INDEPENDENT COMMUNITY BANKERS OF AMERICA, AMY LEDIG

Proposal and Comment Information

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

Comment ID: FR-2025-0042-01-C13

Submitter Information

Organization Name: Independent Community Bankers of America

Organization Type: Organization

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Submitted Date: 08/14/2025

August 14, 2025

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,

The Independent Community Bankers of America (ICBA)[1] appreciates the opportunity to comment on the proposal recently adopted by the Board of Governors of the Federal Reserve (the Board), *Revisions to the Large Financial Institution Rating System and Framework for the Supervision of Insurance Organizations*.

ICBA strongly opposes the proposal and raises the following concerns, discussed further below:

1. The Board invites safety and soundness issues by allowing large firms with a Deficient-1 rating to be considered "well managed" and by removing the presumption that a Deficient-1 rating would result in an enforcement action.
2. Lowering the bar for large banks to be considered "well managed" will accelerate consolidation and exacerbate the problem of too big to fail institutions.
3. The Board must not deemphasize the governance and controls component for growth obsessed large firms, many of which have previously demonstrated weaknesses in these areas.

A finding by the Board that too many large firms are failing to satisfy the criteria to be considered "well managed" should result in an enhanced supervisory and enforcement regime for these firms, rather than the Board lowering its standards to allow too big to fail firms with significant deficiencies to grow with less oversight.

[1] The Independent Community Bankers of America® has one mission: to create and promote an environment where community banks flourish. We power the potential of the nation's community banks through effective advocacy, education, and innovation. As local and trusted sources of credit, America's community banks leverage their relationship-based business model and innovative offerings to channel deposits into the neighborhoods they serve, creating jobs, fostering economic prosperity, and fueling their customers' financial goals and dreams. For more information, visit ICBA's website at icba.org.

Discussion

1. **The Board invites safety and soundness issues by allowing large firms with a Deficient-1 rating to be considered "well managed" and by removing the presumption that a Deficient-1 rating would result in an enforcement action.**

Granting "well managed" status to firms with a Deficient-1 in any component sends a troubling signal that serious deficiencies in capital planning, liquidity planning, and governance and controls at large firms are not a significant issue that must be resolved. Additionally, eliminating the presumption that the Board will bring a formal or informal enforcement action against a large firm with one or more Deficient-1 ratings disincentivizes firms from promptly remediating issues serious enough to warrant a Deficient-1 rating, eroding the deterrent value of supervision. The solution to large firms failing to satisfy the criteria to be "well managed" is for these firms to remedy weaknesses identified by Board supervision staff, not for the Board to lower its standards.

The cost and benefit analysis in the preamble states that one of the main benefits would be reduction in compliance costs and other impediments to growth, and that allowing more firms to be considered "well managed" would "bolster the overall growth of large banking organizations and thus foster economic opportunity."[2] Not only is this purported benefit entirely speculative and unsupported by data in the preamble, it is contrary to research.

Large bank expansion involves incursion of risk even in the best managed firms, with researchers finding a positive and statistically significant association between the growth of a banking organization and increase in operational risk.[3] Firms where assets grow fastest incur higher operational losses, high growth banking organizations are associated with a higher incidence of severe risk events, and firms with higher asset growth pre-global financial crisis had higher operational losses during the crisis.[4] While higher operational losses are associated with both organic growth and M&A, M&A is a significant source of operational risk.[5] Research published by the Federal Reserve Bank of Dallas found that:

> [B]anking organization growth is a relevant dimension for U.S. BHCs' risk outcomes and should be considered when assessing their operational risk profiles. Specifically, increased supervisory attention to faster growing institutions might be warranted. Separately, our findings also highlight the increase of operational risks around significant organizational changes, such as merger and acquisition activity, and suggest banking

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[2] Proposal at 31649.
[3] W. Scott Frame, Ping McLemore & Atanas Mihov, Federal Reserve Bank of Dallas, Haste Makes Waste: Banking Organization Growth and Operational Risk at 2 (Aug. 2020), https://www.dallasfed.org/-/media/documents/research/papers/2020/wp2023.pdf.
[4] *Id.* at 28.
[5] *Id*. at 27-28.

