JEREMY KRESS

Proposal and Comment Information

Title: LFI -Revisions to the Large Financial Institution Rating System and Framework for the Supervision of Insurance Organizations, OP-1868

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Submitter Information

Name: Jeremy Kress

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Please see attached

MICHIGAN ROSS

Jeremy C. Kress
Associate Professor of Business Law
Michael R. and Mary Kay Hallman Faculty Fellow

Stephen M. Ross School of Business
University of Michigan
701 Tappan Street
Ross Building, Rm R5454
Ann Arbor, Michigan 48109-1234
Tel: (734) 764-9181
Email: kressj@umich.edu

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Via Electronic Mail

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

Re: Revisions to the Large Financial Institution Rating System and Framework for the Supervision of Insurance Organizations (Docket No. OP-1868)

Dear Ms. Misback:

I write in opposition to the Federal Reserve Board's proposal to weaken its supervisory standards through changes to the Large Financial Institution (LFI) rating system. This proposal would create unwarranted grade inflation by allowing banking organizations with significant deficiencies to retain "well managed" status. It would thereby undermine incentives for these firms to address supervisory concerns and maintain strong risk management practices.

I make four specific points in this letter: (1) the proposed changes to the LFI rating system are legally impermissible under the Bank Holding Company (BHC) Act, (2) the current LFI rating system is not broken and is not in need of fixing, (3) the Board overstates the regulatory consequences of losing "well managed" status and the purported benefits of the proposal, and (4) the abbreviated 30-day comment period prevents meaningful public participation in this important rulemaking.

1. The Proposed Changes Are Legally Impermissible Under the BHC Act

By its terms, the BHC Act prevents the Board from adopting the proposed changes to the LFI rating system. The statute defines "well managed" to require that a bank holding company (BHC) receive "at least a satisfactory rating for management, if such a rating is given."[1] Under the Board's proposal, however, a BHC could qualify as "well managed" despite receiving an unsatisfactory rating on the governance and controls component of the LFI framework.[2] The governance and controls component directly evaluates management effectiveness and therefore constitutes a

[1] 12 U.S.C. § 1841(o)(9)(A).

[2] Specifically, a BHC that receives a Deficient-1 rating for the governance and controls component would be considered "well managed" as long as it receives at least a Conditionally Meets Expectations rating for both capital and liquidity.

"management rating" within the meaning of the statute. The Board therefore lacks authority to allow institutions with deficient governance and controls ratings to maintain "well managed" status, as doing so would directly contradict the statutory requirement for "at least a satisfactory rating for management."

The Board's attempt to distinguish the governance and controls component from a "management rating" is unconvincing.[3] The governance and controls component explicitly evaluates the "effectiveness of a firm's (i) board of directors [and] (ii) management of business lines and independent risk management."[4] These are essentially the same functions assessed under the "Management" component of the CAMELS rating system for depository institutions.[5]

The Board argues that governance and controls is not a management rating because "each component evaluates different aspects of a firm's management."[6] However, the CAMELS rating system—which has been used for decades—proves the flaws in this logic. The CAMELS system incorporates management assessments across all its components,[7] but it maintains a distinct "Management" rating that evaluates management effectiveness directly. Accordingly, the fact that multiple components of a rating system evaluate managerial competency cannot negate the obvious reality that a component explicitly assessing "management of business lines and independent risk management" constitutes a management rating under the BHC Act.

The conclusion that the governance and controls component constitutes a management rating should not be controversial. Even the Bank Policy Institute—a trade association representing the very banks that would benefit from this proposal—has acknowledged that governance and controls is equivalent to the CAMELS' "Management" rating.[8] Taking BPI at its word, and based on the

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[3] *See* Revisions to the Large Financial Institution Rating System and Framework for the Supervision of Insurance Organizations, 90 Fed. Reg. 31,641, 31,642 n.17 (July 15, 2025) [hereinafter Proposed Rule] ("The LFI Framework does not designate any of the three component ratings as a management rating….").

[4] SR Letter 19-3/CA Letter 19-2, at 2. The governance and controls rating also includes an evaluation of recovery planning.

[5] *See* Uniform Financial Institutions Rating System, https://www.federalreserve.gov/boarddocs/supmanual/cbem/200904/A50201.pdf ("The capability and performance of management and the board of directors is rated based on, but not limited to, an assessment of … the level and quality of oversight and support of all institution activities by the board of directors and management….").

[6] Proposed Rule at 31,641 n.17.

[7] *See* Uniform Financial Institutions Rating System, *supra* note 5, at 3-8 (noting that the Capital Adequacy component includes an assessment of "the ability of management to address emerging needs for additional capital"; Asset Quality includes "the ability of management to properly administer its assets"; Earnings includes "the adequacy of the budgeting systems, forecasting processes, and management information systems in general"; Liquidity includes "the capability of management to properly identify, measure, monitor, and control the institution's liquidity position"; Sensitivity to Market Risk includes "the ability of management to identify, measure, monitor, and control exposure to market risk given the institution's size, complexity, and risk profile").

