BETTER MARKETS

BANKING REPORT

# Banking Crisis Exemplifies the Fed’s Enforcement Failures: Here’s What to Do About It

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## Introduction

The failures of Silicon Valley Bank, Signature Bank, Silvergate Bank, and First Republic Bank—as well as the ongoing banking crisis—have galvanized attention to the risks and dangers posed by large U.S. banks. There is no doubt that the current crisis was exacerbated by the failure to properly regulate and supervise large banks (in these cases primarily the fault of the Federal Reserve and FDIC[1]), and to hold these banks accountable and demand rapid action to fix problems when they are being poorly and dangerously run.[2]

However, even before the latest failures and even before the Trump administration's deregulation, the Fed and the other Banking Agencies have repeatedly failed to effectively enforce the rules and laws against large banks, including even the largest Wall Street banks. While those failures more directly contributed to the recent bank failures and fragility in the banking system, the lack of effective enforcement is also a significant contributing cause. When there is no appropriate punishment for breaking laws or failing to comply with financial safety rules, banks are not effectively deterred from engaging in illegal and unsafe behavior. That is particularly dangerous with respect to banks because they may then take on more risks, engage in more reckless activities, and create more dangers that heighten the threats they can pose to the economy, the financial system, and the well-being of the American people.

Given the outsized dangers posed by large banks, the importance of effective government oversight of these banks cannot be overstated. The failure of these banks—and the catastrophic results of earlier, failed approaches to the oversight of the largest banks—illustrate the damage caused by such banks when they are allowed to operate without financial regulators keeping them in check through strong oversight and enforcement supported by transparent public accountability.

A so-called "light touch" approach to banking oversight prior to the Global Financial Crisis (2008 Crash) contributed to the growth of predatory, reckless, and in some cases illegal behavior which resulted in the buildup of massive systemic risks that ignited that crisis.[3] That "hands off" approach by banking regulators was based largely on a mistaken yet widespread belief among many policymakers that the least regulation was the best because banks themselves had a strong interest in prioritizing their self-preservation over profits and that this, combined with the supposedly compelling powers of "market discipline" that would punish banks for engaging in bad or dangerously risky behavior (even if the activities were profitable in the short term), would serve to constrain the banks from engaging in overly dangerous activities.

It was believed that this combination would create appropriately strong incentives for large banks to manage themselves responsibly, without the need for stronger regulation and what was claimed to be burdensome, overly intrusive oversight by bank supervisors. As proved by the 2008 Crash, that "light touch" approach failed objectively

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[1] The oversight of banks operating in the U.S. is primarily the responsibility of the three banking regulatory agencies – The Federal Reserve (Fed), the Office of the Comptroller of the Currency (OCC) and the Federal Deposit Insurance Corporation (FDIC), collectively referred to in this paper as "the Banking Agencies."

[2] *See Powell-Led Federal Reserve Deregulation Caused the Failure of Silicon Valley Bank and the 2023 Banking Crisis*, Better Markets. (March 27, 2023), https://bettermarkets.org/wp-content/uploads/2023/03/BetterMarkets_FactSheet_Powell-Led_Fed_Eregulation_Caused_SVB_Failure_March-2023.pdf

[3] *See The Cost of the Crisis - $20 Trillion and Counting*, at 76-87, Better Markets. (July 2015) https://bettermarkets.org/wp-content/uploads/2021/07/Better-Markets-Cost-of-the-Crisis_1.pdf ("The causes of the financial crash and crisis will be debated for decades, if not longer. They were indeed multifaceted and complex. But make no mistake: The primary culprits were Wall Street's too-big-to-fail financial institutions that engaged in an almost unprecedented binge of risk-taking, irresponsible lending, and, at times, massive illegal conduct.").

and spectacularly, which resulted in the enactment of the Dodd-Frank Financial Reform and Consumer Protection Act (Dodd-Frank Act) and meaningful changes in oversight by the Banking Agencies responsible for regulating and supervising banks.

However, even before the failures of Silicon Valley Bank, Signature Bank, Silvergate Bank, and First Republic, large banks were regularly breaking the rules and laws and exhibiting routine and ongoing failures in basic risk management and consumer financial protection practices. Wells Fargo is the most egregious (and ongoing) example, but there are many others. For example, there were widespread basic risk management and control failures in both the JPMorgan "London Whale" losses in 2012 and the Goldman Sachs 1MDB crimes in 2012-2013 (which at least resulted in a modest, after-the-fact Fed sanction). The failure of the Archegos hedge fund in March of 2021 led the Fed to issue in December 2021 an unusual supervisory letter to "remind firms of the supervisory expectations" related to the fundamental management of well-known risks stemming from facilitating large market transactions.

The repetitive failure to comply with rules and laws at the biggest U.S. banks has been highlighted by Better Markets research as recently as May 2022. That Report detailed the lawbreaking by the six largest U.S. banks, and it indicates that the lawbreaking has actually increased since banks were re-regulated by Dodd-Frank. For example, in terms of legal actions against those banks (even if not in terms of the dollar amount of sanctions), they have jumped from 90 for unlawful conduct before the 2008 Crash to 232 since the 2008 Crash:

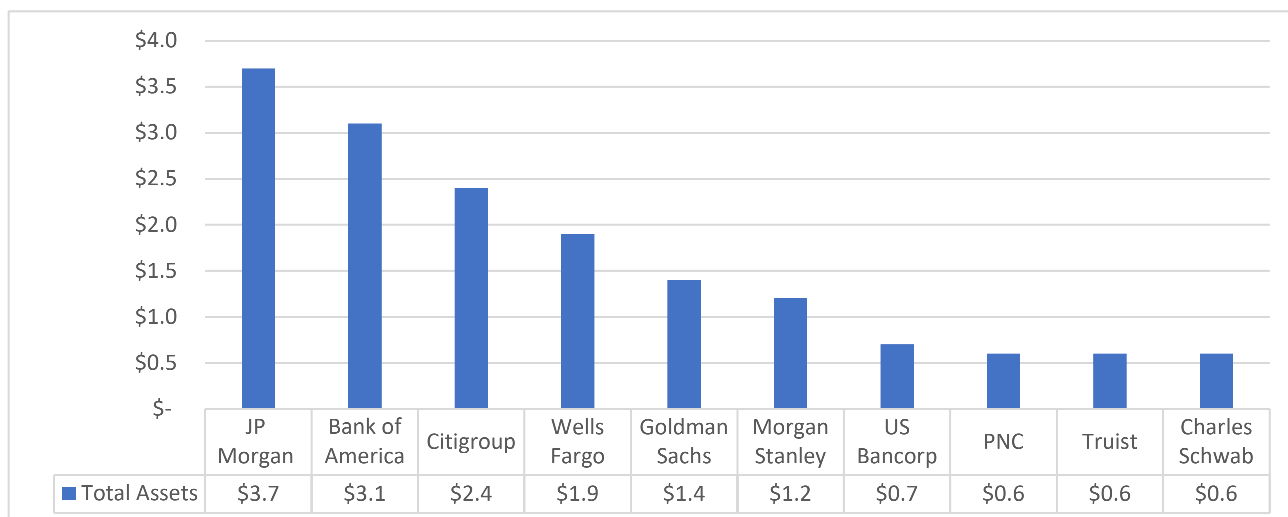
**The Six Largest U.S. Banks – Collective RAP Sheet Highlights**

Total Actions:430 | Total Sanctions: $198,558,675,333

| Time Period: | Pre-Crash | Crash-Related | Post-Crash |
|---|---|---|---|
| **Actions** | 90 | 108 | 232 |
| **Sanctions** | $14,358,799,785 | $156,283,675,000 | $27,916,200,548 |

This is happening while the systemic risks posed by Wall Street's largest banks have grown in recent years along with their size, scope, complexity, importance, and interconnectedness, and they remain too-big-to-fail (TBTF):

**Largest Bank Holding Companies by Assets ($ Trillions)**




Source: FR Y-9C report forms as of Q4 2022

This continues to be the case despite reforms put in place in 2010 following the 2008 Crash, including those in the Dodd-Frank Act, which had as a main objective addressing the dangers associated with TBTF banks and eliminating (or at the very least substantially reducing) the need for taxpayer-funded support when large banks get in trouble.

