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Introduction

With many crisis-era 10th anniversaries approaching, I was hoping to begin my remarks by noting some particular event on this date in 2008. When I looked up what happened on February 28, 2008, however, I got back:

> "Former Prime Minister of Thailand Thaksin Shinawatra is arrested on corruption charges."

Apparently, there *were* several notable events on February 29, 2008, and I thought about trying to postpone my remarks a day, but alas this is a leap year, so there will be no February 29th. So, let me start another way….

Since the holidays, I have read two extraordinary books: *Directorate S*, the second volume of Steve Coll's now 40-year history of U.S. and particularly CIA action in Afghanistan and Pakistan; and *Janesville*, Amy Goldstein's remarkable micro history of a small Wisconsin town in the years since its GM plant closed in 2008. She profiles the laid off workers, their families, and the people at local, state and federal government trying with very limited success to assist them.

While the books could not have more different topics, they deal with two of the most contentious issues of our time, and what most would view as policy failures. And yet, remarkably, both books have few if any villains. I confess that I read them looking for someone to blame (and with some early favorites), but came up largely empty. I finished both books truly humbled. Both at their heart are about flawed people trying to do their best in very difficult circumstances. I could not urge you more strongly to read them.

So, ten years after Thanksin Shinawatra's arrest, what does my winter reading have to say about bank regulatory policy?

First, it is very difficult -- and we owe understanding and support to those trying to weigh its costs and benefits. Indeed, the heart of our work at the Clearing House is to help them in that mission, respectfully and based on data and analysis, rather than arm waving and empty prophesies of doom. We also work closely with an academic community increasingly focused on these issues. Bank regulation is, in its own way, no simpler than counterinsurgency or job retraining, and smart, well-meaning people can reach different conclusions, even on the same set of facts.

Second, though, we should be quite skeptical of those who consider this task simple, who are certain they are right, and who disdain of transparency and debate.

Today I will focus on banking *examination*, the clandestine ground war of banking policy, and not banking *regulation*. (So, sorry, no critique of the LCR or indictment of the leverage ratio.) Supervision is a tough subject to discuss, exactly because public information is limited. And yet when I talk with bankers about what is preventing them

from effectively serving their customers, I hear a lot more about the loss of materiality in the examination process than I do about any given regulation. As the late Bob Wilmers put it in his final shareholder letter:

> At M&T, our own estimated cost of complying with regulation has increased from $90 million in 2010 to $440 million in 2016, representing nearly 15% of our total operating expenses. These monetary costs are exacerbated by the toll they take on our human capital. Hundreds of M&T colleagues have logged tens of thousands of hours navigating an ever more entangled web of … examinations…. During 2016 alone, M&T faced 27 different examinations from six regulatory agencies. Examinations were ongoing during 50 of the 52 weeks of the year, with as many as six exams occurring simultaneously. In advance of these reviews, M&T received more than 1,200 distinct requests for information, and provided more than 225,000 pages of documentation in response. The onsite visits themselves were accompanied by an additional, often duplicative, 2,500 requests that required more than 100,000 pages to fulfill—a level of industry that, beyond being exhausting, inhibits our ability to invest in our franchise and meet the needs of our customers.

The upcoming month's issue of our magazine, *Banking Perspectives*, contains a brilliant article by Meg Tahyar of Davis Polk. It traces the history of banking regulation, and demonstrates that many features of the current examination regime are historical anomalies, not proud traditions.

Supervision of What Exactly?

So, how did we get here? I'll start with a little law and history. Interestingly, bank "supervision" is a term not actually used in the banking law. Instead, the law includes, first, authority for banking agencies to examine all the affairs of the bank and issue a detailed report of examination; and, second, enforcement authority to prohibit or punish unsafe or unsound practices, or violations of law.

At its heart, this is a remarkably simple and straightforward paradigm — banks are examined for the purposes of identifying unsafe and unsound practices or violations of law, and regulators take enforcement action when either is found.

Yet post-crisis, our examination system has lost its moorings. It has extended well beyond its statutory remit, and focused increasingly on immaterial or unrelated issues. As a result, banks have not only incurred significant unnecessary costs, but as I'll describe, more importantly have frequently been blocked from efforts to branch, grow or reorganize to better serve their customers.

In particular, currently, a substantial amount of bank examination time – perhaps even a majority -- is spent on four functions: one that Congress never authorized; two that Congress expressly provided should *not* be the duty of bank examiners; and one that is largely unauthorized and also appears to be a bad idea.

