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IN FOCUS

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Introduction to Bank Regulation: Supervision

To identity and mitigate risks, bank regulators have the authority to monitor bank activities and, if necessary, direct a bank to change its behavior. Bank supervision creates certain benefits (e.g., fewer bank failures, more systemic stability) but imposes certain costs (e.g., bank compliance costs, reduced credit availability). Congress often faces policy questions about whether these benefits and costs are appropriately balanced. This In Focus provides a brief overview of bank supervision and related policy issues.

Who Supervises Banks?

Banks are supervised by a primary regulator, which is determined by a bank's charter type and whether the bank is a member of the Federal Reserve System. The federal primary regulators are the Federal Reserve (the Fed), the Office of the Comptroller of the Currency (OCC), and the Federal Deposit Insurance Corporation (FDIC). (The National Credit Union Administration [NCUA] supervises credit unions.) Banks chartered at the state level also are supervised by state-level bank regulatory agencies.

Banks above a certain asset size also are subject to supervision for compliance with consumer protection laws and regulations by the Consumer Financial Protection Bureau (CFPB). For banks with more than $10 billion in assets, the CFPB is generally the primary supervisor for consumer compliance. For banks with $10 billion or less in assets, the primary regulator generally remains the primary supervisory authority for consumer compliance. (CFPB rules may apply to all banks, regardless of which agency is a bank's supervisor).

Before the Dodd-Frank Act (P.L. 111-203), the Fed, OCC, and FDIC supervised banks for both safety and soundness and consumer compliance. Congress created the CFPB in response to assertions that this dual mandate restricted bank regulators' incentive or ability to monitor and curtail questionable consumer lending practices leading up to the 2008 financial crisis. Critics of the CFPB assert that certain banks subject to its supervision (e.g., those over but near the $10 billion threshold) face overly burdensome examinations; these critics call for raising the $10 billion threshold or returning consumer compliance supervision to the primary regulator. Proponents of the CFPB argue that making such changes could lead to inappropriately lax consumer compliance supervision, similar to what was in place during the run-up to the financial crisis.

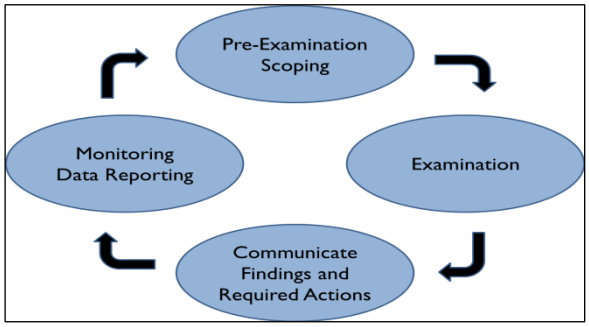
How Are Banks Supervised?

Bank regulators have three main tools to regulate banks: they can *promulgate rules* implementing banking law that banks must follow, they can *supervise* banks to ensure banks are complying with those rules, and they have *enforcement powers* to reprimand banks that are not complying with the rules.

Supervision refers to certain regulators' authority to monitor and examine banks, impose reporting requirements, and instruct banks to modify behavior. Supervision enables regulators to evaluate and promote the safety and soundness of individual banks (known as *micro-prudential* supervision) and the banking system as a whole (*macro-prudential* supervision). In addition, regulators evaluate bank compliance with other statutory requirements, including consumer protection and fair lending laws (*consumer compliance* supervision), anti-money laundering laws, cybersecurity requirements, and compliance with the Community Reinvestment Act (P.L. 95-128).

Regulators have complementary tools to achieve their supervisory goals (see **Figure 1**). They continuously monitor banks, often using information banks are required to report or that was gathered during previous examinations. Supervision is an iterative process, and examiners can use information gathered through monitoring to determine the scope and areas of focus for upcoming exams.

Figure 1. The Bank Examination Cycle



Source: Consumer Financial Protection Bureau.

Note: Certain large banks may have examiners continuously on-site.

Reporting. Banks submit a Report of Condition and Income—referred to as the *call report*—to regulators quarterly. The call report is comprised of "schedules" containing multiple line items related to bank operations for which a value must be reported. These data are reported using standard definitions so that regulators and the public can compare banks. 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 other considerations. The Economic Growth, Regulatory Relief, and Consumer Protection Act of 2018 (P.L. 115-174) mandated further simplification (expected to be implemented in 2019), requiring banks with under $5 billion in assets to file a shorter call report every other quarter. 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." The most recent burden-reducing revisions took effect in June 2018.

