Charting a New Course: Preliminary Thoughts on FDIC Policy Issues

January 10, 2025

Introduction

In ten days, there will be a change in leadership at the FDIC. The agency needs a new direction, and – one way or another – I expect that work to begin on January 20th. Today, I will discuss a few issues I expect the agency to begin addressing in the coming weeks and months, though there are many others that deserve (and I anticipate in the future will receive) attention. The views I express today are my own as Vice Chairman of the FDIC, and not necessarily those of the FDIC or other members of the Board.

Supervision

I'll start with bank supervision. Bank regulators have been tasked by Congress with an important mission: to promote the safety and soundness of banks. To achieve this objective, we promulgate rules that banks must follow, and supervise banks through on-site examinations.

Following the regional bank failures in 2023, the public release of the Silicon Valley Bank (SVB) exam reports and supervisory findings drew attention to bank regulators' emphasis on *process* rather than core financial risks.[1] At the time of failure, SVB was subject to a long list of supervisory criticisms, but most were unrelated to financial risks, and the one criticism related to interest rate risk was focused on the bank's modeling, not on the actual hole in the bank's balance sheet.[2]

There are times when institutions have obvious, well-known management, governance, or control issues that can potentially threaten the safety and soundness of the institution. But today, these are outlier cases. What is far more common is for examiners to focus on a litany of process-related issues that have little bearing on a bank's core financial condition or solvency.

One example is our approach to "sensitivity to market risk," the "S" prong of the CAMELS rating system. Recently, some banks have experienced downgrades of the S rating

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[1] *See, e.g.*, Jeremy Newell and Pat Parkinson, A Failure of (Self-) Examination: A Thorough Review of SVB's Exam Reports Yields Conclusions Very Different From Those in the Fed's Self Assessment (May 8, 2023); Raj Date, Banks Aren't Over-Regulated, They Are Over-Supervised, *Open Banker* (September 10, 2024) ("Indeed, the Federal Reserve's own post-mortem on the 2023 Silicon Valley Bank failure noted that before its demise SVB had 12 'Matters Requiring Immediate Attention,' precisely zero of which focused on the interest rate risk that ultimately drove its fatal bank run.").

[2] *See* Board of Governors of the Federal Reserve System, Silicon Valley Bank Review – Supervisory Materials.

despite being relatively resilient to interest rate shocks. These downgrades can occur for a variety of process-related reasons, ranging from inadequate documentation, to an inability to explain assumptions in models used by outside vendors, to insufficient focus in minutes at Board of Directors meetings. Meanwhile, leading up to the Federal Reserve's interest rate increases, some banks that *were* relatively vulnerable to interest rate shocks nonetheless maintained a satisfactory S rating because they had checked all the process-related boxes. These are opposite sides of the same coin.

There are a number of reasons behind the focus on process, which is deeply entrenched in our manuals and guidance.[3] It is partly rooted in so-called "forward-looking supervision," a desire to address weaknesses before they show up in financial metrics. It is also rooted in the fact that it can be comparatively hard to second-guess a banker's decision about the appropriate resilience to interest rate shocks or the proper loan loss reserve, while it is comparatively easier to run down a checklist of process-related items.

And so the focus on process is an attempt to indirectly encourage better management of risks. This might work on the margins, but only if the improvements to process actually result in better management of risk and/or less risky banks. Instead, the criticisms often have little bearing on a bank's actual health or solvency, are a major distraction for examiners and banks, and are contributing to crushing compliance costs, particularly for community and regional banks.

Changes in this area will take time, but are critically needed. We will need to make adjustments to how we implement the CAMELS rating system and to our examination manuals, and we will need to modify how we train examiners. Basic controls and risk management infrastructure still matter, but should not be the overwhelming focus.

Innovation and Technology

I also expect the FDIC to take a more open-minded approach to innovation and technology adoption, while still promoting core safety and soundness principles. There is a healthy balance between (1) allowing banks to evolve with the times and (2) ensuring banks continue to manage risks prudently, and in recent years the FDIC has done a poor job striking that balance.