Examination as Management Consulting

The first feature of the current system is, in the words of my colleague Jeremy Newell, “examination as management consulting.” And this has created — he is good with words— a vast consulting-industrial complex.

Let me give just a few examples.

- First, large banks have been instructed that it is inappropriate for the head of compliance to report to the general counsel. This is based on no law or regulation, and no analysis or data of which I am aware. Yet everyone knows this.

- Second, examiners now routinely review minutes of meetings to ensure they are complete and reflect a “credible challenge” by senior management or boards of directors. The composition and agendas of board and management committees is also the focus of examinations.

- Third, regulators are now quite enamored of the need for three lines of defense, and have definite opinions about what functions belong in what lines. Yet I am aware of no research or analysis demonstrating that three lines work better than two or four, or what functions should be where.

- Fourth, a continuing post-crisis focus is vendor management, which has now become its own industrial complex. Small businesses have been severely damaged, as they cannot afford the due diligence required under agency guidance, and banks would prefer to conduct due diligence on fewer potential vendors. Certainly, we do not want banks to avoid examination by outsourcing crucial functions, but reviewing the hundreds of pages of guidance in this area, one struggles to imagine how violation of *any* of its provisions could possibly produce a material loss to a bank.

- Finally, the scariest words in examination are now “horizontal review” and “best practices.” Certainly, horizontal reviews can provide examiners perspective, but in practice the two concepts frequently have been combined to mean a multi-bank review where examiners compare a given practice across banks, identify the one they prefer, and force it on all. Banks must immediately adopt an identified “best practice” or risk a downgrade in examination rating, yet there is no opportunity to comment on such a de facto regulatory standard either publicly or privately. Nothing better epitomizes examination-as –management-consulting than this development.

Consumer Compliance

The second major focus of current bank examination is consumer compliance. Again, let’s start with the law:

- Section 1025 of the Dodd-Frank Act transferred to the CFPB "exclusive authority to require reports and conduct examinations on a periodic basis of an insured depository institution with total assets of more than $10 billion" – so, exclusive authority to examine consumer compliance for 94% of the assets of the national banking system.

- Section 1025 also prohibited the banking agencies from taking any consumer compliance enforcement action against such banks unless it first provides the CFPB's with 120-day prior written notice and the CFPB declines to proceed on its own.

- Section 1061 of Dodd-Frank transferred all "consumer financial protection functions" from the federal banking agencies to the CFPB, including "all authority to prescribe rules or issue orders or guidelines" pursuant to *any* Federal consumer financial law.

And yet… by all accounts the banking agencies increased their consumer compliance examination activity in the years after Congress clearly divested them of any authority to engage in it. Banks therefore are now subject to entirely duplicative regimes.

To the extent that the agencies proffered a justification for ignoring the spirit and letter of the law, it was that they retained safety and soundness authority. And so the syllogism goes:

- every consumer compliance problem presents a "reputational risk";
- every "reputational risk" presents a safety and soundness problem; ergo
- every consumer compliance problem is a safety and soundness problem; ergo
- the agencies must examine continually for consumer compliance, just as before.

This logic is nonsensical as pertains to the vast majority of examination efforts in this area, which deal with issues having no possible safety and soundness consequence.

And the logic appears no better even in extreme cases. Consider that even with respect to Wells Fargo -- which we can agree is an unprecedented event with respect to reputational risk -- its CDS spreads continue to trade near record lows; its debt spreads are fine; and its debt was never downgraded – until, ironically, the Federal Reserve capped its asset size. So, there appears to be no evidence whatsoever to support the notation that consumer compliance violations beget reputational risk which begets safety and soundness problems requiring duplicative on-site examination.

Also as a practical matter, if a consumer compliance problem ever *did* rise to the level of a threat to safety and soundness, the CFPB's compliance examiners could simply refer that matter to the relevant banking agency.

One interesting passage in *Janesville* observed that after the plant closing, payday lenders began to appear in town. It seems counterintuitive that non-banks would be willing to

serve out-of-work auto workers, but banks would not. But subprime lending not only carries high capital charges, it also presents "reputational risks" -- risks that non-bank lenders are free to run but regulators treat as a mortal threat.

Let me be clear: consumer compliance is important. Indeed, agree or not, Congress decided eight years ago that it was so important that it should be conducted by an agency solely dedicated to that task, and not by bank examiners. For them, it is now at best a distraction and at worst, as I'll describe further, a significant interference with their core duty.

AML

The third focus is anti-money laundering. (Note here that I am not referring to sanctions policy but rather to banks' obligations under the Bank Secrecy Act to report suspicious activity to law enforcement.)

