

Fed Vice Chair Quarles Calls for Significant Changes to the Supervisory Process: *Implications and Open Questions for the Banking Industry*

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During his tenure as Vice Chair for Supervision, Federal Reserve Board (“FRB”) Governor Randal Quarles has spearheaded efforts to more closely tailor the *regulatory* burdens faced by banking organizations with their actual risk profile. In contrast, however, the historical framework for *supervision* and *examination* of the banking organizations, which occurs at the Reserve Bank level with some centralization at the FRB and has involved significant discretion based on the examiner’s perception of prudential strength and compliance of the supervised institution, has remained intact. A poor examination rating can substantially negate the benefits that the tailoring regulations otherwise would provide. This effect is particularly acute for financial holding companies because an institution with an imperfect examination rating can be subject to restrictions on growth, significant remediation requirements and fines.

Although he has made references to it in past speeches, Vice Chair Quarles recently has forcefully indicated an intention to also remove the opaqueness of this critical supervisory aspect of bank oversight. At the annual meeting of the American Bar Association (“ABA”) Banking Law Committee on January 17, 2020, Vice Chair Quarles called for greater “transparency and clarity” in the FRB’s framework for supervising banking organizations and introduced a series of proposals the agency may adopt to that end.¹ This speech suggests that fundamental changes to the supervisory process may be in the offing.

Below, we briefly summarize Vice Chair Quarles’s speech, discuss its potential implications for the banking industry and consider how the FRB may implement and improve upon the Vice Chair’s recommendations.

¹ Randal Quarles, Vice Chair for Supervision, FRB, Address at the American Bar Association Banking Law Committee Meeting 2020 (Jan. 17, 2020) available [here](#). The Vice Chair also previewed his goals of greater transparency and due process associated with bank supervision in a speech given in the fall of last year. Randal Quarles, Vice Chair for Supervision, FRB, Address at the “Law and Macroeconomics,” a conference at Georgetown University Law Center (Sept. 27, 2019) available [here](#).

A Fresh Perspective on the Theory and Practice of Supervision in the Post-Crisis Regulatory Framework

As in his 2018 remarks before the ABA, Vice Chair Quarles began by describing the principles he believes ought to guide the FRB's engagement with regulated banking organizations. These principles include efficiency, predictability, fairness, accountability and, above all, transparency. He then described how these principles should inform two related, but distinct, spheres of FRB authority: *regulation*, the public process of setting rules of general applicability; and *supervision*, the private process of examining and monitoring an individual banking organization to ensure compliance with law and regulation and its safe and sound operation.

Although the supervisory process “constitutes the bulk of [the FRB’s] engagement with the industry and through which [its] policy objectives are given effect,” it is not subject to the formalities governing regulatory rulemakings and, in large measure, occurs behind closed doors. According to the Vice Chair, this dynamic leaves the process susceptible to charges that it is opaque and capricious and that rules are applied unequally and unfairly. How to “square this circle”—creating a “transparent, efficient and effective supervisory process” while maintaining appropriate confidentiality—is the challenge he appears committed to addressing.

By opening a public dialogue about how best to structure supervision, Vice Chair Quarles’s speech may have been notable as much for the approach and vision animating it as for the incremental (though important) reforms it suggests. Long criticized for being secretive, opaque and inflexible, especially about supervisory matters, pursuant to Vice Chair Quarles’s initiative, the FRB may be entering a period of greater and more productive engagement with banking organizations, and greater alliance with the general norms and practices of U.S. administrative law.

Specific Proposals to Improve Supervision

The Vice Chair recommended a number of “obvious and immediate ways” the FRB could make its supervision of financial institutions more transparent, efficient and effective, steps he readily conceded, are “by no means comprehensive.” These recommendations fall into three broad categories:

- **Revising, and increasing transparency of, the Large Institution Supervision Coordinating Committee (“LISCC”) supervisory program, by:**

- Aligning the agency’s supervisory portfolios to the “tailoring rules” that were finalized at the end of 2019,² which would ensure that the supervisory scrutiny to which LISCC institutions are subject conforms to publicly available criteria and that only the largest and most complex firms (so-called “Category I” institutions) would fall within the LISCC portfolio and be held to the full panoply of rigorous post-crisis capital, liquidity and governance requirements that follow. Notably, this would remove all foreign banking organizations from LISCC review;
- Publishing the LISCC internal procedural materials that the FRB uses to supervise LISCC firms; and
- Revising the stress test and capital planning process to provide additional transparency regarding the FRB’s models and scenarios, “smooth[ing] out” volatility in stress-testing requirements as they apply from year to year, and giving firms more time to respond to supervisory feedback on their stress test results before final capital plans must be submitted.
- **Increasing transparency of other aspects of the FRB, by:**
 - Making available a word-searchable database on the FRB’s public website containing a compendium of historical interpretations by the FRB and its staff of all “significant rules”; and
 - Submitting “significant supervisory guidance” for public comment and congressional review consistent with, and in certain cases required by, administrative law.
- **Improving the general supervisory process, by:**
 - Revising the framework governing confidential supervisory information (“CSI”) to relax restrictions on disclosure to employees, affiliates, service providers, and other government agencies.³
 - Adopting a formal rule regarding the proper use of supervisory guidance, consistent with the (nonbinding) multi-agency “guidance on guidance” published in 2018 (*i.e.*, saying that supervisory guidance cannot be the only basis of a material criticism during an examination); and

² Our prior analysis of the tailoring rules is available [here](#).

