CSBS SINCE 1902
CONFERENCE OF STATE BANK SUPERVISORS

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Sumit Agarwal
Federal Reserve Bank of Chicago
230 South LaSalle Street
Chicago, IL 60604

Amit Seru
Booth School of Business
University of Chicago
5807 South Woodlawn Avenue
Chicago, IL 60637

David Lucca
Federal Reserve Bank of New York
33 Liberty Street
New York, NY 10045

Francesco Trebbi
University of British Columbia
1873 East Mall
Vancouver, BC, V6T1Z1

Dear Sirs:

As the professional association for the State officials who charter and regulate State chartered banks, we appreciate the opportunity to provide comments on your National Bureau of Economic Research (NBER) working paper, "Inconsistent Regulators: Evidence from Banking." This is our first opportunity to provide input into the study. We believe it would have been beneficial for you to have contacted us or any state regulator for the state perspective on this important topic.

Washington Mutual was not State Regulated

Before addressing the substantive analysis, we note the paper frames the problem by referencing Washington Mutual Bank (WaMu) as its primary anecdote suggesting inconsistent oversight by regulators. The paper observes the regulatory responsibility for this institution was with the Office of Thrift Supervision (OTS) and Federal Deposit Insurance Corporation (FDIC). We find it disingenuous to cite the largest bank failure in history as evidence of inconsistent regulation, which for most of its lifecycle was regulated solely by the OTS. The FDIC only has backup authority over federally chartered institutions. This authority was severely curtailed by FDIC board policy, which was significantly influenced by the OCC and OTS. The failure of WaMu was destabilizing to an already very fragile financial system and was accompanied by extensive press coverage and government investigations. To then shift to "inconsistent implementation of regulation by state and federal regulators," implies a cause and effect which was not a factor in the WaMu failure. Utilizing this case as a centering point is inappropriate in a paper that clearly sets out to focus on State regulation.

In addition, we note that WaMu was the largest bank allowed to fail. We believe there is no clearer example of inconsistent supervision than what has been applied to the largest federally chartered institutions as compared to the rest of the industry. You argue that your evidence suggests state regulators were subject to regulatory capture by the banks they supervise. In light of the now available evidence of the build-up of risks in the nation's largest banks prior to the crisis and the extraordinary actions the federal government took, and continues to take, to ensure the success of these institutions, this argument strains credulity.

Flawed Design

We do not have the extensive access to CAMELS ratings that were utilized in the study. We are therefore unable to challenge the methodology used to conduct the analysis. However, we strongly challenge the conclusions you draw from the analysis and take exception to unsupported dicta.

As stated, the hallmark of the paper centers on "its empirical design." We agree with the premise that the ideal experiment would assess differences in supervisory decisions with a bank being examined by the State and federal agency simultaneously but independently. Despite your claim to the contrary, it is virtually impossible to mimic the ideal experiment. As we will explain in greater detail, there are far too many external factors and cumulative effects that impact a bank's condition to control for the effect of time through your simple model.

Understanding the Process of Supervision

This leads to our primary concern: the paper does not reflect sufficient understanding of the examination process or how coordinated supervision is implemented under the State-Federal Nationwide Cooperative Agreement referenced by the paper and contemplated by Federal law. State bank supervision is highly coordinated between the State authority, FDIC, and Federal Reserve regardless of which agency leads the examination. There is regular communication about examination activities, conclusions, recommendations, and final ratings. The cooperative agreement establishes a framework for coordination and information sharing, while protecting the independent authority of each regulator. To assume a State or federal examination is conducted without the opportunity for input from the other agency is untenable and presents a fundamental flaw in the study's design.

While the terms "independent exam" and "joint exam" are commonly utilized terminology, the lines have been blurred over the years. There is participation by both State and federal examiners in many examinations and most certainly in meetings with the bank's management and board of directors. This is most certainly the case when a downgrade is anticipated. Under these conditions, the suggestion that "federal regulators could decide to preemptively downgrade the rating in expectation of a more lenient future cycle under state regulators…"[1] has no basis in fact or practice.

