BANK REGULATION 101

PART 1: THE BASICS – HOW ARE BANKS STRUCTURED AND HOW DO AGENCIES PROVIDE OVERSIGHT?

Feb. 17, 2021
11:00 a.m. – 12:15 p.m. EST
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Discussion Items

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12:00 AM – 12:15 AM
- Q&A Portion
Core Concept #1: What is a Bank?
What’s a “Bank”?

• Although many definitions are possible, U.S. law and regulation generally view a “bank” as an entity that:
  • Takes deposits;
  • Makes loans; and
  • Pays checks and transacts payments.

• The U.S. bank regulatory framework takes as its primary point of focus the first of these functions – deposit taking.
  • Generally, an entity must be chartered and licensed as a bank in order to accept deposits.
  • This is not true of lending or payments activities.

• Thus, for example, note the following are NOT banks:
  • PayPal, Venmo and other payment processors;
  • LendingClub, Quicken Loans and other companies that make loans but don’t take deposits; and
  • Money market and other mutual funds.
The Consequences of Being a Bank

The Benefits of Structuring a Business as a Bank

• Cheap, widely available debt funding (in the form of deposits)
• Funding stability provided by the Federal safety net
  • Federal Deposit Insurance Corporation or “FDIC” insurance
  • Access to Federal Reserve emergency loans (i.e., the “discount window”)
• Operational flexibility and simplicity of preemption of (some) state laws and regulation

The Costs of Structuring a Business as a Bank

• Limitations on activities (what the bank can do) and affiliations (what the bank’s parent and affiliate companies can do)
• Prudential regulation of the balance sheet, governance and risk management
• Government supervision and examination
Core Concept #2: The Structure of Bank Regulation
The Structure of Bank Regulation: Three Big Ideas

1. Deposit-taking activities may only take place within a specially chartered and licensed form of legal entity – the “Insured Depository Institution” or “IDI”
   - The IDI’s deposits must be insured by the FDIC
   - The IDI’s activities must be limited to banking and incidental activities

2. An IDI may affiliate with companies engaged in a broader range of activities closely related to banking or other financial activities under a Bank Holding Company (“BHC”) (e.g., securities brokerage or dealing, asset management or insurance)

3. An IDI may not affiliate with companies engaged in commercial activities
   - This reflects the “separation of banking and commerce” that is a key element of the U.S. framework for banks
The Structure of Bank Regulation – Illustrated

IDI Powers

Holding Company

National Bank

Broker-Dealer

Investment Advisor

Swap Dealer

Insurance Company

Service Corp.

Operating Subsidiary

BHC Powers
Core Concept #3: Bank Holding Company Powers & Activities
BHC Powers & Activities: A Brief History

- 1900 to 1956: Emergence of BHC structure, but no restriction/regulation of BHC activities (other than Glass-Steagall barriers and affiliate transaction rules)

- 1956: Bank Holding Company Act (“BHCA”) enacted, limits activities in which BHCs and their subsidiaries can engage

- 1970: BHCA amended to eliminate “one bank holding company” loophole, which has previously allowed bank holding companies to engage in commercial activities so long as they owned no more than one bank

- 1999: Gramm-Leach-Bliley Act (“GLBA”) enacted, creates new “financial holding company” designation and substantially expands permissible financial activities
  - Note: Title 5 of the GLBA also established a comprehensive Federal privacy framework that applies to banks and other financial institutions
BHC Powers & Activities: Triggers & Implications of Regulation as a BHC

- BHCA applies to any company that controls a bank – including all of its subsidiaries
- Core implications of BHC status include:
  - Need Fed approval to become a BHC, acquire an interest in additional banks and engage in nonbanking activities
  - Limits on activities conducted throughout the BHC
  - Prudential regulation and supervision of entire BHC
BHC Powers & Activities: What is a “Bank” for Purposes of the BHCA?

