IS BANK SUPERVISION FIT FOR PURPOSE?

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I. Introduction

Notwithstanding the contentiousness surrounding banking regulation since the Global Financial Crisis of 2007-2009, when a bank fails there can be moments of at least apparent agreement among parties otherwise sitting on opposite sides of regulatory debates. That was certainly the case in the spring of 2023, when Silicon Valley Bank (SVB), Signature Bank (Signature), and First Republic Bank (FRB) were closed by regulators – respectively the third, fourth, and second largest bank failures in U.S. history, as measured by nominal asset size.[1] There was, and still is, disagreement as to whether regulation of minimum capital and liquidity levels should have been stricter.[2] But, from members of Congress to public commentators to bank trade associations to the federal banking agencies themselves, virtually everyone assigned considerable culpability to bank supervision[3] – a function with few parallels in other areas of administrative law and practice, involving active oversight of the safety and soundness of banks.

The very fact of this atypical consensus should make us sit up and take notice. If flawed supervision lay at the heart of these three bank failures, similar shortcomings might be more widespread, thereby jeopardizing the stability of the U.S. banking system.[4] In that event, there

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[1] These rankings among failed U.S. banks are a bit misleading. The size of large U.S. banks has grown enormously in recent decades. At the end of 2022, the three were not among the largest U.S. banks –ranking 16th, 29th, and 14th, respectively. Also, through the Global Financial Crisis, the federal government generally saved large banks from failure through some combination of brokered acquisitions, open bank assistance from the Federal Deposit Insurance Corporation (FDIC), liquidity assistance from the Federal Reserve, and – perhaps most notably – substantial injections of capital in 2008. Absent these measures, especially the capital injections, it is quite possible that a few of the very largest banks could have failed during the Global Financial Crisis. Still, the first two of these failures – which both occurred on Friday, March 10 -- elicited significant enough fears of contagion to a much broader range of mid-sized regional banks that the Treasury Department, Federal Reserve, and FDIC took extraordinary measures over the ensuing weekend to limit possible contagion to other parts of the banking system.

[2] *See* Greg Feldberg, Carey K. Mott and Jill Cetina, How US Bank Regulation Failed SVB and Its Supervisors, 7 J. Fin. Crises 313(2025), https://elischolar.library.yale.edu/journal-of-financial-crises/vol7/iss2/12.

[3] The very title of a Congressional hearing held two months after the failures is revealing – A Failure of Supervision: Banks Failures and the Federal Reserve Hearing Before the Subcomm. on Health Care and Fin, Services of the H. Comm. on Oversight and Accountability, 118th Cong. (2023). Criticisms of supervision of SVB were offered by the Chair of the subcommittee, *id.* at 1-4 (remarks of Chairwoman Lisa C. McClain), an official of the Government Accountability Office, *id.* at 5-6 (statement of Michael E. Clements), and a representative of the trade association of the nation's largest banks, *id.* at 6-8 (statement of Jeremy Newell, Senior Fellow, Bank Policy Institute).

[4] While supervisory failures undoubtedly played a role in the onset of the Global Financial Crisis, there was a fair degree of consensus for the proposition that inadequate and outdated regulatory rules were principally to blame (as well, of course, as the massive risk management failures of the banks themselves).

would be a powerful case for reform. Unfortunately, the seeming convergence on a diagnosis of supervisory failure was not followed by convergence on a prescription to remedy those shortcomings.

More importantly, even though the banking agencies did announce some changes in supervisory practice, they have not themselves articulated even a moderately well-specified principle to guide bank supervision.[5] The supervisory function has few, if any, parallels in other areas of administrative regulation. As explained more fully in the next section, it is clearly something more than enforcement of existing statutes and regulations. Alluding to one of the more important statutory provisions relevant to supervision, the Federal Reserve says that its supervisory function seeks "to promote [the] safe and sound functioning [of banks], *as well as* their compliance with all applicable laws and regulations that govern their activities."[6] Yet, despite having assigned this and other supervisory tasks to the banking agencies, Congress has never specified *how* safe and sound the supervisory function should aspire to make banks. Because the elimination of all risk in banking would dramatically restrict the extension of credit to households and businesses,[7] the intended level of safety and soundness must obviously be less than absolute. Thus, through history, banking supervisors have exercised considerable discretion in deciding what banking practices should be curtailed.

In fact, supervision may have presented a consensus target for blame in the spring of 2023 in no small part because its purpose is so generally stated that a bank failure can almost always be attributed at least in part to supervisory shortcomings. The absence of an informing standard makes it challenging to determine precisely what supervisors should have been doing (though, as in the SVB case, sometimes a supervisory failure seems intuitively obvious even without benefit of a well-defined standard).