In the case of joint examinations, a rating cannot generally be attributed to one regulator over the other. The paper contends the lead agency in a joint exam assigns the CAMELS rating. The "lead agency" refers to the party managing the process of the exam and the completion of the report. Examination findings and the final rating are determined by both the federal and state examiners. If an agreement cannot be reached, each regulator can issue its own report and ratings. This is a rare occurrence, but is an important construct for ensuring each regulator's authority and independence. Understanding this dynamic is fundamental to understanding how supervision works for State chartered banks and the relationship between the State authority and the federal regulator.

The paper states "the CAMELS rating does not change between exams."[2] This is absolutely incorrect. Bank regulators have full authority to change the rating of a bank based on any relevant information. This happened frequently during the recent financial crisis. Stress in the financial system and a rapidly deteriorating economy caused banking conditions to decline rapidly. This was initially detected through the supervisory review of call reports. The increasing demands on State and federal examination forces did not always allow for an on-site examination to verify results or evaluate the full extent of the problems. In these cases, an interim downgrade was a tool to gauge the general condition of banks across the country and in each State. This process was also used to establish examination priorities, again a coordinated effort between State and federal regulators.

While examiners are provided parameters for assigning ratings under the Uniform Financial Institutions Rating System, the practice still requires judgment. Examiners must consider not only quantitative findings, but also the practices and track record of bank management, corporate governance, operating controls, and local and national economic factors. To truly appreciate the value of on-site examinations, it is important to understand it is a process beyond a single point-in-time examination. The risks a bank assumes, and its policies, procedures, and track record evolve over time. Weaknesses in internal control or an inadequate lending policy may be identified in one examination, but the effects do not materialize until the next examination or even later. Areas of weakness and other concerns are

[1] Agarwal, Lucca, Seru, and Trebbi, *Inconsistent Regulators: Evidence from Banking* (January 2012), page 17.
[2] Ibid, page 11.

always identified, even if, in the examiners' judgment, the bank does not warrant a downgrade in rating. In times of broad industry deterioration, the environment and overall scrutiny of the regulatory function leads to a bias to downgrade. In these periods, it becomes more difficult to rate a bank a 2 than it does to downgrade it to a 3.

There are a variety of factors that can lead to a ratings downgrade. In the traditional analysis, risk is accumulated over time as the loan book grows. The risk profile changes as the bank misjudges risk at origination, credit standards erode over time and/or the economic situation changes significantly. The role of the examiner is to identify the conditions which could expose the bank to excessive risk. As noted in numerous material loss reviews of failed banks by inspectors general of the various federal agencies, examiners did a reasonably good job of identifying these risks and conditions. Bank management was not always responsive to matters brought to their attention in bank examination reports, and formal and informal enforcement actions. Additionally, regulators did not always aggressively pursue corrective actions. These are fair criticisms, and banking regulators have taken steps to alter their approaches. During the period of rapid deterioration in 2009, the states supported the FDIC's initiative to curtail activities which could increase losses in the event of failure, by hand delivering an exit letter to bank management when a ratings downgrade was pending. There are situations, including a local economic event or fraud against the institution that can cause a bank's condition to change very rapidly. In these cases, it would not matter which regulator performed the exam, the ratings would drop. We reject the implication that a ratings downgrade indicates the previous rating was incorrect.

There is a presumption in the paper that a harsher rating must be correct. We reject this premise. To think of ratings in terms of a definitive answer demonstrates a lack of understanding of the examination process and function. As stated above, despite excellent examination manuals and guidance in assigning ratings, examiners are required to exercise judgment. This occurs at the micro level in assessing an individual credit file and at the macro level in assigning the CAMELS rating. Many supervisory issues are addressed without a ratings downgrade or formal enforcement action. Even with problem institutions, state regulators have the ability to work a solution which does not result in an FDIC assisted transaction. To that end, bank supervision is as much about art as it is about science.

The federal agencies often bring their regional or national view of emerging issues to the examination process. While this helps to inform the process, State regulators can serve as a reasonable balance, understanding the local conditions and differences from what may be occurring elsewhere. The paper implies that a superior quality of federal regulators in supervision is their ability to be consistent across the nation at all times. In our view, this fails to acknowledge the remarkable diversity that characterizes the American economy. During the financial crisis, it would have been completely inappropriate to apply the same supervisory strategy to different regions of the country facing wholly different economic circumstances and levels of stability.