The dangers posed by these banks remain too great a threat to financial stability and the prosperity and livelihoods of the American people. In a period of economic and financial turmoil, when these banks are most likely to be struggling, the government will not allow them to fail, and they will be supported by taxpayer-funded programs and even bailouts. At the same time, their long history of dangerously poor management, as well as unethical and even illegal behavior, can give the public no confidence that large banks will operate safely and in compliance with rules and laws unless forced to through strong oversight by the Fed and the other Banking Agencies.

As has recently been demonstrated, these risks and dangers, however, are not limited to the very largest banks in the U.S., the so-called "GSIBs": globally systemically important banks, which tend to get all the attention. As we have pointed out for years, similar risks arise from large (even if they are not the largest) banks, what we call "DSIBs": domestically systemically important banks.[4] Unfortunately, since the Trump administration, the dangers and risks from these banks have been denied or ignored, as a result, they have been deregulated and under-supervised (see this [Fact Sheet]).[5] The gross deficiencies at and failures of the four large regional banks were [the inevitable result] of the weakening of oversight and are reminders that supervision, regulation and enforcement remain dangerously deficient for large banks.

Silicon Valley Bank will likely be remembered as a textbook case illustrating these failings. It has been revealed that the bank was subject to numerous supervisory findings including many at least six Matters Requiring Attention (MRA's) and Matters Requiring Immediate Attention ("MRIA") that had not been adequately addressed by the bank and which had not led to strong action taken by supervisors to require them to be addressed. It has also been publicly disclosed that the bank was subject to a confidential 4(m) agreement restriction, which can

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[4] *Scope and Definitions, Domestic Systemically Important Banks*, Bank for International Settlements. (December 15, 2019), https://www.bis.org/basel_framework/chapter/SCO/50.htm

[5] *See Powell-Led Federal Reserve Deregulation Caused the Failure of Silicon Valley Bank and the 2023 Banking Crisis, supra* note 2.

limit the activities of a bank or its ability to grow. These facts, including in particular those identified in confidential supervisory information that has been made public, all clearly demonstrate the need to strengthen the Fed's supervision, regulation, and enforcement.[6]

## Strengthening Banking Agencies' Enforcement Actions to Rein in the Largest Banks

While steps taken to strengthen banking supervision after the 2008 Crash did lead to some real improvements, key elements were later undermined by Trump administration appointees to the Banking Agencies. Importantly though, even before some of those improvements were rolled back in the Trump era, large bank supervision still fell short in three critical areas that, if properly addressed, could enhance the effectiveness of large bank oversight and make the system substantially safer.[7]

**First**, there has not been enough direct focus on the role of large banks' boards of directors, and—most importantly—not enough is done to effectively evaluate whether boards are successfully carrying out their responsibilities and to hold them accountable when they are not. Such evaluations should be a standard and prominent part of supervisors' periodic assessments of large banks; boards of directors bear the ultimate responsibility for ensuring a bank is well and safely run.[8] However, this rarely carries through in practice to formal assessments of the effectiveness of large banks' boards, and the assessments of boards that have been done have not historically been given appropriate weight in the overall supervisory assessment process.[9]

**Second**, and closely related to the first, penalties applied when banks are being badly managed have not been consequential enough to create appropriately strong incentives for those responsible for ensuring their banks are well run. So-called "formal enforcement actions"—those that must be publicly disclosed, include binding agreements on what must be improved and by when, and can come with meaningful business restrictions—are not used often enough when large banks are poorly run. Most supervisory actions to require correction of bank practices that can either present dangers to the financial condition of the bank or increase the likelihood that a

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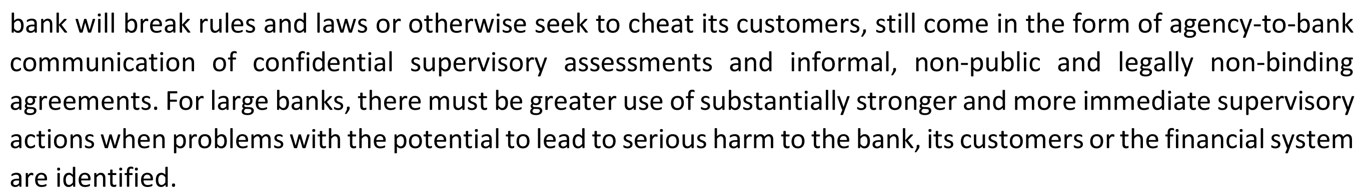
[6] *See Review of the Federal Reserve's Supervision and Regulation of Silicon Valley Bank,* Federal Reserve. (April 28, 2023), https://www.federalreserve.gov/publications/files/svb-review-20230428.pdf

[7] This is, of course, in addition to and not a substitute for re-regulating the banking industry and reversing the rules that undermined effective supervision. *See, e.g., Id. and Protecting our Economy by Strengthening the U.S. Banking System Through Higher Capital Requirements*, Better Markets. (December 22, 2022), https://bettermarkets.org/wp-content/uploads/2022/12/BetterMarkets_Strengthening_US_Banking_System_12-22-2022.pdf

[8] The Basel Committee on Banking Supervision, made up of banking regulators and supervisors from 27 nations, outlines the key roles that boards of directors are expected to play in ensuring their banks are well managed, including having robust risk management and corporate governance practices through its Core Principles for Effective Banking Supervision. *See, e.g., Core Principles for Effective Banking Supervision, at 39-40*, Basel Committee on Banking Supervision. (September 2012), https://www.bis.org/publ/bcbs230.pdf

[9] Indeed, prior to the change in the Federal Reserve's Supervisory rating process for bank holding companies (in 2018), assessments of the effectiveness of the board of directors were included as a part of a bank's risk management rating, rather than driven by assessments of those things for which boards are responsible. A supervisory assessment (and rating) of a board and senior management could be better than the assessments of key practices, including risk management, though they are responsible for ensuring a bank is well run. This has now been changed by the shift to a new bank supervision rating framework for BHCs, but there is much more to be done to ensure the assessments of boards and senior managers are given their appropriate level of importance.



bank will break rules and laws or otherwise seek to cheat its customers, still come in the form of agency-to-bank communication of confidential supervisory assessments and informal, non-public and legally non-binding agreements. For large banks, there must be greater use of substantially stronger and more immediate supervisory actions when problems with the potential to lead to serious harm to the bank, its customers or the financial system are identified.

**Third**, the longstanding emphasis on the importance of keeping supervisors' assessments of large banks confidential undermines both the potential effectiveness of the Banking Agencies' bank supervisors and the potential for more meaningful and better-informed market discipline. While there may well be some information that is appropriately kept confidential (e.g., genuinely proprietary bank information), publicly disclosing the maximum practical amount of information from supervisors' assessments, whether the assessment leads to an enforcement action or not, would allow for better-informed decisions by market participants and the broader public about banks which they may or may not want to invest in or do business with. It would also encourage bank boards of directors to give greater attention to ensuring a bank is responsibly run so as to avoid negative public scrutiny. This would promote and perhaps finally strengthen the potentially useful role market discipline might play in prompting banks to be managed more safely and to operate within the limits of the laws and rules governing them.

As importantly, it would provide the public with information to allow for a better understanding of what the Banking Agencies are doing on its behalf to foster a safer, sounder, fairer, and more stable banking system. This could make the Banking Agencies more effective, by allowing for more and better-informed public oversight and instilling more discipline, potentially promoting increased public confidence in the Banking Agencies and the banking system, and provide for public accountability of those agencies should they fail to carry out their responsibilities effectively and on behalf of the public interest.

## Boards of Directors Play a Critical Role

Like executives and officers of all companies, it is the responsibility of senior bank managers and executives to run their banks effectively and of a bank's board of directors to oversee management to ensure this is the case. When there are significant problems at a bank, the board of directors bears responsibility and should be held accountable. While this seems an obvious point, it is important to highlight as a backdrop to a discussion of who bears responsibility when a bank fails to run itself safely or breaks financial and consumer protection rules and laws.

Unlike most other corporations, the consequences of large banks being poorly run can be catastrophic for the economy, which is why effective oversight by the Banking Agencies is so important. When a bank is dangerously run, or breaks rules or laws, whether due to mismanagement, negligence, recklessness, or intentional actions, it is either the result of choices made by those that run the bank or—less often—incompetence and genuine ignorance. Both are unacceptable and require consequential penalties and real accountability by the Banking Agencies. To be sure, the Banking Agencies are not responsible for ensuring a bank is well and safely run. Rather, they are responsible for identifying problems and taking aggressive action against a large bank at which serious problems are identified. When such problems are identified, ultimately it is the board of directors that should be held accountable. Either the board made an explicit decision that undermined the potential the bank could be well managed—e.g., supporting cost-cutting measures that negatively affected risk management and other key practices—or it failed to effectively carry out its responsibilities for oversight of the senior management team at the bank, or both.

