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Financial Reform: Bank Supervision

Reforms to the bank supervision framework have been proposed as part of the broader financial reform debate, including in H.R. 10, which passed the House on June 8, 2017, and S. 2155, which was reported by committee on December 18, 2017.

Background

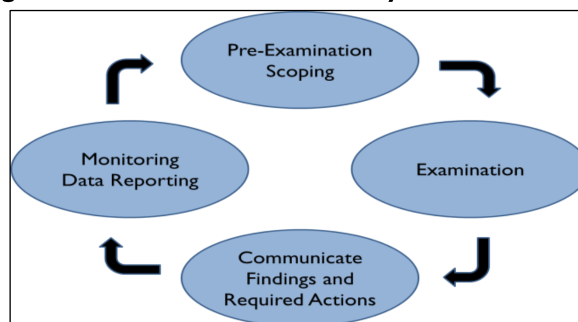
Bank regulation has three distinct components: *rulemaking* (the authority to implement rules with which banks must comply); *enforcement* (the authority to take certain legal actions, such as imposing fines, against an institution that fails to comply with rules and laws); and *supervision*.

Supervision refers to the authority of certain regulators—the Federal Reserve (the Fed), the Office of the Comptroller of the Currency (OCC), the Federal Deposit Insurance Corporation (FDIC), the National Credit Union Administration (NCUA), and the Consumer Financial Protection Bureau (CFPB)—to monitor and examine banks, impose reporting requirements, and instruct banks to modify behavior. Supervision enables regulators to ensure banks are in compliance with applicable laws and regulation and to evaluate and promote the safety and soundness of individual banks (known as *micro-prudential* supervision) and the banking or financial system as a whole (*macro-prudential* supervision). In addition, regulators evaluate bank compliance with consumer protection and fair lending laws (*consumer compliance* supervision). Subjecting banks to a supervisory program may also promote public and market confidence in the banking system.

Regulators have complementary tools to achieve their supervisory goals, as shown in **Figure 1**. They continuously monitor banks, often using data banks are required to report and information gathered during previous examinations. Examiners can use information gathered through monitoring to determine the scope and areas of focus for upcoming exams. Periodic examinations (often on-site at bank offices) involve an evaluation of bank practices and performance. Examiners may either objectively confirm whether banks meet quantitative requirements set by regulation, or they may have discretion to qualitatively interpret whether a bank satisfies the goals of a regulation. In addition, regulators are permanently placed on-site at offices of certain large banks.

Bank examiners rate a bank based on the Uniform Financial Institutions Ratings System, wherein the banks receive a rating from 1 (best) to 5 (worst) across six "CAMELS" components—capital adequacy, asset quality, management, earnings, liquidity, and sensitivity to market risk—and a composite rating based on all those components. Examiners communicate findings and ratings to bank management, and (if necessary) prescribe required corrective actions.

Figure 1. The Bank Examination Cycle



Source: Consumer Financial Protection Bureau.

Policy Issues

The 115th Congress is considering legislation to provide "regulatory relief" for banks. Regulatory relief proposals, may involve a trade-off between reducing costs associated with regulatory burden and reducing benefits of regulation.

Proponents of regulatory relief argue that certain regulations (including ones introduced in response to the 2007-2009 financial crisis) are *unduly burdensome*, meaning their costs do not justify the benefits. In the case of supervision, they contend the time and resources banks dedicate to complying with various examinations and reporting requirements hinder banks' ability to provide credit, restraining economic growth.

Opponents of relief generally believe the current regulatory structure strengthens financial stability and consumer protections, which encourages economic growth. They generally view supervisory actions as striking the appropriate balances ensuring banks are well managed and consumers are protected on one hand, while minimizing regulatory burden on the other hand.

Legislation in the 115th Congress

CFPB Supervision. H.R. 10 would eliminate the CFPB's consumer compliance supervisory authority over large banks, shifting that authority back to the Fed, OCC, FDIC, and NCUA. H.R. 3072 would raise the asset threshold at which the CFPB becomes a bank's supervisor from $10 billion to $50 billion.

Before 2010, the federal bank regulators were charged with regulating for both safety and soundness and consumer compliance. Pursuant to the Dodd-Frank Act, the CFPB acquired certain consumer compliance powers over banks and credit unions that vary based on their asset size. For institutions with more than $10 billion in assets, the CFPB is generally the primary supervisor for consumer compliance. For institutions with $10 billion or less in assets, the prudential regulator generally remains the primary supervisory authority for consumer protection.