Somewhat paradoxically, the absence of an informing standard has become more problematic over the last few decades, as statutory requirements and agency-promulgated regulations have proliferated. In the absence of such rules, supervisory policy was the *de facto* answer to the question of how to trade off more lending against increased risks of bank failure and systemic stress. But now capital and liquidity regulations provide the answer to that question – implicitly by their very substance, and usually explicitly in the banking agencies' explanation for why those specific quantitative rules were adopted. If these regulations reflect the bank agencies' considered judgment as to how safe and sound banks should be, then what –

[5] The banking agencies have, in recent years, made clear what supervisory guidance is *not* – it is not legally binding. But they haven't gone beyond general statements referring to bank safety and soundness to explain how supervision should interact with regulatory rules. Role of Supervisory Guidance, 86 Fed. Reg. 9260 (Feb. 12, 2021) (to be codified at 12 C.F.R. pt. 4) (OCC final rule); Role of Supervisory Guidance, 86 Fed. Reg. 120,79 (Mar. 2, 2021 (to be codified at 12 C.F.R. pt. 302) (FDIC final rule); Role of Supervisory Guidance, 86 Fed. Reg. 18,173 (Apr. 8 2021) (to be codified at 12 C.F.R. pt. 262) (Board of Governors final rule); Bd. of Governors of the Fed. Rsrv. Sys., SR 18-5: Interagency Statement Clarifying the Role of Supervisory Guidance (Sept. 12, 2018), https://www.fdic.gov/news/press-releases/2018/pr18059a.pdf [https://perma.cc/J6HJ-NHHF].

[6] Bd. of Governors of the Fed. Rsrv. Sys., The Federal Reserve System: Purposes and Functions 70 (11th ed. 2021) (emphasis added). The allusion is to 12 U.S.C. §1818(b)(1), which authorizes the federal bank regulatory agencies to obtain cease-and-desist orders to prohibit "unsafe or unsound" banking practices.

[7] In fact, eliminating *all* risk would limit banks to acquiring only entirely safe assets – U.S. Treasuries. This business model is known as "narrow banking." It can provide businesses and households with transaction (checking) accounts, but does not offer them credit.

or how much more – should supervision be doing? If SVB, Signature, and FRB were mostly in compliance with applicable regulations in the period leading up their rapid deterioration, what is meant by saying there was a supervisory failure?

Against this backdrop, this article has two purposes: The first is to propose how, as a conceptual matter, supervision should be understood to complement the statutory and regulatory rules with which banks must comply – in other words, to suggest the contemporary purpose of supervision. The second is to consider whether it is realistic to expect supervision to play this complementary role effectively in light of relevant organizational, governance, and legal factors.

It is noteworthy that reviews of the Spring 2023 failures suggest that supervisory shortcomings at the three banks continued for several years, bridging periods when the banking agencies were led by appointees of Republican and Democratic presidents. An inference can readily be drawn that supervision will fail when – as appears to be the policy of President Trump's appointees – agency leadership adopts a light touch approach,[8] dramatically reduces supervisory resources,[9] or takes other steps to prevent supervisors from addressing latent problems in banking practices or risk management. More tellingly, though, my analysis also suggests that supervision is prone to periodic, significant failures even when the agencies are led by officials who favor a more robust execution of the supervisory role. If I am right, then supervision is not simply, like most government policies, subject to fluctuation as presidential administrations change. In its present form it may not be fit for purpose even where agency principals embrace that purpose.

The article proceeds as follows: Part II begins with a brief recap of the moral hazard and negative externalities rationales for banking regulation, and how the nature of that regulation has evolved over time. The key point here is that, unlike most forms of regulation, the industry "output" that bank regulation seeks to limit – risk of failure – cannot be measured, and thus controlled, directly. Accordingly, bank regulations directed at limiting bank risk must use surrogates like a bank's level of equity capital or liquidity.

Part II then explains how this feature of bank regulatory rules interacts with the characteristics of banking business to produce a role for a supervisory function distinct from enforcement of statutory and regulatory rules. The most important of these characteristics are opaque balance sheets and potentially fast-moving growth in certain bank "products." In light of the proliferation of rules in recent decades, I suggest that the appropriate contemporary role for supervision is generally to maintain the societal trade-off between financial intermediation and the risks from bank failures and financial crises embedded in regulatory rules. This role involves access to the banks' internal information and risk management practices, both to

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[8] For a review of some of the most significant measures relaxing supervision, see Pete Schroeder and Michelle Price, How Trump's Bank Regulators Are Paring Back Supervision, Reuters, May 26, 2026, https://www.reuters.com/legal/transactional/how-trumps-bank-regulators-are-paring-back-supervision-2026-05-26/.

[9] *See* Dyan Tokar and Nick Timiraos, Federal Reserve to Reduce Bank Supervision Staff by 30%, Wall St. J., Oct. 30, 2025, https://www.wsj.com/economy/central-banking/federal-reserve-to-reduce-bank-supervision-staff-by-30-84fcd65f?utm_source=chatgpt.com; Evan Weinberger, Stablecoin Bill Adds to OCC's Workload as Trump Team Cuts Jobs, Bloomberg Law, July 18, 2025, https://news.bloomberglaw.com/banking-law/stablecoin-bill-adds-to-occs-workload-as-trump-team-cuts-jobs?utm_source=chatgpt.com.

identify violations of the rules and, in supervision's more distinctive administrative function, to identify bank activities that intentionally or unintentionally subvert the limits on risk prescribed in the statutory and regulatory rules. The latter function necessarily involves the significant exercise of judgment by supervisors.