A key tenet of corporate governance, including at banks, is that the ultimate responsibility for ensuring an organization is responsibly run lies with the board of directors. If management is not running a bank safely and in compliance with rules and laws, it is the responsibility of the board to put in place a team that can and will do so, and to provide that team with the resources it needs to carry out its responsibilities.[10] Unfortunately, as has been seen repeatedly, boards of directors often fail at this critical duty and frequently appear primarily focused on maximizing short-term profits. Given the long and dangerous history of bad management at large banks, it appears that many boards often treat their responsibilities for ensuring a bank is run safely and in compliance with rules and laws as, at most, a secondary consideration.[11]

It is not hard to see how a board's incentives can support this harmful behavior. Shareholders want if not demand higher short-term profits and rarely if ever punish a board for a bank having weak risk and other management practices, unless perhaps those practices are exposed by poor earnings performance. This may be in part because the Banking Agencies' supervisory assessments of management practices and the effectiveness of boards of directors are confidential. This results in banks' shareholders often not knowing when a bank is being badly and dangerously run unless and until the bank publicly incurs large losses or the Banking Agencies take public actions. Shareholders' incentives to pressure bank boards are generally driven more by the financial consequences of poor management that are directly reflected in the share price rather than by potential threats to safety of the bank caused by mismanagement. This is in a narrow sense rational because losses to equity shareholders are limited to the value of their investment in a bank, whereas gains are theoretically unlimited. The possibility that a bank might fail someday because it is badly run does not often seem to override the desire for profits today.

The failure of Silicon Valley Bank and Signature Bank, which resulted in directors and executives being fired and shareholders being wiped out, will be a test case to determine if, in the future, shareholders pay greater attention to the management of banks given the risk of total loss.  However, it should be noted that while CSI was not publicly available before the failures, there was ample public information that the bank was being run in a dangerously high risk if not reckless manner.  For example, while Silicon Valley Bank failed in March 2023, the Wall Street Journal reported on the front page on November 11, 2022, that its unrealized losses exceeded its equity as of September 30, 2022.  Given that interest rates were continuing to rise, those unrealized losses were going to continue to rise as well.  While some may claim that unrealized losses don't matter because they wouldn't have to be realized under normal circumstances, they were still a screaming red flag that the bank was fragile and operating on a dangerous edge.[12]

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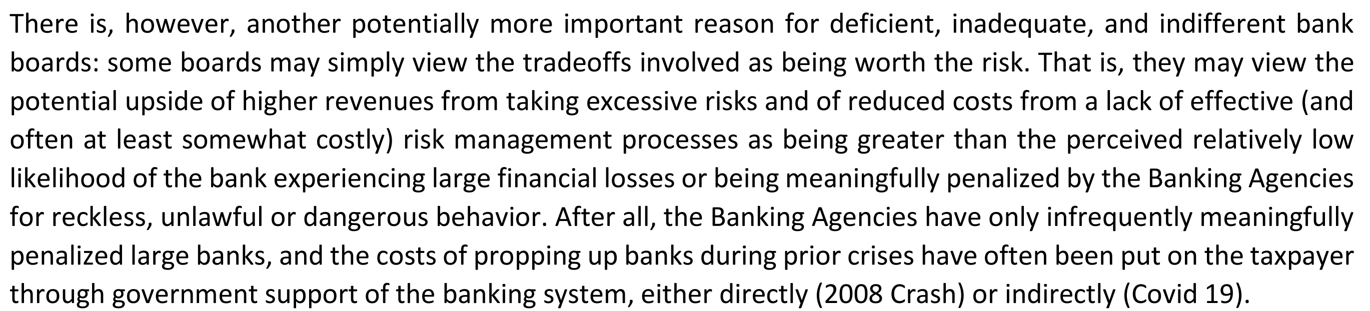
[10] It is worth noting the stark contradiction between the critically important board responsibility to oversee senior management and allowing a bank CEO (i.e., the bank's senior most manager) to be the Chair of a bank's board of directors, which is currently the case at a number of the largest banks in the U.S.

[11] Jeremy Kress uses case studies of the so-called "London Whale" debacle at JP Morgan Chase and the fake account scandal at Well Fargo to argue that a key reason bank boards may fail to effectively carry out certain responsibilities is that they are often simply too busy to give the role appropriate attention. While this is perhaps a contributing cause, it is incomplete and ignores other important reasons, including powerful incentives to put short-term profits above the safety of the bank and promoting ethical and lawful behavior of bank staff. *See* Jeremy Kress, *Board to Death: How Busy Directors Could Cause the Next Financial Crisis*, Boston College Law Review. (September 6, 2022), https://lira.bc.edu/work/ns/9dd0d251-51df-43e7-b814-09aa47bbbd4a

[12] There were lots of other red flags as have been widely reported post-failure that were obvious pre-failure, including that Silicon Valley Bank had $15.3 billion in hedges at the end of 2021, but sold almost all of them in the first half of 2022 to increase profitability.  *See, e.g., Powell-Led Federal Reserve Deregulation Caused the Failure of Silicon Valley Bank and the 2023 Banking Crisis,* at Appendix 3, *supra* note 2.



There is, however, another potentially more important reason for deficient, inadequate, and indifferent bank boards: some boards may simply view the tradeoffs involved as being worth the risk. That is, they may view the potential upside of higher revenues from taking excessive risks and of reduced costs from a lack of effective (and often at least somewhat costly) risk management processes as being greater than the perceived relatively low likelihood of the bank experiencing large financial losses or being meaningfully penalized by the Banking Agencies for reckless, unlawful or dangerous behavior. After all, the Banking Agencies have only infrequently meaningfully penalized large banks, and the costs of propping up banks during prior crises have often been put on the taxpayer through government support of the banking system, either directly (2008 Crash) or indirectly (Covid 19).

It is important to note that tensions between short-term profits and running a bank safely are inevitable, as the expenses and actions that are required to keep a bank safe may reduce short-term profits to at least some extent.[13] There are significant costs associated with putting in place effective risk management and controls, especially for huge banks with complex, diverse, and widespread operations. However, these ongoing costs are relatively small compared to the banks' earnings.

This dynamic is strengthened by the largest banks being TBTF – i.e., knowing that they have been and will be bailed out by taxpayers if their dangerous practices were so bad that their failure could risk a broader financial collapse. This can overwhelm incentives to act responsibly, create a pernicious "moral hazard" situation. If TBTF banks are not forced to internalize the costs of their reckless behavior in real time, then the only costs they may face are the relatively small fines long after the fact from regulatory agencies. This further incentivizes senior management and boards of directors to subordinate or ignore having the strongest practices for risk management and ensuring compliance with financial protection rules and laws in the first place.

## Repeated Failures by Large Bank Boards and Senior Managers Highlight Deficiencies in Banking Supervision and the Banking Agencies' Enforcement Practices

It is astonishing that, despite public scrutiny and outrage, increased government oversight, reputational damage, or losses to the bottom line and shareholders, large banks have continually exhibited dangerously bad management practices and violated rules and laws. This highlights that these banks are not only TBTF but also quite possibly too big and too complex to manage effectively, and that their senior managers and boards are often failing at their duties of ensuring strong risk management and consumer financial protection practices are in place. It also highlights the lack of effectiveness of the supervisory enforcement actions taken by the Banking Agencies, which weakens incentives for bank boards to effectively oversee their management teams and sends the signal that future mistakes and problems may not lead to meaningful negative consequences. This must change if banking supervision is to be effective.

[13] There are inevitable tensions between banks and regulators, but that is neither a sign of failure nor something to be rewarded. It is healthy and necessary given the different objectives and missions of private sector banks seeking to maximize profits and regulators legally obligated to protect investors, financial stability, and the public interest. *See* Dennis M. Kelleher, *Stress Tests as Policy Tool,* Better Markets. (July 9, 2019) https://www.bostonfed.org/-/media/Documents/events/2019/stress-testing/stress-tests-and-policy-paper-kelleher.pdf?la=en ("Conflict between bankers and regulators in financial regulation is inevitable, healthy, and, indeed, a sign of success.").

