February 28, 2020

Ms. Ann E. Misback
Secretary
Board of Governors of the Federal Reserve System
20th Street and Constitution Avenue, NW
Washington, DC 20551

Robert E. Feldman
Executive Secretary
ATTN: Comments
Federal Deposit Insurance Corporation
550 17th Street, NW
Washington, DC 20429

Re: Request for Information on Application of the Uniform Financial Institutions Rating System, RIN OP-1681; RIN 3064-Z08; Docket No. OP-1681

Dear Ladies and Gentlemen:

Better Markets[1] appreciates the opportunity to comment on the request for information noted above ("Request" or "RFI"),[2] issued by the Board of Governors of the Federal Reserve System ("Board") and the Federal Deposit Insurance Corporation ("FDIC") (the Board and the FDIC collectively, the "Agencies").

A request for information to inform possible future rulemaking can, at times, be a useful exercise. However, the lack of any supporting rationale for this Request and any clear indication of what specifically the Agencies plan to do with the resulting information is troubling. Moreover, to the extent the Request portends a de-regulatory proposal that will weaken the important

[1] Better Markets is a non-profit, non-partisan, and independent organization founded in the wake of the 2008 financial crisis to promote the public interest in the financial markets, support the financial reform of Wall Street, and make our financial system work for all Americans again. Better Markets works with allies—including many in finance—to promote pro-market, pro-business, and pro-growth policies that help build a stronger, safer financial system, one that protects and promotes Americans' jobs, savings, retirements, and more.

[2] 84 Fed. Reg. 58,383 (Oct. 31, 2019).

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CAMELS rating system or seek to break the link between supervisory assessments and possible sanctions on banks, we firmly oppose such steps.

COMMENTS

CAMELS ratings play an important role in bank supervision.

The CAMELS supervisory ratings system plays an essential role in promoting the safety and soundness of banks individually and the banking system as a whole. Through assessments and associated ratings, supervisors identify, and alert bank management to, potential problems at a bank before those problems turn into a bank failure that puts taxpayer dollars at risk. Further, they may lead to appropriate sanctions when a rating indicates material problems in one or more of the components. As the Request notes, bank ratings inform the bank application process, ensuring that poorly managed banks do not expand inappropriately and increase the threat they may pose to the financial system.[3] They are also used to determine whether targeted examinations or formal enforcement actions are necessary and appropriate. Given the importance of a strong supervisory system, any changes in the CAMELS ratings contemplated by the Agencies must be supported by a credible, evidence-based rationale that provides the public with a meaningful opportunity to comment. And the Agencies should not weaken the link between supervisory assessments and enforcement actions.

The Request lacks a transparent basis and inhibits meaningful public comment.

The Agencies state in the Request only that they "seek input regarding how CAMELS ratings are assigned to supervised institutions, and the implications of such ratings in the application and enforcement action processes" and that this request is consistent with the Agencies "commitment to increase transparency, improve efficiency, support innovation, and provide opportunities for public feedback."[4]

With respect to transparency and the opportunity for public feedback, the Request fails on both counts, since it does not provide sufficient information about the ultimate goals underlying the Request, the concerns (if any) with the current system that prompted the Request, or how the information to be gathered will be used. This paucity of information makes it difficult for the general public, whose money is ultimately at risk when the banking system is insufficiently supervised, to offer meaningful comment. This is especially the case as the questions are quite specific to the experiences of supervised banks. Given the important role that the CAMELS supervisory rating system for banks plays in the supervisory process, and, ultimately, in ensuring the safety and soundness of the banking system, it is important that meaningful public comment other than that from supervised banks, which inherently have a self-interested perspective, be sought and considered.

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3 Request at 53,385.

4 Request at 53,385.

Not only is the public at a disadvantage in responding to the RFI, in some cases it is unclear that any banks would be in a position to fully answer some of the questions. For example, given the confidential nature of supervisory bank ratings, it is not clear how any particular bank would be in a position to answer Question #4, which seeks views on the consistency of the CAMELS rating process across banks and across agencies, unless such bank is privy to the confidential ratings of other banks and has been subject to ratings by different agencies within a reasonable timeframe to make comparisons meaningful.