In the short term, there are various steps I expect the FDIC to consider. One step is a shift in supervisory attitude towards new technology. For example, certain types of experimentation with new technologies should not require time-consuming engagements with

[3] *See, e.g.*, Federal Deposit Insurance Corporation, Risk Management Manual of Examination Policies.

examiners or extensive approval processes. Another step is reinvigorating the innovation lab, FDiTech, which was established by Chairman McWilliams to directly engage with the private sector, examine the challenges banks face with technology adoption, and help develop solutions. Under current leadership, the FDIC abandoned this model, but I expect the office will be rejuvenated under new leadership. Additionally, the FDIC will need to hire more staff with hands-on experience working with new technologies, both in FDiTech and throughout the agency.[4]

The FDIC should also consider issuing additional guidance on several topics, such as fintech partnerships, artificial intelligence, and digital assets and tokenization. With respect to fintech partnerships, over the past few years, the FDIC and other banking agencies have issued a series of enforcement actions against banks that have adopted a partnership model.[5] Notwithstanding whether some of these actions may have been warranted, I generally think a much better approach would have been to lay out our expectations clearly and transparently on the front end, with an opportunity for the public to comment and provide feedback, rather than go down the line hammering each bank one by one, forcing the industry to reevaluate its compliance approach after every new order.

It is also worth revisiting the possibility of a public-private standard setting organization that would establish standards for due diligence of fintech vendors and technologies, which would reduce the need for each bank that partners with a fintech to conduct costly, time-consuming due diligence of its own.[6] This effort could leverage and build on recent work in this area by the private sector.

Another area in which a reset is sorely needed is the agency's approach to digital assets and tokenization. In 2021, the banking agencies issued a roadmap describing plans to publish various policy documents in 2022 detailing the agencies' expectations for banks engaging in

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[4] One critical step toward hiring staff with expertise in blockchain is modifying the government's overly restrictive policy that prevents employees who hold *any* cryptocurrencies or stablecoins from working on policy issues in this area. *See* United States Office of Government Ethics, Legal Advisory LA-22-04, "Application of the Securities and Mutual Fund Exemptions to Cryptocurrency, Stablecoins, and Related Investments" (July 5, 2022). At minimum, there should be a *de minimis* exception for stablecoins, which are designed to maintain a 1:1 relationship to a fiat currency rather than appreciate in value.

[5] *See, e.g.*, Konrad Alt, Who's Been Toughest on Fintech Partner Banks Recently – The OCC, Federal Reserve, or FDIC? (April 22, 2024) (noting that 15 percent of FDIC-supervised fintech partner banks received a consent order over five quarters from first quarter 2023 through first quarter 2024, while only 1.8 percent of banks across the industry received a consent order during the same time period).

[6] *See* Federal Deposit Insurance Corporation, Request for Information on Standard Setting and Voluntary Certification for Models and Third-Party Providers of Technology and Other Services, 85 Fed. Reg. 44890 (July 24, 2020).

activities related to digital assets.[7] Ultimately, this work was discontinued in early 2022 following a change in leadership at the FDIC, and instead the agencies established processes in which each institution must engage with its regulator on an individual basis before engaging in any activities related to digital assets or blockchain.[8]

I have talked in the past about how damaging this approach has been, as it has stifled innovation and contributed to a public perception that the FDIC is closed for business if institutions are interested in anything related to blockchain or distributed ledger technology.[9] Recent disclosures that the FDIC sent "pause" letters to more than twenty banks instructing them to refrain from "all crypto-related activity" have reinforced this perception.[10] I continue to think a much better approach would have been – and remains – for the agencies to clearly and transparently describe for the public what activities are legally permissible and how to conduct them in accordance with safety and soundness standards. And if regulatory approvals are needed, those must be acted upon in a timely way, which has not been the case in recent years.

Debanking

Closely related to the agencies' recent approach to digital assets is the problem of "debanking." Over the past few years, there have been various accounts of individuals and businesses associated with the crypto industry losing access to bank accounts without explanation. This follows a long history of other types of customers experiencing the problem of debanking, including the politically disfavored business groups targeted by the original "Operation Choke Point,"[11] individuals associated with certain religious or political groups,[12] and many others.[13]

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[7] *See* Federal Deposit Insurance Corporation, Board of Governors of the Federal Reserve System, Office of the Comptroller of the Currency, Joint Statement on Crypto-Asset Policy Sprint Initiative and Next Steps (November 23, 2021)

[8] *See* Federal Deposit Insurance Corporation, Notification of Engaging in Crypto-Related Activities (April 7, 2022) (FIL-16-2022); Board of Governors of the Federal Reserve System, Engagement in Crypto-Asset-Related Activities by Federal Reserve-Supervised Banking Organizations (August 16, 2022) (SR 22-6); Office of the Comptroller of the Currency, Chief Counsel's Interpretation Clarifying: (1) Authority of a Bank to Engage in Certain Cryptocurrency Activities; and (2) Authority of the OCC to Charter a National Trust Bank (PDF) (November 18, 2021) (Interpretive Letter #1179).

