Thank you for providing an opportunity for comment on the Notice of Proposed Rulemaking (NPR): Unsafe and Unsound Practices, Matters Requiring Attention. I appreciate the agency making a good faith attempt to solicit feedback, prior to implementation.

As written, the NPR constitutes one of the most sweeping changes to bank supervision since the enactment of the Dodd-Frank Wall Street Reform and Consumer Protection Act. The agencies should thoroughly understand the gravity of the changes they seek to implement, and the impact it will have on supervision, regulation, and financial stability.

I will start by commending portions of the NPR to which I lend full agreement, then proceed by suggesting changes to sections that require additional study. Next, I will suggest practical alternatives to the current proposal. Lastly, I will conclude with select comments to the questions you posed in the NPR.

First, the NPR rightly identifies an overdue need to clarify what constitutes an unsafe or unsound practice. Any attempt to add transparency to this label would greatly benefit the banks overseen and their ability to prioritize issues.

I also agree that the purpose of regulatory feedback, is to bring deficient practices to management's attention, that unsafe and unsound practices should be documented for management, and that the purpose of regulatory feedback is not to recommend best practices.

The issues that I see with the agency proposal fall into four categories. The first is the binary classification of supervisory feedback, the second is prejudice for small institutions, the third is moral hazard from financial anchoring, and the fourth is the codification of supervisory feedback into law.

The proposal as written would only result in Matters Requiring Attention for unsafe and unsound practices. The primary issue with this is that supervisory feedback is not binary, it is not either unsafe or unsound practice, or a communication of best practice. It spans a wide continuum of feedback. You could have underfunded legal reserves, management teams lacking requisite experience, unreconciled balance sheet accounts, or insufficient interest rate risk management; none of which rise to the level of material financial harm. However, this feedback is valuable to bank management and the agencies. Noting these important observations as a non-binding communication is insufficient to preserve financial stability.

The next point for agencies to seriously consider is the impact on large complex institutions relative to community banking organizations. Materiality is not defined (see additional detail in questions), though the bar for financial materiality is high by design. The problem with this approach is that one billion dollars is not material to a Citibank, JPMorgan, or

Bank of America, but it is catastrophic to a small or mid-sized institution. A billion dollars could be a cyber ransom attack, it could be an operational wire issue, or loan allowances for a regional economic downturn. It is difficult for this author to imagine any scenario which would be financially material for the largest institutions. Their diversified earnings are more resilient than those of our smallest, most vulnerable banking institutions. Financial viability is a constant threat to small banks where margins are paper thin, and I know firsthand they take it seriously. Are we really going to give large banks a free pass on feedback when they already benefit from greater earnings? Do they not already benefit from implicit benefits? Can the agencies name any small banks that posed a risk to the Deposit Insurance Fund?

Next, it is important to review the very premise of anchoring unsafe and unsound feedback to financial materiality, and the moral hazard this presents. Financial materiality encourages risk-taking and perverse incentives. For example, a bank that has not invested in business continuity planning has just boosted their financial position. Similarly, a bank could increase risky assets, or reduce liquidity to boost earnings, without evidence of imminent *material* financial harm. Moral hazard is the reason prudential supervision exists. Reducing prudential supervision to the narrow lense of financial impact would misalign incentives.

To understand the practical consequence of this behavior, one must look closely at the 2023 bank failures and the associated FDIC special assessment. What we learned in 2023 is that there is a distinct possibility, or *probability*, of system risk exception invocation because of the inherent correlation of banking assets and depositor behavior. The special assessment amounted to *mutualization of losses*. Please read this twice. The possibility, or probability, of assessing well managed banks for decisions of a bad management team in the absence of non-financial supervisory feedback, is an unacceptable solution. If regulatory agencies do not seek to correct poor management practices because they were not financially material at the time of observation, understanding moral hazard and mutualization, this will reflect poorly.

Next, I'll address the codification of matters requiring attention practice into law. The rule of law is important and allows for structured approaches, enforceable through our judicial system. Did the agencies seek information on why these definitions had not been codified in law previously, or ask banks for input as to whether this step was helpful?

The downside of having supervisory practices outside of rulemaking is that is allows for interpretation and variability of practice. The benefit of having supervisory practices outside of rulemaking is that it allows for interpretation and variability of practice. Supervision is inherently subjective, because banks are different, management teams are different, geographies are different and agencies best serve our financial system when they can tailor approaches to the needs of the institution. Codifying supervisory feedback terms in law significantly reduces the agency's ability to provide tailored feedback to banks that often need agency expertise. It also means bank examiners will certainly be reticent to give *any* feedback, for fear of breaking the law. The approach is too heavy-handed and removes valuable services which banks appreciate.

Separately, while admittedly situation specific, material financial harm and violations of law should require an enforcement action. Have the agencies thought through what would happen to enforcement if we've codified material financial harm to be an MRA? Would a bank now receive an enforcement action with each MRA? This approach does not allow an institution to correct the practice before it is too late.

Alternative Approaches

Reforms to supervision are clearly necessary to preserve confidence in our banking institutions and provide for access to credit. Therefore, I put forth the following suggestions for you to consider with respect to unsafe and unsound practices, and matters requiring attention.