For example, in December 2021 the Fed issued an unusual supervisory letter to "remind firms of the supervisory expectations" related to the management of risks in facilitating large market transactions. This letter was based on the findings of supervisory reviews conducted in response to the so-called Archegos debacle, which caused more than $10 billion in losses across several banks and about $200 billion in market value losses for shareholders in certain related stocks.[14]

It is alarming that the Fed felt it needed to remind large banks of their responsibilities around such basic risk management practices, as this clearly indicates that there are still widespread risk management deficiencies across the largest banks even well over a decade after the 2008 Crash. If this public letter was not supplemented by concrete and meaningful supervisory actions requiring banks to address weaknesses immediately and promising severe consequences otherwise, then the letter was, ultimately, little more than the Fed publicly "wagging its finger" at the banks involved. This sends exactly the wrong message to the banks and their boards. The public cannot know what the banks were told with respect to addressing the risk management failures exposed by this debacle, since supervisory communications are kept confidential unless they are accompanied by formal public actions, which this was not.[15] The lack of any public enforcement action means there were no binding requirements placed on the banks. If the Banking Agencies want to ensure the largest banks address such weaknesses quickly, they should more frequently use public enforcement actions and publicly disclose the details of what is being required.

One of the most egregious, obvious, and high-profile recent public examples of a bank board of directors and its senior management team continually failing at their responsibilities is Wells Fargo.[16] After being fined by the CFPB and the OCC in 2016 for years of defrauding customers and creating fake accounts, in 2018 Wells Fargo was restricted by the Fed from growing its asset size until it addresses the management weaknesses this case exposed.[17] Five years later, the growth restriction is still in place, indicating that the bank has still not fixed its problems. More recent actions from regulatory agencies show even more clearly that it has not.

That so-called "phony account scandal" was not the only management failure at Wells Fargo that led to the bank cheating its customers. In 2018, Wells Fargo was fined again—a combined $1 billion by the CFPB and OCC—for cheating customers in both the auto loan and mortgage businesses. In 2021, the OCC fined the bank for violating that 2018 supervisory action and consent order and placed further restrictions on its business activities.

In December 2022, the CFPB ordered the bank to pay $3.7 billion, including $2 billion to compensate consumers, for continuing and newly-identified problems in their auto and mortgage businesses as well as customer account

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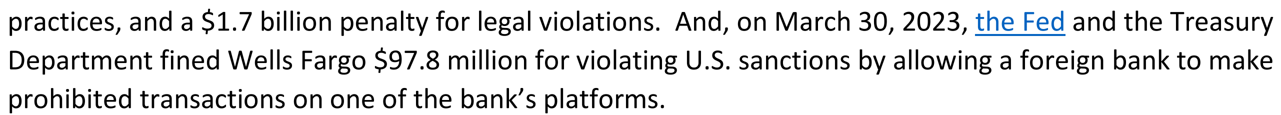
[14] Archegos Capital Management, a private wealth management firm, invested heavily in leveraged positions in stocks, supported by funding from banks. As some of these positions started to decline in value, the firm was unable to meet obligations to the banks that had lent it money, leading to forced selling of the firm's assets that ultimately resulted in substantial financial losses for some large banks. See Dennis M. Kelleher and Phillip Basil, *Fed shouldn't have to remind large banks about managing obvious risks*, American Banker (March 11, 2022, 11:43 AM), available at https://www.americanbanker.com/opinion/fed-shouldnt-have-to-remind-large-banks-about-managing-obvious-risks

[15] Except in the current unprecedented case of Silicon Valley Bank where the Fed has appropriately decided to publicly disclose substantial amounts of CSI.

[16] *See On the 5th Anniversary of the Asset Cap on Wells Fargo, the Fed's Credibility is at Risk; It Should Stop Capital Distributions and Break Up the Bank*, Better Markets. (January 30, 2023), https://bettermarkets.org/newsroom/on-the-5th-anniversary-of-the-asset-cap-on-wells-fargo-the-feds-credibility-is-at-risk-it-should-stop-capital-distributions-and-break-up-the-bank/

[17] Due to the confidential nature of Banking Agencies' supervisory processes, it is impossible for the public to know what supervisory actions the Fed may have been taking, if any, to try to address the problems at Wells Fargo prior to its February 2018 public action and announcement.



practices, and a $1.7 billion penalty for legal violations. And, on March 30, 2023, the Fed and the Treasury Department fined Wells Fargo $97.8 million for violating U.S. sanctions by allowing a foreign bank to make prohibited transactions on one of the bank's platforms.

While these fines and restrictions may seem significant and punitive, to date they clearly have not been effective incentives to deter woefully deficient management, improve board of directors' oversight, and stop bad action and illegal conduct.

The ongoing and seemingly never-to-be-resolved issues at Wells Fargo highlight a significant deficiency with respect to banking supervision: the actions taken against banks for this type of dangerous and harmful behavior are often just not punitive enough to motivate banks to fix their problems. As with fines imposed more generally on large banks, the fines on Wells Fargo have represented only a relatively small share of the bank's earnings. It remains to be seen if the recent $3.7 billion penalty will finally inspire the bank's board to fix all its problems as quickly as possible, or if shareholders will demand that it does.[18]

Notably, throughout all this Wells Fargo's board of directors has been allowed by the Federal Reserve to reward shareholders through the payout of dividends and the continuation of stock buybacks that boost the value of shareholders' investments. For example, in 2022, Wells Fargo repurchased $6 billion shares of common stock and issued over $4 billion in cash dividends.[19] This is a surprisingly common practice even when banks are known by supervisors to have serious weaknesses.

It is hard to justify allowing a bank to reward its shareholders when it has been caught repeatedly cheating its own customers and five years later has still not fixed problems that allowed this to happen. Should they be rewarded for sticking with their investments in a bank that is badly run and cheats its customers? Moreover, it is not hard to imagine that if the Fed had immediately restricted Wells Fargo's ability to reward shareholders through dividends and buybacks in 2018, those shareholders would have demanded the board of directors ensure rapid action was taken to address the bank's weak risk management practices and unethical and illegal behavior. And it is unquestionable that had dividends and buybacks been restricted the bank would have had billions of dollars more to invest in addressing and fixing its egregious problems once and for all.

There are private costs associated with being a well-run bank with effective management, but there are much greater potential costs to society resulting from the actions of banks that are not well-run. This was made very clear by the 2008 Crash, which was so costly to society—a $20+ trillion catastrophe—and why post-2008 Crash reforms were enacted with full knowledge that they would require the banks to incur increased costs. It is the potential costs to society that must be the primary consideration of the Banking Agencies overseeing large banks, and the private costs of doing business for banks should require them to internalize costs associated with reducing the dangers they can pose to the financial system, the economy, and their customers.

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[18] We are doubtful. See On the 5th Anniversary of the Asset Cap on Wells Fargo, the Fed's Credibility is at Risk; It Should Stop Capital Distributions and Break Up the Bank, Better Markets, supra note 15; see also CFPB's Latest Action Against Wells Fargo's Years-Long, Widespread, Repeated Lawbreaking Again Raises the Question "Is It Time to Break Up Wells Fargo, Better Markets. (December 20, 2022), https://bettermarkets.org/newsroom/cfpbs-latest-action-against-wells-fargos-years-long-widespread-repeated-lawbreaking-again-raises-the-question-is-it-time-to-break-up-wells-fargo/

[19] *See* 2022 Annual Report, Wells Fargo. https://www08.wellsfargomedia.com/assets/pdf/about/investor-relations/annual-reports/2022-annual-report.pdf

## Large Bank Supervision Must Be Forward-Looking and More Transparent

In overseeing massive banks that can cause grave and widespread harm, the Banking Agencies have little margin for error. They must use all available tools to try to ensure banks stay ahead of risks and must take quick action to mitigate the damage these banks can create. This is not an easy task by any means, but it is not as hard or as complicated as many would have us believe. It does require that the Banking Agencies have the political will to take meaningful action against politically powerful banks early and often when dangerous practices at large banks are identified.

When practices that could threaten the viability of the bank or harm to its customers are identified, the Banking Agencies must take actions that are strong enough to prompt meaningful action to fix those practices by those in charge at the banks. There are potentially valuable tools for this task available to the Agencies. But there has often been a reluctance to use them, in large part because some of the strongest tools would be public and there is a longstanding sensitivity among the Agencies about calling public attention to a large bank's weaknesses.

