Core Concept #7: Examinations

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Examination Authority

- Federal Reserve examines the bank holding company
  - Significant, given that modern bank management tends to be centralized
  - The Fed defers to the SEC and CFTC with respect to a securities subsidiary's compliance with the securities laws.
  - The Fed (along with the chartering state's banking authority) also examines a subsidiary state member bank.
- The OCC examines a subsidiary national bank, or the FDIC (along with the chartering state's banking authority) for a subsidiary state nonmember bank.
- The CFPB examines banks with assets greater than $10 billion (and their bank-affiliates) for compliance with the consumer financial protection laws, though the frequency and intensity of those examinations vary greatly.
- In many areas, the agencies duplicate examinations.

Examination

- **Option 1:** Delegate authority to the bank's onsite examination teams.
  - Benefit: that team understands the bank.
  - Cost: that team is prone to capture (or reverse capture); it also lacks a broader perspective and some subject matter expertise.

- **Option 2:** Centralize examination authority in Washington, and rely on "horizontal reviews" by subject matter experts to enforce common standards
  - Benefit: a broader view with experts going bank to bank
  - Cost: examiners don't understand each bank's unique business models or expertise and impose one-size-fits-all standards (e.g., "industry MRAs," without any notice and comment process
- Currently, OCC is Option 1, and Fed is Option 2
- During the pandemic, offsite monitoring approaches have been utilized by examiners

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Key Federal Reserve LISCC Portfolio Supervisory Priorities & the Impact of COVID-19

2018-2019 Federal Reserve LISCC Supervisory Priorities	Planned 2020 Federal Reserve LISCC Supervisory Priorities*
Capital – Capital planning – Regulatory reporting – Counterparty risk – Collateral management – Wholesale credit underwriting	**Capital** – Practices supporting stressed loss/revenue forecasting – Credit risk management – Current expected credit loss (CECL) implementation – Underwriting standards
Liquidity – Internal liquidity street test assumptions – Liquidity position – Governance over liquidity data, contingency funding plans, and currency risk management – Compliance with liquidity regulation	**Liquidity** – Internal liquidity stress test assumptions – Liquidity position – Risk management and governance, for example for liquidity data and new products – Compliance with liquidity regulation
Governance and Controls – Information technology and cyber-related risks – Internal audit – Compliance and business conduct – Vendor risk management – Risk committee practices	**Governance and Controls** – Information technology and cyber-related risks – Internal audit – Compliance risk management – Operational resilience of critical systems – LIBOR preparedness
Recovery and Resolution Planning – Recovery planning – LISCC foreign bank intermediate holding company resolution plans	**Recovery and Resolution Planning** – Recovery planning – LISCC domestic firm resolution plans follow-up (as needed) and LISCC foreign bank IHC resolution plans; preparation for LISCC firm targeted resolution plans

*The Fed temporarily curtailed most non-critical examinations for institutions with over $100 billion in assets, extending time periods for remediating supervisory findings, and delaying regulatory report filing deadlines. These accommodations allowed the industry to focus on critical pandemic-specific issues, including monitoring capital, liquidity, asset quality, operational preparedness and consumer impacts.

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Key Federal Reserve LFBO Portfolio Supervisory Priorities & the Impact of COVID-19

2018-2019 Federal Reserve LFBO Supervisory Priorities	Planned 2020 Federal Reserve LFBO Supervisory Priorities*
Capital – Loss-estimation methodologies – Capital policies and scenario design	**Capital** – Capital planning and risk management, including credit loss estimation and governance – Wholesale credit underwriting and controls and independent loan review functions – CECL implementation
Liquidity – Liquidity buffer – Contingency funding plans	**Liquidity** – Internal liquidity stress testing assumptions and business-as-usual cash flow projections – Governance over liquidity data – Daily and short-term liquidity risk management monitoring programs
Governance and Controls – Cyber-related risks – Internal audit – Compliance and business conduct – BSA/AML and OFAC compliance program control	**Governance and Controls** – Cyber-related and information technology risks – Third-party or vendor risk management – LIBOR preparedness – BSA/AML and OFAC compliance
Recovery and Resolution Planning – Resolution plans, including IHC resolution plans	

*The Fed temporarily curtailed most non-critical examinations for institutions with over $100 billion in assets, extending time periods for remediating supervisory findings, and delaying regulatory report filing deadlines. These accommodations allowed the industry to focus on critical pandemic-specific issues, including monitoring capital, liquidity, asset quality, operational preparedness, and consumer impacts.

Holding Company Level Examination: The New LFI Rating System

- The Large Financial Institution (LFI) Rating System applies to: U.S. bank holding companies (BHCs) with total consolidated assets of $100 billion or more, noninsurance, noncommercial SLHCs with total consolidated assets of $100 billion or more, and U.S. intermediate holding companies (IHCs) of foreign banking organizations with total consolidated assets of $50 billion or more.

- The Federal Reserve assigned initial ratings to LISCC firms in early 2019 and began assigning ratings to LFBO firms in early 2020. Smaller banks will continue to be rated using the RFI rating system.