• NOT simply an insured depository institution
• Key exclusions:
  • Thrifts (but see S&L holding company regime);
  • Credit card banks;
  • Certain trust companies;
  • Edge Act/agreement corporations; and
  • Industrial loan companies (“ILCs”)
• We typically refer to the above excluded entities as “nonbank banks”
BHC Powers & Activities: Scope

• BHCs can engage in banking and control or manage banks – § 3 of the BHCA
• BHCs can also engage in activities closely related to banking – § 4 of the BHCA:
  • Making/acquiring/brokering/servicing loans;
  • Leasing real/personal property;
  • Operating a thrift or trust company;
  • Acting as investment/financial advisor;
  • Securities – brokerage, private placement, underwriting/dealing in bank-eligible securities;
  • Management consulting;
  • Courier/check/payments services;
  • Community development; and
  • Processing banking/financial/economic data
BHC Powers & Activities: Expanded powers for BHCs that qualify as “FHCs”

• As part of the GLBA in 1999, Congress created a new “type” of BHC, which is defined by statute as a “financial holding company” or FHC
  • In general, FHCs are authorized to engage in a wider range of financial activities
• In order for a BHC to become an FHC, it must be “well-capitalized” and “well-managed,” and have a satisfactory Community Reinvestment Act (“CRA”) record
• For qualifying FHCs, expanded powers include “activities that are financial in nature” under § 4(k) of the BHCA:
  • Full range of securities dealing and underwriting activity through a registered broker-dealer;
  • Insurance activities;
  • Merchant banking activities; and
  • Others as permitted by Fed over time
• Also includes activities deemed by the Fed to be “complementary” to a financial activity (e.g., commodities trading activities)
Core Concept #4: Prudential Regulation
Prudential Regulation: Overview

• “Prudential regulation”:
  • Primarily focused on the safety and soundness of the institution
  • Applies at both the BHC and IDI level – though underlying legal regimes differ, and often more stringent at the IDI level
  • Distinguish from “market regulation” done by the U.S. Securities and Exchange Commission (“SEC”) and Commodity Futures Trading Commission (“CFTC”)

• Rationales for prudential regulation in banking:
  • Protect depositors;
  • Protect FDIC;
  • Protect banking system; and
  • Limit moral hazard

• Consequences: Prudential regulation of banks has a substantial impact on the economics, design and management of activities in which the bank engages – and therefore both the business model of individual banks and of the banking industry as a whole
Prudential Regulation: Safety & Soundness Framework at a Glance

- Activity restrictions (as described above)
- Capital and liquidity rules (to be addressed in detail later)
- Supervision, examination and enforcement (to be addressed in detail later)
- Governance standards
- Risk management standards
- Special regimes for loans to one borrower, insider lending and affiliate transactions
Prudential Regulation: Affiliate Transactions

• **Overview:** Sections 23A and 23B of the Federal Reserve Act and Regulation W place substantial limits on transactions between an IDI and any “affiliate” thereof.

• **Quantitative limits:** Any “covered transactions” between an IDI and an affiliate are limited as to amount (23A)
  - Covered transactions with a single “affiliate” limited to 10% of IDI’s capital/surplus, and covered transaction with all affiliates combined to 20% thereof.
  - “Covered transactions” include extension of credit to an affiliate, asset purchases from an affiliate, holding securities issued by an affiliate, acceptance affiliate securities as collateral, issuing a guarantee on behalf of an affiliate and credit exposure from derivatives and securities financing transactions.

• **Collateral requirements:** Extensions of credit and other credit exposures to an affiliate must be fully collateralized at specified levels at all times (23A).

• **Low-quality asset prohibition:** An IDI may not purchase low-quality assets from an affiliate (23A).
Prudential Regulation: Affiliate Transactions (cont.)

- **Attribution rule:** Transactions by an IDI with a third party, the proceeds of which are transferred to an affiliate or that benefit an affiliate are considered made to the affiliate (23A)
- **Market terms:** Almost all transactions by an IDI with affiliates must be on market terms or better from the perspective of the IDI (23B)
- **Safety and soundness:** All covered transactions by an IDI with affiliates must be consistent with safe and sound banking practices (23A)
Prudential Regulation: Volcker Rule

• **Overview:** Added by § 619 of the Dodd-Frank Act (§ 13 of the BHCA), the Volcker Rule statute prohibits “proprietary trading” and sponsorship of, or investment in, private equity and hedge funds (so-called “covered funds”), and also places restrictions on certain transactions with advised, sponsored and managed covered funds
  
  • Key exemptions apply to the proprietary trading prohibition, and permit certain underwriting and market making-related activities, hedging activities, trading in certain government obligations and trading on behalf of customers
  
  • Key exemptions apply to the covered fund restrictions, and permit investment in/sponsorship of a covered fund in connection with organizing and offering the covered fund, as well as certain underwriting, market making-related activities and hedging activities

• **Scope of application:** Applies to IDIs and any affiliate thereof (regardless of whether part of a BHC or not)
  
  • Also applies to non-U.S. banking groups with U.S. banking operations on a group-wide basis (subject to certain “exemptions” for activities conducted “solely” outside of the U.S.)
  
