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The Case for Strong, Effective Banking Supervision

Remarks by

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I am pleased to be here today to discuss a core part of the Federal Reserve’s mission: banking supervision.¹ Much of what the Fed does to conduct monetary policy, promote a stable financial system, provide a safe and efficient payments system, and support consumers and community development depends on a healthy banking system. Lending fuels entrepreneurship, helps families buy homes, and enables communities to thrive—all critical aspects of a healthy economy. Ensuring banks operate in a safe and sound manner is essential because the banking system sits at the center of the economy. That is why banks’ risk-taking must always be guided by clear guardrails, underpinned by effective banking supervision.

We need these guardrails because experience shows that market discipline alone does not prevent excessive risk-taking by banks.² As I’ve noted before, time and again, periods of relative financial calm have led to efforts to weaken regulation and supervision.³ This has often had dire consequences, as we saw prominently during the Global Financial Crisis.

In the midst of that crisis, I saw first-hand in my own community in Michigan what weak regulation and supervision could mean: foreclosed homes, shuttered businesses, and lost jobs. According to the Federal Reserve Bank of Chicago, Michigan’s unemployment rate was 14.9 percent in 2009, meaning one in seven workers

¹ The views expressed here are my own and are not necessarily those of my colleagues on the Federal Reserve Board or the Federal Open Market Committee.

² For example, in 2008 Alan Greenspan testified before Congress that he had “found a flaw” in his ideology of trusting markets to self-correct. Alan Greenspan, “The Financial Crisis and the Role of Federal Regulations: Hearing before the Committee on Oversight and Government Reform,” testimony delivered to the 110th Congress 55-764, Washington, DC, October 23, 2008, <https://www.govinfo.gov/content/pkg/CHRG-110hhrg55764/html/CHRG-110hhrg55764.htm>.

³ Michael S. Barr, “Booms and Busts and the Regulatory Cycle” speech delivered at The Brookings Institution, Washington, DC, July 16, 2025, <https://www.federalreserve.gov/newsevents/speech/barr20250716a.htm>.

were out of jobs.⁴ Nationwide, the consequences were immense: nearly 9 million jobs lost, 8 million homes foreclosed upon, and a \$17 trillion loss in household wealth.⁵

We are now, I believe, at a moment of inflection in the regulatory and supervisory approaches that help keep banks healthy. There are growing pressures to weaken supervision—to scale back examiner coverage, to dilute ratings systems, and to redefine “unsafe and unsound”—in ways that will make it harder for examiners to act before it is too late to prevent a build-up of excessive risk. These pressures present real dangers to the American people.

The Mission of Banking Supervision

Let me begin with the mission of bank supervision, which is to promote a safe, sound, and efficient banking system that supports a strong economy.⁶ Our banking system relies on trust. That trust is earned when banks behave responsibly and when supervisors effectively perform their statutory duties. These duties include verifying that banks are operating soundly and identifying and addressing weaknesses before they threaten the solvency of particular banks and possibly spread through the financial system. Supervision also ensures compliance with laws and regulations that safeguard the integrity of the banking system. This reduces the risk of misconduct or malfeasance, including real-world consequences of fraud, consumer abuse, cyberattacks, money

⁴ Martin Lavelle, “How Tight Is Michigan’s Labor Market?” *Federal Reserve Bank of Chicago* (Michigan Economy Blog), October 11, 2016, <https://www.chicagofed.org/publications/blogs/michigan-economy/2016/how-tight-is-michigans-labor-market#:~:text=Michigan's%20labor%20market%20continues%20to,shorter%20and%20milder%20001%20recession.>

⁵ Christopher J. Goodman and Steven M. Mance, “Employment Loss and the 2007–09 Recession: An Overview,” *Monthly Labor Review* (2011), <https://www.bls.gov/opub/mlr/2011/04/art1full.pdf>. See also <https://www.stlouisfed.org/publications/regional-economist/july-2012/household-financial-stability--who-suffered-the-most-from-the-crisis> and <https://www.newyorkfed.org/newsevents/speeches/2017/dud171106>.

⁶ See “About the Fed,” <https://www.federalreserve.gov/aboutthefed.htm>.

laundering, and terrorist financing. Trust in the banking system relies on strong supervision.

