer compliance issue or any unresolved supervisory issue can prevent a bank from expanding in any way. There are two results. First, obviously, bank expansion and investment in new technologies has been curtailed to an unhealthy extent. Second, and more importantly, *this arrangement has given examiners powers never contemplated by Congress, without any procedural check or balance.*

To be clear, Congress has authorized the banking agencies to restrict the growth of financial institutions under some circumstances, but those circumstances were intended to be quite limited. Under section 4(m) of the Bank Holding Company Act and implementing regulations, and the Board's Regulation Y, a financial holding company which receives either a rating of Deficient-1 or Deficient-2 on any component under the LFI rating system or whose subsidiary bank receives a CAMELS "3" composite or Management rating must receive Federal Reserve approval to conduct certain non-banking activities.²² A related provision requires the Board to consider a company's effectiveness in combatting money laundering activities in connection with applications to acquire bank shares or assets.²³ Similarly, under the law governing interstate mergers and branching, for a bank to open a branch in any state in which it does not already have a branch, the bank must satisfy certain statutory standards and requirements for the bank to be "well capitalized" and "well managed."²⁴

These provisions have been extended far beyond their statutory intent and become part of the shadow enforcement regime. First, as noted above, the requirement to *consider* anti-money laundering effectiveness in connection with *some* applications became a bar to *any* expansion by any institution with an outstanding AML consent order, regardless of whether the alleged problems were minor or major, or what their state of remediation was.²⁵ Second, in conditioning certain non-banking activities on a "3" rating, Congress understood that rating to reflect the management of the overall organization. Indeed, by its own terms, the Management rating is intended to reflect "the capability of the board of directors and management, in their respective

²² 12 U.S.C. § 1843(m)(3); 12 CFR 225.83(d)(2).

²³ 12 U.S.C. § 1842(c)(6).

²⁴ 12 U.S.C. § 1831u. A similar requirement exists for approval of interstate mergers

²⁵ According to Federal Reserve SR 13-7, which addresses *de novo* branching by state member banks rated "3," "In all cases, the bank's Bank Secrecy Act/Anti-Money Laundering program needs to be considered satisfactory."

roles, to identify, measure, monitor, and control the risks of an institution's activities and to ensure a financial institution's safe, sound, and efficient operation in compliance with applicable laws and regulations.”²⁶ Post-crisis, however, the Management rating has become less about the financial condition of the bank and more about compliance with banking agency rules, guidance and examiner preference. This represents a fundamental change.

The direct result of this shift (lower ratings) was less important than its indirect result: adding an enforcement mechanism for MRAs that Congress never considered. Once the Management rating became subjective and untethered to financial condition, the threat of a downgrade to a “3” rating became as powerful an enforcement tool as any formal order. So, too, did an actual downgrade, with the need for Federal Reserve approval to continue conducting non-banking activities unless the bank remediate exactly as instructed.

Again, though, section 4(m) relates only to non-banking activities conducted by bank affiliates. It has nothing to do with the establishment of branches, or even the acquisition of or merger with other depository institutions or bank holding companies. Congress has never conditioned the opening of a branch on a particular management rating of the bank. Yet in practice, the agencies have done that themselves.²⁷

Examination Appeals

As the banking agencies have avoided statutory enforcement mechanisms that come with congressionally established procedural rights in favor of informal but equally binding examination mandates, the importance of the examination appeals process, and the agency ombudsman, has grown significantly.

Sadly, for both structural and practical reasons, these tools are effectively dead letters for banks, and thus almost never used. Between 1995 and 2012, the OCC issued 157 decisions, and the Federal Reserve issued 25.²⁸ Consider that against a backdrop of tens of thousands of MRAs, and clearly something is very, very wrong.

The reasons for the paucity of appeals are not hard to divine. First, every banker and bank counsel is taught that "examiners have long memories," such that potential for retaliation is always a concern.²⁹ Second, appeals are made to the same agency that assigned the rating. For example, at the Federal Reserve, the ultimate arbiter in an appeal is a designated Federal Reserve

²⁶ Uniform Financial Institutions Rating System, 61 FR 67021, 67027 (Dec. 19, 1996).

²⁷ *See Louisiana Public Service Comm'n v. FCC*, 476 U.S. 355, 375 (1986) (“[A]n agency literally has no power to act... unless and until Congress confers power upon it... Thus, we simply cannot accept an argument that the FCC may nevertheless take action which it thinks will best effectuate a federal policy. An agency may not confer power upon itself.”)

²⁸ Julie Anderson Hill, *When Bank Examiners Get It Wrong: Financial Institution Appeals of Material Supervisory Determinations*, 92 Wash. U. L. Rev. 1101 (2015). The author notes that data from 1995 – 2000 was unavailable for the Federal Reserve.

²⁹ In recognition of this tendency to retaliate, the agencies have adopted internal policies criticizing examiner retaliation against institutions for pursuing supervisory appeals. One can question their effectiveness in practice, however.