  • The Economic Growth, Regulatory Relief and Consumer Protection Act (S. 2155) exempts banks with less than $10 billion in total assets from the Volcker Rule, as long as the banks have less than 5% total trading assets and liabilities.
Prudential Regulation: Volcker Rule (cont.)

• **Volcker 1.0:** The original regulations adopted in 2013 by the five Volcker Rule agencies [the Federal Reserve, FDIC, OCC, SEC and CFTC (Agencies)] posed a number of challenges and were widely perceived as complicated and burdensome:
  • Distinguishing prohibited “proprietary trading” (speculating) from “market-making” and other permissible trading activities;
  • Appropriately defining terms associated with the restrictions on hedge fund and private equity fund sponsorship/investment; and
  • Defining the extraterritorial reach and the “solely” outside of the U.S. standard.

• **Volcker 2.0:** The Agencies amended these regulations relating to the proprietary trading and covered funds portions of the Volcker Rule in 2019 and 2020, respectively:
  • Under Volcker 2.0, balance sheet risk management positions (cash flow hedges, investment securities, etc.) are no longer subject to the proprietary trading prohibition even if the position is sold or unwound within 60 days
  • Stringency of compliance requirements is now generally based on a banking organization’s volume of trading assets/liabilities
  • Credit funds, venture capital funds and certain family wealth management and customer facilitation vehicles are now excluded from the covered funds restrictions (subject of range of key conditions)
Core Concept #5:
Types of Banks & Their Charters
Types of Banks & Their Charters: Key Takeaways

- Key elements to understand:
  - What type of bank is it?
  - Under what law is the bank *chartered* (i.e., incorporated)?

- Understanding the types of banks and their charters is crucial, because this will determine:
  - Who regulates the bank;
  - What laws and regulations apply to the bank; and
  - What activities the bank can engage in
## Types of Banks & Their Charters: Visual Overview

<table>
<thead>
<tr>
<th>BANK</th>
<th>Federal Charter</th>
<th>State Charter</th>
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<tbody>
<tr>
<td></td>
<td>National Bank</td>
<td>State Member Bank</td>
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<tr>
<td></td>
<td></td>
<td>State Non-Member Bank</td>
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<td>THRIFT</td>
<td>Federal Savings Association</td>
<td>State Savings Bank</td>
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<td></td>
<td>State Savings &amp; Loan</td>
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<td></td>
<td></td>
<td>State Savings Association</td>
</tr>
</tbody>
</table>
Types of Banks & Their Charters: National Banks

- Chartered under Federal law – National Bank Act of 1864
- Regulated and supervised by the Office of the Comptroller of the Currency ("OCC")
- Typically engage in a variety of deposit-taking, retail lending (e.g., mortgage lending) and commercial lending
- Primary charter choice for larger banks, particularly over the last 25 years
- Must be a member of the Federal Reserve System
- Deposits must be insured by the FDIC
Types of Banks & Their Charters: State Banks

- Chartered under state law – individual state laws vary
- Primarily regulated and supervised by their state banking agency (e.g., the New York Department of Financial Services)
  - But also subject to Federal regulation and supervision (either Fed or FDIC)
- Typically engage in a variety of deposit-taking, retail lending (e.g., mortgage lending), and commercial lending
- More frequently the charter of choice for smaller community banks
- May or may not be a member of the Federal Reserve System:
  - Determines whether the bank is a “state member” or “state non-member” bank
  - Important because it determines which Federal agency provides supplementary regulation and supervision
- Deposits insured by the FDIC
Non-bank Banks

• Definition of bank
  • Section 2(c)(1) of the BHC Act defines bank as: (1) an insured bank or (2) an institution organized in the United States or its territories that both accepts demand deposits and makes commercial loans.
    • Certain entities may be involved in one of more aspects of the business of banking - accepting deposits, making loans or payment services – without technically being banks.
  • Section 2(c)(2) of the BHCA excludes a variety of institutions from the definition of bank, including:
    • Credit unions
    • Credit card banks
    • Industrial loan companies
  • Other institutions are not banks because they don’t meet the definition in the BHC Act.
  • Recent entrants into the banking space that are also not “banks” include:
    • Institutions chartered under the proposed OCC payments charter
    • State-chartered special purpose depository institutions (SPDIs)
Non-bank Banks (cont.)