[9] *See* Travis Hill, "Banking's Next Chapter? Remarks on Tokenization and Other Issues" (March 11, 2024).

[10] *See* Federal Deposit Insurance Corporation, FDIC Redacted Pause Letters.

[11] *See* FDIC Office of Inspector General, The FDIC's Role in Operation Choke Point and Supervisory Approach to Institutions that Conducted Business with Merchants Associated with High-Risk Activities, Report No. AUD-15-008 (September 2015).

[12] *See, e.g.*, Rupa Subramanya, The Debanking of America, *The FreePress* (October 17, 2024).

[13] *See, e.g.*, Ron Lieber and Tara Siegel Bernard, Why Banks are Suddenly Closing Down Customer Accounts, *The New York Times* (November 5, 2023) (Updated, June 3, 2024).

Access to a bank account is essential for individuals and businesses to participate in many aspects of the modern economy. A longstanding goal of the FDIC's has been to *decrease* the number of people who are unbanked. Efforts to debank law-abiding customers are unacceptable, regulators must work to end it, and there is no place at the FDIC for anyone who has pushed – explicitly or implicitly – banks to stop serving law-abiding customers.

While adopting a new approach to digital assets – and putting an end to any and all Choke Point-like tactics – are essential first steps, regulators also need to reevaluate our approach to implementing the Bank Secrecy Act (BSA). While we all share the goal of ensuring criminals and terrorists are not using the banking system to fund drug trafficking, terrorism, and other serious crimes, the current BSA regime creates an incentive for banks to close accounts rather than risk massive fines for inadequate BSA compliance. It is also worth reexamining the policy of requiring banks to provide adverse action notices explaining the reasons why a customer is denied a loan, while at the same time often *prohibiting* banks from providing any reason if a customer's entire account is closed. These issues, along with others in the BSA realm,[14] warrant attention and scrutiny during the next Administration.

Climate

I've talked in the past about the FDIC's misguided focus on climate.[15] Banks have dealt with natural disasters and extreme weather events for centuries, yet there is no record of any U.S. banks ever failing due to climate-related events. Although these events can be devastating for families, communities, and businesses - as we have painfully witnessed in Southern California this week - there is no evidence such events pose an elevated safety and soundness or financial stability risk for banks. In fact, banks often benefit in the aftermath of such events as loan demand grows and funds flow into the community.[16]

As agency leaders have repeatedly told Congress and others over the past four years, the banking agencies' authorities in this area are limited to promoting the safety and soundness of institutions, *not* to using banks to pursue environmental policy.[17] Yet, the FDIC and other U.S.

[14] *See, e.g.*, Travis Hill, Statement on the Proposal to Amend the Bank Secrecy Act Compliance Rule (June 2, 2024).

[15] *See* Travis Hill, "Insights on the FDIC's Agenda" (September 21, 2023); Travis Hill, Statement on Interagency Guidance on Principles for Climate-Related Financial Risk Management for Large Financial Institutions (October 24, 2023).

[16] *See, e.g.*, Kristin S. Blickle, Sarah N. Hamerling and Donald P. Morgan, How Bad Are Weather Disasters for Banks?, *New York Fed Staff Reports* (November 2021) (Revised January 2022).

[17] *See e.g.*, *Oversight of Prudential Regulators: Ensuring the Safety, Soundness, Diversity, and Accountability of Depository Institutions: Hearing Before the H. Comm. on Fin. Servs.*, 117th Cong. (November 16, 2022) (statement of Michael Barr) ("The Federal Reserve's role in this area is an important role, but it's a very narrow role. And that's

agencies continue to be members of the international Network for Greening the Financial System (NGFS). "Greening the financial system" is not within our authorities or mandate, and thus I would expect the FDIC's withdrawal from this group to occur imminently following the change in leadership.

Additionally, a little over a year ago, the Basel Committee issued a consultation paper that proposed a disclosure framework for climate-related financial risks.[18] I expect that, regardless of what the Basel Committee might publish next year, the FDIC will not be issuing any quantitative or qualitative climate disclosure regime for banks in the U.S. I also think climate policy is very far afield from what the Basel Committee was originally set up to do (coordinating supervision of banks operating in multiple jurisdictions) and what the Basel Committee has generally focused on over the years (most notably, coordinating capital and liquidity standards for global banks).[19]

Capital

Speaking of Basel, it is possible that in 2025 the banking agencies may consider a new proposal to implement the 2017 "Basel endgame" agreement. I strongly opposed the 2023 proposal[20] and expressed concerns that the 2024 (unpublished) reproposal[21] needed additional work. I continue to believe that a proposal that is *roughly* capital neutral, consistent with the original objectives of U.S. and international regulators,[22] remains a prudent starting point.