An example of a very strong, effective, and public supervisory tool was the so-called "qualitative objection" element of the Comprehensive Capital Analysis and Review program (CCAR).[20] This was introduced after the 2008 Crash and used by the Fed to restrict dividend payouts and share buybacks when large banks were found to have such weak risk management and capital planning practices that they were unable to provide credible plans for their capital needs in the event of severe stress. The CCAR qualitative assessment and the related objection to capital distributions were found to be very successful in forcing large banks to improve risk management.[21] Indeed, in one of the most misguided and shortsighted moves by the Fed in the Trump era, this was claimed by the Fed to have been so successful that it was no longer needed because it had already made the banks fix their risk management problems.[22] That, of course, is nonsensical and has turned out to not be the case in any event. Obviously, while risk management had been improved at large banks, the Archegos debacle and the SVB collapse highlight how much is left to be done and effectively killing the CCAR qualitative objection weakened the Fed's ability to ensure more progress is made. In fact, the CCAR qualification objection and its public release was an excellent illustration of the type of tool that can get the attention of bank directors, management, and shareholders. Rather than all but eliminating it, the Fed should be using it as a model for enforcement actions in other areas beyond capital management.

Wall Street's TBTF banks and their lobbyists often claim that costs associated with requirements that make the banks stronger and more resilient will adversely impact society. For example, a frequent argument is that higher capital and liquidity requirements present not just increased costs to banks but also to their customers and that raising capital requirements can reduce the supply of available credit. A similar argument—usually couched in the

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[20] *Stress Testing Under the Prior Capital Frameworks*, Federal Reserve. https://www.federalreserve.gov/supervisionreg/stress-tests-capital-planning.htm

[21] *See* Donald Kohn and Nellie Liang, *Understanding the Effects of the U.S. Stress Tests,* Federal Reserve Conference Stress Testing: A Discussion and Review, (July 9, 2019), available at https://www.bostonfed.org/-/media/Documents/events/2019/stress-testing/effects-of-stress-test-paper.pdf?la=en

[22] *See* Randal K. Quarles, *A New Chapter in Stress Testing* (November 9, 2018), https://www.federalreserve.gov/newsevents/speech/quarles20181109a.htm

statement that complying with regulatory and supervisory requirements can be "too burdensome" for banks—is used to criticize the higher costs of being required to have robust and effective management processes.

However, this argument does not align with some rudimentary financial economics: if banks are well-run and their risk of failure (as well as the risk of frequent fines and settlements) decreases, then their cost of capital and other funding should be lower because the risks of incurring financial penalties or facing bankruptcy also decrease.[23] Put differently, the improved safety and soundness of banks necessarily improves their resiliency to financial and economic stress, which should reduce their funding costs and increase the amount of funding available to them.

The combined costs associated with meeting regulatory requirements and supervisory expectations for a well-run bank are but a small fraction of total revenue for large banks and are dwarfed not only by the immense profits they make but also by the rewards paid out to benefit shareholders and bonuses paid to bank employees and executives. Relative to the revenues large banks generate it's easy (and common for banks and their advocates) to overstate the burden of such costs while understating the benefits. In addition, for the largest banks, their huge profits are supported by benefits and subsidies they get from being TBTF. These benefits come in the form of relatively lower funding costs than would be the case if they were not viewed as TBTF, which stem from knowledge the government (i.e., taxpayers) will likely have to bail them out if needed to protect the system from the collateral damage caused by such a bank failing.[24]

Considering that and the potential costs to taxpayers, the economy, and the livelihoods of Americans of another financial crisis, there is no compelling rationale for the claimed "more simple, more efficient"[25] supervision promoted by those in charge at the Banking Agencies during the Trump era. The focus should instead be on making supervision more effective to protect the public interest. This will require that the agencies be willing to take meaningful action when the largest banks are found to be dangerously poorly run or repeatedly break the rules and laws. It would also be supported by greater transparency and disclosure of some key supervisory assessments, including about the Banking Agencies' views of the effectiveness of the banks' boards of directors.

## Bank Supervision and Bank Regulation are Complementary and Equally Important

Both the regulation and supervision of large banks are critical to promoting a safer, fairer, and less exploitative U.S. banking and financial system. Due to the Banking Agencies longstanding policies promoting a lack of transparency—and the relatively arcane nature of supervisory practices—most Americans are not aware of what the Banking Agencies actually do when it comes to large bank oversight. But they do understand the potentially

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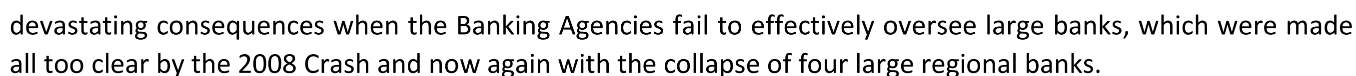
[23] Basel Committee on Banking Supervision, *Evaluation of the impact and efficacy of the Basel III reforms*, (December 2022), https:/ https://www.bis.org/bcbs/publ/d544.pdf/www.bis.org/bcbs/publ/d544.pdf ("The analyses do not indicate a significant negative side effect in the form of a higher cost of capital. Rather, they indicate that banks experienced a cost of capital decrease following introduction of the Basel III reforms.").

[24] *See* William C. Dudley, *Ending too big to fail*, Global Economic Policy Forum. (November 7, 2013), https://www.bis.org/review/r131108g.pdf

[25] *See* Randal K. Quarles, *The Eye of Providence: Thoughts on the Evolution of Bank Supervision* (December 11, 2020), https://www.federalreserve.gov/newsevents/speech/quarles20201211a.htm



devastating consequences when the Banking Agencies fail to effectively oversee large banks, which were made all too clear by the 2008 Crash and now again with the collapse of four large regional banks.

Banking regulations set the rules that detail requirements for banks in key areas, including, for example, how much liquidity and capital they should have, their responsibilities with respect to anti money-laundering controls, and consumer financial protection rules. They can also detail specific requirements for risk management and governance practices. These can include, for example – the use of stress testing in measuring capital and liquidity needs; mandating that boards of directors have risk management committees to oversee management and provide for an independent risk management function; and an independent internal audit function to serve as the eyes and ears of the board in assessing the effectiveness of banks' internal practices.

The complementary role of banking supervision is to assess whether banks have effective practices in place both to ensure they are complying with the laws and regulations to which they are subject and to assess if a bank is being run well and safely, so that it does not pose a threat to its depositors, the deposit insurance fund or, in the case of large banks, broader financial stability and the economy. This latter aspect of banking oversight is known as "prudential supervision", and the focus is on whether a bank is being run in a "safe and sound" manner – i.e., being run responsibly and in a way that minimizes the likelihood it will suffer a financial collapse.

Banking supervision involves assessing banks' financial condition, management practices, and business activities. This is done relative to two sets of standards:

1. Those set out in regulations and laws: explicit rules-based requirements and laws, for which there are generally clear lines between complying and not complying.
2. "Principles-based" safety and soundness expectations (the core of prudential supervision) for which the lines are by nature less clear and the assessments more subjective. In these cases, banks are assessed against general principles that serve as the foundation and guidelines for the fundamental practices needed to run a bank safely and responsibly.

Much of the Banking Agencies' most important banking supervision efforts fall into the second category. Because banking practices and activities constantly evolve (and often quickly), there is no practical way to cover everything in a rules-based regime, which makes the use of assessments against principles-based expectations so important. While there is a need to further strengthen the rules-based regime—including, for example, strengthening capital requirements to make large banks more resilient—the principles-based approach will always be critical. It can evolve more quickly to a rapidly changing environment and is more dynamic than a rules-based regime. For example, it allows supervisors to better keep up with bankers' seemingly never-ending quest to get around the letter of laws and rules they don't like by developing "new" practices and products that can be fit through loopholes in existing laws and rules.

The expectations under the principles-based approach are most often communicated publicly through so-called "guidance" from the Banking Agencies, though they are also often communicated and discussed privately and directly with banks. Through such guidance banks cannot be required to implement specific practices, but they are nonetheless expected to have practices that satisfy the general principles, which often are based on common sense. For example, a basic expectation is that a bank must be able to identify and measure all the material risks it faces, because managing risks is impossible if a bank does not know they exist in the first place. And a bank is further expected to be able to effectively manage those risks. However, principles-based guidance will not prescribe exactly how a bank should go about those efforts.

Two key questions faced by the Banking Agencies in the supervisory process are:

1. At what point do weak practices in important areas represent a concern about the potential safety of the bank or its potential for harming customers that warrants the use of strong supervisory action? And,
2. How best to address concerns raised about the effectiveness of a bank's management and board of directors given that such weak practices are a clear and direct manifestation of them failing to do their job effectively?