Critics of the CFPB argue that certain banks subject to CFPB supervision face overly burdensome examinations. They assert that raising the threshold at which the CFPB becomes the primary supervisor or eliminating CFPB bank supervisory authority would still provide appropriate consumer protection, because banks would still be examined by their primary regulators.

Proponents of the CFPB argue that certain banks subject to CFPB supervision are similar in size to certain institutions that were arguably among some of the worst violators of consumer protections during the housing bubble. They contend that raising the threshold or eliminating CFPB bank supervision could lead to those entities being subject to inappropriately lax consumer compliance supervision.

Examination Cycle. S. 2155 would raise the size thresholds for banks eligible for an 18-month exam cycle from $1 billion in assets to $3 billion in assets, provided the banks met certain other criteria.

Regulators generally conduct a full-scope, on-site examination of banks at least once every 12 months. However, banks that (1) have less than $1 billion in total assets, (2) meet the capital requirements necessary to be considered well-capitalized, and (3) were found to be well managed and given an exam rating of "outstanding" (banks under $200 million in assets must receive only a "good rating") on the most recent examination are examined once every 18 months. (These statutory thresholds were raised in 2015.) Thus, the supervisory burden is lower for banks that meet those conditions.

Small bank proponents argue that there are economies of scale to compliance—in other words, compliance costs rise less than proportionately with size. If true, this would mean compliance costs on small banks are disproportionately high compared with larger banks. By contrast, the existence of supervisory costs does not necessarily mean the supervision is unduly burdensome; benefits such as greater safety and soundness among banks or stronger consumer protection could justify those supervisory costs.

Call Reports. Banks submit a Report of Condition and Income—referred to as the *call report*—to their regulator quarterly. H.R. 4725 and S. 2155 would require the regulators to develop a shorter call report to be filed in the first and third quarters for banks that have less than $5 billion in assets and satisfy other criteria. H.R. 10 would require regulators to do the same, but for institutions of any size that qualify as well capitalized and satisfy other criteria.

The call report is made up of various "schedules," each containing multiple line items related to bank operations that must be given a value. These data are reported using standard definitions so that banks can be compared by regulators and the public. To lower the burden on small banks relative to big banks, the number of items that a bank must report depends on its size and activities. In addition, current statute requires the regulators to review call reports every five years to eliminate any information or schedule that "is no longer necessary or appropriate." Recent burden-reducing revisions are set to take effect in the second quarter 2018 call report.

Proponents of the legislation contend the current tailoring does not go far enough and that call reports are currently unduly complex and burdensome for community banks. Opponents argue that call reports can provide an early indication that a bank's risks or industry risks are changing and removing too many items could mute the early warning signal the call report provides.

Appeals Process. H.R. 10 and H.R. 4545 would establish an ombudsman (called the Office of Independent Examination Review) within the Federal Financial Institutions Examination Council (FFIEC), an interagency forum for bank regulators, to investigate complaints from banks about supervisory exams; give banks the right to appeal exam results to the ombudsman or an administrative law judge; and prohibit specific supervisory actions in retaliation for appealing. The bills would also make other changes empowering banks in the exam appeal process.

Bank regulators have established a number of processes for a bank to appeal its examination results. Although regulators often resolve disputes informally through discussion between the bank and the examiner, they are required to maintain a formal independent appeals process for supervisory findings, appoint an independent ombudsman, and create safeguards to prevent retaliation against a bank that disputes the examination findings. Each agency ombudsman's exact role varies, but they generally serve as a facilitator for the resolution of complaints. Only the OCC currently allows banks to appeal an examination directly to the agency's ombudsman.

Proponents of altering the appeals process argue that the supervisor currently plays the role of prosecutor, judge, and jury, and is unlikely to admit a mistake had been made in the original exam. Thus, they assert that the proposed ombudsman—being more independent—would be better positioned to appropriately adjudicate disputes.

Opponents view the creation of an additional ombudsman for all banking agencies as redundant, because each agency already has its own. In addition, they argue the new ombudsman would not have "inside knowledge" of the supervisory process (which inherently involves examiner discretion on a bank-by-bank basis), and so may not be better positioned to make accurate assessments regarding the condition of and appropriate corrective actions for individual banks. If true, and if shifting the appeals process to an ombudsman results in more overturned supervisory decisions, the new ombudsman could potentially undermine supervisors' ability to promote the safety and soundness of banks and systemic stability, putting taxpayer funds at risk.

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