In seeking information about the consistency of ratings and their use in the application and enforcement action processes, one must assume the agencies have been subject to specific instances of bankers providing compelling examples of current problems in this regard. It would have been far more helpful to the general public, when seeking to understand the reason for this request and the purposes for which it will be used, if such complaints had been made public (in generic form).

If the RFI is ultimately to be used to inform proposals to make any substantive changes in the Agencies' practices, the Agencies must of course issue proposals that explain in detail the basis for and nature of such proposals so that an opportunity for robust comment is afforded to the public.

The Agencies should abandon any contemplated effort to weaken the CAMELS system, absent a compelling reason grounded in the public interest.

References in the Release to promoting "efficiency" and "innovation" raise concerns about the underlying purpose or aims of the RFI. Promoting efficiency and innovation are too often invoked by regulators as euphemistic justifications for unnecessary and dangerous de-regulation or weakening of supervision practices. Suspicions about forthcoming and related de-regulatory measures are especially apt where, as here, it is unclear from the RFI whether and how the current framework impedes "efficiency...[and] innovation" or how the Agencies envision that the RFI will promote these goals. Moreover, given the recent pattern of weakening regulatory standards that has been displayed by financial regulators, including the Agencies, it is plausible to infer that this RFI is intended to inform proposals to weaken banking supervision practices.

Such de-regulatory measures could include both a general erosion of the importance of qualitative assessments informed by the expert judgment of the Agencies' supervisors, or a more specific effort to weaken the connection between supervisory assessments and possible restrictions on banks activities or other sanctions that can stem from these assessments.

In any event, if indeed the Agencies' objective is to alter the CAMELS framework in a way that undermines effective supervision of banks, then they should rethink their objective. As noted above, the CAMELS system is an important supervisory tool, and weakening it will increase the risks of bank instability and ultimately systemic instability. Certainly, such a de-regulatory step cannot be justified in the interest of efficiency or innovation, as these are not among the Agencies' primary mandates. And even if they were, the Agencies would face a heavy burden to

justify, against these amorphous benefits, the costs and risks that would attend efforts to undermine the CAMELS system.

Responses to specific questions.

Notwithstanding the lack of articulation of the reason for this RFI, we respectfully offer the following more specific comments on questions 3, 5, 6, 8 and 9.

Question #3 – "Does the agencies' use of the CAMELS rating system vary from one examination, or examination cycle, to the next? Please explain."

Consistency in the application of ratings is an important objective in the supervisory process, within reason. However, slavish adherence to consistency is inappropriate in the context of bank examinations. What might be viewed as cycle-to-cycle "inconsistencies" may in fact be justified by a variety of factors; a desire for cycle-to-cycle consistency should not be used as a means of challenging assessments in a current cycle.

An appropriate assessment **at the time it is developed** is the key goal. An appropriate assessment is one that is based on the best information available at the current time, and on how the elements subject to the assessment align with supervisory expectations or requirements spelled out in rules, the rating framework, or other relevant guidance provided to a bank.

Notwithstanding that assessments were appropriate at the time they were developed, changes in ratings from one cycle to the next can result from a variety of causes, including:

- A bank's practices or condition may have changed;
- New information about preexisting issues could come to light, even when practices remain unchanged from a prior cycle;
- Examiners in a later assessment period may determine that the assessment done in an earlier period was inconsistent with the rating guidelines and correct that misalignment; and
- With respect to a composite rating, a particular component of the framework may have taken on greater significance given, for example, a different operating environment or newly-emerging risks, and thus may be more important factors influencing the composite rating than in prior years.