Congress in the Bank Secrecy Act explicitly vested sole regulatory, examination and enforcement authority in the Treasury Department, an agency with considerable financial but also law enforcement and national security knowledge -- *not* the banking agencies. Congress rightly saw that this was an altogether different mission, requiring different expertise. However, decades ago, an understaffed and underfunded FinCEN delegated all examination authority to the banking agencies, and then abdicated any oversight role in how they conducted it.

The result is a system where the end users of suspicious activity reports, or SARs– law enforcement and national security – have little or nothing to say when a bank's compliance is evaluated. Examiners are generally not permitted to know which SARs are valued by the end users, and so focus on what they do know: policies and procedures.

For example, banks know that examiners test compliance by reviewing alerts and trying to identify cases where a SAR was not filed but arguably should have been. Therefore, they reportedly spend more time documenting decisions *not* to file SARs than they do following up on SARs they do file. In other words, they focus on the noise, not the signal. And they continue to use antiquated, consultant-devised, rules-based systems– rules known to the bad guys, by the way – rather than innovative artificial intelligence approaches, largely because the former are conducted under policies and procedures that have passed muster with regulators.

Furthermore, under this regime no one sets priorities – unlike any law enforcement or national security agency in the word. According to bank analysis – there is little to no governmental analysis – the great majority of SAR filings receive no uptake from law enforcement. For certain categories of SARs – structuring, insider abuse -- the yield is close to 0 percent. And those categories now represent a *majority* of the SARs filed.

Read a series of bank AML consent orders, large banks or small, and notice what is *not* there. In most cases, there is no mention of actual money laundering. There is *never* any

criticism for failure to innovate; indeed, the mandate is generally to reinforce a decades-old system. I am aware of no case where a consent order cited any data on the value of the SARs the bank actually filed, or its subsequent off-the-record efforts to assist law enforcement or national security agencies in making cases, and thus how truly effective the bank's program really was. For tennis fans, the sole focus is foot faults or unforced errors, not winners.

It is as broken a system as one could imagine. But to date, in an area vital to our national welfare, no one has yet taken responsibility to make fundamental changes.

I contrast this with what I read in Steve Coll's *Directorate S*. Across multiple Administrations, senior national security officials showed an extraordinary willingness to rethink their strategy. They frequently designated insiders, outsiders, and quasi-outsiders — NSC or State Department experts, retired intelligence officers, even academics — to visit Afghanistan and Pakistan and spend months assessing the situation on the ground. They listened hard, and frequently changed course as a result. And they did so in a world where secrecy was paramount, and where they were being subjected to withering criticisms. They may have failed to get the right answers, but it was not for lack of trying.

The Penalty Box

So, continuing to pull on this string, why does all this matter? Here we reach the penalty box.

Let's start with the CAMELS rating, which is a
crucial component of bank examination. As I've written previously, that regime is out of date; for example, in evaluating the Capital component, the published standards do not include consideration of any post-1978 regulatory capital standards.

But the standards for a Capital component don't really even matter because all CAMELS components are not created equal. My colleague Bill Nelson recalls going through examiner training years ago, and being taught that the least significant component of the CAMELS rating system was the "M" (for Management) because it was the most subjective. Today, the M is the *predominant* component, generally driving the composite rating — exactly *because* it is subjective. It is effectively unappealable, and it gives regulators extraordinary leverage over the banks they examine.

So, what does the "M" really measure, then? One would think that a profitable bank with good market metrics and in full compliance with all applicable capital and liquidity requirements would be presumptively rated a 1 or 2 for management. Certain, those are the type of banks that investors and analysts would consider well managed. But by all accounts, that is not the type of management that determines today's rating. Rather it is matters such as consumer compliance and AML practices, as well as other often immaterial compliance issues, and the alacrity with which management remediates them.

At the Clearing House we like data, and so thought it would be interesting to study the predictive power of CAMELS ratings for bank performance. (One earlier study seemed to show them to be negatively predictive.) Some time ago, we filed a FOIA request with the agencies asking for aggregate, anonymized ratings — basically, how many banks were 1s, 2s and 3s. In the event, the OCC and FDIC denied our request. The Fed at least has had the prudence to ignore it. Bottom line: if I were considering an investment in a bank and could access any 10 pieces of information, public or private, about that bank, its CAMELS rating would not make my list. And the same at 20 or even 50. Because CAMELS really isn't about that anymore.

