AFR Americans for Financial Reform

AFR Comment for the Record to Senate Banking Committee

Hearing on "Guidance, Supervisory Expectations, and the Rule of Law", April 30, 2019

Americans for Financial Reform ("AFR") appreciates the opportunity to comment on today's hearing. We are a coalition of more than 200 national, state, and local groups who have come together to advocate for reform of the financial industry.[1]

Today's hearing addresses the ability of banking regulators to issue guidance to their in-the-field supervisors, and whether guidance and supervision practices somehow conflict with rule of law principles of accountability and transparency. This statement addresses our concern that efforts by industry lobbyists to restrict agency guidance and supervisory discretion threaten to weaken and undermine traditional prudential safety and soundness supervision of large banks. Other relevant issues, including in-depth legal analysis and the relationship with consumer regulation, are addressed in today's testimony by Professor Patricia McCoy.

Bank prudential supervision differs fundamentally from other forms of regulation, in that supervisors are empowered to make discretionary enforcement determinations regarding broad issues of safety and soundness that may not be precisely anticipated in written rules. As a recent Federal Reserve Bank of New York analysis states:[2]

> "Supervision is closely related to, but distinct from, regulation of banking organizations. Regulation involves the development and promulgation of the rules under which banking organizations operate, as well as their enforcement in the court of law. Supervision is closely related to regulation to the extent that it is often entrusted with compliance with regulation. But a key feature of supervision is ensuring that banks don't engage in "unsafe and unsound" practices. "Safety and soundness" is not hard-coded into law, reaches far beyond written rules, and crucially involves judgment in assessing whether a bank may be engaging in excessive risk….In practice, supervisory activities involve monitoring banks and using this information to request corrective actions from banks should their conditions or practices be deemed unsafe or unsound."

Federal prudential bank supervision in the United States dates back over 150 years, to the National Bank Act of the 1860s. With the passage of the New Deal banking laws in the 1930s, which provided government insurance to deposits and thus weakened market discipline, bank supervision became more aggressive and more oriented toward prudential safety and soundness concerns. Statutes that explicitly grant general safety and soundness authority to key banking

[1] Members of our coalition include consumer, civil rights, investor, retiree, community, labor, faith based, and business groups. A list of coalition members is available at http://ourfinancialsecurity.org/about/our-coalition/

[2] Eisenbach, Thomas, David Lucca, and Robert Townsend, The Economics of Bank Supervision, Staff Report No. 769, Federal Reserve Bank of New York, March 2016 (Revised January 2017). https://nyfed.org/2VytJor

regulators include the Federal Deposit Insurance Act of 1950 for the FDIC, and the Bank Holding Company Act of 1956 for the Federal Reserve.

It would be ironic if in the aftermath of the catastrophic 2008 financial crisis Congress moved to restrict prudential supervisory authority and make it more difficult for bank supervisors to take action to address threats to the financial system. Yet this is the thrust of current lobbying efforts by the representatives of the nation's largest banks, and their arguments in this hearing. For example, in a recent publication by the Bank Policy Institute, Margaret Tayhar, who is testifying at today's hearing, describes safety and soundness supervision as an unaccountable "secret realm" of regulation that evades the rule of law as represented by the more transparent processes in the Administrative Procedures Act.[3] She criticizes a wide variety of post-crisis supervisory and regulatory actions, including guidance on leveraged business lending, resolution planning and its associated capital and liquidity requirements, horizontal reviews, and expanded examination scope, as illegitimate products of this "secret realm", implying that they should be reversed or limited due to their lack of transparency.

It is striking that large banks are only now criticizing supervisory regimes that have existed since at least the 1950s if not before. The most logical explanation for this is that, due to the example of the 2008 financial crisis and its devastating human and economic impact, supervisors have recently begun to use their safety and soundness supervision powers more aggressively to address bank risks and inappropriate business practices. Given the fact that bank prudential supervision was clearly inadequate before the crisis, and that Congress mandated enhanced prudential supervision of large banks in the Dodd-Frank Act, this is entirely appropriate.