[8] *See, e.g.*, BPI Staff, *Making Sense of the Federal Reserve's Report on Supervisory Developments*, BANK POL'Y INST. (Nov. 19, 2024), https://bpi.com/making-sense-of-the-federal-reserves-report-on-supervisory-developments/ ("Without greater clarity regarding the standards by which examiners judge the quality of governance and controls at LFIs (or 'management' at IDIs), it is hard to assess whether their judgments are reasonable.").

plain language of the BHC Act and the LFI rating system itself, the Board lacks legal authority to adopt the proposed changes.

2. <u>The Current LFI Rating System Is Not Broken</u>

The Board's proposal rests on the unfounded premise that supervisory ratings are broken and require fixing. The evidence demonstrates the opposite. A substantial body of academic literature, including recent Federal Reserve research, confirms that supervisory ratings are highly predictive of bank failure and provide valuable information about institutional health.[9] Studies from the Federal Reserve Bank of St. Louis and the Office of the Comptroller of the Currency show that Management ratings in particular outperform purely financial metrics in predicting future firm performance.[10] Notably, the Board fails to engage with any of this literature in its proposal.

The Board claims to have "observed based on its implementation of the LFI Framework since 2018 that a firm that receives two component ratings of Conditionally Meets Expectations or better and a single Deficient-1 component rating can maintain safe-and-sound operations through a range of conditions."[11] This conclusion is far too premature. The period from 2018 to present has been characterized by extraordinary government intervention: massive fiscal stimulus, unprecedented monetary accommodation, and emergency lending facilities. The United States has not experienced a recession without extraordinary support nor a financial crisis without systemic risk exceptions during this time. Drawing supervisory policy conclusions from BHCs' performance during this artificially supported period is methodologically unsound and wildly inappropriate.

The Board attempts to justify its proposal by pointing to a supposed divergence between large BHCs' capital ratios and their LFI ratings.[12] This reasoning fails on multiple levels. First, the Board cherry-picks misleading statistics. When measured by the more reliable leverage ratio, large BHCs' capital has actually declined in recent years, tracking the same downward trajectory as their LFI ratings.[13] Second, and more fundamentally, the Board's premise contradicts express

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[9] *See* Sergio Correia, Stephan Luck & Emil Verner, Supervising Failing Banks (Apr. 15, 2025) (unpublished working paper), https://papers.ssrn.com/sol3/papers.cfm?abstract_id=5185769; Robert Deyoung, Mark J. Flannery, William W. Lang & Sorin M. Sorescu, *The Information Content of Bank Exam Ratings and Subordinated Debt Prices*, 33 J. MONEY, CREDIT & BANKING 900 (2001); Allen N. Berger, Sally M. Davies & Mark J. Flannery, *Comparing Market and Supervisory Assessments of Bank Performance: Who Knows What When?*, 32 J. MONEY, CREDIT & BANKING 641 (2000); Allen N. Berger & Sally M. Davies, *The Information Content of Bank Examinations*, 14 J. FIN. SRVS. RSCH. 117 (1998).

[10] *See* Drew Dahl & Daniel C. Coster, *Subjective Assessment of Managerial Performance and Decisionmaking in Banking*, 104 FED. RSRV. BANK OF ST. LOUIS REV. 210 (2022); Lewis Gaul & Jonathan Jones, *CAMELS Ratings and Their Information Content*, (OCC Working Paper No. 2021-01, 2021), https://www.occ.gov/publications-and-resources/publications/economics/working-papers-banking-perf-reg/economic-working-camels-ratings.html.

[11] Proposed Rule at 31,642.

[12] *See id.* at 31,647 ("Notably, the upward trend in the number of firms being considered not 'well managed' has occurred over a period when the regulatory capital ratio of large financial institutions as a group have remained generally stable around 13 percent."); *id.* at 31,648 ("[T]he share of well capitalized banks has increased over this period, from 94 percent in 2020 to 99 percent in 2024.").

[13] *See* Sabrina Pellerin, *Bank Capital Analysis Semiannual Update*, FED. RSRV. BANK OF KAN. CITY (May 21, 2025) (showing that GSIBs' Tier 1 leverage ratio declined from 9 percent in 2016 to roughly 7 percent in 2024); *see also* Stephen G. Cecchetti, Jeremy C. Kress & Kermit L. Schoenholtz, *Basel Endgame: Bank Capital Requirements and*

Congressional intent. Congress deliberately required separate assessments of whether a BHC is "well managed" and "well capitalized"—recognizing that strong capital does not necessarily indicate competent management. The Board's proposed approach would essentially collapse these two distinct statutory requirements into a single inquiry, directly undermining Congressional intent.