Moreover, while on their face the quantitative aspects of the CAMELS components should present the fewest challenges in terms of consistency, that may not always be the case as new information may become available from period to period that affects the supervisory assessment. This can also be the case for assessments of qualitative elements of a component. Supervisors should not hesitate to change a rating in light of new information, even in cases where the underlying practices have not changed from the prior period. Put differently, an inaccurate assessment made in one year—due either to incomplete or inaccurate information, or simply a

misunderstanding of the bank's practices or the expectations provided in rules or guidance—should not be carried forward in future years. A bank's argument that it is inconsistent to change a rating when practices have not changed from the prior assessment period on its face may sound compelling, but it does not represent a compelling critique if any of the factors cited above exist.

Essentially, consistency is certainly an important goal of the supervisory process—the exact same set of conditions should not result in different assessments. However, the ultimate goal is to appropriately assess the condition of a bank at a particular time, given a particular set of conditions, and this goal should never be sacrificed in the name of consistency. And the Agencies should view with skepticism any claims of inconsistencies by banks and their allies that are made with the goal of weakening the supervisory framework and inhibiting the ability of examiners to make appropriate assessments in light of the current environment.

Question #5. – "To what extent do the agencies apply the CAMELS rating system in a manner that is sufficiently flexible to reflect differences between financial institutions such as size, business models, risks, and internal and external operating environments, as well as overall technological developments and emerging risks?"

Flexibility to account for differences between banks is already inherent in the CAMELS system. For example, the FDIC's statement of policy on CAMELS states that:

> It is recognized, however, that appropriate management practices vary considerably among financial institutions, depending on their size, complexity, and risk profile. For less complex institutions engaged solely in traditional banking activities and whose directors and senior managers, in their respective roles, are actively involved in the oversight and management of day-to-day operations, relatively basic management systems and controls may be adequate. At more complex institutions, on the other hand, detailed and formal management systems and controls are needed to address their broader range of financial activities and to provide senior managers and directors, in their respective roles, with the information they need to monitor and direct day-to-day activities. All institutions are expected to properly manage their risks. For less complex institutions engaging in less sophisticated risk-taking activities, detailed or highly formalized management systems and controls are not required to receive strong or satisfactory component or composite ratings.[5]

Thus, it appears that the Agencies' examination policies sufficiently address the flexibility needed to assess different institutions differently, and it is unclear what concerns (if any) are driving this question. Nonetheless, it is important to point out the interplay between this question on flexibility, and Question 4, regarding consistency of ratings between institutions. There is obviously a tension between these two—providing examiners with flexibility to assess different institutions differently necessarily introduces potential differences that some may define as

5 https://www.fdic.gov/regulations/laws/rules/5000-900.html.

"inconsistency." The Agencies should be wary of comments arguing that supervisory standards should be weakened while ignoring the tradeoff here—if for example industry commenters argue that there is too much "inconsistency" in the current system while they ignore that the supposed inconsistency is a necessary byproduct of the flexibility required to effectively assess banks, each of which may have its own unique risk profile.

Question #6. – "To what extent does the scope of supervisory work performed during an examination cycle align with the components of the CAMELS rating system? Which areas, if any, should receive more or less emphasis in order to assign a CAMELS rating appropriately?"

Assessments of various risk management and internal controls practices are a part of and appropriately inform a number of the component ratings. The management ('M') component assesses the quality of oversight provided by banks' management and boards of directors, among other elements, and it should incorporate an assessment of the effectiveness of processes captured in other components. The responsibility to ensure that risk management and control frameworks are in place and adequately account for the risks of a bank rests with the board, supported by design, implementation, and oversight of execution by senior management. Given this interaction across components, and the important roles played by the board and senior management in running a firm in alignment with all laws and regulations, and in a safe and sound manner, the 'M' component should be weighted most heavily in the composite rating. Moreover, the 'M' rating should always be a critical consideration in restrictions or sanctions implemented by supervisors through applications or enforcement actions; a bank that is not well managed presents heightened risks.