Benefits of Supervision

Supervision delivers clear benefits not only for individual banks but also for the stability of the financial system as a whole. Enforcement actions are associated with lower systemic risk, and research shows that banks subject to more oversight are safer and just as profitable as their peers.⁷ While supervision does impose costs, it is most effective when calibrated to the risks each institution poses. More closely supervised banks tend to experience steadier income and fewer loan losses, making them more resilient during times of stress, when contagion risks are greatest.⁸

Supervision is critical to the Federal Reserve’s mission to promote the stability of the financial system and contain systemic risk. A macroprudential perspective—where we look across the entire banking system for correlated risks—complements traditional microprudential oversight where we examine individual banks. This is done by focusing on risks that threaten financial stability and the banking system’s core functions: credit, payments, and intermediation. Our economy depends on a strong and stable financial system, which makes banking supervision essential for every household and business.

The Foundations of Effective Supervision

Effective supervision begins with appropriate regulation as a foundation. Regulation provides the rules of the road that establish minimum capital levels, liquidity requirements, and define permissible activities. But regulation alone is not enough.

⁷ Beverly Hirtle, Anna Kovner, and Matt Plosser, “The Impact of Supervision on Bank Performance,” *Journal of Finance* 75, no. 5 (2020): 2,765–2,808, <https://doi.org/10.1111/jofi.12964>.

⁸Hirtle, Kovner, and Plosser, “The Impact of Supervision on Bank Performance,” 2798-99.

Supervision is necessary to ensure banks stay on the road and comply with the rules, especially as conditions shift and new risks emerge.

Effective supervision depends on its human capital. The knowledge necessary to be an effective examiner comes from both formal training and through an accumulation of on-the-ground practical exposure. Supervisory staff carry responsibility for risk identification and analysis and execution of examinations to assess whether a firm truly understands its risks, whether its governance and controls are effective, and whether its capital and liquidity are sufficient for its business model. Institutional knowledge and experience-based judgment are critical for supervisors' ability to manage these responsibilities. They take time to develop and cannot be easily replicated.

Effective supervision also requires moving with speed, force, and agility appropriate to the risks posed. This requires institutional commitment to act swiftly as risks emerge, using supervisory tools decisively, and adapting to shifts in markets or the economy.⁹

Effective Supervision Under Pressure

Beyond these foundations, effective supervision is based on numerous other factors. Today I will outline key components of strong, effective supervision that are at risk of being seriously weakened in the current environment.

A credible ratings framework. First, effective supervision requires a credible rating system.¹⁰ A credible rating system incentivizes firms to promptly remediate

⁹ Michael S. Barr, "Supervision with Speed, Force, and Agility," speech delivered at the Annual Columbia Law School Banking Conference, New York, NY, February 16, 2024, <https://www.federalreserve.gov/newsevents/speech/barr20240216a.htm>.

¹⁰ Banks receive ratings that quantify their safety and soundness based on supervisory exams. Ratings evaluate banks' performance on key risks, including their capital and liquidity positions and management quality.

weaknesses by translating supervisory assessments into objective outcomes that matter for management and boards of directors. It ensures consistency across institutions, supports transparency in how risks are evaluated, and anchors supervisory discipline.

Crucially, a credible rating system looks beyond immediate financial metrics to the quality of a firm's governance, internal controls, and risk management practices.¹¹ Weak management rarely shows up first as a capital or liquidity problem. Rather, it becomes evident through inconsistent processes, inadequate escalation of supervisory concerns, unclear lines of accountability, and organizational blind spots that, over time, allow risks to accumulate. These weaknesses can prevent management from seeing and effectively acting on emerging risks. A ratings system that captures only past actions that have resulted in observable financial harm is inherently backward-looking. It will miss the risks of what may come.

Unfortunately, the framework for supervisory ratings is currently being modified in ways that diminish its strength and credibility. For example, earlier this month, the Federal Reserve Board issued its final rule making changes to the Large Financial Institution (LFI) rating system.¹² Poor performance is being deemphasized, which is tantamount to grade inflation, a problem this academic audience understands. As I noted in my dissent, I believe these changes reduce incentives for large banks to fix serious

¹¹ See, for example, key findings that the Management component of CAMELS ratings has significant predictive power for future bank risk/performance. Lewis Gaul and Jonathan Jones, "CAMELS Ratings and Their Information Content," OCC Working Paper WP-2021-01 (Office of the Comptroller of the Currency, January 2021), <https://www.occ.treas.gov/publications-and-resources/publications/economics/working-papers-banking-perf-reg/economic-working-camels-ratings.html>.

