Modernizing Bank Supervision to Restore Integrity, Stability, and Growth

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Bank supervision **protects the safety and stability of the financial system**, ensuring banks of all sizes can serve people and businesses in communities nationwide.

However, supervision has **diverged from its core goals**, making it harder for banks to support customers and businesses across the economy. Given the critical importance of banks to our nation's prosperity and growth, we need to get back to a rigorous, but sensible, approach.

Priority #1: Focusing on Material Financial Risk

"Large examination bureaucracies are at grave risk not just of lethargy, but also of being encumbered by so many internal reporting requirements and conflicting incentives that they **lack the ability to distinguish material weaknesses from minor failings** and then to rapidly resolve or punish persistent material weaknesses and violations."

– Federal Financial Analytics, Inc., Managing Partner Karen Shaw Petrou[1]

To be effective, bank supervisors must focus their limited resources on those practices that have clear and material bearing on bank health. Supervisors should **prioritize material financial risks such as capital, liquidity, and credit risk** to help ensure the banking system remains strong. However, supervision instead has been centered on reviewing processes unrelated to risk.

The failure of Silicon Valley Bank (SVB) in 2023, the second biggest bank failure in U.S. history, is a prime example. In its post-failure report, the Federal Reserve detailed that the majority of the issues flagged by SVB's supervisors before it failed fell under the area of "Governance and Controls," including a range of largely process-driven issues such as "data governance," "vendor management," and "IT asset management." While not irrelevant, **these issues do not relate to the core banking functions** that drive the ability of a bank to serve its customers.

Ensuring regulators **maintain focus on material risks** will improve financial stability and safety and soundness across the banking system.

1. Petrou, Karen. "U.S. Bank Supervision: How to Make It Both Good and Just." Federal Financial Analytics, Inc., July 24, 2024. https://fedfin.com/wp-content/uploads/2024/07/Karen-Petrou-Remarks-Peterson-Institute-for-International-Economics-072424.pdf

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Reforming Bank Supervision: Three Other Priorities for Better Outcomes

In addition to refocusing supervision on materiality, three other changes are needed.

Respect the Line Between Supervision and Regulation

Bank supervisors have an important job - to assess whether banks comply with existing regulations in support of safety and soundness. They are not charged with making new regulations or tweaking existing rules. Bank supervision reform **must ensure that supervisors do not instill de facto regulatory changes** through the supervisory process, which does not have the benefit of an open and transparent comment process.

Establish an Effective Challenge Process

The government should establish a transparent, efficient process for banks to contest supervisory decisions through independent parties not involved in the initial findings. Such a transparent challenge process would **ensure that expert views are taken into consideration in an unbiased manner,** improving overall financial stability for the long term.

Make Expectations Clear

Supervisory feedback should be timely and actionable to **ensure constructive engagement and effective response.** Further, when issues are identified, supervisors should establish predictable timelines for making changes, identify practical actions, and promote conversation between banks and supervisors to constructively address issues and enhance overall supervisory quality.

It's Time to Get Bank Supervision Back on Track

Effective bank supervision strengthens the stability of the financial system and **promotes the ability of banks to support the economy** when it focuses on material risks, adheres to regulatory limits, and enables timely improvement. It's time to return supervision to a system that helps **ensure a safe and resilient banking system** that benefits consumers, businesses, communities, and the wider economy.