The increased criticism of safety and soundness supervision has led to efforts to restrict the discretionary use of practices that are essential parts of the supervisor's toolkit. Notably, legislators and lobbyists have sought to restrict underwriting judgements by supervisors, and the use of essential risk management techniques such as stress testing. For example, the ability of agencies to issue supervisory guidance on underwriting loans to highly leveraged corporations without triggering legal restrictions has been placed under question.[4] A recent letter from Chairman Crapo to regulators has also placed in question regulators' ability to issue routine guidance to supervisors regarding stress testing in cases where Dodd-Frank (DFAST) stress tests are not legally mandated for a bank.[5]

Such restrictions threaten to significantly undermine the ability of supervisors to assess the safety and soundness of banks and the financial system. Oversight of loan underwriting and the

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[3] Tayhar, Margaret, "Are Bank Regulators Special?" Banking Perspectives, Bank Policy Institute, March 3, 2018. http://bit.ly/2GScZ3A

[4] Government Accounting Office, Applicability of the Congressional Review Act to Agency Guidance on Leveraged Lending, B329272, October 19, 2017. http://bit.ly/2IQFNM5

[5] Chairman Mike Crapo, Letter to Chairman Jerome Powell, Chair Jelenna McWilliams, and Comptroller Joseph Otting Re Joint Guidance on Stress Testing, December 18, 2018.

performance of stress tests on particular instruments and portfolios have been a routine part of bank supervision for decades. They are routinely found in bank supervisory manuals dating from well before the financial crisis. Bank regulators issued urgent guidance on leveraged lending in response to issues observed after the collapse of Long Term Capital Management.[6] The Comptroller's Handbook from early 2008 lays out underwriting standards for leveraged loans, and a 1997 supervisory letter by the OCC calls for bank management to stress test individual credits and overall credit portfolios, and for supervisors to ensure that such stress testing is properly conducted. [7] Numerous other examples can be found of pre-crisis regulatory guidance from banking agencies that instruct banks and supervisors to engage in portfolio stress testing and to implement strong underwriting standards.[8]

The recent claim that traditional supervisory tools, or guidance issued to supervisors concerning how these tools should be used, conflicts with the rule of law is a striking departure from multi-decade practice. As stated above, the apparent motivation here is apparently the more intensive nature of the supervisory processes adopted since the financial crisis. In response to heightened supervision, large banks are now attempting to tie supervisors' hands by forcing pre-specification of supervisory actions in rules governed by extensive APA procedural requirements. This conflicts with the nature of prudential supervision, which is highly context specific and demands the exercise of supervisory judgement. We urge Congress to resist such efforts and maintain the ability of bank supervisors to respond flexibly to facts on the ground through underwriting judgements and basic risk management tools such as stress testing.

With that said, we do agree that aspects of the traditional supervisory model could usefully be revisited. In particular, the sometimes excessive limits on the release of confidential supervisory information can have a negative effect in preventing adequate public oversight and understanding of supervisory activity, and can even hamper sharing of data between regulators. We have previously called on regulators to release significantly more information to the public on the supervisory practices and decisions involved with the implementation of the Volcker Rule and the approval of bank resolution plans. Greater sharing of supervisory information with the public concerning key details of supervision would be beneficial, but it should not take place in a manner that undermines the ability of supervisors to act forcefully to address safety and soundness risks to banks or threats to the stability of the financial system.

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[6] See p. 43 in Government Accounting Office, Risk Focused Banking Examinations: Regulators of Large Banking Organizations Face Challenges, GAO/GGD-00-48, January, 2000. http://bit.ly/2XP7U1s

[7] Comptroller of the Currency, Leveraged Lending: Comptroller's Handbook, February 2008. http://bit.ly/2GUDGVd ; Comptroller of the Currency, Advisory Letter 1997-3: Credit Underwriting Standards and Portfolio Credit Risk Management, March 11, 1997. http://bit.ly/2LeXJSn

[8] Office of the Comptroller of the Currency, Board of Governors of the Federal Reserve System, Federal Deposit Insurance Corporation, Final Guidance: Concentrations in Commercial Real Estate Lending, December 12, 2006. http://bit.ly/2W9hZWF; Office of the Comptroller of the Currency, Board of Governors of the Federal Reserve System, Federal Deposit Insurance Corporation, Office of Thrift Supervision, Expanded Guidance for Subprime Lending Programs, January 31, 2001. http://bit.ly/2GJTUza