> organizations might benefit from tightening internal processes and controls around these events.[6]

Both research and history confirm that expansion of the largest firms are not free of risk and firms seeking to expand must be properly supervised. However, this proposal would result in more firms with supervisory deficiencies being considered "well managed" and therefore more easily able to grow through M&A or expand their range of activities, without commensurate supervisory restriction and/or oversight. The proposal would violate the supervisory principle that deficiencies in core safety-and-soundness areas should be addressed before a firm may expand and take on new risks, and therefore should not be adopted.

2. **Lowering the bar for large banks to be considered "well managed" will accelerate consolidation and exacerbate the problem of too big to fail institutions.**

The proposal would allow a firm to be considered "well managed" with no more than one Deficient-1 component rating if the other two components are rated "Broadly Meets Expectations" or "Conditionally Meets Expectations." Per analysis in the preamble, this could decrease the number of large firms that are not "well managed" by between three and eight, meaning that 8 to 22 percent of large firms could be the beneficiaries of the lowered standards put forth in this proposal. The changes would make it easier for large firms to elect Financial Holding Company status, unlocking new activities and permitting further expansion.

Functionally, the proposal materially lowers supervisory thresholds, encouraging expansion and mergers involving large firms that are not well managed. This will intensify consolidation in the financial sector, further concentrating market power and eroding competition.

While the preamble paints growth of the largest firms as a positive outcome in and of itself, it fails to adequately acknowledge the inherent risk these institutions pose to the financial system, and in turn, the risks the proposal could pose to the economy. Large and connected financial institutions pose substantial risks to the broad financial system, with losses at the US GSIBs predictive of worse losses for financial firms as a whole.[7] These risks exist even when firms remain solvent:

> Even absent outright failure and bankruptcy, perceived weakness of a large and connected financial firm can result in decrease valuation of other firms – due to perceived linkages – and overall decrease in market liquidity. Therefore, identifying the firms that pose the largest systemic risks is critical to appropriately developing regulatory and supervisory strategies that minimize financial instability.[8]

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[6] *Id*. at 5.
[7] Andrew Hawley & Marco Migueis, FRB, FEDS Notes: Measuring the systemic importance of large US banks (Sept. 2021), https://www.federalreserve.gov/econres/notes/feds-notes/measuring-the-systemic-importance-of-large-us-banks-20210930.html.
[8] *Id*.

Rather than being subjected to appropriate safeguards, too big to fail firms receive significant subsidies and benefits as a result of their size and clout.[9] The Board's proposal provide large firms with additional regulatory forbearance despite the fact that that stress at large banks negatively impacts the real economy, a result that increases relative to a bank's size.[10] Permitting too big to fail banks to more easily expand despite the increased risks runs contrary to the historical data about the performance of these institutions:

> One may ask whether "survival of the biggest" is due to more prudent behavior of the large banks in the run-up to crises. Our second finding is that the opposite is true. Large banks typically take more, not less, risk than smaller banks in the run-up to crises, and large banks suffer bigger equity losses and contract their lending more in the aftermath of crises. Specifically, large banks take increased risk (relative to smaller banks) along a number of dimensions in the run-up to crises: a) increase their loans growth at a faster rate, b) decrease their capital ratios more, c) increase the ratio of wholesale funding to total assets more, and d) decrease the ratio of "safe assets" to total assets more. Large banks also disproportionately contribute in the aggregate to the credit booms preceding banking crises—especially after 1945, where the top-5 banks account on average for about 75% of credit growth during the run-up to banking crises and nearly all of the credit contraction after crises. Greater ex-ante risk-taking by large banks is also reflected in higher average ex-post equity losses during crises. … Interestingly, large banks' risk-taking measures and subsequent losses are magnified when large banks' size relative to the financial system is higher to begin with. *In short, large banks tend to be more pro-cyclical, engage in more risk-taking, and have greater equity losses relative to smaller banks.*[11]