If risk management or other critical practices are found to be so poor as to raise concerns about the safety of a bank, or its ability to comply with rules and laws, the Banking Agencies can require a bank to replace them with effective ones. To stick with the risk management examples from above, if a bank is found by supervisors to be missing important risks in its risk identification and measurement practices, this would call into question its ability to manage its risks on a day-to-day basis.

This in turn would call into question how senior decision makers (i.e., executive management and boards of directors) could credibly make critical decisions, such as determining the capital and liquidity needed to keep the bank operating safely, without a solid understanding of the bank's true risks. This, by definition, should raise concerns about the bank's "safety and soundness," in which case supervisors could require the bank to fix the weak practices. This would also expose clear weaknesses in the effectiveness of the board, and those should also be directly addressed.

The results of these supervisory assessments inform a variety of possible responses and actions the Agencies can take. They can form the basis for requirements to increase capital and liquidity positions or to strengthen processes that are needed to run a bank safely and in compliance with rules and laws. Also, they can inform supervisory ratings of banking organizations, which can lead to meaningful negative consequences—including constraints on business activities or expansion—when these ratings are particularly negative.[26]

Identified issues can lead to either "informal" (non-public, not legally binding) or "formal" (public and legally binding) enforcement actions. Informal actions can include confidential agreements between a bank and the Banking Agencies that a specific problem or set of problems will be addressed and fixed within an agreed timeframe. If the bank fails to meet the terms of that informal agreement, it could lead to the Banking Agencies taking formal and public actions—that can legally require the issues to be fixed—including using fines and business restrictions, though the latter does not happen often enough (examples of business restrictions include the actions taken against Wells Fargo discussed above).

Among the possible outcomes from the Banking Agencies' supervisory assessments, by far the most frequent is using them to inform the confidential supervisory rating of and communications to the bank, and the least typical is public enforcement actions. Short of breaking the law or clearly failing to comply with rules and/or private agreements with supervisors, most problems supervisors identify at banks are addressed in a non-public manner between the Banking Agencies and the banks they oversee.

Non-public actions include:

- Communication of so-called "matters requiring attention" (MRAs) and "matters requiring immediate attention" (MRIAs);[27]
- Private informal agreements such as a memorandum of understanding (MOU);

[26] 12 U.S.C. § 1843(m).

[27] MRAs and MRIAs are private communications to banks about problems identified by supervisors that banks are expected to address.

- So-called “moral suasion” – e.g., telling the bank it must do better; and
- The pressure of a potential negative confidential supervisory rating, which can but does not necessarily have significant negative implications for a bank – an example of a negative impact comes through, a so-called “4(m) agreement” which can result from a negative supervisory assessment, and which take their name from the relevant section of the Bank Holding Company Act.

Importantly, the 4(m) provision, which was strengthened under the Dodd-Frank Act, provides the agencies with the authority—indeed, the requirement—to take a number of possible actions that can include restricting expansionary activities and/or revoking a banking organization’s status as a “financial holding company”, if a bank that is operating under FHC status is found to be not “well managed” or fails to address substantial weaknesses in 180 days.

Revoking FHC status is a potentially very serious consequence, as it is this status that allows banks to engage in businesses other than traditional banking, such as certain trading and investment banking activities that often represent a significant source of their profits. A revocation of this status could result in a bank having to sell businesses or otherwise jettison non-traditional banking activities that were only allowed to engage in based on being an approved FHC.

However, the revocation of FHC status for being poorly run has not been used for a major US bank, not even in the case of Wells Fargo, which by any measure cannot be considered “well managed” and has failed to address significant problems even years after they came to light.[28] Consequently, whatever potential effect this penalty could have is undermined in practice, proving yet again a law is meaningless unless it is actually used and enforced. And indicating that the consequences of revoking a large bank’s FHC status are deemed by the Fed to be so great, that even in the most egregious cases they are reluctant to use this enforcement tool. This indicates it is precisely the kind of tool that the Fed should use more often as it is very likely to provide the kind of necessary strong incentives needed to get large banks to actually fix their problem and manage themselves better.

A study by the Federal Reserve Bank of New York found that of around 1,500 supervisory “actions” issued against the largest banks in their district between 2011 and 2014, only about 20 were formal public supervisory actions (a miniscule 1.5%). Roughly 20 of the other 1,480 supervisory actions were non-public MOUs and 4(m) agreements. Nearly all of the others were MRAs and MRIAs that the Fed told large banks they needed to address.

Considering the apparent inability of large banks to consistently comply with all rules and laws to which they are subject, and to meet reasonable supervisory expectations for being well managed, it is not difficult to see that nonpublic supervisory actions have not served as either effective motivation or deterrent. Silicon Valley Bank is regrettably providing a very clear illustration of this fact. And, as discussed above, it is equally clear that even public enforcement actions with large fines have often been unable to provide such meaningful incentive.

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[28] U.S. Senator Elizabeth Warren has called on the Fed to revoke Wells Fargo’s FHC status amid failures to meet regulatory requirements. *See Warren Slams Wells Fargo CEO, Calls on Fed to Revoke Bank’s Status as Financial Holding Company Amid Ongoing Failure to Meet Regulatory Requirements,* (September 14, 2021), https://www.warren.senate.gov/oversight/letters/warren-slams-wells-fargo-ceo-calls-on-fed-to-revoke-banks-status-as-financial-holding-company-amid-ongoing-failure-to-meet-regulatory-requirements

# Effective Banking Supervision Is Critical to Promoting a Safe Banking System

The 2008 Crash exposed huge weaknesses in banks' risk management practices, indicating that supervisors at the Banking Agencies either had not been able to detect these problems, had not done enough to require the banks to fix them, or a combination of the two. It was a clear example that, for banks that are large enough to threaten the financial system and the economy when dangerously run, waiting until their recklessness has already caused a problem is far too late. The ineffective supervision of Wells Fargo, the Archegos "finger wagging" letter, and the supervisory failures at Silicon Valley Bank only show that many of the problems challenging the Banking Agencies year ago can still be present and can still pose serious dangers.

The long and ongoing history of repeated illegal, unethical, and dangerous behavior by large banks implies that either:

a) the supervisory actions typically used (or threatened) are not creating strong enough incentives for banks to take the actions required to ensure they are well run; or
b) these giant banks are just too large and complex to be well and safely managed.

One cannot know with any certainty the answer to these questions until penalties applied for failing to run a large bank safely create stronger incentives for banks' management teams, their boards, and shareholders.

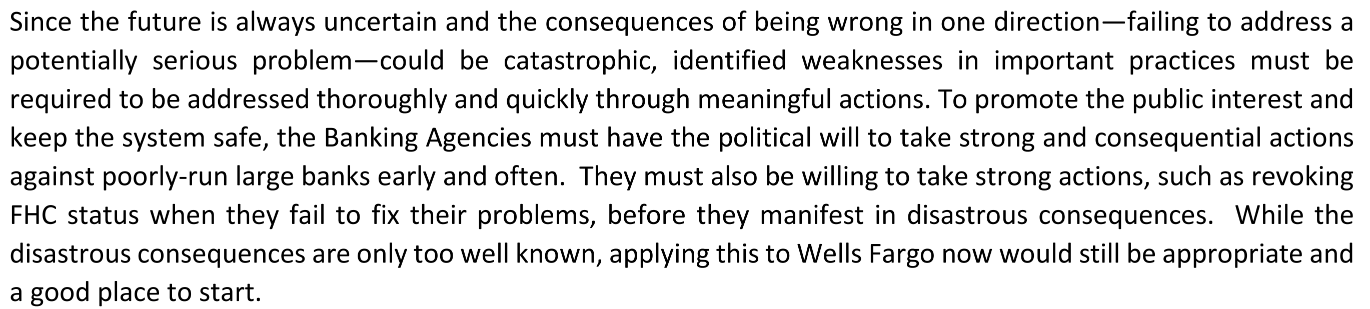
In either case, efforts to build stronger, more effective supervision to address the challenges and dangers posed by large banks should focus on four key elements:

1. Assessments that incorporate forward-looking views of the potential for harm;
2. Increased transparency of the supervisory process and public disclosure of as many key aspects of the Agencies' assessments of large banks as practicable;
3. Greater use of public enforcement actions for safety and soundness concerns,; and
4. Greater direct and meaningful accountability for those in charge of the banks, including boards of directors.