Part III leads with a brief account of how supervision fell woefully short of satisfactory performance of this role at Silicon Valley Bank, the first of the three sizeable banks that failed in the spring of 2023. Suggestive as this and the other two case studies are, however, they are just that – case studies that should not be read too broadly as incriminating the supervisory function as a whole. Part III goes on to discuss legal, political economy, and institutional factors that together give grounds for a more generalized concern that these supervisory failures may be a recurring problem. The opaqueness of bank balance sheets that helps explain the need for supervision is paralleled by difficulties identifying sources of risk and monitoring supervisory activity meant to penetrate bank opacity. The monitoring difficulties exacerbate agency problems in the relationship between line supervisors and their superiors in bank regulatory agencies, but also in the accountability of the leadership of those agencies to Congress and the public. Additionally, and perhaps most interestingly, organizational efforts to direct the activities of line supervisors as a partial response to these monitoring challenges may discourage the very exercise of judgment that lies at the heart of the rationale for supervision in a bank regulatory system dominated by detailed regulations. Ironically, the incentives created by efforts to systematize supervision can simultaneously undermine its effectiveness in controlling bank risk and burden banks with unnecessary demands.

Although a full consideration of possible reforms is beyond the scope of this article, Part IV surveys some potential paths for reform by assessing their promise in overcoming existing structural impediments to effective supervision. A series of incremental reforms might improve things at the margin and may be worth implementing in the short term. However, effectively addressing the expertise, monitoring, and incentive issues will require more far-reaching measures. Some existing ideas that would entail significant change also fail for a combination of practical and structural reasons. The incorporation of Artificial Intelligence (AI) may ultimately be the best bet for mitigating these problems. While this suggestion may at first glance seem fanciful, the rapid improvements in AI and the increasing use of AI by banks in their risk management suggests that over time it may also prove essential to effective supervision.

II. The Role of Supervision in a Rule-Heavy Regulatory System

Bank supervision is a distinctive administrative function.[10] Though the line separating it from enforcement has never been a sharp one, supervision is unquestionably something more than enforcement of statutory and regulatory rules. It routinely includes the identification of potentially unsafe and unsound practices in the manifold aspects of bank activity unaddressed by legislative rules, both for banks generally and for individual banks. Although the three federal

[10] For a more complete description of the contemporary supervisory function, see Daniel K. Tarullo, Bank Supervision and Administrative Law, 2022 Colum. Bus. L. Rev. 279, 286-315 (2022) [hereinafter "Bank Supervision and Administrative Law"]

bank regulatory agencies,[11] like many other administrative agencies, regularly issue guidance, bank supervisors also engage in an iterative process with banks on how the latter should most effectively follow that guidance. And, especially for the larger banks for which the agencies have created dedicated teams of supervisors that continuously monitor a specific bank, there are frequent interactions between supervisors and bank officials on matters affecting the safety and soundness of the bank that are not explicitly addressed in statutes or regulations. Though most supervisory communication is not legally binding, it is intended to affect bank practice. It usually, though not always, does. It is thus a decidedly non-Weberian form of administrative practice, since by definition it involves the substantial exercise of discretion to supplement generally applicable rules.

Today there are numerous statutory provisions authorizing or specifically requiring various supervisory activities. But this was not the case for much of supervision's long history, which dates back to state governments in the early 1800s and to the federal government's Office of the Comptroller of the Currency (OCC) following passage of the National Banking Act in 1863. As Peter Conti-Brown and Sean Vanatta show in their history of supervision,[12] for much of this period banking agency efforts to constrain risky bank activity were ultimately grounded in the implicit threat to exercise the limited – and often Draconian – regulatory authority they did have. That is, while bank supervision involves the exercise of discretion to affect bank behavior in ways not explicitly required by statute (or, more recently, regulations), the scope of that discretion has always been shaped by the statutory scheme under which a banking agency operates.

For example, the National Banking Act gave the OCC authority to charter national banks, which were required to deposit with the Treasury Department U.S. government bonds equal to their bank notes in circulation.[13] The OCC could place into receivership a national bank that failed to observe this requirement, or any of the others established by Congress.[14] This, of course, was a severe remedy for what might be modest breaches; closing such banks would often come at the cost of reduced availability of credit needed to fuel economic growth. Thus the OCC could, and did, forbear from invoking such a remedy even when a national bank violated the statutory requirements. On the other hand, when OCC examiners (as supervisors were, and often still are, called) observed a national bank operating in an imprudent fashion, they could demand a change in its practices, even if the worrisome practices in question did not themselves violate the National Banking Act. However, if the bank ignored its guidance, OCC had a legal response available only if the bank were also out of compliance with the statutory criteria, and only if the

[11] The three are the Board of Governors of the Federal Reserve, the Office of the Comptroller of the Currency, and the Federal Deposit Insurance Corporation.
[12] Peter Coni-Brown and Sean Vanatta, Private Finance, Public Power: A History of Bank Supervision in America (2025).
[13] These notes were evidence of indebtedness of a bank, like a bond. But, critically, they were also used as circulating money by the public. The requirement of government bond backing for these notes was intended to protect the value of the "money" created by the bank.
[14] Id. at 47-74.

