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FACT SHEET

Reducing Supervision of Banks Endangers Depositors and Economic Growth

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Banks—and their executives—are supervised by the banking regulators at the Federal Reserve ("Fed"), Office of the Comptroller of the Currency ("OCC"), and Federal Deposit Insurance Corporation ("FDIC") to make sure they don't misuse depositors' money, break the law, or engage in high-risk activities that could result in large losses, failures, catastrophic crashes, taxpayer bailouts, and economic calamity for the country. Banks have done this repeatedly, for example:

- At JP Morgan in 2013 when reckless actions and failures in risk management resulted in $6 billion "London Whale" trading losses
- In the 2023 regional bank crisis when three of largest bank failures in history happened, causing more than $40 billion in direct bailouts and more than $300 billion in total costs, including a reduction of credit to Main Street families
- In 2008 when tens of millions of Main Street Americans lost their jobs, homes and savings due to the catastrophic 2008 crash caused by the risk-taking of Wall Street's biggest financial firms, which were not properly supervised or regulated.

Without strong supervision, banks take big risks because more risk means higher profits and bigger bonuses for the executives. Risk-taking is how Wall Street banks were passing out $100 million bonuses to traders before the 2008 crash and how JPMorgan Chase CEO Jamie Dimon just pocketed $770 million. The prospect of such enormous riches creates powerful incentives for bankers to ramp up risk-taking, push limits, and bend the rules (or sometimes even break them).

That's why properly supervising banks and bankers is so vital. It's the only way to prevent risk taking from going too far and resulting in damage to banks, the financial system, and – ultimately – taxpayers. But bank failures are not the only harmful result of excess risk taking, it also is bad for economic growth. The way banks take on a lot of risk is by redirecting financial resources away from activities that support durable growth in the real economy towards risky activities in financial markets and activities that lead to the type of bubble growth that always results in economic crashes and harm to Main Street households.

Some Wall Street CEOs have understood the importance of supervision. For example, former Morgan Stanley CEO John Mack, who got what was then a record-breaking $40 million bonus in 2006 before his bank went bankrupt in 2008, said in 2009 that

> “Regulators have to be much more involved. We [meaning Wall Street’s biggest banks] cannot control ourselves.”

He went so far as to say that the government – supervisors and regulators – “had to step in and control Wall Street.” As the New York Times reported

> “Mr. Mack went even further in his praise of the dozen or so regulators [really supervisors] who now patrol Morgan Stanley’s offices in the wake of the firm becoming a bank holding company. ‘I love it,’ he said, adding that **it forced him and his firm to watch the level of risk they were taking on.**”

That’s exactly the purpose of bank supervision – to make sure banks have strong risk management in place and are practicing good financial discipline by avoiding excessive risk taking.

Unfortunately, the banking agencies under the current administration are determined to destroy bank supervision, which will benefit the largest banks and their highly profitable, highly risky activities. That’s good for them but very bad for community banks, Main Street borrowers, and economic growth. Taken together, the actions of the agencies are dismantling the proper supervision of the largest banks and their most dangerous activities.

This couldn’t happen at a worse time. Supervision of large banks is more important now than ever. Large banks increasingly are engaging in all sorts of risky financial activities – such as trading and derivatives – and exposed to the risks of nonbank financial companies like hedge funds. And soon deregulatory efforts by the agencies will return large banks to the dangerous capital levels they had just before the 2008 crash, which were grossly insufficient and resulted in catastrophic failures, huge bailouts, and economic devastation. So, if strong supervision is not in place, large banks will take on more risks and will have less capital to absorb the losses when those risks become reality, making large bank failures and bailouts a virtual certainty.

Adding insult to injury, weaker supervision for large banks also damages community banks and economic growth. That’s because reduced supervision for big banks means increasing the already-huge advantage big banks have over community banks, which hurts Main Street because large banks prioritize financial markets over lending. In fact, the largest banks use only 40 percent of their deposits for direct lending to the real economy, while community banks use 75 percent of their deposits for lending. That means fewer loans, fewer small businesses, fewer jobs, and lower economic growth.

Bank supervision alone cannot prevent all problems, but it is an essential component of an overall architecture that enables banks to engage in appropriate risk taking, support the real economy, fuel rising living standards and wealth creation, while at the same time not threatening the lives and livelihoods of hardworking Americans.