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[9] Elijah Brewer III & Julapa Jagtiani, How Much Did Banks Pay to Become Too-Big-To-Fail and to Become Systemically Important? Working Paper No. 11-37 at 3-4 (2011), https://www.philadelphiafed.org/-/media/frbp/assets/working-papers/2011/wp11-37.pdf ("The benefits of TBTF may be captured in numerous ways, such as gaining favor with uninsured bank creditors and other market participants, operating with lower regulatory costs, and increasing the chances of receiving regulatory forbearance. Access to the federal government's safety net allows TBTF institutions to operate with less capital and a lower funding cost relative to other institutions. To the extent that the public believes that the government would protect the TBTF banking organizations, their uninsured creditors do not charge as high a price for the use of their funds as they would in the absence of this perception.")

[10] Amy G. Lorenc & Jeffery Y. Zhang, Board of Governors of the Federal Reserve System, The Differential Impact of Bank Size on Systemic Risk, Finance and Economics Discussion Series 2018-066 at 2 (2018), https://doi.org/10.17016/FEDS.2018.066 ("[O]ur empirical results show that financial stress at large banks has a statistically significant and negative impact on the real economy. This impact increases with bank size. For instance, scaling our empirical results to the size distribution of banks in the fourth quarter of 2017, we find that the negative impact on real quarterly GDP growth caused by stress at banks with greater than $250 billion in total assets is more than twice as large as the impact caused by stress at banks with greater than $50 billion in total assets, and more than three times as large as the impact caused by stress at banks with greater than $30 billion in total assets. These results are qualitatively similar when analyzing the impact on the unemployment rate.")

[11] Matthew Baron, Moritz Schularick & Kaspar Zimmermann, Survival of the Biggest: Large Banks and Financial Crises at 2 (Sept. 2023), https://www.fdic.gov/analysis/cfr/bank-research-conference/annual-22nd/papers/baron-paper.pdf (emphasis added).

In addition to the high level systemic risks that may result from facilitating the expansion of too big to fail firms, there are downstream impacts in the banking sector that the Board failed to adequately consider. Community banks already compete at a disadvantage to large institutions that benefit from scale, diversified revenue, and implicit "too-big-to-fail" benefits. Despite this unequal playing field, community banks play a critical role in the banking system and take an outsized role in the provision of credit, particularly with regard to small business and agricultural lending.[12] Yet, the Board failed to offer meaningful analysis of the competitive effects of the proposal and did not provide any analysis of the effects on small-business and agricultural lending, sectors where community banks play a critical and often irreplaceable role. This is a significant oversight and is an example of the cursory nature of the "analysis" in the preamble that fails to adequately support the substance of the proposal. Such arbitrary and capricious decision making is contrary to the requirements of the Administrative Procedure Act.[13]

There is also the matter of fairness and unintended consequences. The proposal would establish two different sets of rules, with standards for large firms far more lenient than those for community banks. **This undermines supervisory consistency and if anything, it suggests that a firm can outrun safety and soundness requirements through growth. This is a dangerous signal to send in a sector that has already undergone tremendous consolidation and is dominated by too big to fail institutions.**

3. **The Board must not deemphasize the governance and controls component for growth obsessed large firms, many of which have previously demonstrated weaknesses in these areas.**

The preamble downplays the importance of the governance and controls component, even posing a question as to whether a firm should be considered "well managed" despite a rating of Deficient-2 in this component. Recent experience shows the risks of taking this path, given the collapse of several large banks only two years ago, and the resulting $22.3 billion of losses to the Deposit Insurance Fund.[14]

The Federal Reserve Board's post-failure report on Silicon Valley Bank concluded that the failure "can be tied directly to the failure of the board of directors and senior management," who "failed to effectively oversee the risks" in the bank's strategy and "did not take sufficient steps in a timely fashion to build a governance and risk-management framework that kept up with its rapid growth

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[12] *See, e.g.*, Kansas City Federal Reserve Bank, Community Banking Bulletin - The Critical Role of Community Banks (Aug. 2024), https://www.kansascityfed.org/banking/community-banking-bulletins/the-critical-role-of-community-banks/; Matt Hanauer, Brent Lytle, Chris Summers & Stephanie Ziadeh, Kansas City Federal Reserve Bank, Community Banks' Ongoing Role in the U.S. Economy, 48 (2021) https://www.kansascityfed.org/Economic%20Review/documents/8159/EconomicReviewV106N2HanauerLytleSummersZiadeh.pdf.