- Define unsafe and unsound practices to guide bank examiner use of the terms.
- Insist of greater agency coordination to reduce duplication of work. Consider offsite supervision of Bank Holding Companies where the bank constitutes >95% of consolidated assets.
- Eliminate the practice of citing internal audit findings as MRAs.
- For well managed banks, eliminate citing MRAs for self-identified issues.
- Re-evaluate examination cycles for well managed banks, consider extending examination cycles and possible supplementation from other agencies.
- Conduct off-site business strategy and business model reviews to understand bank risk taking and growth.
- Prioritize supervision of spot risk before forward-looking risk to ensure that spot risk is addressed in every review. Rigorously re-train examiners on this approach.
- Leverage internal audit for closure of MRAs.
- Deploy data tools to automate the shared national credit program.
- Retain valuable agency MRA practices at a lower threshold than material financial harm; calibrate feedback for prudent growth and managed risk-taking.
- In every supervisory letter, remind banks that there is an independent appeals process for supervisory feedback.

Notice of Public Rulemaking Questions

Question 1: What effect would the proposed rule have on the agencies' ability to address misconduct by institutions under their enforcement and supervisory authority? What effect would the proposed rule have on the agencies' ability to address misconduct by institution-affiliated parties under their enforcement and supervisory authority?

The NPR significantly limits the type and frequency of feedback available to banks. In addition, the agencies are likely to see bank examiners hesitate to cite issues. The agencies' ability to address conduct would have to be decided by the courts.

Question 2: Does the proposed definition of unsafe or unsound practice appropriately capture the types of objectionable practices, acts, or failures to act that should be captured? Please explain.

No, the proposed definition is calibrated too high and it has the unintended consequence of creating incentives to boost financial performance at the expense of controls.

Question 3: Does the proposed definition of unsafe or unsound practice provide the agencies with adequate authority to proactively address risks that could cause a precipitous decline in an institution's financial condition, such as a liquidity event or a cybersecurity incident?

It moves the agencies focus from proactive to reactive supervision. No feedback will be given until laws are violated; a clear and imminent loss to the DIF is obvious; material financial harm is present, or laws have been violated.

Question 6: Should the agencies consider specifying one or more quantitative measurements to define or exemplify "material harm'' to the financial condition of the institution?

It would be fair and helpful if you could identify any real [anonymized] scenarios that might constitute material financial harm for large, complex banks. If you can show the industry the type of feedback this will result in, i.e. what an MRA might practically look like, the industry can better assess the impact.

Question 7: Should the agencies define “materially’’ in the regulation? If so, how?

Question 8: Should the agencies define harm to the financial condition of an institution in the regulation? If so, how? Should this include specific indicators or thresholds, or adverse effects to capital, liquidity, or earnings?

The need for these questions and associated definitions are evidence for why this should not be codified in law. Each institution is different, and this approach reduces supervision to a compliance exercise.

To illustrate, based on bank’s I’ve worked with, a financial loss could be problematic for a small concentrated commercial lender. It could be immaterial for a community bank with 20% CET1 and low credit risk.

Question 14: The proposal would allow the agencies to issue MRAs based on “reasonably foreseeable conditions.’’ Is “reasonably foreseeable’’ the right standard? As an example, at what point in Silicon Valley Bank’s timeline would an MRA for weaknesses in interest rate risk management have been (1) appropriate and (2) permissible under the proposal? If another standard would be more appropriate, please explain.

This is not the right standard. It was foreseeable that interest rates would increase, however the terminal rate and speed of increase was not foreseeable. The exposure to up rate scenarios should have been identified under a business strategy review, irrespective of where rates ended.

Question 20: Should the agencies require any downgrade to a CAMELS composite rating of 3 or below to be accompanied by an MRA or enforcement action?

MRAs, Enforcement Actions, and CAMELS composite ratings are all inherently linked. Proposing to change any one of these, without thinking about the interplay between the three would be in haste. Please allow proper time for study of impact to these changes, show the industry what ex-ante and ex-post supervisory messaging would realistically look like, and what the impact would be to CAMELS ratings and Deposit Insurance Assessments.

Are there instances in which, for example, general economic conditions or idiosyncratic risk factors could cause financial deterioration without evidence of objectionable practices, acts, or failures to act?

Yes, this can and has happened in past recessions. Good lenders, writing good loans, can watch their bank fail because of economic downturns unrelated to underwriting.

Question 22: How should the agencies tailor the framework for community banks? For example, should there be different standards for institutions of different sizes and complexity? Please explain.

Yes, community banks rely on examiner feedback. I would hate to see bank examiners fear breaking the law at the expense of the valuable expertise they provide to community institutions.

Question 23: Should the proposal tie material harm to the financial condition of an institution more specifically to the impact of a practice, act or failure to act on the institution's capital? Should there be a higher standard for large banking organizations compared to all other banking organizations? Should the potential or actual harm to an institution's financial condition be tied to the capital standards in the prompt correction action framework set forth in 12 U.S.C. 1831o?

The proposal is an enormous blow to small community institutions and a free pass to large institutions that already benefit from exorbitant privileges. Harm should be tailored to each institution's business strategy and risk profile.