

The ABCs of Banking Law:

Supervision, Examination & Enforcement

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Overview

What is the purpose of supervision?

How is supervision conducted?

What results from an examination?

Is supervisory information confidential?

What happens if an examination uncovers violations of law or unsafe and unsound practices?



Supervision, Examination & Enforcement

- **While laws and regulations set out the rules of the road for the financial industry, supervision is the process for ensuring banks are following those rules and are operating in a safe and sound manner**
- **Supervision is cradle to grave – from chartering to resolution – and is tailored in areas to address the risk profile and complexity of individual institutions**
- **Agencies use their supervisory tools to evaluate the types of risks present at an institution, the amount of risk, how well the institution is managing the risks, and, directionally, where is risk trending**
- **These supervisory assessments are communicated to the institution's board and senior management and set out supervisory views of the overall financial condition of the institution and whether there are financial or risk management weaknesses that require correction**
- **If weaknesses are present, the agencies may seek to address them through either the supervisory process or through enforcement actions**



Supervisory Framework

- The U.S. does not have a unified financial services regulator – a large financial services company will have multiple regulators, who can have areas of overlapping supervisory coverage
- Focus of Federal financial services regulators
 - OCC, FRB: safety and soundness of the institution and increased focus on compliance and operational risk management
 - FDIC: safety and soundness of the institution; protection of the deposit insurance fund; increased focus on compliance and operational risk management
 - CFPB: compliance with consumer protection legislation and regulations
 - SEC: effective functioning of the securities markets and investor protection
 - CFTC: effective functioning of the futures and options markets and protections related to the sale of commodities and financial futures and options
- Regulators seek to coordinate their supervisory efforts where possible to manage impacts on institutions



How is Supervision Conducted?

- **Examinations**
 - **Access to books and records, speaking with management**

12 USC § 481: “The Comptroller of the Currency, with the approval of the Secretary of the Treasury, shall appoint examiners who shall examine every national bank as often as the Comptroller of the Currency shall deem necessary. The examiner making the examination of any national bank shall have power to make a thorough examination of all the affairs of the bank and in doing so he shall have power to administer oaths and to examine any of the officers and agents thereof under oath and shall make a full and detailed report of the condition of said bank to the Comptroller of the Currency....”
 - **Full scope examinations are periodically required, and targeted examinations may focus on a product, an organizational function, a type of risk, or a specialty area**
 - **Horizontal exams (examinations across a range of institutions focused on a particular issue or matter)**
- **Periodic reporting requirements**
- **Corporate applications or notices**
- **Systemic risk evaluations (CCAR, stress testing, recovery and resolution planning)**



Supervision and Examination

- **OCC**
 - Community banks are assigned to a manager who has a portfolio of community banks within her or his coverage
 - Midsize and large banks are assigned an examiner-in-charge (the EIC), who has a dedicated examination team supporting them but also may use other OCC resources
 - 12 USC 1820(d): On-site examinations are required every 12-18 months for insured depository institutions
 - An 18-month cycle is permitted only for smaller banks that are well-capitalized and do not have areas of supervisory concern and have not undergone recent changes in control
- **Federal Reserve**
 - BHCs are generally subject to examination every 12-24 months based on size, complexity, and their supervisory condition
- **CFPB**
 - Examination cycles are determined by the assessment of risks posed to consumers and the requirement to coordinate examinations with other regulators



How are Examinations Conducted and What Results from Them?

- Examination letters (scope of exam, information needed, timing)
- Entrance meetings (discussion of the scope and the role of the exam team and how it will be conducted, confirm availability of institution's personnel and points of contact)
- Periodic check-ins (discuss any key issues identified or challenges in the examination)
- Exit meetings (preliminary findings and conclusions, discussions of risks identified, seek commitments from management to any needed corrective actions, discussion of any needed follow-up supervisory activities)
- Written Communications
 - Supervisory Letters (supervisory observations, matters requiring attention, violations of law)
 - Examination/Inspection Reports



Supervisory Ratings

- **Supervisory Ratings**
 - **CAMELS ratings for depository institutions (OCC and FDIC)**
 - **Capital adequacy, Asset quality, Management, Earnings, Liquidity, Sensitivity to risk**
 - **Consumer compliance ratings (CFPB)**
 - **Evaluates the board and management, the compliance program, and violations of law and consumer harm**
 - **LFI and RFI/C(D) ratings for bank holding companies (Federal Reserve)**
 - **BHCs \geq \$100 Billion of total consolidated assets receive Large Financial Institution ratings**
 - **capital planning and positions; liquidity risk management and positions; and governance and controls (effectiveness of the Board, management of core business lines, and independent risk management and recovery planning)**
 - **BHCs $<$ \$100 Billion of total consolidated assets receive RFI/C(D) ratings**
 - **Risk management, Financial condition, Impact on depository institution subsidiaries, Composite and Depository institution subsidiary rating**
- **Why do ratings matter?**



Confidential Supervisory Information is ... Confidential

- **Non-public / confidential supervisory information extends to all information related to an agency's supervision, licensing, regulation, and examination of an institution and is considered the confidential information of the agency – not the subject institution**
- **Unless permitted by the agency's regulations or unless expressly authorized by the agency in writing, disclosure of its CSI is prohibited (see generally: Federal Reserve rules at 12 CFR Part 261; OCC rules at 12 CFR Part 4; FDIC rules at 12 CFR Part 309; and CFPB rules at 12 CFR Part 1070)**
- **The agencies have made efforts to harmonize their disclosure rules, but differences exist, and requirements for disclosure vary based on the recipient:**
 - **to officers, employees or directors of the subject institution**
 - **to parent companies or to affiliates**
 - **to external auditors**
 - **to outside counsel**
 - **to consultants**
 - **to other agencies with supervisory authority over the institution**
- **Institutions and individuals that violate the disclosure rules may be subject to enforcement actions**