Examinations. Regulators are generally to conduct a full-scope, on-site examination of banks at least once every 12 months. However, banks that (1) have less than $3 billion in assets (this threshold was raised by P.L. 115-174), (2) meet the capital requirements necessary to be considered well-capitalized, and (3) were most recently found to be well managed and in "outstanding" condition (banks under $200 million in assets can be in "good" condition), among other conditions, are to be examined once every 18 months.

Periodic examinations (often on-site at bank offices) involve an evaluation of bank practices and performance. Examiners may objectively confirm whether banks meet requirements set by quantitative regulations or may subjectively interpret whether a bank satisfies the goals of qualitative regulations. Problems may lead to more frequent or detailed exams. 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 require corrective actions for banks with poor ratings. Similar uniform interagency ratings systems are used for cybersecurity and consumer compliance.

Regulators also examine banks under the Community Reinvestment Act (P.L. 95-128) to determine how well they are meeting the credit needs of the communities in which they operate. In these exams, banks are given a composite rating based on up to three component ratings in lending, investment, and service. Ratings range from *outstanding* to *substantial noncompliance*, and poor ratings can be the basis for regulators to deny permission to a bank to expand operations into additional areas.

Guidance. After a rule has been finalized, regulators can issue nonbinding guidance or supervisory letters to banks providing explanations of how to adhere to a regulation. Although changes in supervision cannot substitute for the rulemaking process, they can subtly influence regulatory burden by changing how rules are complied with or enforced in ways that critics argue amount to rulemaking outside the rulemaking process. High-profile examples in recent years include a joint agency guidance on leveraged lending and a joint agency statement on commercial real estate loans. A CFPB guidance on discrimination applying to indirect auto lenders (which include banks) was nullified by P.L. 115-172 under the Congressional Review Act (CRA) in 2018, following a 2017 decision by the Government Accountability Office that guidance was subject to the CRA. For more information, see CRS Report R45248, *The Congressional Review Act: Determining Which "Rules" Must Be Submitted to Congress*.

Appeals Process. Bank regulators have established 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 maintain safeguards to prevent retaliation against a bank that disputes the examination findings. Each agency ombudsman's exact role varies, but generally the ombudsman serves as a facilitator for the resolution of complaints. Only the OCC currently allows banks to appeal an examination directly to the agency's ombudsman.

Some observers argue that this appeals process is unfairly slanted against banks, as the supervisory agency may be unlikely to admit mistakes. They propose changes, such as establishing a more independent ombudsman and giving banks the right to appeal exam results to an administrative law judge. Opponents to these changes view the creation of an additional ombudsman for all banking agencies as redundant and express concerns that the proposed changes could result in incorrectly overturned supervisory decisions.

Regulatory Relief Debate

Bank supervision creates certain benefits, such as reducing losses from bank failures and providing systemic stability, which may improve overall economic growth. Subjecting banks to a supervisory program also may promote public and market confidence in the banking system. However, it imposes costs on banks, such as resources expended to comply with examination and reporting requirements, which could reduce the amount of credit available and thus slow economic growth.

Broadly, recent congressional debates related to the bank supervisory framework involve questions about whether bank supervision is *unduly burdensome* (i.e., the benefits do not justify the costs) and whether banks should be provided with *regulatory relief* (i.e., supervision should be made more lenient). The 115th Congress provided regulatory relief from bank supervision in P.L. 115-174, and regulators provided relief in recent rules. The 116th Congress may continue the debate about whether current practices strike the appropriate balance between costs and benefits, particularly for banks below certain asset thresholds.

Small Banks. As the recent changes to call reports and examinations indicate, some aspects of supervision are tailored to reduce regulatory burden for small banks (often called *community banks*). Proponents contend that current tailoring does not go far enough. They argue that there are economies of scale to compliance (i.e., 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 and more likely to be unduly burdensome.

Opponents of this view argue that too many restrictions on the supervision of small banks—hundreds of which failed during the financial crisis—could blunt its effectiveness. They note that the existence of compliance costs does not necessarily mean supervision is unduly burdensome; benefits such as greater safety and soundness among banks or stronger consumer protection could justify those costs.

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