[13] 5 U.S.C. 706(2)(A).

[14] FDIC, Special Assessment Pursuant to Systemic Risk Determination, https://www.fdic.gov/deposit-insurance-assessments/special-assessment-pursuant-systemic-risk-determination.

and business model risks."[15] This is a clear, recent link between governance and control failures and the collapse of a major firm.

Additionally, the FDIC's review of Signature Bank's determined that the root cause of the Bank's failure was poor management.[16] Per the agency's report,

> SBNY's board of directors and management pursued rapid, unrestrained growth without developing and maintaining adequate risk management practices and controls appropriate for the size, complexity and risk profile of the institution. SBNY management did not prioritize good corporate governance practices, did not always heed FDIC examiner concerns, and was not always responsive or timely in addressing FDIC supervisory recommendations... SBNY's poor governance and inadequate risk management practices put the bank in a position where it could not effectively manage its liquidity in a time of stress, making it unable to meet very large withdrawal requests.[17]

Governance and control failures not only directly undermined firm performance but also impacted financial stability, as the risk of contagion from these failures was so significant that regulators exercised the systemic risk exception.[18]

Beyond the 2023 failures, large firms have a spotty history of compliance with regulatory requirements related to governance and controls. Consider the following, which account for just a few of the enforcement actions brought by the Board against large firms in recent years:

- A fine of $100 million assessed against Discover Financial Services for overcharging certain interchange fees from 2007 through 2023,[19]
- A fine of $123.5 million against Toronto-Dominion Bank for failure "to conduct adequate risk management and oversight of its retail banking operations in the United States, resulting in a U.S. subsidiary being used to launder hundreds of millions of dollars in illicit proceeds,"[20]

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[15] Board of Governors of the Federal Reserve Board, Review of the Federal Reserve's Supervision and Regulation of Silicon Valley Bank at 2 (April 2023), https://www.fdic.gov/deposit-insurance-assessments/special-assessment-pursuant-systemic-risk-determination.
[16] FDIC, FDIC's Supervision of Signature Bank at 2 (April 2023), https://www.fdic.gov/news/press-releases/2023/pr23033a.pdf.
[17] *Id.* at 2-3
[18] *See, e.g.,* FDIC, Systemic Risk Exception Recommendation (March 12, 2023), https://www.fdic.gov/foia/systemic-risk-exception-recommendation-memorandum.pdf.
[19] FRB, Press Release: Federal Reserve Board announces approval of application by Capital One Financial Corporation to merge with Discover Financial Services and issues a consent order with Discover (April 18, 2025), https://www.federalreserve.gov/newsevents/pressreleases/orders20250418a.htm.
[20] FRB, Press Release: Federal Reserve Board fines Toronto-Dominion Bank $123.5 million for violations related to anti-money laundering laws (Oct. 10, 2024), https://www.federalreserve.gov/newsevents/pressreleases/enforcement20241010a.htm.

