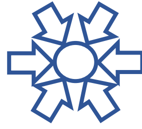
U.S. Bank Supervision:
How to Make It Both Good and Just



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- Many supervisory-efficacy problems dating back at least to the great financial crisis remain uncorrected. Promises from the FRB and FDIC and OCC self-confidence since the 2023 failures do not constitute rapid reform.
- Supervisors must operate under tight deadlines with accountability to agency leadership and to the public to ensure that material weaknesses are quickly differentiated from minor failings and that banks that do not quickly and meaningfully remedy these failings are punished or shut down.
- U.S. supervisors should remain self-funded, but disclose supervisory ratings to ensure necessary transparency and effective market discipline. Supervisors worry so much about market disruption that they wait too long, fail too many resolvable banks, and heighten moral hazard.
- Effective bank supervision follows the policing model to protect the public good: get probable offenders off the street ASAP while adhering to basic rights, allow for appeal, punish meaningfully and swiftly where this is just and thus protect the public good.

Thank you very much, Nicolas, for inviting me to speak on the subject of bank supervision in the wake of profound challenges evidenced in 2023 and uncertain corrective action ever since. My remarks today will focus on the state of the supervisory art in the United States, providing a brief update and critique to build on Claudia's important review of recent European Union developments.

What I find most discouraging about the United States' supervisory situation is how much remains unchanged in terms of structure, results, and supervisory accountability not just since March of last year, but also since the 2008 Great Financial Crisis (GFC). To be sure, enormous effort went into implementing significant regulatory changes after the GFC laid bare serious deficiencies in capital adequacy, emergency liquidity, internal controls, and incentives. However, as events of 2023 make all too clear, supervision did not keep up. Autopsies from the Federal Reserve[1] and FDIC[2] have

documented much of what went wrong, but what has happened over a year later to remedy them is known only anecdotally and often unreliably. Combined with the workplace-culture debacle at the FDIC,[3] it is likely that change at the FDIC has been at best uncertain and that at the Fed known only from assurances, not transparent reports ensuring accountability.

The third federal regulator, the Office of the Comptroller of the Currency, seems sanguine about its supervisory acumen since none of the banks that failed at the height of the 2023 crisis were under its jurisdiction. However, I urge caution in taking this for granted. A recent Office of Financial Research report concludes that 519 U.S. banks are at risk due to combined commercial real estate exposures, large unrealized losses, and uninsured-deposit reliance.[4] At the height of the 2023 crisis, a Federal Reserve study shows that twenty-two banks were experiencing viral runs.[5] They survived, but whether this is due to effective supervision or systemic bailout two days after the run began is not addressed in this work. At least some of all of these troubled banks have federal charters.

So, what to do? Let me quickly offer several suggestions as well as explain why "just" supervision is not lax supervision and how it would in fact make bank supervision better, faster, and surer.

Speed and Certainty

The supervisory autopsies after last year's failures are public proof that one of the most egregious supervisory failings contributing to the GFC remains uncorrected: the long delays between when examiners spot problems and then get up the gumption to bring these to the attention of a bank's CEO and, where necessary, quickly also to the board of directors. This is all too often followed by lengthy delays between promises to do better and assessments of whether better has in fact been done and, if not, then also for rapid and intrusive demands for meaningful remediation.

In my firm's work after the GFC, I became privy to many confidential reports showing that bank examiners often quickly spotted looming problems. They were, though, either cautious or captive, failing to do much more than wring their hands at more and more meetings, issuing meaningful enforcement actions only when it was far too late. Other than promises, we have no evidence that the banking agencies will now actually undertake the rapid escalation the FRB and FDIC have promised and the OCC needs to ensure.

Effectiveness

A recent, withering report from the Bank Policy Institute details many irrefutable and structural challenges to effective bank supervision in the United States.[6] BPI's report of course represents the interests of its large-bank members, but its factual conclusions stand unchallenged unless or until the banking agencies lay out the facts they believe paint a more positive picture.

How can bank supervision be effective when federal bank supervisors number well over 5,300 not counting those at the FDIC (which does not disclose these data), the Consumer Financial Protection Bureau, and, where applicable, state bank supervisory agencies (many of which are substantial in their own right). Large banks also often have hundreds of examiners who are often resident in the bank, with at least a dozen exams ongoing at all times. The IMF's assessment of post-2023 bank supervision targets inadequate resources as one obstacle to effective supervision.[7] This cannot be said of the United States. Indeed, it may be the agency's self-funding model that not only rightly renders them politically

independent, but also wrongly insulates them from the organizational rigor necessary to any well-managed entity.