This fact sheet highlights the destructive actions of the banking agencies and the dangerous and pernicious implications for large bank supervision.

Changing the definition of “unsafe and unsound”

Recently, the agencies [introduced a new supervisory standard]() that on its own effectively destroys supervision by severely restricting it. Under the current standard, supervisors are tasked with identifying and addressing issues early, ***before they become major problems***. But under the new standard, supervisors essentially would have to ***wait until there already are major problems***, defeating the fundamental purpose of supervision. This type of heavily restricted, “too little, too late” scope for supervision will leave the agencies with virtually no room to address problems before they lead to significant losses and likely failure.

Repeatedly, there have been bank failures that resulted from risks that were identified in advance by supervisors but simply were not acted on forcefully and early enough. ***Put simply, supervision works***, ***and it works best when issues are fixed before they become big problems.*** For example, significant issues at Silicon Valley Bank were identified [over a year]() prior to its distress and failure, but forceful actions were not taken by the Fed to address them.

There are laws in place that are intended to keep our banks healthy and to protect depositors from the losses of risky activities, which the laws refer to as “unsafe and unsound” practices. The laws, however, do not define “unsafe and unsound” and clearly intended to allow supervision to evolve over time along with the banking system’s structure, risks, and environment. That is exactly what has happened over the last 160 years of federal bank supervision – lawmakers and regulators have expanded the authorities of supervision in response to numerous catastrophic bank crises.

But now the agencies are ignoring that history and putting in place a definition of “unsafe and unsound” that greatly limits what is considered to be risky activities to only those that likely will very soon cause material financial losses to a bank. Risks at banks either build over time or go unnoticed until there is a stress situation. In either case, early identification is absolutely necessary to preventing losses. If bank supervisors are stepping in only when significant losses are likely to occur, it is already too late.

Changes to the Federal Reserve’s supervisory ratings framework for large institutions

The Fed has [significantly weakened]() its supervisory ratings framework for large banking institutions, making it much easier for those institutions to take big risks and much harder for supervisors to prevent big problems and big losses. Large institutions should have the highest ratings standards because their size and complexity increases risks to the banking system and financial stability. But the Fed’s changes result in little difference between the standards for large institutions and smaller institutions, leaving the system exposed to significant risks and giving the largest banking institutions a huge advantage.

The Federal Reserve has a unique supervisory authority over what are known as “bank holding companies” or BHCs. This is important because the largest BHCs – like JP Morgan with $4.5 trillion in assets – are financial conglomerates with numerous nonbank subsidiaries that engage in a lot of complex and risky financial activities, such as trading and derivatives. For example, the largest BHCs dealt heavily in the risky real estate-linked derivatives that caused the 2008 crash. That's exactly why the Fed had put in place a special supervisory ratings framework for large BHCs that had higher standards. Now that those higher standards have been stripped back, banks and the system are exposed to greater risks.

It also makes the large BHC supervisory ratings framework nearly the same as the framework for smaller banks, which increases the huge advantage large banks already have. In fact, the proposal for the new framework boasted that it would "better align" with the framework for smaller institutions. This will make it even harder for small banks to compete, hurting lending to Main Street households and small businesses.

Allowing banks to determine when supervisory issues have been resolved

In a bizarre and reckless move, the Fed stated in an internal letter that it would allow banks, instead of supervisors, to decide when to close out issues that have been identified by supervisors. Allowing banks to make their own determinations about issues identified by supervisors is like allowing students to grade their own tests. This, of course, makes absolutely no sense and defeats the purpose of having supervisors in the first place.

The explanation provided to "justify" the change is that banks have an internal audit function that makes resolution determinations for issues a bank has identified on its own. So – the Fed argues in its letter – if supervisors have not found material issues with the audit function, then the function should also be able to determine if supervisory issues have been resolved.

However, if a bank's internal audit function missed an issue that was identified by supervisors, then that means there is a material issue with the audit function. Therefore, the audit function should not be able to determine if issues have been resolved, and, instead, both the identified issue and the audit function should be under supervisory review. So, not only does the new Fed policy not make any practical sense, but also the Fed's justification for it makes no sense.