### Forward-Looking Assessments are Critical

To be effective, large bank oversight must be forward looking and aggressively engaged in requiring large banks to rapidly address bad practices that could potentially create foreseeable problems. This includes problems related both to the banks' financial resilience as well as their potential to harm consumers and other customers. It is not enough to punish huge banks only after they have made mistakes that could lead to financial instability, economic turmoil or direct harm to consumers. The damage is already done. For large banks, early identification of potential problems in key areas is critical and making them fix them before they can evolve into existential problems will promote stronger, more resilient large banks and greater confidence in the system.

A common pre-2008 Crash view was that supervisors should try to avoid so-called "false positives." In other words, in this context, they should be careful not to criticize a bank too harshly for a potentially dangerous practice that may not ultimately turn out to cause a significant problem. While Banking Agencies should not capriciously penalize banks harshly for insignificant issues, for the largest banks the greater danger to society and the financial system (and the bank itself) comes from false negatives – assuming (or simply hoping) that weaknesses in key practices will not end up causing a major problem. This appears to have been what happened with SVB.



Since the future is always uncertain and the consequences of being wrong in one direction—failing to address a potentially serious problem—could be catastrophic, identified weaknesses in important practices must be required to be addressed thoroughly and quickly through meaningful actions. To promote the public interest and keep the system safe, the Banking Agencies must have the political will to take strong and consequential actions against poorly-run large banks early and often. They must also be willing to take strong actions, such as revoking FHC status when they fail to fix their problems, before they manifest in disastrous consequences. While the disastrous consequences are only too well known, applying this to Wells Fargo now would still be appropriate and a good place to start.

**The Agencies Should Increase Transparency in Banking Supervision and Publicly Disclose Key Information From their Supervisory Assessments of the Largest Banks**

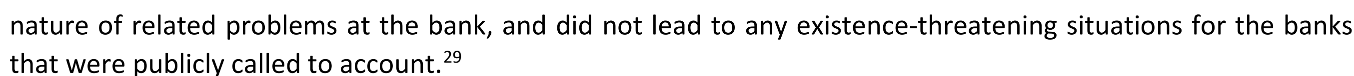
The lack of transparency that hampers effective bank supervision (and undermines the concept of meaningful market discipline) has been built into the process over many decades through the Banking Agencies' policies and their implementation. It is ingrained into the culture and ethos of the Banking Agencies. It is past time to make changes to these practices, changes that will support better bank supervision and can help to create a stronger banking system.

The public has a legitimate right to know—at least at a high level—how supervisors view the largest, "systemically important" banks since the actions and performance of these banks can threaten the economy, financial system, and the livelihoods of Americans, as well as precipitate massive taxpayer-funded bailouts. Greater public disclosure can also be a path both to promoting better-informed "market discipline" and enhancing the Banking Agencies' capacity to hold large banks accountable.

Market discipline has rarely if ever been effective for large banks in part because there is simply not enough useful information about large banks in the public domain for it to actually work. Even when information is made public, it is often too late to be an effective motivation for market discipline because, as noted above, public actions are often taken only well after an issue has become serious and large enough to be broadly known. This can be years after the fact. For example, the recent $3.7 billion penalties waged against Wells Fargo by the CFPB. This penalty punishes (mostly) past actions, and may serve some future deterrent function, but even with the required compensation of consumers harmed by the bank's behavior, is still too late to undo some of the real damage already done to people's lives by, for example, losing their homes to inappropriate and illegal foreclosures or their cars to illegal repossession.

Market discipline could be more effective if the public knew that a bank has weaknesses that increase its propensity to engage in financially dangerous or customer-harming conduct **and** knew that there would be meaningful action taken by the Agencies to spur the bank to fix its problems. Such actions could include things that will have an impact on shareholders, like a suspension of dividends or the revocation of FHC status. Additionally, and of critical importance, greater disclosure of key aspects of supervisory assessments could also enhance public confidence in the Banking Agencies and increase public accountability for their mission to promote a safe, sound, and fair banking system.

There is useful information from supervisory assessments that can—and should—be made public on a bank-by-bank basis. The Fed began disclosing some details about individual bank's weaknesses as part of the CCAR qualitative assessment process. These weaknesses were related to risk management and measuring and planning for capital needs in stressful economic and financial conditions. These disclosures provided the public with important information about banks at which weaknesses had been found, informed all stakeholders of the general



nature of related problems at the bank, and did not lead to any existence-threatening situations for the banks that were publicly called to account.[29]

This practice of disclosing weaknesses in practices at large banks should be revived, expanded, and used for other important areas of supervisory focus as well, including:

- Liquidity and liquidity risk management;
- Compliance with consumer protection laws and rules;
- Organization-wide corporate governance and internal controls; and
- The effectiveness of a bank's board of directors.

Several possible concerns are often cited in arguments against making such information public. First, some claim that such transparency could lead consumers to precipitously—or out of proportion to such disclosure—stop doing business with a specific bank (i.e., cause a run on the bank or a loss of business that was unwarranted). Second, some fear that such disclosures could cause other financial firms to stop doing business with the bank, for example, by refusing to extend or rollover existing credit. For larger banks, it is argued that this could create financial stability concerns if it leads to, for example, funding pressure on the bank. But significant supervisory issues at large banks are themselves a substantial financial stability concern.

The most important consideration must be to get large banks to fix their problems, not protect them from the market consequences of widespread knowledge that the problems exist or, worse, that the bank has known about them and repeatedly failed to correct them. Moreover, if there is ever to be any real market discipline, there must be disclosure of sufficient material information for the markets to understand and assess the associated risks, which should be reflected in the markets. Thus, while greater public disclosure should be balanced against the risk of legitimately harmful disclosures of information, the overriding goal must be to disclose as much information as possible to enable real market discipline, which is largely nonexistent now.

A possible approach to minimize unwanted negative effects and maximize the benefits of the increased disclosure would be to announce that this policy change will be implemented at some specific not-too-distant future date. A potential positive outcome from such an approach may be that banks have stronger incentives to expend the time, effort and money to address their weaknesses before this increased disclosure becomes effective. Indeed, it is at least theoretically possible that this might spark a "race to the top" with banks vying to fix problems rapidly and putting in place processes to run themselves more safely than their competitors to benefit from positive public disclosures in absolute terms and relative to their competitors. And if not, the other advantages of greater transparency discussed above will still promote a stronger and fairer banking system.

### There Must Be Greater Use of Public Enforcement Actions

Along with increased transparency and disclosure of supervisory assessments, it is critical to design and use enforcement actions and other mechanisms for disciplining banks in such a way as to create more meaningful incentives for banks' decision-makers. After-the-fact (often years later, as in the case of Wells Fargo) fines and other penalties, for example, are simply not enough and have proved to be insufficient given the recidivist activities of large banks over the years. A bank may pay what is often, in the context of its massive earnings, a

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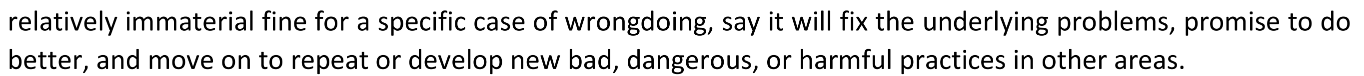
[29] As noted earlier, the Fed ended the public disclosure of qualitative assessments of bank practices carried out as part of CCAR since 2019, and the assessments are now folded into the ongoing non-public confidential supervisory process. *See Stress Testing Under the Prior Capital Frameworks*, *supra* note 18.



relatively immaterial fine for a specific case of wrongdoing, say it will fix the underlying problems, promise to do better, and move on to repeat or develop new bad, dangerous, or harmful practices in other areas.

As noted above, supervisors have traditionally attempted to address most problems through the confidential supervisory assessment and rating process, sometimes coupled with an informal, non-public agreement with a bank. For the largest banks, the use of public enforcement actions for significant risk management, internal control, and corporate governance weaknesses, as well for shortcomings in practices meant to ensure compliance with consumer financial protection and other rules and laws, must become the expectation rather than the exception.

Once issues are identified that have the potential to lead to significant negative outcomes, supervisors should use consequential, public enforcement actions that not only require plans be put in place to address the identified issues, but require that new practices are effectively implemented and actually fix the problem before releasing the bank from the “penalty box”. This would provide stronger incentives for boards and senior managers not only to fix the problems that have been identified but also to be more proactive in ensuring processes are in place to prevent new problems from arising. Such actions could be used in conjunction with 4(m) agreements that allow for the revocation of FHC status for banking organizations that fail to address significant problems in a timely manner.