- Supervision
  - The non-bank bank itself is generally subject to supervision by the licensing authority.
  - Parent companies, which may be commercial/nonfinancial entities, are not subject to consolidated supervision
    - No or limited restrictions on commercial activities
    - No capital or liquidity requirements
    - Not subject to consumer financial and data protection laws on an enterprise-wide basis
Industrial Loan Companies (ILCs) – In General

- State-chartered depository institutions that may engage in a wide range of banking activities, including accepting FDIC-insured deposits (though not demand deposits) and engaging in unlimited payments and lending activities
  - However, not treated as a “bank” under the BHC Act; therefore, may be owned by commercial/nonfinancial companies
  - Are not subject to holding company capital and liquidity rules
  - Are not examined by the Federal Reserve (or any other regulator)
- Seven states offer ILC (or industrial bank) charters, but most larger ILCs are chartered in Utah or Nevada.
- Major issues raised when Walmart applied in 2006 to establish an ILC: led to regulatory and then legislative moratorium
## Current 15 Largest ILCs

<table>
<thead>
<tr>
<th>Name</th>
<th>State</th>
<th>Deposits</th>
<th>Assets</th>
<th>Owned by a Commercial/Nonfinancial Company?</th>
</tr>
</thead>
<tbody>
<tr>
<td>UBS BANK USA</td>
<td>UT</td>
<td>$48,516,990</td>
<td>$56,096,450</td>
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<td>SALLIE MAE BANK</td>
<td>UT</td>
<td>$21,557,119</td>
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<td>BMW BANK OF NORTH AMERICA</td>
<td>UT</td>
<td>$6,471,085</td>
<td>$10,384,602</td>
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<tr>
<td>OPTUM BANK, INC.</td>
<td>UT</td>
<td>$8,370,878</td>
<td>$10,300,041</td>
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<td>COMENITY CAPITAL BANK</td>
<td>UT</td>
<td>$7,355,921</td>
<td>$9,697,956</td>
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<tr>
<td>BEAL BANK USA</td>
<td>NV</td>
<td>$2,607,020</td>
<td>$5,269,206</td>
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<td>MERRICK BANK</td>
<td>UT</td>
<td>$3,060,819</td>
<td>$3,929,460</td>
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<td>WEX BANK</td>
<td>UT</td>
<td>$2,564,453</td>
<td>$3,191,732</td>
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<tr>
<td>ENERBANK USA</td>
<td>UT</td>
<td>$2,134,349</td>
<td>$2,416,734</td>
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<td>USAA SAVINGS BANK</td>
<td>NV</td>
<td>$323,745</td>
<td>$1,866,188</td>
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<td>MEDALLION BANK</td>
<td>UT</td>
<td>$927,758</td>
<td>$1,109,361</td>
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<tr>
<td>TOYOTA FINANCIAL SAVINGS BANK</td>
<td>NV</td>
<td>$850,976</td>
<td>$1,032,966</td>
<td>Yes</td>
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<tr>
<td>WEBBANK</td>
<td>UT</td>
<td>$751,237</td>
<td>$924,603</td>
<td>No</td>
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<tr>
<td>CELTIC BANK</td>
<td>UT</td>
<td>$672,695</td>
<td>$898,493</td>
<td>No</td>
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<tr>
<td>THE PITNEY BOWES BANK, INC.</td>
<td>UT</td>
<td>$594,128</td>
<td>$724,925</td>
<td>Yes</td>
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</tbody>
</table>
Core Concept #6: The U.S. Bank Regulators
U.S. Bank Regulatory Agencies: Key Takeaways