³ As described in our prior analysis available [here](#), the FRB published a proposed rule to revise its CSI regulations in June 2019. Vice Chair Quarles indicated that he expects the rule to be finalized later this year.

- Making various changes to supervisory communications practices to reduce subjective supervisory adverse outcomes, such as:
 - Reviving the practice of issuing “supervisory observations” for less significant safety and soundness issues identified during examinations;
 - Issuing Matters Requiring Attention (“MRAs”) only for violations of law, violations of regulation, and material safety and soundness issues; and
 - Instituting a process for routine, independent review of important supervisory communications and guidance documents.

Such steps, Vice Chair Quarles readily admitted, will not alone “square the public interest in agile supervision with the public interest in transparency and accountability” but rather serve to “open the exploration” toward a supervisory process that functions more efficiently and effectively for supervisors and the banking industry alike.

More Should Be Done to Ensure Fairness and Accountability

Many industry participants rightfully have applauded Vice Chair Quarles for his leadership and openness to rethinking what have become fundamental tenets of the FRB’s approach in the critical supervisory area. Although many of these efforts could benefit supervised institutions, building a more transparent and efficient supervisory process is difficult and proper implementation will be critical to its success. We believe that the Vice Chair has provided the appropriate starting point and framework. Below, we identify opportunities to further develop the framework he sets forth.

Adherence to the Law as a Starting Point

Many of the Vice Chair’s proposals appear to be based on, and in some cases intended to ensure that the FRB improves its compliance with, the requirements of the Administrative Procedure Act (“APA”) and other administrative law—in his words, “build[] respect for and adherence to the law.” As an example, the 2018 interagency “Guidance on Guidance” reminds supervisors how supervisory guidance may, and may not, be used under law. It is perhaps telling of the current view of the supervisory process that one of the Vice Chair’s proposals is to codify this aspect of the guidance: to “state that the [FRB] will follow and respect the limits of administrative law in carrying out its supervisory responsibilities” (*i.e.*, to adopt a regulation instructing the Federal Reserve System to observe applicable law). Other proposals from the Vice Chair likewise appear intended to improve the FRB’s compliance with other aspects of the APA. For example, his proposal to remove “mandatory language in guidance” appears similarly

intended to ensure that guidance documents are not deemed directives, and thus be improperly promulgated regulations under the APA.⁴

Even where Vice Chair Quarles does not explicitly tie a proposal to administrative law, many of his proposals appear to be modeled after APA requirements. For example, the proposals to publish on the FRB's website the LISCC internal procedures manual and staff interpretations appear to align with the requirement of the Freedom of Information Act to publish in the Federal Register or "make available for public inspection in an electronic format" many interpretations, administrative staff manuals and rules of procedure.⁵

Similar to the APA-related examples above, the Vice Chair also outlined efforts to increase compliance with the Congressional Review Act ("CRA"), including his proposal to submit "significant supervisory guidance" to Congress. The CRA requires general statements of policy and interpretations, as well as regulations, to be submitted to Congress before they can take effect.⁶ The Government Accountability Office ("GAO") has noted in a series of letters addressing specific supervisory guidance documents that the CRA requires the FRB to submit the guidance documents to Congress.⁷ Submission of "significant supervisory guidance" to Congress should improve the FRB's compliance with the CRA.⁸

Building on This Framework

Although holding the FRB to applicable law—such as the APA and CRA—is a laudable goal in itself, the Vice Chair's goals for supervision run deeper. He appears to be trying to help ensure that supervision is "fair, predictable, efficient, and accountable." Greater "transparency," specifically through procedures required or inspired by the APA, is the principal tool on which he proposes to rely. We believe that more could be done to ensure the Vice Chair's goals for supervision are met and that the APA continues to

⁴ See *Appalachian Power Co. v. EPA*, 208 F.3d 1015, 1023 (D.C. Cir 2000). His proposal to "increase the transparency" around CCAR scenarios may also be in part motivated by arguments that the CCAR scenarios are improperly promulgated regulations under the APA.

⁵ See 5 USC 552(a).

⁶ 5 USC 801(a)(1)(A).

⁷ See, e.g., GAO letter to Hon. Thom Tillis (Oct. 22, 2019) ("SR 11-7 is subject to the requirement that it be submitted to both Houses of Congress and the Comptroller General for review before it can take effect.") (emphasis in original) available [here](#).