Comptroller were willing to close the bank. Thus the legal backdrop both created and limited OCC's supervisory leverage.[15]

The legal backdrop for supervision has substantially changed from that prevailing in the earlier decades of the three federal banks agencies. First, over time Congress has given the agencies a number of intermediate legal remedies for bank activities raising safety and soundness concerns. As a result, in most respects the agencies no longer face the challenge of constructing a supervisory regime on a foundation of legal remedies that were often too drastic to be invoked. Second, Congress has mandated a number of supervisory functions – exercises of judgment by banking agencies to affect bank practices that do not necessarily violate an existing legally binding requirement. Third, Congress has granted the banking agencies broad authority to adopt regulations to govern bank activities. In some cases, Congress has required the agencies to exercise that authority in a specific area, though usually with considerable discretion as to *how* to regulate.[16] In others, the decision whether to regulate a particular bank activity or practice at all is left to the discretion of the agencies.[17] The result is an extensive set of rules, filling half a dozen volumes of the Code of Federal Regulations.

The progressive creation of intermediate remedies is exemplified in the growth of Section 8 of the Federal Deposit Insurance Act.[18] Its heading, "Termination of Status as Insured Depository Institution" reflects the FDIC's original, limited statutory authority to terminate deposit insurance for a bank that continued to engage in unsafe or unsound practices. But in 1966 Congress gave the federal banking agencies authority both to issue cease-and-desist orders against banks engaged in "unsafe or unsound" banking practices and to remove bank officials found to have violated the law or to have themselves engaged in unsafe activities with certain defined consequences.[19] In 1978 Congress augmented these intermediate remedies by, among other things, extending the reach of the removal power[20] and authorizing the agencies to impose civil money penalties.[21]

In requiring banking agency approval for a range of bank activities – from mergers to branch openings – Congress created what amounts to another indirect form of supervisory

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15 Professors Conti-Brown and Vanatta explain how early supervisory efforts by the Federal Reserve and Federal Deposit Insurance Corporation (FDIC) were similarly shaped by those agencies' authority to, respectively, offer or withhold liquidity to banks at the Discount Window and grant or revoke deposit insurance. Id. at 109-138, 173-206.
16 For example, the so-called "Volcker Rule" – a statutory provision prohibiting insured depository institutions from affiliating with any firm engaged in proprietary trading of securities – leaves it the regulatory agencies to define proprietary trading and to elaborate the various exceptions (such as market-making) provided by the statute. 12 U.S.C. §1851.
17 So, for example, Congress requires that the Federal Reserve set more stringent prudential regulations for banking organizations posing greater systemic risk, but does not specify how or to what extent it should do so. 12 U.S.C. §5365.
18 12 U.S.C. §1818.
19 Financial Institutions Supervisory Act of 1966, Pub. L. 89-695 §202, 80 Stat. 1046 (1966), codified at 12 U.S.C. §1818(b).
20 Financial Institutions Regulatory and Interest Rate Institutions Control Act of 1978, Pub. L. 95-630 §107(d)(1), 92 Stat. 3656 (1978), amending 12 U.S.C. §1818(e).
21 Financial Institutions Regulatory and Interest Rate Institutions Control Act of 1978, Pub. L. 95-630 §107(e)(1), 92 Stat. 3660 (1978), codified as amended at 12 U.S.C. §1818(i) gave the authority to the FDIC. A parallel provision in §101(a), 92 Stat.3641, codified at 12 U.S.C. §504, gave the authority to the Federal Reserve and the Comptroller of the Currency for the banks they regulated.

remedy. A banking agency may, for example, withhold its approval of a proposed merger between banks because of concerns about "managerial resources"[22] or the impact of the transaction on financial stability.[23] These non-antitrust factors provide the agencies an effective means to motivate remedial efforts by banks whose activities have concerned supervisors. Because of the time sensitivity of many proposed mergers, banks may be considerably more diligent in addressing supervisory concerns before or immediately following a merger application than when faced with supervisory reprimands at other times.

The second significant feature of the contemporary statutory backdrop against which supervision takes place is a set of *requirements* for supervisory action. As explained already, in its early decades, supervision was dominantly a matter of discretion, in which banking agencies leveraged their statutory authority to induce banks to operate more prudently, despite the absence of explicit rules requiring them to do so. Today, though, supervisors are required by statute to exercise certain forms of oversight. These statutes were often enacted following a spate of bank failures.

Foremost among these is the system of bank (and bank holding company) ratings created by the banking agencies following passage of 1978 legislation that required them to "establish uniform principles and standards and report forms for the examination of financial institutions."[24] The so-called CAMELS[25] ratings system, along with the LFI (Large Financial Institution) ratings system established by the Federal Reserve for large bank holding companies, is a focal point of modern supervision. Ratings are generally assigned annually after an examination by supervisors. Low ratings have both supervisory and regulatory consequences. As to the first, formal or informal supervisory actions may follow immediately upon assignment of the rating. At the least, supervisors will expect bank officials to develop plans for improving the area(s) found wanting. Regulatory consequences include higher deposit insurance premiums and a requirement that banks seek approval of changes in their board of directors or senior management.