Board Governor, while at the FDIC, appeals are ultimately decided by the agency's Supervision Appeals Review Committee.

To their considerable credit, some of the agencies have recently sought public comment on their internal appeals processes. My suspicion, though, is that the problem cannot be solved without related reforms of the type discussed in this testimony.

Attorney-Client Privilege

A case study in the examination status quo concerns the attorney-client privilege. Examiners take the position that they can override attorney-client privilege, whether in the course of an ordinary examination of a bank or of an enforcement action. Thus, for example, in the latter case, the agencies take the position that they can begin their investigation by seeking the interview notes of inside and outside litigation counsel who have been defending the case. This is remarkable. So too is the fact that the SEC and the Department of Justice take the opposite position in the enforcement context.

What is more remarkable is that there is no legal basis for this position. Seven of the nation's leading law firms have done a joint opinion that concludes "There is no valid legal basis for the Agencies to demand that supervised institutions disclose privileged material. As discussed, all the relevant case law and fundamental legal principles compel this conclusion."³⁰ The American Bar Association in a 2012 letter to the CFPB agreed that the examination powers of the agencies do not allow them to invade the privilege, finding "the ABA is not aware of any reported Federal appellate court case holding the Federal Banking regulators – or any other Federal agencies – can require production of privileged materials, nor do the Federal banking statutes contain such authority."

Of course, the agencies state that the privilege still holds with respect to all other third parties, and that providing privileged material to examiners or enforcement lawyers does not constitute a waiver of the privilege. While this is true, it is akin to saying that only the government will be reading your email or searching your house, not other third parties. The fact that the government is potentially accessing any and all privileged information absolutely vitiates the goal of the privilege, which is to "encourage full and frank communication between attorneys and their clients and thereby promote broader public interests in the observance of law and administration of justice."³¹

Notably, none of the banking agencies has contested the legal merits of the seven-firm memorandum in any venue at any time. Rather, they have continued their practice unabated. And banks have almost universally complied.

³⁰ See "Banking Regulators' Examination Authority Does Not Override Attorney-Client Privilege," Opinion of Cleary Gottlieb Steen & Hamilton; Covington & Burling; DavisPolk; Debevoise & Plimpton; Simpson Thacher & Bartlett, Sullivan & Cromwell; and Wilmer Cutler Pickering Hale and Dorr, available at https://www.sullcrom.com/siteFiles/Publications/SC_Publication_Banking_Regulators_Examination_Authority_Does_Not_Override_Attorney_Client_Privilege.pdf

³¹ *Upjohn Co. v. United States*, 449 U.S. 383, at 389, citing *Hunt v. Blackburn*, 128 U.S. 464, 470 (1888).

Why? This question really gets to the heart of the post-crisis hidden regime. First, it is unlikely that any bank (or trade association) would have standing to bring a declaratory judgment action against the agencies. A court's likely response would be that a case or controversy would exist only if a bank refused to provide privileged material and the agencies served a subpoena for it. But no bank is going to take that step, because of concerns about retaliation and reputational harm if labeled as uncooperative. For that reason, the Department of Justice and SEC affirmatively state that a bank's failure to provide a "voluntary" waiver will not be considered against it in assessing cooperation and penalties. Neither, importantly and conversely, will a company be rewarded for a waiver.³²

As a result, banks (and indeed, banks alone) operate without the benefit of the candid legal advice that the attorney-client and work product privileges have ensured for centuries. Examiner pressure on keeping minutes of all management committee meetings and criticizing banks when the minutes are not specific enough are another means to chill candid conversations within the banking organization itself.

The Results

The results of this new supervisory regime are significant. Many banks of all sizes have been restricted from branching, investing in new businesses, or merging for reasons that are neither public nor assessable. (Indeed, the Committee might consider asking the banking agencies for a list of all banks that have been subject to a non-public growth restriction over the past five years, to be reviewed *in camera*.) Bank technology budgets often are devoted primarily not to innovation but to redressing frequently immaterial compliance concerns. Indeed, an underrated cause of the rise of fintech companies over the past ten years has been the fact that banks were spending their innovation budgets on compliance systems geared towards immaterial issues.

Board and management time has been diverted from strategy or real risk management and instead spent remediating frequently immaterial compliance concerns and engaging in frequent meetings with examiners to ensure that they are fully satisfied.

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; thus, bank supervision has shifted away from this legal concept to a more malleable and supple one – "best practices" enforced by MRAs (Matters Requiring Attention) that are effectively unappealable.

A Way Forward

Notwithstanding the problems and concerns I have articulated, it is important to acknowledge several recent developments that suggest more attention is being paid to these issues:

- The General Accountability Office in a series of opinions requested by Members of Congress has ruled that various types of agency action self-described as "guidance" are in fact rules under the Congressional Review Act; they are therefore unenforceable until

³² § 28710-20; SEC Division of Enforcement Office of Chief Counsel, Enforcement Manual (Oct. 28, 2016).

they are submitted for Congressional review and not invalidated. Furthermore, these decisions have served to highlight the fact that rules the agencies have clearly treated as binding³³ not only were not submitted to Congress but also were never published for public comment, in violation of the Administrative Procedure Act.