⁸ The CRA generally requires any "agency statement of general or particular applicability and future effect designed to implement, interpret, or prescribe law or policy or describing the organization, procedure, or practice requirements of an agency" to be submitted to Congress. See 5 USC 551, 804(3). Similarly, revising the scope of certain supervisory guidance in light of the FRB's tailoring final rules, as proposed by Vice Chair Quarles, could cause the newly revised guidance also to be submitted to Congress, essentially providing the FRB with an opportunity to make existing guidance compliant with the CRA. Although the CRA does provide exceptions for certain agency statements, the exceptions generally do not turn on significance. *Id.* at 804(3).

provide a useful guide. Below we identify two important procedural protections of the APA that can be further leveraged to meet these goals followed by examples of how these processes may be so leveraged.

- **APA’s Public Comment Process:** A well-known and critical aspect of the APA’s rulemaking process is an agency’s requirement to respond to public comment.⁹ This aspect makes the agency more accountable to the public and increases the likelihood that the final rule is fair—two of the Vice Chair’s goals. The Vice Chair’s proposal “to seek comment on more supervisory guidance going forward” would of course help achieve public accountability and fairness. However, the FRB already proposes certain supervisory guidance for comment (e.g., the Interagency Guidance on Leveraged Lending), and it is unclear whether the Vice Chair proposes to expand the scope of agency issuances to be proposed for comment.
- **APA’s Individualized Decision-making Protections:** The APA applies its procedural requirements to individualized actions in addition to general rulemakings.¹⁰ Agencies generally are required to provide a rationale for their decisions (whether or not made through rulemaking) and respond to concerns of affected parties. These requirements help ensure that an agency has engaged in a deliberative and fair decision-making process—even if the particular decision only affects one institution. The Vice Chair similarly stated that “[g]reater transparency in supervision about the content of our expectations and about how we form our expectations and judgements can make supervision more effective by building trust and respect for the fairness and rationality of supervision.” But few of the Vice Chair’s proposals appear likely to create the principled determinations he desires. None of the proposals, for example, would appear to require supervisors to provide additional or more developed rationales for their supervisory findings or invite the affected institution to challenge the findings.

The Vice Chair made clear that he did not intend his proposals to be comprehensive, noting that the supervisory process is a “complex and consequential issue” that will be a “significant focus of [his] going forward.” Potential modifications to his proposals—as well as additional proposals—that would help achieve his goals would hopefully be welcomed and considered. For example, modifications to existing guidance resulting from the Vice Chair’s proposed review could be subject to notice and comment. Additional public involvement should help ensure that revisions to the existing guidance appropriately address nuanced and complex issues like the removal of bright

⁹ See 5 USC 553(b)-(c).

¹⁰ See, e.g., 5 USC 551(4), (6) and (7), 553, 554, 706.

lines.¹¹ Issuing generally applicable FRB legal interpretations for public comment could similarly help achieve the Vice Chair's goals (e.g., transparency, fairness, predictability).

In addition, the Vice Chair's proposal to adopt a rule addressing the FRB's use of guidance in the supervisory process could be improved by also providing greater procedural safeguards to help ensure individualized decisions are sufficiently supported and responsive to the institutions affected. Procedural safeguards should include required written rationales for supervisory determinations and a process for the effected institution to respond to draft determinations. Otherwise, supervisory observations, which supervisors could view as less significant and easier to issue, may result in financial institutions receiving more supervisory comments in the aggregate and inappropriately increasing their compliance burden. Likewise, the FRB should provide clear criteria for the issuance of MRAs for "material safety and soundness issues," as the ambiguity and potential breadth of the phrase would appear to be inapposite to the Vice Chair's goals.

Conclusion

Whether the Vice Chair's proposals are implemented, much less whether those proposals have their intended effect, remains to be seen. Not only does this initiative involve changing supervisors' long-standing behaviors, but it would also be conceptually difficult and require a balanced approach.

Vice Chair Quarles appears to believe that the nature of supervision is, to some extent, at odds with the goals he articulated and the responsibilities of government in a democracy; he noted that there is good reason why supervision is not subject to a formal framework. Although it would not be appropriate to incorporate completely the rulemaking framework of U.S. administrative law into the supervisory process, the Vice Chair's speech highlights that more can and should be done to afford supervised institutions basic procedural protections of reasoned decision-making.

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Please do not hesitate to contact us with any questions.

¹¹ Although we agree with the Vice Chair that "bright lines [in guidance] tend to carry the implication that the standard they are delineating is binding," bright lines in certain instances can be helpful to banking organizations given the ambiguity in many of the regulations that apply to them. For example, removing bright lines governing the applicability of guidance might cause additional confusion in some cases and could lead to additional burden to the industry as firms feel restricted in their ability to engage in otherwise compliant and safe and sound activities. Likewise, bright lines regarding substantive expectations can provide institutions with a helpful safe harbor or benchmark.

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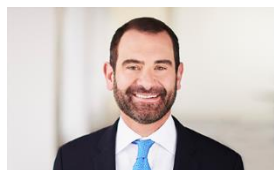
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