¹² Board of Governors of the Federal Reserve System, "Federal Reserve Board Finalizes Changes to Its Supervisory Rating Framework for Large Bank Holding Companies," press release, November 5, 2025, <https://www.federalreserve.gov/newsevents/pressreleases/bcreg20251105a.htm>.

management problems.¹³ They will also allow firms with significant governance weaknesses to expand or acquire other enterprises, raising the chance and cost of future failure. Changes to the LFI rating system also reduce supervisory attention on compliance matters for the largest banks. As such, bank holding companies could have, for example, seriously deficient consumer compliance programs but still be considered well managed. Further, the revisions remove the presumption that large firms with significant deficiencies must face an enforcement action—a move that could significantly weaken accountability for poor practices. And in taking this action, the Board ignored a more moderate reform option that would have established a composite rating for large bank holding companies.

In addition, I understand that efforts are currently underway to modify the CAMELS rating system, the interagency framework used by supervisors to assess banks' overall condition.¹⁴ Some have proposed changes that would effectively diminish the weight assigned to the management component. I believe that such a move would be misguided and shortsighted. The “Management” rating is not simply one item among six; it is the element that ties the others together. It measures the quality of governance, risk identification, internal controls, and the institution's ability to respond to emerging threats.¹⁵ Strong management can compensate for unexpected stress, whereas weak

¹³ “Statement on Large Financial Institution Rating Framework by Governor Michael S. Barr,” press release, November 5, 2025, <https://www.federalreserve.gov/newsevents/pressreleases/barr-statement-20251105.htm>.

¹⁴ CAMELS evaluates six components: Capital Adequacy, Asset Quality, Management, Earnings, Liquidity, and Sensitivity to Market Risk. Each component is rated on a scale from 1 to 5, and together they form the institution's composite rating, which supervisors rely on to evaluate safety and soundness. See Board of Governors of the Federal Reserve System, “Uniform Financial Institutions Rating System,” SR letter 96-38 (December 27, 1996), <https://www.federalreserve.gov/boarddocs/srletters/1996/sr9638.htm>.

¹⁵ See Gaul and Jones, “CAMELS Ratings and Their Information Content” (finding that Management rating is most strongly correlated with compositing of all CAMELS components and has significant predictive power for future bank performance and risk measures).

management can magnify even modest vulnerabilities. Deemphasizing the rating system's focus on management could lead to significant increases in risk, even in institutions that look good on paper.

Furthermore, in October, the Federal Deposit Insurance Corporation (FDIC) and the Office of the Comptroller of the Currency (OCC) proposed a rule that would limit the issuance of enforcement actions for “unsafe or unsound practices.”¹⁶ This would have the effect of making it harder for supervisors to issue an enforcement action and compel a bank to fix its flaws. This effectively ties examiners hands. The proposed rule would also limit the issuance of matters requiring attention, or MRAs, which are supervisory findings used to prompt a bank to act quickly to fix problems before they become enforcement actions. The new standards for issuing enforcement actions and MRAs would center on a narrow definition of “material financial risk” and exclude material nonfinancial risks except in limited circumstances, such as violations of law.

To put this into context, under the standard established by this proposed rule, a bank with woefully deficient controls to prevent money laundering or discrimination would not necessarily receive an MRA requiring the bank to correct the situation unless the bank had actually violated the law or supervisors were able to identify a material financial harm that had already occurred due to the lapse in controls or that could be shown to likely cause such harm. Waiting to act until the bank, its customers, or potentially the financial system have been harmed is not a responsible approach to risk

¹⁶ Unsafe and unsound practices would be defined under Section 8 of the FDIA as any act, practice, or failure to act that deviates from generally accepted standards of prudent banking and either causes material harm to an institution's financial condition or, if continued, would be likely to do so or pose a material risk to the Deposit Insurance Fund. See <https://www.federalregister.gov/documents/2025/10/30/2025-19711/unsafe-or-unsound-practices-matters-requiring-attention>.

management or supervision. Bottom line—under this proposal, examiners will issue fewer MRAs, even where financial and operational risks have been identified. This will also lead the agencies to issue fewer enforcement actions. I fear that the Fed may head down a similar, or even worse, path, further tying supervisors' hands.