Large examination bureaucracies are at grave risk not just of lethargy, but also of being encumbered by so many internal reporting requirements and conflicting incentives that they lack the ability to distinguish material weaknesses from minor failings and then to rapidly resolve or punish persistent material weaknesses and violations. With so many examiners who, like all employees, are worried at least as much about themselves as about bank safety and soundness, there is no way to ensure that supervision does not spend so much time examining superficial scratches that mortal danger is missed.

To be sure, large banks are complex organizations often engaged in high-finance ventures only a highly-trained financial engineer can hope to understand. U.S. banking agencies generally try to deal with this critical examination challenge by recruiting in-house specialists. This is doomed. Even with ample resources, government organizations cannot pay financial specialists the salaries – often well above that paid even to the U.S. President – needed to recruit and retrain competent expertise. Examiners are thus always the proverbial day late and many dollars short, locked as they are in an unwinnable effort to masses' complex transactions with dozens of staffers instead of with the targeted specialists needed to do so.

Supervisors and the public should not abandon hope of expert examination nor allow this flaw to go unremedied. One option would be to hire trained consultants under ironclad conflict and confidentiality restrictions, using supervisory resources to manage and enforce these, not endlessly trail financial-system innovation or seek to halt it, as is sadly all too often the case.

Accountability

In the U.S., the public is only given the information needed to hold supervisors accountable after a bank fails. That is, of course, far too late.

When I testified before Congress in 2001 following the then-largest insured-depository collapse since the S&L crisis of the 1980s,[8] I urged public release of the CAMELS ratings assigned insured depositories and the like-kind ratings assigned their parent holding companies. Twenty-three years on, I'll do so again.

We know all over again that supervisors granted favorable ratings to each of the banks that failed in 2023 well after each bank's failings were clear and supervisors fretted about them. Why the high scores? As I said, supervisors are slow to act, hesitant to demand, and faint-hearted to enforce.

Knowing that a CAMELS rating will be public and depositors will soon learn of it is a tough-minded, but effective way to ensure that supervisors know their reputations are at risk if they focus on internal incentives instead of rapid remediation and that bank management cleans up its act before market discipline demands that it does so in no uncertain terms likely past the point of recovery. We know all too well the high risk of "extend-and-pretend" when it comes to delaying delinquent-loan classification. Extend-and-pretend is still more lethal when it comes to bank supervision. U.S. practice has been to cloud CAMELS ratings because regulators fear the consequences of objective, cold-hearted market discipline. As the systemic designation that follows each banking crisis demonstrates all too clearly, waiting too long for banks to behave builds larger and larger banks that cannot be disciplined without costly bailouts, still more banking-system concentration, and even more profound moral hazard.

Making Supervision Just as Well as Good

There is much to be said for top-down reviews of supervisory decisions, appeals, and ombudspeople, with various reforms meant to ensure this taking place over the years and new legislation to force still more binding supervisory safeguards pending in the U.S. House.[9] However, in the absence of structural reforms along the lines I've briefly outlined, these administrative safeguards may well only tie the banking agencies into still larger knots of administrative overkill and attention to meaningless detail, leading them to cross off procedural boxes instead of ensuring rapid-fire response to emerging risks. Supervision that is not only good, but also just must balance effective response and mandatory injunctions with the need always to ensure that the rights of supervised banks to a hearing if supervision goes too far must be respected.

A real-world analogy of how this should work is policing: we want law-enforcement officers quickly to get dangers off the streets given probable cause to do so that is free of racial or other biases. We also want accused offenders to be treated with dignity and have numerous avenues to ensure that their rights are respected at each turn in the judicial process. This can delay punishment, but often not for long and, even when it does, someone with a gun is off the streets.

Of course, this doesn't work all the time and it won't work all the time for bank supervision, but it will work better than supervision does now and that's all to the essential public good.

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[2] Federal Deposit Insurance Corporation (FDIC), "FDIC's Supervision of Signature Bank," (April 28, 2023), https://www.fdic.gov/sites/default/files/2024-03/pr23033a.pdf.
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[4] Tom Doolittle et. all, "Bank Health and Future Commercial Real Estate Losses," *Office of Financial Research*, (July 11, 2024) https://www.financialresearch.gov/briefs/files/OFRBrief-24-04-bank-health-and-future-commercial-real-estate-losses.pdf.
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[9] Bank Resilience and Regulatory Improvement Act, H.R. 8337, 118th Congress § 2, (2024), https://www.congress.gov/bill/118th-congress/house-bill/8337.