A low CAMELS rating is one but not the only way to enter the penalty box. Under post-crisis practice, particularly beginning in 2014:

- A "3" CAMELS rating for management significantly limits the ability to expand.
- Any AML consent order operates as a multiyear ban on expansion for any purpose, regardless of the seriousness of the conduct motivating the order or the progress made by the firm in remediating it.
- A "Needs Improvement" CRA rating also functions as a multiyear ban, regardless of what triggered it or how it is being remediated.
- The existence of unremediated compliance issues or an open investigation can put an application into purgatory.

This penalty box is a post-crisis invention, generally with no grounding in law. For example, while some statutes governing expansion require an assessment of management, many do not. And of those that do, such as the Bank Holding Company Act, each speaks to "management resources" – presumably, the ability of management to oversee an integration.

In sum, I believe that mission leap in examination scope, and a stronger link between examination findings and the ability of a bank to expand, have harmed, not helped, the examination process. Traditionally, the examination process has included informal give-and-take, and examiner recommendations short of MRAs with ratings consequences. Examiners bring useful perspective to bank processes, identifying problems that may not rise to the level of unsafe and unsound. On the other hand, bank management should be able to consider that criticism, and explain why they have chosen to go another way. In my view, weaponizing the examination process by magnifying its impact on bank powers, and shifting its focus to matters unrelated to safety and soundness, has seriously degraded this valuable interchange.

And One More Problem

A final supervisory focus has not affected bank expansion but is worth noting. This is "macroprudential supervision" or the notion that bank activities that are <u>not</u> unsafe and unsound practices should nonetheless be restricted if they collectively imperil financial stability. I think of the words of the great Alanis Morrisette, as macroprudential is the "thin transparent dangling carrot" of supervision.

Funny, even here, Congress has granted the Fed some authority under section 165 of Dodd-Frank, but denied it to the other banking agencies. Yet they are on board the macropru train as well.

As an example, consider the case of leveraged lending guidance issued by the three banking agencies in 2013 and 2014. As my colleague Bill Nelson has documented, financial stability risks from leveraged lending were discussed repeatedly by the FOMC, and Chair Yellen described the guidance in a speech as a tool to address those risks. Much attention has been paid to the question of whether that guidance was treated as binding — which it clearly was — and whether the agencies will now continue to so treat it — I trust not. But the greater lesson of the leveraged lending guidance is its demonstrated failure on its own terms.

First, at the time the guidance was issued, the agencies provided no evidence that there was a risk to financial stability posed by leveraged loans. Such evidence would have been hard to find, as investments in risky assets do not generally present financial stability risk so long as the investments are not funded with short-term debt. According to OFR's 2013 annual report, leveraged loans were purchased by mutual funds or bundled into CLOs, and thus not short-term funded.

Second, even if there had been systemic risk associated with leveraged lending, two separate Fed working papers have concluded that the leveraged lending guidance was an ineffective tool for addressing that risk. Both papers found that the guidance had the effect of shifting leveraged lending origination activity away from large banks and towards less regulated market participants, with no meaningful reduction in any systemic risks posed.

So, before attempting to grab this carrot again, I'd suggest that regulators consider their ability to pre-identify macroprudential threats, and whether they can actually achieve macropudential goals simply by increasing the stringency of microprudential rules on a handful of large banks.

Now, at last, some good news.

At the Fed, Vice Chair Quarles has indicated that his review of post-crisis regulation will include a look at supervisory processes.

Indeed, the Federal Reserve has recently sought comment on a proposal to replace the current bank holding company rating system with a new rating system for large financial institutions. As proposed, the system would refocus examination on safety and soundness and the risk of the firm experiencing material distress.

Perhaps more importantly, at the bank level, it could be adopted by the FFIEC in place of the current CAMELS regime, or serve as a model for a wholesale review of that regime by the FFIEC.

Also, just yesterday, the Fed proposed changes to its examination appeals process. I would describe fully the many flaws in the existing regime, but I think I actually drafted it during my boyhood at the Fed. But I like to think I've gotten smarter between now and then, and so it seems have they.

For its part, the CFPB, in its least noticed recent Request for Information, actually sought public comment on many of the matters I've discussed today. Of particular note, the request seeks input on the agency's use of MRAs, its internal supervisory appeals process, and how the Bureau should coordinate its examination activity with Federal and state supervisory agencies.

Finally, the OCC has clarified, after notice and comment, that a bank's Community Reinvestment Act rating will not be affected by consumer compliance violations, which remain fully punishable under a separate regime, unless there is a logical nexus to the statutory and regulatory standards under which community reinvestment is evaluated.

What is most encouraging about the proposals from these three agencies, though, is their commitment to transparency, to the rule of law, and to creative thinking. I hope they serve as a model for further reform, and a transparent process for achieving it.