Recently, the Federal Reserve announced it will soon propose "significant changes to improve the transparency" and "reduce the volatility" of the stress tests.[23] The Federal Reserve

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to look at financial risk management at firms with respect to climate issues. … I don't think it's the business of the Federal Reserve to tell firms who to lend to or who not to lend to, with respect to these issues, and you will not see us doing that.") (statement of Michael Hsu) ("So our role is firmly rooted and focused on safety and soundness, which means focusing on the risk management aspects of climate risk management. I agree to echo what Vice Chair Barr said: we are going to stay in our safety and soundness lane; that's very important.").

[18] Basel Committee on Banking Supervision, Consultative Document: Disclosure of climate-related financial risks (November 29, 2023).

[19] *See, e.g.*, Basel Committee on Banking Supervision, History of the Basel Committee.

[20] *See* Federal Reserve System, Office of the Comptroller of the Currency, Federal Deposit Insurance Corporation, Notice of Proposed Rulemaking—Regulatory Capital Rule: Large Banking Organizations and Banking Organizations with Significant Trading Activity, 88 Fed. Reg. 64028 (September 18, 2023).

[21] *See generally* Michael Barr, "The Next Steps on Capital" (September 10, 2024).

[22] *See, e.g.*, Travis Hill, Statement on the Proposal to Revise the Regulatory Capital Requirements for Large Banks (July 27, 2023), at note 8.

[23] Board of Governors of the Federal Reserve System, Press Release, "Due to evolving legal landscape & changes in the framework of administrative law, Federal Reserve Board will soon seek public comment on significant changes to improve transparency of bank stress tests & reduce volatility of resulting capital requirements" (December 23, 2024).

also noted that "[t]hese proposed changes are not designed to materially affect overall capital requirements." If the changes to the stress test do not materially impact the stress capital buffer (SCB), I expect the next iteration of the Basel endgame proposal will need more comprehensive changes than the 2024 draft.

Most significantly, the agencies need to reconcile the Fundamental Review of the Trading Book (FRTB) and the global market shock (GMS) in the stress test. The FRTB was intended to address the fact that the existing market risk framework does not sufficiently capitalize for tail risk events, but in the U.S. this weakness is currently addressed by the GMS. Using *both* the point in time capital framework and the SCB to address these deep tail risks will make some of these activities uneconomical for banks to engage in, and as a result damage financial market functioning. In the absence of more fundamental changes to the SCB, the banking agencies will need to make additional changes to the FRTB beyond what was contemplated in the 2024 draft.

Any reproposal should also fully address all issues raised by commenters to the 2023 proposal, rather than only a select handful, as was the case in the 2024 draft, and should include a robust economic analysis. The agencies should also be open to reconsidering aspects of the overall design, such as considering a one-stack, rather than a two-stack approach.[24]

I also believe that, if the capital rule is being reopened, the agencies should consider expanding the scope of the rule to address other longstanding capital issues. For example, interagency discussions earlier in this process included consideration of credit risk transfers and the supplementary leverage ratio. Tackling the capital treatment of credit risk transfers is particularly ripe given the growing interest from institutions in engaging in these types of transactions. Addressing the issue holistically and transparently through a notice-and-comment rulemaking process would be a much better approach than the current approach of considering transactions on a one-off basis, and will ensure consistent treatment across the agencies.

Conclusion

In conclusion, the FDIC will soon embark on a new course across a range of issues, while still continuing to execute its key responsibilities and mission. I discussed a few issues facing the agency today, but there are many others I expect the FDIC to focus on in the coming weeks, months, and years, ranging from merger policy, to de novo policy, to resolution readiness and planning, to liquidity, to what the agency discloses (or requires be disclosed) to the public[25] and

[24] *See* Travis Hill, "Reflections on Bank Regulatory and Resolution Issues" (July 24, 2024), at note 78.

[25] For example, I have long been of the view that the FDIC should not publish the aggregate assets of banks on the Problem Bank list.

what the agency shields or prohibits from disclosure,[26] to deposit insurance, to the FDIC's workforce culture, among many others.

Thank you for your time.

[26] For example, the initial redactions to the "pause" letters referenced in note 10 were particularly egregious.