Tougher Banking Agency Examination Guidelines—The Less Publicized Ramification of the 2023 Bank Failures

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Much attention (appropriately) has been devoted to the flurry of federal banking agency (collectively, the "Agencies") rulemakings and policy statements since the spring 2023 financial crisis.[1] The banking industry has responded to these Agency efforts with comment letters and, in some cases, lawsuits.[2] These industry actions appear to be having an impact, with Federal Reserve Board ("FRB") Chair Jerome Powell, for example, testifying before Congress on March 7 that there would be "broad and material changes" to the Basel III Endgame proposal.[3] The final picture of the new regulatory framework thus remains unclear.

However, although less publicized, and not subject to industry comment, recent and pending Agency changes to bank examination procedures may prove no less significant to the industry, given the importance of exam ratings to banking institution activities, expenses and growth. Members of Congress criticized the Agencies' examination approach for contributing to the 2023 spring financial crisis, accusing the Agencies of "appear[ing] to have been asleep at the wheel," that they "knew the problem, but nobody dropped the hammer," and that "Fed supervision didn't react decisively enough."[4] A 2024 U.S. Government Accountability Office Report ("GAO Report") specifically focused on this issue, stating that although examination staff communicated

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1 *See, e.g.*, our Debevoise in Depth on the OCC proposal *here*; our Debevoise in Depth on the FDIC's proposed bank merger guidance *here*; our Debevoise in Depth on regulators' proposals to enhance capital and long-term debt requirements for U.S. GSIBs and large banks *here*; our Finreg and Fintech blog post on the Basel III Endgame proposal *here*; our Finreg and Fintech blog post on the Acting Comptroller's preview of upcoming changes to liquidity regulations *here*; and our Debevoise discussion on the final rule amending Community Reinvestment Act regulations *here*.

2 For example, a coalition that includes the Independent Community Bankers of America and American Bankers Association sued the Agencies on account of exceeding their authority in their overhaul to the Community Reinvestment Act ("CRA"). On March 29, 2024 a federal judge in Texas enjoined the Agencies from enforcing the new CRA regulations, with the decision available *here*.

3 Bloomberg Government, United States Senate Committee on Banking, Housing, and Urban Affairs Hearing, The Federal Reserve's Semi-Annual Monetary Policy Report (Mar. 7, 2024). The Hearing Video is available *here*.

4 WSJ, Lawmakers Scold Fed Over Silicon Valley Bank Collapse (March 28, 2023), available *here*; Bloomberg Government, United States Senate Committee on Banking, Housing, and Urban Affairs Hearing, The Federal Reserve's Semi-Annual Monetary Policy Report (Mar. 7, 2024). The Hearing Video is available *here*.

effectively with the banks, "regulators did not escalate supervisory actions in a timely fashion, which could have helped to prevent the failures."[5]

Perhaps at least in part in response to this congressional criticism, last year the number of severe enforcement actions issued by the Agencies against US banks reached its highest level since 2016.[6] However, although an increase in the number of individual enforcement actions suggests a harsher environment in 2023, recent and pending actions by the Agencies to amend their examination framework to increase the escalation of examination issues could result in this more difficult examination environment extending well into the future. Additionally, the coordination and oversight among Agencies and third parties (exemplified by the Federal Reserve's letter agreeing to the GAO Report's supervisory reform proposals),[7] emphasize the importance for banks to monitor changes in examination procedures across Agencies, regardless of their own primary federal supervising agency.

Key Takeaways

- The spring 2023 financial crisis is affecting Agency examinations (and ratings), as well as regulations.
- Each of the Agencies either have already toughened their examination escalation procedures, or are in the process of doing so.
- Given the importance of examination ratings to activities, expenses and growth, banks are encouraged to stay abreast of and as necessary adapt their examination strategies to these developments.

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5 GAO Report, Bank Supervision: More Timely Escalation of Supervisory Action Needed (Mar. 6, 2024), available here. The GAO Report mentions, for example, that the FDIC first made liquidity supervisory recommendations to Signature Bank in 2018, yet the recommendations remained open until the bank failed in 2023. SVB had three times the number of supervisory concerns as an average Large and Foreign Banking Organization ("LFBO") bank, and though Federal Reserve Bank of San Francisco examiners initiated an informal enforcement action in July 2022, examiners did not finalize the action before SVB's failure in March 2023.

6 *See* S&P Capital IQ report, US banking regulators' severe enforcement action issuance hits 7-year high (Feb. 15, 2024).

