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Oral 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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Chairman Crapo, Ranking Member Brown, my name is Greg Baer, and I am CEO of the Bank Policy Institute. I am here to testify about how legal process has broken down in the regulation and examination of banks. I will not focus on the *substance* of post-crisis requirements but rather on a *process* that has prevented the public – 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.

The breakdown has three parts:

First, examination reports have been effectively turned into enforcement actions, as their mandates – specifically, Matters Requiring Attention, or MRAs — are treated as binding orders.

By law, an examination report is not binding. Make no mistake, however: the banking agencies take the position that MRAs must be remediated. So, too, do bank compliance teams.

This is significant because the volume of MRAs is extreme. Between the OCC and Fed, at any given time over the past ten years, there have been between 8,000 and 20,000 MRAs outstanding. Each could be viewed as a quasi-enforcement order. Each, under agency rules, is also secret, and bankers are subject to criminal penalties for discussing them publicly.

Notably, many if not most of these MRAs have not focused on capital and liquidity – the core rules that protect taxpayers -- but rather on matters such as how banks manage their vendors, update models or spreadsheets, structure reporting lines, or monitor transactions.

Second, the basis for those MRAs frequently has not been a violation of law but rather of "guidance" or unwritten rules.

Post-crisis, the agencies have generally avoided notice and comment rulemaking in favor of a massive volume of "guidance" in the form of supervisory letters, bulletins and circulars. Guidance also includes examination handbooks and even enforcement actions, which are read to bind *all* banks.

In other cases, MRAs are not based even on guidance, but simply on examiner preference. Asked for the legal basis for such actions, examiners often cite "safety and soundness." Indeed, they are doing so increasingly, as the law has recently become clearer that guidance is non-binding and cannot serve as the basis for an MRA. But "safety and soundness" must be shorthand for an "unsafe and unsound banking practice," which is defined in the case law as referring only to "practices that threaten the financial integrity of the institution." A very high bar. The vast majority of MRAs likely fail to meet this standard.

Third, these examination mandates must nonetheless be obeyed because a shadow enforcement regime that has grown up post-crisis whereby a firm with unresolved MRAs is potentially subject to limitations on its growth – limitations never authorized by Congress. That is why banks have diverted extraordinary resources to comply with mandates that are often immaterial to their safety and soundness and against their better judgment.

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 appropriate required to pay fines and remediate their practices, but no one suggests that 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 a bank as a reaction to a compliance failure.
How could matters be improved?

First, the banking agencies should grant a petition for rulemaking filed by the Bank Policy Institute and the American Bankers Association and confirm what they have already said in a recent statement: that guidance is not binding and that only a violation 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 has been ineffective in practice.

Second, more broadly, the agencies should seek public comment on what an MRA is. If it 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 come with appropriate procedural protections.

Third, a zero-based review of the application process should be undertaken to clarify what factors are relevant.

Fourth, the CAMELS rating system should be rethought entirely. The Federal Reserve Board has recently adopted a thoughtful revision of holding company ratings, which could serve as a model.

Conclusion

In closing, Congress did not enact the Administrative Procedure Act 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.

That spirit should be reinjected into bank examination and regulation.

Many thanks for the opportunity to appear before you today.