It is notable that twenty years after mandating a uniform examination system, Congress appeared to express approval of the CAMELS system in a very consequential context. The 1999 Gramm Leach Bliley Act removed the prohibition on affiliations (i.e., common ownership in a bank holding company) between commercial banks and investment banks that had been adopted in the Depression Era Glass-Steagall Act. It thereby enabled creation of today's financial conglomerates such as JP Morgan Chase, Citigroup, and Bank of America. In order for a commercial bank to affiliate with an investment bank and certain other kinds of non-bank financial firms, each insured depository institution affiliate was required to be, among other things, "well managed."[26] That term was defined as "a CAMEL composite rating of 1 or 2" or

[22] 12 U.S.C. §1828(c)(5)(B).
[23] Id.
[24] Financial Institutions Regulatory and Interest Rate Control Act of 1978, Pub. L. No. 95-63-, 92 Stat 3641, 3694 (codified at 12 U.S.C. § 3305 (a)).
[25] "CAMELS" is the acronym for the components on which banks are rated: Capital, Asset Quality, Management, Earnings, Liquidity, and Sensitivity to Market Risk. Each bank is assigned a rating from 1 (best) to 5 for each component and a composite rating..
[26] 12 U.S.C. § 1843(l)(2)(A).

its equivalent in another rating system.[27] Following the Global Financial Crisis, Congress added a requirement that the holding company itself be "well managed."[28]

There are other Congressional mandates for supervisory action. The 1978 legislation that directed creation of a uniform examination system also instructed the interagency council of bank regulators to "make recommendations for uniformity in other supervisory matters, such as, but not limited to. . . identifying financial institutions in need of special supervisory attention."[29] Following the savings and loan crisis of the late 1980s, Congress added more requirements for supervisors. One was to create a system of "prompt, corrective action" in response to a bank's deteriorating capital position.[30] The banking agencies were instructed to create categories of capital adequacy; as a bank fell into lower categories, the appropriate banking agency was required to take some measures and was given discretion to take others. Another post S&L crisis provision required the agencies to "prescribe standards relating to" a range of bank conditions and practices, including internal controls, loan documentation, credit underwriting, interest rate exposure, asset growth, compensation, asset quality, earnings and stock valuation.[31] The agencies were given the option of proceeding by regulation or "guideline." Supervisors must require a remediation plan from a bank failing to meet a standard that is contained in a notice-and-comment regulation, but they are also authorized to require such a plan to correct a deficiency determined by reference to supervisory guidance.[32]

The third significant contrast between the supervisory environment before the 1970s and that which exists today is the number, breadth, and detail of prudential regulations adopted by the banking agencies – sometimes under instructions from Congress, often under discretionary authority granted them by statute. At the center of this mass of rules are minimum capital requirements. Up until the 1980s, the agencies used minimum capital ratios only as guidelines whose breach would prompt supervisory attention, rather than as legally binding obligations.[33] These guidelines were quite rudimentary, which meant that supervisory judgment needed to be exercised to decide whether to take action when a bank's ratio dropped below the guidelines (or whether the composition of a bank's balance sheet meant that it was operating in too risky a fashion even if it formally met the guideline). Beginning in 1985 with the adoption of the first, very simple binding capital regulation,[34] the agencies promulgated increasingly detailed rules on minimum capital requirements. Regulations apply to all banks and bank holding companies, though the specific rules vary with the size of the institution.

Prompted by Congress, or on their own initiative, the agencies have adopted rules on many aspects of bank operations. There are regulations governing interbank liabilities,[35] insider

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[27] 12 U.S.C. § 1841(o)(9).
[28] Pub. L. 111-203, § 606(a), 124 Stat. 1376, 1607 (2010) (amending 12 U.S.C. §1843(l)(1).
[29] 12 U.S.C. § 3305(b)(1).
[30] 12 U.S.C. § 1831o.
[31] 12 U.S.C. § 1831p-1 (a), (b).
[32] 12 U.S.C. § 1831p-1(e).
[33] For an account of the use of capital guidelines prior to the 1980s, see Daniel K. Tarullo, Banking on Basel: The Future of International Financial Regulation 29-38 (2008),
[34] U.S. Department of the Treasury, Office of the Comptroller of the Currency, Final Rule, Minimum Capital Ratios; Issue of Directives, 50 Fed. Reg. 66193 (Mar. 14, 1985). Unlike under current practice, the agencies adopted the same regulation in parallel rule-makings, rather than undertaking a joint rule-making.
[35] 12 C.F.R. § 206.4.

loans,[36] management interlocks with other banks,[37] swaps and derivatives margining,[38] funds transfers,[39] transactions with affiliates (i.e., commonly-owned financial firms),[40] and permissible types and amounts of securities holdings.[41] For larger banks,[42] there are also quantitative liquidity requirements,[43] stress testing requirements,[44] counterparty credit limits,[45] risk management standards,[46] long-term debt requirements,[47] and resolution planning requirements.[48]

Over time, these three trends in banking regulation have placed the supervisory function in a paradoxical position. On the one hand, Congress has explicitly legitimated the supervisory function and given it intermediate disciplinary tools that provide supervisors more leverage through an implicit threat of enforcement proceedings or restrictions on bank activities. On the other hand, the proliferation of prudential regulations has clearly altered the role of supervision, insofar as those regulations are now the principal means for requiring specified levels of bank resiliency and governing bank activities. But neither Congress nor the agencies have explained how the increased supervisory powers relate to the raft of detailed rules.