- Under the new rating system, the Federal Reserve assigns three component ratings: (i) capital planning and positions, (ii) liquidity risk management and positions, and (iii) governance and controls.

- In contrast to the prior rating system, the new rating system does not assign a standalone composite or subcomponent rating.

- The new system uses a four-category rating system:

- *See* SR 19-3 / CA 19-2 Letter, Large Financial Institution (LFI) Rating System at https://www.federalreserve.gov/supervisionreg/srletters/sr1903.htm for more information.

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IDI Examinations: CAMELS Rating System

CATEGORIES	Capital	Asset Quality	Management	Earnings	Liquidity	Sensitivity to risk

SCORES	1 Strong	2 Satisfactory	3 Less than Satisfactory	4 Deficient	5 Critically deficient

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How Do the C-A-M-E-L-S Add up to a Composite Rating?

- CAMELS System: no statutory mandate; invented by banking agencies circa 1978; has never been meaningfully reviewed since (other than adding an "S" in 1996)
- At a time prior to regulatory capital and liquidity standards, detailed financial reporting and detailed call reports – and before most large banks were publicly traded – an examiner rating was the best and often only objective assessment of a bank's financial condition.
- As capital and liquidity regulation has become more quantitative and objective, CAMELS ratings have become more qualitative and subjective: a 1996 update to the CAMELS standards stated that "the management component is given special consideration when assigning a composite rating." Over time, it has become the predominant consideration.
- Ratings tend to cluster at 2s and 3s. Game theory:
  - A "1" puts an agency at risk in the event the bank later has troubles.
  - A "4" comes with significant restrictions on activity, and might be contested by the bank.
  - A "5" basically means insolvency.

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Other Written Communications & the MRA/MRIA

Matters Requiring Attention

Matters Requiring Immediate Attention

- No statutory or regulatory definition
- Come with no prescribed penalties for their issuance or a failure to remediate
- In practice, they are treated by regulators and bank compliance staff as binding legal orders.
- Failure to remediate in practice can lead to downgrade in management rating or entry into “penalty box.”

Consequences of a Low Rating or Other Examiner Criticism: Impact on Applications

- Colloquially known as the "penalty box," regulators post-crisis used the confidential examination process to prohibit a bank (without taking a public or formal enforcement action) from expanding through investment, merger, or adding a branch. There were various ways into the penalty box.
- A "3" rating for management has been an automatic halt on expansion.
  - Under section 4(k) of the Bank Holding Company Act, a financial holding company whose subsidiary bank receives a "3" rating for management must receive Federal Reserve approval to expand certain non-banking activities.
  - Regulators extended that prohibition to include almost any type of expansion.
- Under Federal Reserve SR 14-02, a wide range of supervisory examination concerns triggered a ban on expansion.
- Theory is that a bank lacks the managerial resources to both remediate the identified compliance problem and expand at the same time. Organic growth generally (but not always) is permitted
- Unique to banking regulation. Contra: Volkswagen; Boeing; Facebook.
- In recent years, penalty box has shrunk in practice, though it has not been publicly disavowed or reformed.

Trends in Examination Findings

Federal Reserve Supervision and Regulation Report, November 2019

- Supervisory ratings for large firms have generally held steady over the past year (figure 14). As was the case in 2018, “firms with less-than-satisfactory ratings generally exhibit weaknesses in one or more areas such as compliance, internal controls, model risk management, operational risk management, and/or data and information technology (IT) infrastructure. Some firms also continue to exhibit weaknesses in their Bank Secrecy Act (BSA) and anti-money-laundering (AML) programs.”

- Approximately, 40% of holding companies with >$100B in assets still appear to have a Less-than-Satisfactory rating (Figure 14).

- Approximately 90% of all MRAs issued to LBO and non-LISCC FBO firms are in the Governance and Controls area (Figure 16). The percentage for LISCC firms is 60% (Figure 15).

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Trends in Examination Findings (cont.)

Bank Supervision: Regulators Improved Supervision of Management Activities but Additional Steps Needed, May 14, 2019

- "All the regulators frequently cited management as a primary risk area in the supervisory concerns issued during the period (2012-2016)….
- Corporate governance was the largest of 26 categories of MRAs issued by the Federal Reserve in that period, constituting approximately 19 percent of all MRAs.
- Enterprise governance and operations was the third-largest of 16 examination areas of MRA concerns issued and closed by OCC in 2012–2016, constituting about 11 percent of all MRA concerns. The largest examination area of MRA concerns issued was credit at about 37 percent, followed by bank information technology at 13 percent."

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Appeals of Examination Ratings

- The Riegle Act directed the federal banking agencies to establish an “independent intra-agency appellate process” for the review of “material supervisory determination[s]” and to ensure that “appropriate safeguards exist for protecting the appellant from retaliation by agency examiners”
- The appeals process is not often utilized
    - Julie Andersen Hill, When Bank Examiners Get It Wrong: Financial Institution Appeals of Material Supervisory Determinations , 92 Wash. U. L. Rev. 1101, 1143-1148, 1165-1167 (2015)
- Contested cases generally occur only when individuals are charged
- There has been increased attention placed on this process and the Federal Reserve and FDIC have taken steps to improve due process and fairness.

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