Enforcement Actions

- **Violations of law or unsafe or unsound conditions or practices may result in an enforcement action**
- **When to use enforcement action vs. supervisory process?**
 - **Discretion utilized considering examination ratings; risk profile; severity of matter; extent of unsafe/unsound practices; ability of board and management to correct deficiencies in a timely manner; potential adverse impact to customers, the deposit insurance fund, or the public generally; the existence, nature and extent of prior uncorrected deficiencies; and progress in achieving compliance with existing enforcement actions**
- **If an enforcement action is merited, the action may either be informal or formal**
 - **There are different types of informal and formal enforcement actions used to achieve different supervisory objectives and that may be taken in conjunction with one another and against the institution and/or its affiliated parties**



Enforcement Actions

- The severity of the matter, supervisory ratings, and level of risk at the institution are considered when evaluating whether to take informal or formal enforcement action
 - Informal actions may be used when the institution's condition is sound but the deficiencies either have not been timely corrected or the nature of the deficiency warrants escalation beyond citation of a violation of law or documentation of a concern in a supervisory letter
 - The OCC presumes the use of formal actions for banks with CAMELS composite 3 ratings; when significant deficiencies exist in risk management systems; significant insider abuse is present; systemic or significant violations of law are present; board or management has disregarded or otherwise failed to correct identified deficiencies or failed to satisfactorily maintain books and records or attempted to limit the conduct of exams or examiner access to books and records
- Institutions are generally provided prior notice and an opportunity to respond to a potential action



Enforcement Actions

- **Examples of informal actions include:**
 - **Commitment letters**
 - **Memorandums of Understanding**
 - **Notices of Deficiency (OCC Part 30)**
- **Examples of formal actions include:**
 - **Written Agreements/Consent Orders**
 - **Cease & Desist Orders**
 - **Temporary C&D Orders**
 - **Civil Monetary Penalties**
 - **Restitution Orders**
 - **Removal and Prohibition Orders**
 - **Prompt Corrective Action Orders**
 - **Safety & Soundness Orders**



Enforcement Actions

- **Actions may be taken not only against the institution but also against others (current or former institution-affiliated parties (IAPs))**
 - **IAPs (12 USC 1813u) include current or former directors, officers, employees, and controlling stockholders; stockholders participating in the conduct of the institution's affairs; and independent contractors (accountants, attorneys, appraisers, etc.) that knowingly or recklessly participated in a violation of law, breach of fiduciary duty, or unsafe/unsound practice causing, or likely to cause, significant financial loss or adverse consequence to the institution**
- **Enforcement actions stipulating that the institution take corrective action require the development and delivery of action plans and periodic progress reports**
- **The failure to achieve compliance with the action plan may result in civil monetary penalties and/or other enforcement actions**



Civil Monetary Penalties (CMPs)

- **CMPs may be issued against an institution and/or an IAP**
- **General authority to issue CMPs against insured banks and IAPs derives from 12 USC 1818(i), which classifies CMPs into three tiers based on the severity of the conduct and level of culpability**
 - **Tier 1: violations of law or regulation, final or temporary orders, conditions imposed in writing, or written agreements**
 - **Tier 2: Tier 1 criteria as well as reckless engagement in unsafe and unsound practices or breach of fiduciary duty that is either part of a pattern of conduct, or that causes, or is likely to cause, more than minimal loss, or that resulted in pecuniary gain**
 - **Tier 3: Tier 2 criteria that knowingly or recklessly caused substantial loss or resulted in substantial pecuniary gain**
- **1818(i) requires that agencies consider the following in setting the amount of the CMP: size of the financial resources and good faith; the gravity of the violation; history of prior violations; and other factors that justice may require**



Civil Monetary Penalties (CMPs)

- To assess the statutory considerations, the agencies will take into account the following relevant factors: evidence that the violation was intentional; the duration and frequency of the violation or practice; whether the violation or practice was continued after notification; failure to cooperate; efforts to conceal the violation or practice; actual or threatened loss or harm to the institution; financial gain or benefit; evidence of restitution; history of prior violations; prior criticism for similar actions; state of compliance program; tendency to engage in violations; existence of enforcement agreements
- Agencies utilize a weighted matrix for scoring the level of severity of each relevant factor, which results in a suggested (non-binding) amount
- Utilization of the matrix may result in no suggested CMP and agencies may instead issue a supervisory letter or letter of reprimand if the matrix results in a small suggested CMP, the misconduct was technical in nature, and there is no prior history of misconduct or intent



Civil Monetary Penalties (CMPs)

- Supervision consults with agency legal and enforcement teams for application of the matrix and prior notice is generally provided before a CMP is assessed or a reprimand letter issued
- The recipient is provided an opportunity to respond
- If the agency elects to proceed with a CMP, the recipient receives a letter outlining the assessed CMP and a proposed consent order
 - If the recipient does not accept the order, the agency files a notice of assessment (presumptively made public) and commences an administrative hearing
- If the agency elects not to proceed with a CMP, it is not barred from deciding later to act and the election does not serve to waive other agency rights