In, say, the 1960s, with few of what we would today recognize as prudential regulations governing bank operations, bank supervisory practice effectively decided the societal trade-off between the economic benefits that come from risk-taking and credit growth, on the one hand, and the potential for economic harm that comes from bank failures and financial instability on the other. In all likelihood, the banking agencies did not undertake a macroeconomic analysis of optimal capital levels or funding practices of the sort bank regulators use today. The societal trade-off was set through the aggregation of decisions supervisors made on specific banking practices. Whether self-consciously or not, though, supervisory discretion made that judgment, even if the means to implement it were limited.[49]

Today the situation has been substantially reversed. Supervisors have more tools to influence bank behavior. But now the judgment as to the optimal social trade-off is embedded, at least presumptively, in all those regulations referred to earlier – especially capital requirements. In this context, what is the role of supervision? To be sure, the people who are themselves *supervisors* know that one of their jobs is to uncover violations of regulations that might go undetected absent the supervisors' access to bank records and personnel. But what is the purpose of *supervision* as a distinct administrative function – that is, as an effort to constrain bank

[36] 12 C.F.R. § 215.4.
[37] 12 C.F.R. § 212.3.
[38] 12 C.F.R. §§ 237.1.-237.12.
[39] 12 C.F.R. §§ 210.25-210.47.
[40] 12 C.F.R. §§ 223.11-223.16.
[41] 12 C.F.R. § 208.21(b).
[42] Many, though not all, of these additional prudential requirements are required by statute. 12 U.S.C. § 5365.
[43] 12 C.F.R. §§ 249.10-249.131.
[44] 12 C.F.R. §§ 252.41-252.47.
[45] 12 C.F.R. §§ 252.70-252.78.
[46] 12 C.F.R. § 252.33.
[47] 12 C.F.R. §§ 252.60-252.65.
[48] 12 C.F.R. §§ 243.1-243.13.
[49] In some instances, the banking agencies have quite explicitly had these considerations in mind. See, e.g., Eugene N. White, Lessons from the History of Bank Examination and Supervision in the United States, 1863-2008, in FINANCIAL MARKET REGULATION IN THE WAKE OF FINANCIAL CRISES 30-31 (Alfredo Gigliobianco & Gianni Toniolo eds., 2009)

behavior that is not prohibited by the regulations? Is it to make the banks even *less* prone to failure or destabilizing actions such as asset fire sales in the face of a depositor run? If so, how *much* safer?

We do not find an answer to this question by looking to the pattern and substance of the legislative developments noted above. This omission may at least in part be due to the fact that the first two trends – the creation of intermediate remedies and assignment of specific supervisory tasks – had taken hold before the movement to notice-and-comment regulations began in earnest. One way or another, supervisory practice lay at the heart of a bank failure in the 1960s. The supervisors may have been inattentive to unreasonable risks that the bank was taking. Alternatively, they may have seen the risks but lacked the tools to discipline the bank, short of the often unattractive option of closing the institution – or, what would quickly amount to the same thing, revoking its federal deposit insurance. A third possibility is that the bank had failed despite capable supervisory oversight. That is, the de facto trade-off between economic growth and the deleterious effects of bank failures might reasonably have contemplated the failure of some (small) number of banks, since supervision demanding enough to prevent *all* bank failures would have excessively limited credit creation. Yet the failure would still have been the result of supervisory judgment. Thus it is easy to understand why Congress both demanded more of supervision and empowered supervisors through the creation of intermediate remedies in the period before the proliferation of statutory and regulatory prudential rules.

But what does it mean to attribute the recent demise of SVB, Signature, and FRB to supervisory failure, given that those banks appear – with one possible exception – to have been in compliance with applicable capital and other regulatory requirements, at least for most of the period covered by the agency and Inspector General reviews? Let me suggest a working concept of the aims of supervision in a rule-heavy system of banking regulation. The basic idea is that supervision complements statutory and agency rules by protecting the societal trade-off reflected in those rules between more near-term extension of credit and the risk of a future destructive economic shock from widespread bank failures or a full-fledged financial crisis. In so doing, supervision allows the system of banking regulation to achieve a specified level of resiliency more efficiently than through sole reliance on statutory and regulatory rules. To understand why, a short digression on the basics of banking regulation is necessary – in particular, the fact that the aim of most prudential regulation is the containment of risk, a property that cannot be measured or regulated directly.