- The U.S. regulatory structure for banking is immensely complex
  - Largely a product of U.S. political and economic history
  - Frequently the subject of detailed – and unsuccessful – efforts to rationalize and harmonize the agencies
- Regulatory authority is driven on a legal-entity, not functional, basis
- Overall framework is one in which multiple regulatory agencies often have similar or overlapping authority for the same banking organization
  - For example, various parts of the largest U.S. banks are overseen by Fed (bank holding company), OCC (national bank), FDIC (any insured bank), SEC (broker-dealer and/or asset manager), CFTC (swap dealer) and others.
  - This trend was further entrenched by the Dodd-Frank Act
- Key functions of the bank regulatory agencies:
  - Implement and interpret statutes;
  - Supervise and examine banks; and
  - Enforce laws and regulations.
U.S. Bank Regulatory Agencies: Overview

• Primary Federal regulators
  • Board of Governors of the Federal Reserve System ("Federal Reserve Board")
  • Office of the Comptroller of the Currency ("OCC")
  • Federal Deposit Insurance Corporation ("FDIC")

• Other key regulators
  • State banking agencies
  • Securities & Exchange Commission ("SEC")
  • Commodity Futures Trading Commission ("CFTC")
  • State insurance regulators
  • Financial Crimes Enforcement Network ("FinCEN")
  • Consumer Financial Protection Bureau ("CFPB")
  • National Credit Union Administration ("NCUA")
  • Financial Stability Oversight Council ("FSOC")
U.S. Bank Regulatory Agencies: Federal Reserve Board

- Created in 1913
- Primary Federal regulator for bank holding companies and (since 2012) savings and loan holding companies
  - Provides consolidated regulation and oversight for entire organization, not just the holding company
  - But subject to a general principle of “functional regulation” – general deference to functional regulator of each subsidiary (e.g., SEC oversight of a broker-dealer subsidiary)
- Also serves as Federal regulator for state member banks
  - Supplements state banking agency regulation/supervision and provides uniform “floor” of Federal regulation/supervision
- The Federal Reserve also serves as regulator of any foreign bank operating in the United States
  - Foreign banks typically operate in the U.S. through a branch or subsidiary bank
  - Foreign banks may also engage in a range of other financial activities in the U.S. through subsidiaries; the Federal Reserve has required foreign banks with larger U.S. operations to consolidate all such subsidiaries and activities in an “intermediate holding company” (IHC)
- Federal Reserve Board exercises rulemaking authority but in practice often delegates supervision duties to local Federal Reserve banks
U.S. Bank Regulatory Agencies: Office of the Comptroller of the Currency

- Created in 1864
- Primary Federal regulator for national banks and Federal savings associations
  - Authority also extends to subsidiaries of national banks/Federal savings associations
- Performs its supervision and examination functions through a combination of its principal office in Washington, D.C. and regional offices throughout the United States
U.S. Bank Regulatory Agencies: FDIC

- Created in 1933
- Insures the deposits of all Federal and state banks and thrifts pursuant to Federal law
  - Maintains the Deposit Insurance Fund (“DIF”)
- Primary Federal regulator for state non-member banks and state thrifts
  - Supplements state banking agency regulation/supervision and provides uniform “floor” of Federal regulation/supervision
- Because of its interest as deposit insurer, effectively acts as a “secondary” Federal regulator for all IDIs
- Insolvency and receivership powers:
  - By statute, is responsible for closing any failed Insured Depository Institution (IDI)
  - Under Dodd-Frank Act, also has special authority to resolve failed systemically-important financial institutions
Regulators Use Three Different Forms of Oversight

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<table>
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<tbody>
<tr>
<td>Regulation</td>
<td>- The rules under which banks are required to operate</td>
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<tr>
<td>Supervision</td>
<td>- The review of a bank’s books and records to determine its financial soundness and compliance with law</td>
</tr>
<tr>
<td>Enforcement</td>
<td>- The use of legal tools to compel compliance and penalize those responsible for imprudent or improper conduct</td>
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**Principal U.S. Agencies & SROs Involved in Supervision/Enforcement**