While the paper repeatedly concludes the data demonstrates State regulators are more lenient, the table with the supporting tabulation, Table 5[3], shows that 86% of the observations are state non-member banks, with rotation between the FDIC and State. The report commentary clearly observes for these institutions, the FDIC is more likely to downgrade <u>and</u> upgrade.[4]

We believe there is a natural and productive tension between the State and federal regulator. The paper refers to State supervisors competing with federal supervisors. This is a complete mischaracterization of the relationship and the value the different perspectives bring to the process. The productive tension between the chartering authority and deposit insurer is by design and is good for the financial system. Unfortunately, the paper concludes without a single piece of evidence that state supervisors are "captured by the constituents they supervise."[5] This unsubstantiated conclusion is insulting to the state officials who have accepted the responsibility to charter and supervise banks. These officials are accountable to a State statute crafted to ensure the safe and sound operation of banks in the State. We see no justifiable reason to systematically impugn their character.

Community Banks did not Destabilize the Financial System

The goal of the paper is to speak "to the debate on supervision and regulation of banks prompted by the recent financial crisis."[6] Unfortunately, given the deficient understanding of supervisory processes, the paper only serves to divert attention from the real issues of the financial crisis and related regulatory short-comings. We would agree there are lessons learned about the risk management and supervisory practices for community and regional banks. However, those shortcomings did not destabilize the entire financial system. In fact, the resolution regime for these banks worked exactly as designed. The chartering authority closed the bank, appointed the FDIC as receiver, and in most cases sold the bank to another institution with assistance from the industry funded Deposit Insurance Fund, the same fund which the industry is now in the process of restoring.

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[3] Ibid, page 38.
[4] Ibid, page 16.
[5] Ibid, page 24.
[6] Ibid, page 27.

Conversely, the largest banks required extraordinary assistance from taxpayers in the form of capital and asset guarantees to protect the broader financial system. In the process, the U.S. Government also protected the firms' stockholders and creditors. Given the paper's focus on inconsistent supervision, perhaps the more appropriate approach would be to analyze the ratings and enforcement actions for the firms which received extraordinary assistance. There was never a formal enforcement action issued for the largest taxpayer-assisted banks. In fact, none of these banks were ever deemed a "problem."

Recently released board minutes from the FDIC indicate at the time the FDIC was considering assistance for Citigroup to ensure they had enough cash to operate, the bank's liquidity was rated a 3. FDIC Chairman Sheila Bair questioned how this could be when the Office of the Comptroller of the Currency (OCC) was on the verge of having to close Citigroup's national banks over funding demands. The Comptroller of the Currency, John Dugan, responded that the 3 rating for liquidity essentially anticipates what the rating will be once the transaction before the Board was approved. The minutes go on to report:

> "Chairman Bair responded, in turn, that the Corporation does not use that just-described approach as a criterion in its liquidity ratings and that it is certainly not the criterion used for the liquidity ratings of other banks."[7]

Conclusion

We appreciate your interest in scientifically and quantitatively analyzing various trends and factors affecting the banking system and bank supervision. We hope you also understand that your results and conclusions might easily be taken out of context or misconstrued by those with a political agenda. As we continue to recover from the financial crisis and work to implement the Dodd-Frank Act, it is difficult to see how one would conclude that the biggest problem in U.S. bank regulation is lenient community bank supervision.

We do not believe undermining a coordinated supervisory model which has largely served the industry and the economy well is in the country's best interest. However, as we have stated, the paper clearly lacks an appreciation for soft information, human discretion, and the reality of supervisory processes because such factors do not qualify as inputs in a numerical equation. This is ironic emerging from a financial crisis preceded by an effort by the largest internationally active firms to quantify all aspects of their risk to justify significantly lower levels of capital under Basel II.

[7] Minutes of the meeting of the Board of Directors of the Federal Deposit Insurance Corporation, November 23, 2008, page 56625.

We firmly believe the coordinated supervisory framework results in greater consistency and provides effective checks and balances to protect against both laxity and overzealousness. We would welcome the opportunity to discuss these issues further. We are deeply interested in an effective regulatory regime, which enhances financial stability and ensures a diverse financial system.

Best regards,

John W. Ryan
President & CEO