Moreover, the 'M' component rating should never be rated better than any other component rating when the rating of that other component stems from weaknesses in bank practices, for which the board and management are always the ultimate responsible parties given their respective mandates. For example, if a bank engaged largely in commercial and/or consumer lending businesses is rated less than satisfactory in the Asset Quality ('A') component due to inadequate underwriting standards and/or other weak credit risk management or internal controls practices, there is no compelling reason for the 'M' component to be rated anything other than less than satisfactory. It is the responsibility of boards of directors and senior management to ensure credit risk management practices are in place and working effectively. When they are not, one can hardly claim that the board and management are satisfactorily carrying out their oversight functions.

Question #8 – "To what extent does an institution's condition, as reflected in its CAMELS ratings, affect the agencies' actions on applications, particularly for new or expanded business activities? To what extent, if any, should the agencies modify or clarify their approach?"

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As noted in the RFI, there are direct links between supervisory ratings and the consideration of bank applications.[6] Severing or weakening these links would substantially undermine the value of the supervisory assessment and rating process and reduce the ability of supervisors to hold banks accountable for failing to operate consistent with regulatory requirements and in a safe and sound manner. Supervisors' assessments should always be directly linked to appropriate consequences for a bank. As is currently the case, those consequences follow from processes that require, for example, the Federal Reserve Board to formally approve an application or a recommendation from Fed supervisors for an enforcement action at a bank.

It may sometimes appear difficult to draw a direct relationship between the identified weaknesses at a bank and restrictions that can be placed on them in the application process. Nonetheless, for banks in less-than-satisfactory condition, a key rationale for potential restrictions on expansionary activities is that the bank should focus its managerial and financial resources on addressing those issues that led to a less-than-satisfactory rating before undertaking any expansionary plans.[7] This is an appropriate rationale, and any change in this practice must be supported, if possible, with credible evidence justifying the reason for the change and confirming that the change will not undermine safety and soundness. Moreover, such changes must be subjected to notice and comment rulemaking. An attenuation of the link between supervisory assessments and applications or enforcement actions could weaken incentives for bank boards and management to address important weaknesses, such as flaws in a bank's risk management and other managerial capacities or weaknesses in consumer compliance practices, including compliance with Community Reinvestment Act requirements.

Question #9. "To what extent do the CAMELS ratings impact the issuance of enforcement actions? To what extent does the issuance of enforcement actions impact CAMELS ratings? To what extent, if any, should the agencies modify or clarify their approach?"

The need for a direct link between supervisory assessments and enforcement actions is clear. As noted in the RFI, it is often, though not exclusively, through examinations supporting the supervisory assessment process that actions or practices warranting informal or formal enforcement actions may be identified. A direct linkage between CAMELS ratings and enforcement actions helps ensure that supervisors' assessments lead to timely and meaningful remedial action at a bank when that is warranted.

With respect to modifications in the approach the Agencies take to enforcement actions, we recommend the Agencies publicly commit to increasing the use of formal, public enforcement actions relative to informal non-public actions, especially for large banks. This would serve two important purposes: (1) meeting the commitment to greater transparency highlighted by the Agencies in this RFI while informing the public of the actions supervisors are taking to address

6 For standards for Safety and Soundness: FRB – 12 CFR 208, Appendix D and FDIC – 12 CFR part 364 of FDIC Rules and Regulations

7 FRB – 12 CFR 208.3 Plus a couple guidance letters – SR 14-2 and SR 13-7. For the FIDC – 12 CFR part 303 of FDIC Rules and Regulations

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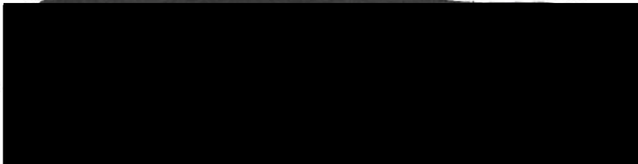
unsafe and unsound or inappropriate practices at large banks; and (2) strengthening the incentives for large banks to address such practices in the earliest stages, providing greater confidence that uncorrected problems will not lead to a bank's failure to comply with laws or rules or impair the safe and sound operations of a bank, increasing the likelihood of its demise.

CONCLUSION

We hope you find these comments helpful.

Sincerely,



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