**Legend:**

- **CFPB**: Consumer Financial Protection Bureau (assuming that the IDI has greater than $10 billion in assets)
- **CFTC**: Commodity Futures Trading Commission
- **FDIC**: Federal Deposit Insurance Corporation
- **FRB**: Federal Reserve Board
- **FinCEN**: Financial Crimes Enforcement Network
- **NASD**: National Association of Securities Dealers
- **NFA**: National Futures Association
- **OCC**: Office of the Comptroller of the Currency
- **SEC**: Securities and Exchange Commission
- **SRO**: Self-regulatory Organizations

* Office of Foreign Assets Control, Department of Justice and U.S. Attorneys, and State Attorneys General do not have supervisory authority but have the authority to bring certain enforcement and/or criminal actions against the bank holding company and its subsidiaries.
Confidential Supervisory Information (CSI)

- The examination process and examination ratings – as well as informal enforcement actions – are secret.
  - They are exempt from disclosure under Freedom of Information Act (FOIA)
  - The agencies take the position that any exam-related information is government property and thus that its improper disclosure is a conversion of federal property, so a federal crime
- In recent years, agencies have designated a wide set of information as “confidential supervisory information”
  - Requests for information
  - “Industry MRAs”
- Specific CSI rules vary somewhat across agencies
Confidential Supervisory Information – FRBNY Circular 11002

Improper Disclosure of Confidential Supervisory Information by Financial Institutions

To the Chief Executive Officers of All State Member Banks, Branches and Agencies of Foreign Banks, Bank Holding Companies, and Edge Corporations in the Second Federal Reserve District:

“It has recently come to my attention that certain financial institutions may be improperly disclosing confidential supervisory information. This letter is intended to ensure that all institutions supervised by the Federal Reserve in the Second Federal Reserve District understand what constitutes confidential supervisory information, and for what purposes an institution may use such information.

As you should know, the Board of Governors of the Federal Reserve System has promulgated regulations defining "confidential supervisory information" as:

... [R]eports of examination and inspection, confidential operating and condition reports, and any information derived from, relating to, or contained in them. "Confidential supervisory information" may consist of documents prepared by, on behalf of, or for the use of the Board [of Governors, or] a Reserve Bank ..... (12 CFR 261.2(b))
Except to the limited extent otherwise provided by law, reports of examination or inspection -- whether prepared solely by the Federal Reserve or jointly with a Federal or state supervisory agency -- are confidential, as is all information contained in such reports, including an institution's supervisory rating, such as BOPEC, CAMELS or ROCA. Any workpapers that examiners have prepared in the course of an examination are confidential, whether or not these workpapers have been shared with a financial institution. Any evaluation of a loan or other credit, including any evaluation made pursuant to the Shared National Credit Program, is confidential. The first-day letter that the Reserve Bank sends to a financial institution in anticipation of an examination, along with the institution's responses to that letter, are also confidential. Moreover, any non-public enforcement actions, such as memoranda of understanding between the Reserve Bank and an institution, are confidential. Questions as to whether any other material is confidential supervisory information should be addressed to the Reserve Bank before any public disclosure of the information is made.

... 

Disclosure of confidential supervisory information constitutes a violation of the Board of Governors' regulations, and could lead to formal supervisory action, including the imposition of substantial civil money penalties.”
Core Concept #7: Examinations
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
Key Federal Reserve LISCC Portfolio Supervisory Priorities & the Impact of COVID-19

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

*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

<table>
<thead>
<tr>
<th>Capital</th>
</tr>
</thead>
<tbody>
<tr>
<td>- Loss-estimation methodologies</td>
</tr>
<tr>
<td>- Capital policies and scenario design</td>
</tr>
</tbody>
</table>

<table>
<thead>
<tr>
<th>Liquidity</th>
</tr>
</thead>
<tbody>
<tr>
<td>- Liquidity buffer</td>
</tr>
<tr>
<td>- Contingency funding plans</td>
</tr>
</tbody>
</table>

<table>
<thead>
<tr>
<th>Governance and Controls</th>
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</thead>
<tbody>
<tr>
<td>- Cyber-related risks</td>
</tr>
<tr>
<td>- Internal audit</td>
</tr>
<tr>
<td>- Compliance and business conduct</td>
</tr>
<tr>
<td>- BSA/AML and OFAC compliance program control</td>
</tr>
</tbody>
</table>