Prudential banking regulation[50] is directed both at limiting moral hazard and at keeping the risk of bank failures at a level consistent with the societal trade-off between near-term economic growth and longer-term financial stability, as chosen by policymakers.[51] In traditional banking, the risk is mostly of losses from loans gone bad. Various forms of debt securities, another major component of a commercial bank's balance sheet, also carry a risk of loss.[52] In

[50] Banks are also subject to regulations other than those designed to maintain their financial soundness, notably consumer protection and anti-money laundering rules.
[51] Since the Global Financial Crisis of 2007-2009, the banking agencies – especially the Federal Reserve – have paid more attention to the risk that large banks (i.e., those providing substantial amounts of credit to businesses and households) may be unable to remain viable lenders, even if they could remain technically solvent.
[52] In the case of U.S. government securities such as Treasury bonds, this risk has historically been only the market risk that interest rate increases will reduce the present value of the bonds. In the case of corporate and municipal

great enough numbers, losses can impair the viability of the bank as a lending institution or even render it insolvent. In the banking world as it has existed since creation of the FDIC in the 1930s, insured depositors have limited reason to worry about potential losses of banks in which they have placed their funds, and thus may provide funding to banks taking excessive risks. In addition, federally insured banks may borrow at the Federal Reserve's Discount Window to relieve short-term liquidity squeezes. The resulting moral hazard is a traditional rationale for bank regulation. Perceptions that very large banks may be considered too-big-to-fail, and thus kept afloat by the government even if they become insolvent, are an additional source of moral hazard.

Failures, especially of larger banking organizations, can also produce significant negative externalities – losses to society that exceed the losses incurred by shareholders of the banks, and consequently are not taken into account by banks in their risk/return calculus.[53] Contagion – whether direct,[54] reputational,[55] or through fire sales[56] – is one important such externality. More generally, if a significant part of the banking system becomes weakened or insolvent during an economic downturn, and thus inhibited from continuing lending, then even creditworthy households and businesses may be starved of funds for consumption and investment. The resulting restraint on economic activity will then deepen or prolong the recession.[57] This socially undesirable limitation on credit is related to yet another reason for prudential bank regulation: When commercial banks lend by increasing the funds in a borrower's transaction account, they create money. Indeed, this "inside" money is quantitatively much more important than the money directly created by the Federal Reserve. If the banking system is not fundamentally sound, society's interest in an effective transmission of monetary policy through banking channels can be severely compromised.

Bank regulation attempts to keep the risk of bank failure in a range that reflects policymaker judgment of the optimal societal trade-off. That is, bank regulation should aim to

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bonds, which commercial banks are permitted to own in limited amounts, there is also some risk of non-payment. Mortgage-backed securities ("MBS") are created by pooling together large numbers of mortgages. MBS that were constructed from subprime and so-called "Alt-A" mortgages were subject to substantial losses during the Global Financial Crisis.

[53] The term "banking organizations "includes bank holding companies – the largest of which have very large broker/dealer, investment banking, and other affiliates, as well as commercial banks.

[54] Direct contagion occurs when the failure of a debtor to repay a creditor causes that creditor itself to become illiquid or insolvent.

[55] Reputational contagion occurs when investors or counterparties withdraw funding from a firm that appears to share salient characteristics with a firm that has already encountered problems and lost funding. So, for example, SVB's failure led to stress – and in the cases of Signature and First Republic, failure – in a number of banks that had some combination of high proportions of uninsured deposits, substantial unrecognized losses on their securities portfolios, or heavy involvement in tech-related lending.

[56] Contagion through fire sales takes place when troubled financial institutions must sell large amounts of assets quickly in an effort to mean repayment demands. When the asset sales take place at a "fire sale" price – i.e., one notably below the book or previously marked value of the asset – there is an impact on the balance sheets of all other financial firms holding any such asset that must be regularly marked to market. Thus other firms can face significant reductions in their capital cushions even before they have suffered funding runs or defaults on loans they have extended.

[57] In the extreme case of a financial crisis, there is considerable evidence that the affected economy suffers a permanent downward shift in its growth trajectory. For a review of the literature discussing these hysteresis effects, see Valerie Cerra, Antonio Fatás, and Sweta C. Saxena, Hysteresis and Business Cycles, 61 J. Econ. Lit. 181 (2023).

keep banks at the point at which an incremental increase in their risk of failure[58] – with the attendant economic damage – would not be offset by the economic benefits of more credit intermediation. However, the risk of failure cannot be observed – and thus regulated – directly. The EPA can monitor how much pollution a plant is spewing into the air to determine if it is in compliance with a regulation limiting concentrations of particulate matter in its emissions. But, because risk of failure is not an observable metric, the Fed or OCC could not directly monitor compliance with a regulation specifying that banks should operate so as to run no more than – for example – a 1% risk of failure. Thus banking regulation must use surrogate measures such as requirements for minimum capital and liquidity levels, which *are* observable, to indirectly pursue its risk-limiting aim.