7 GAO Report, Bank Supervision: More Timely Escalation of Supervisory Action Needed, Appendix II (Mar. 6, 2024), available *here*.

Agency Movement Toward More Rigorous Examination Procedures

Although moving at different paces, as least as to amendments of their written examination guidelines, the Agencies are all acting to increase the certainty and speed with which issues, particularly those extending over more than one exam cycle, result in more significant enforcement interventions and actions. In the case of the FRB, these changes also likely will include greater expectations for banking institutions approaching a category threshold of its enhanced prudential standard regulations.[8]

OCC

In May 2023, the Office of the Comptroller of the Currency ("OCC") revised Policies and Procedures Manual ("PPM") 5310-3, "Bank Enforcement Actions and Related Matters" (its policies and procedures manual on bank enforcement actions), by introducing Appendix C: "Actions Against Banks with Persistent Weaknesses." This addition to the manual offers clearer guidelines to OCC examiners on identifying and addressing "persistent weaknesses" in banks.[9] "Persistent weakness" for this purpose may include the following:

- composite or management ratings that are "3" or worse, or three or more weak or insufficient quality of risk management assessments, for more than three years;
- failure by the bank to adopt, implement or adhere to all the corrective actions required by a formal enforcement action in a timely manner; or
- multiple enforcement actions against the bank executed or outstanding during a three-year period.

Appendix C establishes a presumption in favor of additional and increasingly severe action(s) when a bank has continuing, recurring or increasing deficiencies and persistent weaknesses for a prolonged period with insufficient demonstrable bank efforts to correct them. Resulting enforcement actions listed in the added Appendix may include the following:

- requiring the board to oversee the development and implementation of an enterprise-wide action plan to promptly resolve the bank's persistent weaknesses, including to improve poor ratings and assessments;

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[8] Barr report Re: Review of the Federal Reserve's Supervision and Regulation of Silicon Valley Bank (Apr. 28, 2023), available *here*.

[9] OCC, OCC Revises Bank Enforcement Manual to Address Actions Against Banks with Persistent Weaknesses (May 25, 2023), available *here*.

- restrictions on the bank's growth, business activities or dividend payments; or
- requirements to take affirmative actions, including holding additional capital or liquidity or making or increasing investments targeted to aspects of its operations.

Should a bank fail to correct its persistent weaknesses despite supervising actions such as the foregoing, the OCC will consider further action, including possibly requiring the bank to reduce its asset size, divest subsidiaries or business lines, or exit from one or more markets of operation.[10] Discussing these revisions, Acting Comptroller Hsu stated that the PPM "promotes strong management by making clear that a bank's inability to correct persistent weaknesses will result in proportionate, fair, and appropriate consequences, including growth restrictions and divestitures when warranted."[11]

FDIC

In August, 2023, the Federal Deposit Insurance Corporation ("FDIC") updated its procedures for escalating supervisory concerns in a supervisory memorandum (the "Memorandum").[12] The Memorandum advises examiners to perform a "progressive supervisory response" ("PSR"). A PSR is defined as elevating a supervisory concern and recommendation to at least a matter requiring board attention ("MRBA") if supervisory recommendations are repeated or remain uncorrected at the next examination cycle. When such issues arise, a PSR requires at least elevating the matter to an enforcement action.

Highlighting the Memorandum's focus on escalation, the new procedures state that if an examiner identifies a supervisory issue and believes that a PSR is not warranted, the FDIC examiner must provide written justification to their regional office management. Management would then determine whether to agree or disagree with the examiner's decision not to escalate the repeated or uncorrected concern.[13] Examiners were trained on these new instructions on September 13, 2023, and were provided the opportunity to comment on the instructions by September 29, 2023.[14] The GAO Report states that the FDIC intends to update its procedures again to require, rather than consider, that

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[10] PPM 5310-3, "Bank Enforcement Actions and Related Matters," Appendix C (May 25, 2023), available *here*. The PPM does not explain the criteria the OCC uses to determine if a bank is considered to have failed to correct its persistent weaknesses.

[11] OCC Revises Bank Enforcement Manual to Address Actions Against Banks with Persistent Weaknesses (May 25, 2023), available *here*.

[12] FDIC, Supervisory Recommendations (Including Matters Requiring Board Attention) and Progressive Supervisory Response, 2023-015-RMS (Washington, D.C., Aug. 29, 2023).