Furthermore, I am concerned about an initiative that will allow the banks themselves to decide whether a supervisory finding or requirement imposed by an enforcement action should be lifted. Under this approach, if a bank had a satisfactorily-rated internal audit function, that internal audit function would have the ability to decide if the bank had appropriately remediated a deficiency identified in the supervisory finding or enforcement action. A bank's internal audit function would essentially displace validation by Federal Reserve examiners. Examiners would not independently determine whether the terms of the supervisory findings or enforcement action provisions had been met, or whether the bank's changes were sustainable. A parallel approach was tried at the Federal Housing Finance Agency (FHFA), where the internal audit function of Fannie Mae and Freddie Mac was permitted to "validate" remediation of MRAs, and FHFA's supervisory division sometimes accepted that validation in closure determinations without independent validation. In 2018, the FHFA's inspector general found this problematic, and warned that allowing such discretion "without a predicate supervisory conclusion ... creates the risk that ... assessments ... will be impaired."¹⁷

¹⁷ Federal Housing Finance Agency: Office of Inspector General, *FHFA Requires the Enterprises' Internal Audit Functions to Validate Remediation of Serious Deficiencies but Provides No Guidance and Imposes No Preconditions on Examiners' Use of That Validation Work* (FHFA: OIG, March 2018), https://www.fhfaoig.gov/Content/Files/EVL-2018-002_Redacted.pdf.

This is a bad idea for bank prudential supervision, and to be clear, will not be implemented in the consumer compliance function.

Forward-looking supervision. A second component of effective supervision is that it must be forward-looking.¹⁸ The purpose of supervision is to prevent risks from becoming problems that harm banks and the public. By anticipating vulnerabilities and prompting early action, supervisors use tools such as stress testing and scenario analysis to prevent problems from escalating. In contrast, backward-looking supervision often detects weaknesses only after they become serious problems. Forward-looking approaches, grounded in judgment and horizontal comparisons, are more effective in promoting the safety and soundness of individual banks and safeguarding financial stability. In short, supervision needs to see and point out how weak risk management can lead a bank to be vulnerable to unanticipated shocks.

Stress tests illustrate this principle clearly: they are supposed to provide a rigorous way to assess resilience under severe but plausible conditions that may occur in the future. Supervisory stress tests are structured exercises conducted by supervisors to evaluate how a bank's capital and earnings would perform under adverse macroeconomic scenarios—such as a sharp rise in unemployment, a collapse in asset prices, or a severe market disruption. They are designed to test the soundness of a bank's balance sheet and to ensure that it could continue to operate and support the economy even in times of stress. These tests help to uncover vulnerabilities at individual banks and across the financial system.

¹⁸ Tobias Adrian, Marina Moretti, Ana Carvalho, Hee Kyong Chon, Fabiana Melo, Katharine Seal, & Jay Surti, "Good Supervision: Lessons from the Field," IMF Working Paper WP/No. 23/181 (International Monetary Fund, September 2023): 18–20, <https://doi.org/10.5089/9798400253782.001>.

In October, the Federal Reserve proposed several changes to our heretofore-successful stress testing program.¹⁹ I noted then that the proposed changes risk turning the stress test into a rigid exercise that offers false confidence by producing overly optimistic results driven by less conservative modeling and opportunities for banks to game the process.²⁰ The proposed changes would weaken capital requirements and erode incentives for strong independent risk management. Weaker stress tests mean worse supervision.

Another valuable forward-looking tool that has been criticized lately is the use of horizontal reviews, supervisory examinations focused on a specific topic across multiple banks simultaneously. This technique allows supervisors to spot emerging risks, helping supervisory frameworks remain proactive rather than reactive. Because financial risks develop and change at a faster pace than regulation, horizontal reviews are valuable to compare practices and outcomes across banks, identifying patterns of systemic or inter-firm amplification that might otherwise go undetected.²¹ Just as importantly, horizontal reviews promote consistency and fairness in supervisory judgments. They are not meant to impose rigid benchmarks or uniform expectations, but rather to shed light on emerging vulnerabilities, highlight sound practices, and ensure that judgments are grounded in comparable evidence. Severely limiting their use would constrain supervisory insight and weaken the ability of supervisors to address emerging problems.

¹⁹ See <https://www.federalreserve.gov/aboutthefed/boardmeetings/enhanced-transparency-and-public-accountability-proposal-fm.pdf>.

²⁰ “Statement on Proposals to Enhance the Transparency and Public Accountability Of the Board’s Stress Testing Framework By Governor Michael S. Barr,” press release, October 24, 2025, <https://www.federalreserve.gov/newsevents/pressreleases/barr-statement-20251024.htm>.