- Last September, the federal banking agencies and CFPB issued an “Interagency Statement Clarifying the Role of Supervisory Guidance,” which reaffirmed that supervisory guidance “does not have the force and effect of law, and the agencies do not take enforcement actions based on supervisory guidance.”³⁴ This represented an important step forward in ensuring that agency guidance is issued and applied in a manner consistent with the APA and the Congressional Review Act and, more broadly, that formal examination criticisms focus on matters material to the financial condition of a bank. Unfortunately, there are numerous reports that the statement (which is itself non-binding guidance) is not being followed in practice.
- Also last year, the CFPB issued a bulletin that established two categories of examiner mandates – a step that could serve as a model for the federal banking agencies. The bulletin notes that the CFPB would continue to use MRAs going forward, but only to address and correct issues that are “*directly related* to violations of Federal consumer financial law”;³⁵ the bulletin then establishes a separate and distinct category of communication, the “Supervisory Recommendation” (SR), which will be used “to recommend actions for management to consider taking . . . when the Bureau has not identified a violation of Federal consumer financial law, but has observed weaknesses in CMS.”³⁶ Thus, the CFPB statement allows for an important dialogue to continue between examiners and the institution with respect to non-material matters, but without legal sanction. In other words, with respect to matters that do not involve a violation of law, a bank’s management is free to design and innovate, while examiners remain free to identify best practices and provide input.
- Last November, the Federal Reserve finalized a new ratings system for large financial institutions that was substantially clearer, more objective, and better focused on core matters of financial condition than its predecessor. Although not perfect, this new framework not only represents a meaningful shift closer to transparency and the rule of law for those institutions.
- The FDIC has recently withdrawn hundreds of Financial Institution Letters, its version of regulatory guidance.
- In general, there has been a recent trend towards publishing more regulatory requirements for public comment. As the numbers show, the number of outstanding MRAs has reduced over the past few years. Still, the numbers remain extraordinarily high, particularly given that by every possible objective measure the banking industry is in

³³ See, e.g., Ryan Tracey, “Feds Win Fight Over Risky-Looking Loans,” *Wall Street Journal* (Dec. 2, 2015), available at <https://www.wsj.com/articles/feds-win-fight-over-risky-looking-loans-1449110383>.

³⁴ See, e.g., Federal Reserve Supervisory Letter SR 18-5 / CA 18-7, *Interagency Statement Clarifying the Role of Supervisory Guidance* (Sept. 12, 2018).

³⁵ BCFP Bulletin 2018-01, *Changes to Types of Supervisory Communications* (Sept. 25, 2018) (emphasis added).

³⁶ *Id.*

good health. Furthermore, we cannot know whether those lower numbers reflect a greater focus on material safety and soundness matters by examiners, or simply the fact that banks have spent billions of dollars redressing every possible examiner concern for the past few years.

More broadly, some banks have reported that examinations have recently become more focused on material issues. Others, though, have not. But the primary concern remains: when the great majority of requirements are imposed in secret, with no process, they can vary across banks and across time because there simply are no checks or balances. So, this fundamentally is not an issue of tighter regulation or looser regulation (deregulation) but an issue of consistent and predictable regulation that is consistent with the law.

Potential Next Steps

How could matters be improved?

First, the banking agencies should grant the petition for rulemaking filed by the Bank Policy Institute and the American Bankers Association, follow the example set by the CFPB, and confirm what they have already said in a recent statement: that guidance is not binding and will not form the basis for an MRA, and that only violations of law (including an unsafe and unsound practice) will form the basis for an MRA. This step is necessary because by numerous accounts their earlier statement is being disregarded in practice.

Second, more broadly, the agencies should seek public comment on what an MRA is. If an MRA is an unenforceable suggestion, with no consequences for a company's ability to grow or invest, then they should make that clear. If it is a *de facto* order, then it should be issued only when there is a legal basis for it— a violation of law or an unsafe or unsound banking practice – and the bank should receive APA-prescribed process.

Third, 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 formally 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 of the Currency, and the Directors of the FDIC personally 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.

Fourth, the CAMELS rating system should be rethought entirely.³⁷ The Federal Reserve Board has recently adopted a significant rethinking of holding company ratings, and the banking agencies/FFIEC should do likewise. Such a review should emphasize the benefits of objective,

³⁷ The expansion of bank supervision is having an impact on the economy. See Greg Baer & Jeremy Newell, *How Bank Supervision Lost Its Way*, Underwritings: The BPI Blog (May 25, 2017), <https://bpi.com/how-bank-supervision-lost-its-way/>.

transparent, consistent standards over subjective, opaque, and ad hoc standards. In particular, 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 thereby subject to an expansion ban. Any assessment of management should focus on financial management. A meaningful appeals process should be instituted.

Conclusion

Many thanks for the opportunity to appear before you today.