- An enforcement action against JPMorgan Chase & Co. and a fine of "approximately $98.2 million for an inadequate program to monitor firm and client trading activities for market misconduct,"[21]
- A $60.6 million fine assessed against Citigroup for violating the Board's 2020 enforcement action and having made "insufficient progress remediating its problems with data quality management and failed to implement compensating controls to manage its ongoing risk,"[22]
- A fine of $67.8 million assessed against Wells Fargo & Co. "for the firm's unsafe or unsound practices relating to historical inadequate oversight of sanctions compliance risks at its subsidiary bank, Wells Fargo Bank,"[23] and
- A $154 million fine against the Goldman Sachs Group, Inc "for the firm's failure to maintain appropriate oversight, internal controls, and risk management with respect to Goldman's involvement in a far-reaching scheme to defraud a Malaysian state-owned investment and development company, 1Malaysia Development Berhad (1MDB)."[24]

This pattern of significant risk management and compliance failures suggests that the largest firms should be subject to stricter, not more lenient, supervision. Clearly governance and controls at large firms remain extremely relevant to their performance and to the financial system as a whole, and lessening the weight given to this component as proposed could make it easier for other firms to repeat the costly mistakes that contributed to the collapse of Silicon Valley bank and Signature Bank.

<u>Additional discussion of other rating systems</u>

The Board asked what other changes to supervisory rating systems should be considered. While community bankers generally value the CAMELS system, they want the supervisory staff implementing it to be more objective, consistent, and accountable.

Community bankers have encountered issues with CAMELS ratings being too subjective and inconsistently applied from one examination cycle to the next, or across agencies, despite the

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[21] FRB, Press Release: Federal Reserve Board issues enforcement action against JPMorgan Chase & Co. and fines the firm approximately $98.2 million for an inadequate program to monitor firm and client trading activities for market misconduct (March 14, 2024), https://www.federalreserve.gov/newsevents/pressreleases/enforcement20240314a.htm.

[22] FRB, Press Release: Federal Reserve Board fines Citigroup $60.6 million for violating the Board's 2020 enforcement action (July 10, 2024), https://www.federalreserve.gov/newsevents/pressreleases/enforcement20240710a.htm.

[23] FRB, Press Release: Federal Reserve Board fines Wells Fargo $67.8 million for inadequate oversight of sanctions risk at its subsidiary bank (March 30, 2023), https://www.federalreserve.gov/newsevents/pressreleases/enforcement20230330a.htm.

[24] FRB, Press Release: Federal Reserve Board fines the Goldman Sachs Group, Inc. $154 million for failure to maintain appropriate oversight, internal controls, and risk management with respect to 1Malaysia Development Berhad (1MDB) (Oct. 22, 2020), https://www.federalreserve.gov/newsevents/pressreleases/enforcement20201022a.htm.

expectation of uniformity across the system. Reinforcing expectations regarding appropriate application of rating criteria among staff across the banking agencies would greatly improve the community bank supervision experience.

Additionally, ICBA appreciates the steps the FDIC is taking to enhance the fairness of its appeals process,[25] and encourages the Board to consider improvements that can be made to its own process. Given that the Board's appeal process includes initial review by current Reserve Bank employees,[26] the Board should consider how to increase independence of the reviewing body and ensure that community banks are able to seek redress without concern for retaliation.

Conclusion

ICBA appreciates the opportunity to comment on the proposal and urges the Board not to finalize the proposed changes to the large financial institution rating system. The Board should seek to appropriately supervise and manage the risks posed by the largest firms, not to lower its standards and permit the largest firms to expand while failing to adequately address safety and soundness risks. As we have seen throughout history and, in particular with recent failures, risks at the largest firms spill over to the broader financial system, and community banks and their customers should not be left to pay the price for lax supervision of too big to fail firms.

Should you wish to discuss our positions in further detail, please contact the undersigned at amy.ledig@icba.org.

Sincerely,

/s/

Amy Ledig
Vice President, Capital, Accounting, and Finance Policy
Independent Community Bankers of America

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[25] FDIC, Notice: Guidelines for Appeals of Material Supervisory Determinations, 90 FR 33942 (July 18, 2025), https://www.fdic.gov/board/guidelines-appeals-material-supervisory-determinations.pdf.
[26] FRB, SR 20-28 / CA 20-14: Internal Appeals Process for Material Supervisory Determinations and Policy Statement Regarding the Ombudsman for the Federal Reserve System (Dec. 2020), https://www.federalreserve.gov/supervisionreg/srletters/SR2028a1.pdf.