### Supervisory Enforcement Should Focus on Strengthening the Incentives of Boards of Directors

An important area that is often not given enough attention in the supervisory process is a bank’s senior management team’s capacity and willingness to run it safely and within laws and rules; the effectiveness of the board’s oversight of the management team; and the board of directors’ judgment and its understanding of the bank’s weaknesses and risks. Put differently, when the key practices banks use to manage themselves are weak or even dangerous, it is evident that the board and senior management are failing at their duties and should be held accountable. The biggest problem is often not just the bad practice, it’s the bad management and lack of effective oversight by the board of directors that led to the bad practice in the first place.

In cases where significant weaknesses in key practices are identified, the board is likely to have been making important decisions, such as how much capital the bank needs, based on inaccurate or incomplete information, potentially undermining the bank’s financial strength. In such a case the board and senior managers must be held accountable and the Banking Agencies must take supervisory actions that are strong enough to spur them to rapidly address the problems that have led to this dangerous state of affairs. Otherwise, even if identified weak practices are fixed, problems will likely arise in other areas because those responsible for overseeing the issues have insufficient incentive to improve the bank’s behavior. This type of “band-aid approach”, that fixes a specific problematic practice but leaves the root cause of the problem unaddressed—e.g., poor management and poor oversight from the board—cannot be tolerated at the largest banks.

Immediate changes in the supervisory approach are needed with respect to requiring boards of directors at large banking organizations to be effective in carrying out all their responsibilities. As the Fed itself has noted, these responsibilities include being willing and able to ensure that a bank’s activities and strategic plans:

> "…are commensurate with a firm's ability to identify and manage risks, including identifying activities that pose a material risk to the safety and soundness of the firm, threaten the financial system, violate a law, or harm consumers."[30]

In 2021 the Federal Reserve articulated what an effective board of directors at a large bank should be able to do, but it has not made clear what actions it will take when it finds a board to be ineffective, nor has it made clear enough how that determination is being or will be made. Moreover, this issue was addressed through supervisory guidance, not a rule, yielding an unenforceable set of expectations that will likely at best only be reflected in a bank's non-public supervisory rating, undermining the potential to promote truly strong incentives for boards.

There are a variety of possible ways to try to promote stronger incentives for boards of directors, ranging from holding the board and its members directly responsible for a bank's failings, to taking actions that can create particularly strong incentives for board members, such as restricting a bank's ability to pay dividends, carry out share buybacks, or otherwise reward shareholders and management. The latter can currently be used in cases where banks' capital levels are found to be insufficient or the risk management practices supporting banks' capital planning are weak, a critical enhancement put in place after the 2008 Crash.[31] Rather than all but eliminating the use of the CCAR qualitative objection for large US banks as the Fed has done, its use should be revived and substantially expanded. It should be used in cases where there is clear evidence that a bank is so poorly managed and ineffectively overseen by its board of directors that it is consistently unable to run itself in line with fundamental expectations for safe practices or in compliance with the laws and consumer financial protection rules to which it is subject.

# Conclusion

It is clear based on the miserable record of large banks repeatedly doing dangerous, unethical, and illegal things, that regulation and supervision must be strengthened given the dangers those banks can pose to the economy, financial system, and livelihoods of all Americans. While in many ways the Banking Agencies supervisory framework has been improved since the 2008 Crash, with more attention paid to the truly critical practices and processes at banks, the Banking Agencies supervisory enforcement mechanisms must be strengthened, and the strongest ones used more often. And to be effective, they should be used publicly.

Previous failures in both regulations and supervision were in large part driven by a broadly held philosophy among the Banking Agencies that downplayed the importance of strict regulation and supervisory oversight of large banks. But even after experiencing the devastating consequences of the pre-2008 failures of bank supervision and regulation, it is alarming how some of the key lessons learned from that disaster are not aggressively incorporated into regulation and supervision today. Whether forgotten, ignored, or discarded, Silicon Valley Bank and the current banking crisis proves again that it is past time that those lessons inform the Banking Agencies' actions before they have to be learned again at the cost of catastrophe to the American people.

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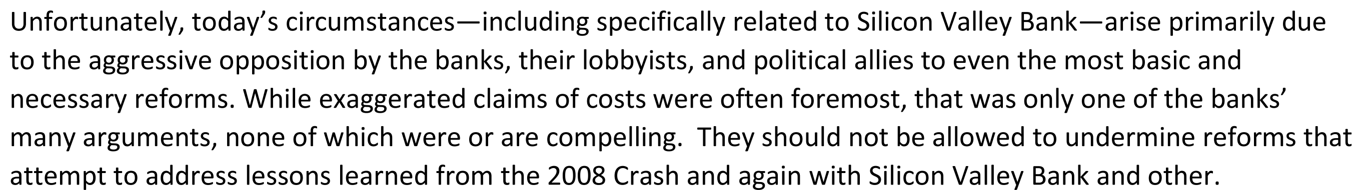
[30] Federal Reserve, *Supervisory Guidance on Board of Directors' Effectiveness*, (February 26, 2021).

[31] As noted earlier, since 2019 the Fed has virtually eliminated that ability to restrict capital distributions based on identification of weak risk management and governance practices.



Unfortunately, today's circumstances—including specifically related to Silicon Valley Bank—arise primarily due to the aggressive opposition by the banks, their lobbyists, and political allies to even the most basic and necessary reforms. While exaggerated claims of costs were often foremost, that was only one of the banks' many arguments, none of which were or are compelling. They should not be allowed to undermine reforms that attempt to address lessons learned from the 2008 Crash and again with Silicon Valley Bank and other.

However, one simply cannot overstate the immense political and lobbying power of the largest banks, power that they have used relentlessly to try to weaken, gut or kill virtually every important reform put in place after the 2008 Crash. The industry has to a large degree been successful at pushing back against many of the needed reforms, and has been granted numerous unwarranted concessions, particularly during the Trump administration. The continuing political power of an industry dominated by huge banks that have repeatedly broken the laws, run themselves in an unsafe manner, and failed to protect their customers is as alarming as it is remarkable.

It is past time that egregious bank conduct be counterbalanced by a particularly strong regulatory regime and an assertive banking supervision approach that regularly uses stronger and public enforcement actions by the Banking Agencies that oversee large banks. Yet, until the collapse of and contagion from Silicon Valley Bank, there had been few, if any, recent public discussions by the Banking Agencies of possible changes that might be made to strengthen banking supervision of the largest banks. At the same time, however, continued problems at some banks, even in areas that were thought to have already been addressed, have highlighted the need for tougher continuous oversight to promote the resilience of large banks.

The Banking Agencies must put in place a supervisory approach that makes clear that bank management ***and*** their boards of directors are responsible and will be held accountable when they fail in their responsibilities to comply with laws and rules and ensure the banks are run safely and well. The current investigations of Silicon Valley Bank (and to a lesser extent Signature Bank and Silvergate Bank) by the Banking Agencies, the Department of Justice, the SEC and others will be an acid test of the willingness to in fact hold deficient executives and directors accountable.

However, that will not be enough. To prevent yet more collapses if not crashes in the future, more information must be provided to the public to increase transparency around risks at the largest banks and the supervisory process so that both banks and the Banking Agencies are accountable before failure. Robust, more transparent, and continuously assertive banking supervision by the Banking Agencies is essential to promoting a safe and sound banking system that will better serve Americans and the economy and protect against catastrophic financial crises. It's not that hard, and as the 2008 Crash and the collapse and contagion of Silicon Valley Bank make clear, it must be done.

## Better Banks | Better Businesses

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Better Markets is a public interest 501(c)(3) non-profit based in Washington, DC that advocates for greater transparency, accountability, and oversight in the domestic and global capital and commodity markets, to protect the American Dream of homes, jobs, savings, education, a secure retirement, and a rising standard of living.

Better Markets fights for the economic security, opportunity, and prosperity of the American people by working to enact financial reform, to prevent another financial crash and the diversion of trillions of taxpayer dollars to bailing out the financial system.

By being a counterweight to Wall Street's biggest financial firms through the policymaking and rulemaking process, Better Markets is supporting pragmatic rules and a strong banking and financial system that enables stability, growth, and broad-based prosperity. Better Markets also fights to refocus finance on the real economy, empower the buyside and protect investors and consumers.

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