Removing the Fed from the supervisory process for banks

The Fed also stated in that same letter that it will start deferring to other federal and state authorities for the supervision of the bank subsidiaries of BHCs as well as certain banks not affiliated with a BHC. This is a significant and consequential change that goes directly against the reason lawmakers gave the Fed supervisory authority in the first place – that there must be a regulatory agency which assesses BHCs wholistically, including both bank and nonbank subsidiaries, and which assesses certain non-BHC banks that other agencies don't supervise.

First, the bank subsidiaries of BHCs usually are quite large, and so this change removes a huge portion of BHCs from Fed supervision. For example, JP Morgan holds over $4.5 trillion in assets, and its major bank subsidiary – Chase Bank – holds over 80 percent of those assets. And with small and midsized BHCs the bank subsidiaries hold almost all the assets. Many in the industry argue that the failure of Silicon Valley Bank, which was supervised by the Fed, supports the idea of taking bank supervision away from the Fed. On the contrary, Fed supervisors identified the relevant issues early, and if anything, the failure is an indication that Fed supervisors must be given more authority to take forceful actions much sooner in the supervisory process.

Second, there are numerous interactions between the holding companies, bank subsidiaries, and nonbank subsidiaries. Fed supervision involves not only assessing risks within individual subsidiaries but also risks that arise between the subsidiaries and between subsidiaries and the holding companies. Preventing the Fed from assessing the bank subsidiary also prevents the Fed from conducting the wholistic assessment it is mandated to do.

Raising the "heightened standards" threshold to $700B

The OCC recently issued a proposal that would greatly reduce the number of banks to which it applies the strictest supervisory standards from 38 to just 8 banks by increasing the asset threshold for the standards from $50 billion to $700 billion. The so-called "heightened standards" are necessary for the supervision of large banks because they set minimum risk management expectations that are not applicable to other banks. These standards ensure the largest banks have basic but very important risk management practices in place. The change, therefore, would allow the other 30 large banks to manage their risks however they want.

In the proposal the OCC provides no support for the change. Instead, it states simply that the strict standards should apply only to banks that "pose the greatest risk to financial stability and the banking system." This "justification" blatantly ignores that Silicon Valley Bank was just over $200 billion when it failed and still led to systemic risks that required a bailout from the Fed, far below the proposed $700 billion threshold.

Not only would this change give banks below that threshold the latitude to manage risks however they want, but it also would limit actions supervisors can take to address identified issues. So, as with Silicon Valley Bank, supervisors would not be able to act forcefully enough to prevent bank failures, but – unlike Silicon Valley Bank – it would be much more likely that supervisors would not identify issues in the first place.

Removal of reputation risk

Last year the Fed removed reputation risk from its supervisory assessments, and the OCC and FDIC have issued proposals to do the same. As seen many times throughout history, including during the bank turmoil of Spring 2023, reputation risk has been an important factor to maintaining safety and soundness. Banks have a long history of dangerously poor management, not operating safely or in compliance with rules and laws, as well as outrageous unethical behavior, as Better Markets has detailed in multiple "Rap Sheet" reports over the years.

The foundation of safe and sound banking is the confidence earned by banks from their customers, other financial institutions, and financial markets. And foundational to that confidence is reputation. That is why reputation risk is so important and must be included as a key, standalone risk in the supervisory process and why banks have been required to look beyond strictly financial matters to determine if there are unacceptable risks arising.

Furthermore, buildups in other risks, such as liquidity or capital risks, can turn into reputation risks with catastrophic consequences. For example, Silicon Valley Bank's financial position triggered a loss in confidence and run by depositors, ultimately resulting in its failure and subsequent systemic risk that was bailed out by the Fed.

Conclusion

The banking agencies have taken numerous consequential actions that essentially destroy supervision, especially for the largest banks. The most consequential has been changing the definition of "unsafe and unsound" practices, which is the foundation of supervisory assessments and corrective actions. Under the new definition, banks will be able to build massive risks before supervisors can step in, at which point it will be too little, too late. This change creates a huge advantage for the largest banks, which engage in the riskiest activities, increasing their profitability and leaving Main Street to pick up the pieces when their activities lead to losses and failures.

That foundational advantage for the largest banks is made much larger by all the other changes being implemented by the agencies, especially the Fed weakening its large bank supervisory ratings framework and removing itself from the supervision of bank subsidiaries of BHCs. Taken together, the changes being made by the agencies to supervision are endangering the banking system and hurting support for Main Street small businesses and households. The banking agencies must stop putting the priorities of the largest banks above what is good for all Americans.

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