While the current LFI ratings framework is not broken, the proposal would render it effectively toothless. Consider a telling example. Under the current LFI framework, Silicon Valley Bank Financial Group (SVBFG) lost its well managed status in May 2022 when the Federal Reserve downgraded its governance and controls rating to Deficient-1 on the grounds that its "governance and risk management practices [were] below supervisory expectations" and that its "risk-management program [was] not effective."[14] Under the proposal, by contrast, SVBFG would have been considered "well managed" on the basis of its LFI ratings until the day SVB failed in March 2023 because its other two component ratings were satisfactory.[15] Any ratings framework that would have rated SVBFG as "well managed" on the eve of its collapse lacks credibility and should be rejected.

3. <u>The Board Overstates the Consequences of Losing "Well Managed" Status and the Benefits of the Proposal</u>

The Board biases its analysis by overstating both the negative consequences of losing "well managed" status and the purported benefits of the proposal.

First, the Board significantly overstates the practical impact of losing "well managed" status. The Board claims that such loss "can constrain a banking organization that is a financial holding company; can limit the banking organization from benefiting from certain expedited processing available to 'well managed' firms; and can limit the scope of certain new activities permissible for the firm."[16] As my research has shown, though, these sanctions are largely toothless.[17] The Board has permissively interpreted the BHC Act to allow financial holding companies to continue their full range of activities even when they are not "well managed."[18] Most tellingly, the Board has

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the Future of International Standard Setting 9-10 (Nat'l Bureau of Econ. Rsch., Working Paper No. 33982, 2025) (noting that the decline of GSIBs' leverage ratios is unrelated to the increased holdings of reserves and other zero-risk-weight assets).

[14] BD. OF GOVERNORS OF THE FED. RSRV. SYS., REVIEW OF THE FEDERAL RESERVE'S SUPERVISION AND REGULATION OF SILICON VALLEY BANK 39 (2023).

[15] Although SVBFG's governance and controls rating was Deficient-1, its capital rating was Broadly Meets Expectations, and its liquidity rating was Conditionally Meets Expectations. *See id.*

[16] Proposed Rule at 31,642.

[17] *See* Jeremy C. Kress, *Solving Banking's 'Too Big to Manage' Problem*, 104 MINN. L. REV. 171 (2019).

[18] *See id.* at 223. ("During the pendency of a section 4(m) agreement, the Federal Reserve generally permits a firm to continue engaging in all of its existing activities, including investment banking, insurance underwriting, and merchant banking. The only substantive constraints in most section 4(m) agreements are prohibitions on commencing a new financial activity or acquiring shares of a company engaged in a BHC-impermissible activity. These restrictions, however, have little practical effect on the largest FHCs, which already engage in the full panoply of financial activities and may therefore continue these activities even when they are not 'well capitalized' or 'well managed.'").

<u>never</u> revoked a BHC's financial holding company status despite persistent unsatisfactory ratings.[19] The Board cannot credibly claim that penalties are burdensome when it has already rendered those sanctions effectively meaningless.

At the same time, the Board overstates the purported benefits of grade inflation. The Board claims that by artificially boosting LFI ratings, "the proposal could bolster the overall growth of large banking organizations."[20] The Board frames this effect as an unqualified good. But extensive research demonstrates the opposite: growth in large banking organizations increases operational risks and creates diseconomies of scale and scope that harm both the institutions and the broader financial system.[21] Once again, the Board's proposal fails to address contradictory evidence that challenges its core assumptions.

4. <u>The 30-Day Comment Period Prevents Meaningful Public Participation</u>

The Board's 30-day comment period is woefully insufficient for a proposal of this magnitude. Executive Order 13,563 directs agencies to provide "a meaningful opportunity to comment" with a comment period that "should generally be at least 60 days."[22] This proposal—which would alter supervisory standards for the largest and most systemically important financial institutions—warrants at least the full 60-day period contemplated by the Executive Order. The abbreviated timeline is particularly problematic given the Board's simultaneous consideration of multiple complex rulemakings that compete for public attention. The rushed schedule creates the impression that the Board has prejudged its decision and seeks to minimize meaningful public input. The Board should extend the comment period by at least 30 additional days to provide the public more time to analyze the proposal and present their views.

Sincerely,

Jeremy C. Kress

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[19] *See id.* at 178. ("The Federal Reserve has never exercised its divestiture authority under section 4(m), despite many opportunities.").

[20] Proposed Rule at 31,649.

[21] *See, e.g.*, W Scott Frame, Ping McLemore & Atanas Mihov, *Haste Makes Waste: Banking Organization Growth and Operational Risk*, REV. CORP. FIN. STUD. (2025) ("This study shows that higher banking organization growth is associated with higher operational losses per dollar of total assets and incidence of tail operational losses. Event studies using merger and acquisition activity … provide consistent evidence."); Markus M. Schmid & Ingo Walter, *Do Financial Conglomerates Create or Destroy Economic Value?*, 18 J. FIN. INTERMEDIATION 193, 214-15 (2009) (finding evidence of diseconomies of scope among diversified financial institutions).

[22] Improving Regulation and Regulatory Review, Exec. Order No. 13,563, 76 Fed. Reg. 3821, 3822 (Jan. 18, 2011).