²¹ “Horizontal reviews and benchmarking provide a cross-sectoral perspective of risks, enable a deeper review of certain topics and promote consistency in the exercise of expert judgment...Horizontal reviews that focus on a specific issue across banks are increasingly used for a proactive, forward-looking supervisory approach.” See <https://www.bis.org/bcbs/publ/wp45.pdf> at 2.

A strong supervisory staff. Finally, effective supervision requires skilled supervisory staff. The strength of a supervisory system depends not only on its policies and tools, but also on the expertise, capacity, and judgment of the people who implement them. Adequate staffing—measured both by headcount and experience—ensures that supervisors can conduct thorough examinations, identify emerging risks early, and respond swiftly to signs of instability. It also supports the institutional memory and continuity needed to assess complex financial institutions over time. Having sufficient and experienced staff is crucial.

Staff at both the Federal Reserve Board and the Reserve Banks play distinct but complementary roles in safeguarding the banking system. Board staff in Washington, D.C., focus on risk identification, oversight, consistent policy, horizontal reviews, and coordination across the entire banking system. Most Board supervisory staff who focus on day-to-day supervision of banks work on banks with assets exceeding \$10 billion rather than community banks. Reserve Bank examiners conduct most day-to-day supervision of individual banks and holding companies. Together, these efforts form an integrated supervisory framework.²²

Recently announced plans to reduce staffing in the Board’s Supervision and Regulation division by 30 percent by the end of 2026 will impair supervisors’ ability to act with the speed, force, and agility appropriate to the risks facing individual banks and the financial system. Such a drastically reduced staff will slow response time for the public and the banks themselves, limit supervisory findings and enforcement actions, and

²² “Understanding Federal Reserve Supervision,” Board of Governors of the Federal Reserve System, last modified April 27, 2023, <https://www.federalreserve.gov/supervisionreg/understanding-federal-reserve-supervision.htm>.

erode supervisors' ability to be forward-looking. Losing experienced supervisory staff with institutional knowledge also means the system will have diminished capacity to manage crises when they arise. Among other things, the financial crisis showed that the Fed's bank supervision had failed to keep up with the growth in the size and complexity of the banking system, and it took nearly a decade afterward to build up this capacity. Now it is being gutted, practically overnight.

The impact of these staffing cuts is compounded by reductions at other supervisory agencies. Deep reductions in force are also underway at the FDIC, the OCC, and the Consumer Financial Protection Bureau (CFPB), with the CFPB recently announcing that it would not seek any funding for the foreseeable future.²³ It is difficult to argue, as some have, that the Federal Reserve can rely solely on the work of other agencies in its holding company evaluations when those agencies are also experiencing significant contraction.

Cumulative Effect of Weakened Supervision

Let me close by emphasizing that I support the healthy evolution of banking supervision. It is both natural and appropriate to regularly assess supervisory approaches and tools over time. After periods of crisis, regulators logically strengthen oversight to prevent a recurrence. After periods of relative stability, there is often pressure to lower the guardrails put in place. Adjustments can be constructive, but they must be made with foresight and care to preserve the hard-won resilience of the financial system.

²³ Katanga Johnson and Weihua Li, "Trump Cuts Thousands of Wall Street Cops While Markets Swing," *Bloomberg*, May 7, 2025, <https://www.bloomberg.com/news/articles/2025-05-07/trump-s-layoffs-cut-more-than-2-300-from-us-bank-and-markets-regulators?sref=zNmRO0gk>.

Today I have outlined several essential components of robust banking supervision that, I believe, are being altered without sufficient appreciation for the consequences of these actions. Weakening any one of these elements diminishes supervisory effectiveness; taken together, the cumulative impact could be profoundly damaging to banks and destabilizing for the financial system.

History reminds us that we have seen this pattern before, including in the financial crisis.²⁴ Periods of weakened supervision have often preceded episodes of financial excess and instability. The erosion of supervisory resources, the diminished focus on governance and controls, the weakening of forward-looking tools, and the constraints placed on supervisory action all undermine supervisors' ability to adequately protect against excessive risk taking. When coupled with broader deregulatory momentum, these trends create a dangerous environment for both institutions and the economy at large.

The vulnerabilities that weaker supervision and regulation create may not be visible in the short term. They rarely are. But experience tells us that the bill always comes due. The only question is when, and how high the cost will be.

²⁴ Michael S. Barr (2025), "Booms and Busts and the Regulatory Cycle."