[13] *Id.*

[14] FDIC Director of Risk Management Services response to OIG's Material Loss Review of Signature Bank of New York (Oct. 23, 2023), available *here*.

examiners escalate in those situations, so as to ensure that escalations occur on a timely basis.[15]

FRB

The FRB has not yet published similar revisions to its examination guidelines. However, FRB Chair Powell stated in Congress on March 7, 2024 that in light of "a clear supervisory failure" during the bank failures, the FRB had "undertaken an assessment of its supervisory process to identify and address gaps related to the speed, the force and the agility of its supervision," and in light of that assessment is "working hard to develop a new [supervision] rule book and another set of practices which are still going to be evidence-based and fair," but are "going to involve earlier interventions and more effective ones."[16] The GAO Report promoted this approach, recommending that Chair Powell ensure that the FRB Director of Supervision revise the FRB's escalation procedures to be clearer and more specific, including measurable criteria on when to escalate deficiencies to formal or informal actions, so as to, among other things, assist examiners to more aggressively deal with emerging risks.

Given its role in supervising large bank holding companies under the EPS tailoring rules,[17] the FRB also is acting to eliminate the concern with the spring 2023 failures that an increase in regulatory requirements did not correspond with the rapid increase in assets of the failed banks. In a February 16, 2024 speech, FRB Vice Chair for Supervision Barr stated that large bank management should be investing in the bank's ability to manage risk as it grows. To ensure that is occurring, the FRB is increasing coordination between its regional bank and large bank supervisory teams with the "goal" that the "transition to heightened supervision [e.g., crossing $100 billion of assets, and thus becoming a Category IV institution under the tailoring framework] for fast growing banks is more of a gradual slope and not a cliff." Barr further noted that for banks subject to the tailoring rules, the FRB plans on instituting more horizontal reviews to improve consistency across these banks.[18] This latter action raises the concern that the FRB will apply a "highest common denominator" approach to examination practices across these institutions.

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15 GAO Report, Bank Supervision: More Timely Escalation of Supervisory Action Needed (Mar. 6, 2024), available *here*.

16 Bloomberg Government, United States Senate Committee on Banking, Housing, and Urban Affairs Hearing, The Federal Reserve's Semi-Annual Monetary Policy Report (Mar. 7, 2024). The Hearing Video is available *here*.

17 Federal Reserve, Supervisory Policy and Guidance Topics, Large Banking Organization Supervision, available *here*.

18 Vice Chair Barr, Supervision with Speed, Force, and Agility (Feb. 16, 2024), available *here*.

Suggested Bank Response

Banks have typically taken examinations seriously. However, the tougher Agency examination guidelines, along with the potentially multi-year ramifications of less than satisfactory examination results, makes engagement between, before and during examinations more critical than ever. The new guidelines have a particular focus on issues that extend more than one exam cycle, suggesting that: (1) establishing realistic deadlines with examiners for remediation when issues are identified; (2) providing updates to Agencies, particularly if unexpected remediation delays occur; and (3) documenting all remediation efforts for easy Agency review may help mitigate the risk of an increased supervisory outcome. Banks should also promptly communicate examination issues and findings to their boards to prioritize and rectify any issues. More generally, even if these Agency changes are not subject to banking industry review and comment, remaining abreast of examination changes imposed by any Agency to understand the likely Agency approach to exam issues may assist in engaging with the Agency in a way that enables all parties involved to best fulfill their objectives.

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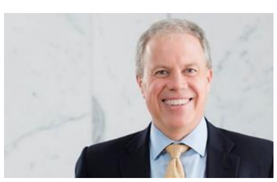
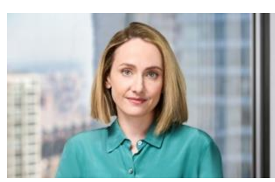
Please do not hesitate to contact us with any questions.


Helen V. Cantwell
Partner, New York
+1 212 909 6312
hcantwell@debevoise.com


Courtney M. Dankworth
Partner, New York
+1 212 909 6758
cmdankworth@debevoise.com


Satish M. Kini
Partner, Washington, D.C
+1 202 383 8190
smkini@debevoise.com


Gregory J. Lyons
Partner, New York
+1 212 909 6566
gjlyons@debevoise.com


Caroline N. Swett
Partner, New York
+1 212 909 6432
cnswett@debevoise.com


Alexandra N. Mogul
Associate, New York
+1 212 909 6444
anmogul@debevoise.com

Elliott Werner
Law Clerk, New York
+1 212 909 7486
ewerner@debevoise.com