<table>
<thead>
<tr>
<th>Recovery and Resolution Planning</th>
</tr>
</thead>
<tbody>
<tr>
<td>- Resolution plans, including IHC resolution plans</td>
</tr>
</tbody>
</table>

#### Planned 2020 Federal Reserve LFBO Supervisory Priorities*

<table>
<thead>
<tr>
<th>Capital</th>
</tr>
</thead>
<tbody>
<tr>
<td>- Capital planning and risk management, including credit loss estimation and governance</td>
</tr>
<tr>
<td>- Wholesale credit underwriting and controls and independent loan review functions</td>
</tr>
<tr>
<td>- CECL implementation</td>
</tr>
</tbody>
</table>

<table>
<thead>
<tr>
<th>Liquidity</th>
</tr>
</thead>
<tbody>
<tr>
<td>- Internal liquidity stress testing assumptions and business-as-usual cash flow projections</td>
</tr>
<tr>
<td>- Governance over liquidity data</td>
</tr>
<tr>
<td>- Daily and short-term liquidity risk management monitoring programs</td>
</tr>
</tbody>
</table>

<table>
<thead>
<tr>
<th>Governance and Controls</th>
</tr>
</thead>
<tbody>
<tr>
<td>- Cyber-related and information technology risks</td>
</tr>
<tr>
<td>- Third-party or vendor risk management</td>
</tr>
<tr>
<td>- LIBOR preparedness</td>
</tr>
<tr>
<td>- BSA/AML and OFAC compliance</td>
</tr>
</tbody>
</table>

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*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.
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:

IDI Examinations: CAMELS Rating System

<table>
<thead>
<tr>
<th>CATEGORIES</th>
<th>Capital</th>
<th>Asset Quality</th>
<th>Management</th>
<th>Earnings</th>
<th>Liquidity</th>
<th>Sensitivity to risk</th>
</tr>
</thead>
</table>

<table>
<thead>
<tr>
<th>SCORES</th>
<th>1 Strong</th>
<th>2 Satisfactory</th>
<th>3 Less than Satisfactory</th>
<th>4 Deficient</th>
<th>5 Critically deficient</th>
</tr>
</thead>
</table>
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.
Other Written Communications & the MRA/MRIA

- 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.”
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).

GAO-19-352
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.”
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

- 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.
Core Concept #8: Enforcement Actions
Types of Action: Informal vs. Formal Enforcement Actions

- Formal Written Agreement
- Cease & Desist (C&D)
- Personal Cease and Desist Order (PC&D)
- Prompt Corrective Action (PCA)
- Safety and Soundness Directive
- Termination of FDIC Insurance
- Removal or Suspension of Institution Affiliated Party (IAP)
- Civil Money Penalties (CMPs)

Informal Actions: Commitment Letter, Board Resolutions, MOU
Parties Subject to Enforcement Actions and Grounds on Which Actions May be Brought

- Parties subject to enforcement
  - Supervised Institutions
  - Institution-Affiliated Parties
    - Directors, officers, employees, agents of the institution
    - Person who controls an IDI
    - Independent contractors (e.g., attorneys) who act knowingly/recklessly
- Grounds on which enforcement actions may be brought
  - Violation of a law, rule, regulation or a final Order
  - Breach of fiduciary duty
  - Unsafe or unsound banking practice
Types of Remedies: Cease & Desist

- Generally requires board to manage the remediation plan
- Issued to halt violations of law as well as to require affirmative action to correct any condition resulting from such violations.
- May be issued upon consent by Board ("Consent Order"), or involuntarily, after service of a Notice of Charges and an administrative hearing resulting in a final agency Order.
  - In practice, always by consent, with company neither admitting nor denying liability
  - Generally, agree to multi-year remediation plan, in many cases conducted and overseen by a consulting firm
- Personal Cease & Desist Orders (PC&Ds) may be issued against an “institution-affiliated party”
- In practice, 100% of cases against large banks are settled, given reputational and retaliation risks of litigating with one’s regulator, and generally on agency terms. The result is a consent order
- Such orders often mandate hiring of an outside consultant and include a series of actions the bank must take
- The consent orders are generally amended by the agency over time to add more requirements with the threat of a new order if the bank does not agree to the amendment
Bank Regulation 101 - Part 2: Coming Spring 2021