Risk-based capital regulation lies at the core of contemporary prudential bank regulation. It requires banks to maintain loss-absorbing equity cushions that vary with the risk of loss associated with its assets, thereby aiming to contain moral hazard and limit the possibility of large negative externalities from bank failures.[59] Whether explicitly or implicitly, the calibration of capital requirements reflects a decision on the appropriate societal trade-off between the costs of potential financial distress and the benefits of increased financial intermediation. Risk-based capital regulation has become progressively more detailed – almost mind-numbingly so – since it was introduced in the 1980s. Despite the continuing effort by the banking agencies to achieve ever greater risk sensitivity in their capital regulations – and in some respects *because* of this effort – there remains an imperfect congruence between the regulatory aim of risk limitation and the regulatory tools using observable metrics to achieve that aim. The characteristics of banking help explain this incongruence and, consequently, define the role of bank supervision in the contemporary, rule-heavy state of bank regulation.

The most salient characteristics of banking are the opacity of balance sheets and the potential for fast-moving increases in risk because of the fungibility of money. The opacity of a bank's balance sheet is most readily understood by considering the loans that traditionally accounted for a large share of its assets. An investor or large depositor examining the bank's balance sheet will learn only that a certain percentage of its assets are loans or, perhaps, in a more detailed version of the balance sheet, commercial real estate loans. The investor cannot know how carefully those loans were originally underwritten by the bank and, not knowing all the specific properties that have been financed, how the value of the underlying collateral may have deteriorated since a property was first offered as collateral. Similarly, an investor has no access to the details of many capital market activities that create significant synthetic exposure,

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[58] A more nuanced goal would include preventing the emergence of "zombie" banks – those that are either close to insolvency but continue to operate or actually insolvent but kept afloat through government assistance, regulatory forbearance, or delayed recognition of losses. Zombie banks are generally focused on avoiding recognition of losses on existing loans and make few new loans. They may also waste social resources by "gambling for resurrection" --- taking excessive risks in hopes of regaining solvency. While the zombie bank phenomenon is real, it is harder than insolvency to specify with quantitative criteria. For a discussion, see Viral V. Acharya, Matteo Crosignani, Tim Eisert and Sascha Steffen, Zombie Lending: Theoretical, International, and Historical Perspectives, 14 Ann Rev. Fin. Econ. 21 (2022).

[59] Reflecting the progressively greater negative externalities that failure may have as banks grow larger and more interconnected with the financial system as a whole, and thus the different trade-offs between near-term economic growth and the risk of medium-term disruption of the financial system, capital requirements now increase in stringency with the size and systemic significance of a bank.

such as total return swaps. In most industries, the quality of a product usually can be determined fairly soon after it is created. But because many poorly underwritten loans or ill-considered derivatives trades may perform satisfactorily until a macroeconomic or sector-specific shock occurs, the opacity of the bank's assets may allow a longer-term accumulation of questionable assets.[60]

An important reason why a bank's risk can increase quickly is that money is the principal input to all its products. For most manufacturing and services firms, redeployment of resources to other products takes time. Money, though, is the ultimately fungible input. If a bank sees opportunity in a particular area of lending, it can often expeditiously redirect funding from some of its current activities to the area that promises greater profits. The opacity of the bank's balance sheet means, again, that investors will not be able to evaluate the quality of the bank's underwriting as it ramps up lending in the new area.

The opacity of bank balance sheets suggests that some presence inside a bank is needed to ensure that it is complying with applicable regulations. So, for example, if the applicable capital regulation sets a lower requirement for commercial real estate mortgages where the collateral is valued at some multiple of the loan, compliance can be monitored only by those with access to the bank's documentation. While supervisors have this monitoring responsibility, it is better understood as part of an enhanced rule enforcement function than as a distinctively *supervisory* function. Indeed, wherever a firm's compliance with any form of regulation is not verifiable externally, some form of inspection will be needed. Think here of the inspections by the Occupational Safety and Health Administration to ensure compliance with workplace safety regulations, or the legions of municipal inspectors who enforce building codes.

The more distinctive *supervisory* role relates to the fact that prudential banking rules cannot directly regulate for a specified risk of insolvency. Instead, they are imperfect surrogates for risk regulation. The point can be illustrated by reference once again to capital requirements. Capital requirements are built upon assumptions of the riskiness of specific assets.[61] These assumptions are formed from regulators' analysis of the performance of each asset class in the past, sometimes with a measure of judgment about the likely future riskiness of each asset. The higher the risk weight, the more capital the bank must hold relative to the value of the asset. Of course, the riskiness of the asset may be under- or overestimated from the outset. But even if we stipulate a basic soundness in the initial risk weight, there are multiple ways in which the aim of achieving a specified buffer against loss reflected by that risk weight can be undermined, even

[60] A good example is the pre-GFC capital treatment of AAA-rated mortgage backed securities (MBS) supported by credit protection from monoline bond guarantors. The combination of the AAA rating and guarantee resulted in these securities having very low risk-weights for capital regulation purposes. However, after the severe shock to the housing market, not only were there defaults on mortgages contained within the supposedly low risk MBS. Some monoline insurers, which had little business outside insuring MBS that might have diversified their risk, were unable to fulfill the guarantees they had made on the MBS.

[61] There is a different, complementary kind of capital requirement called a leverage ratio, which does not risk weight assets. It simply requires that a bank maintain capital in a specified proportion of the bank's total assets. This metric is thus not susceptible to the problems discussed in the text. On the other hand, it is totally risk insensitive. It requires as much capital to be held against a short-term Treasury bill as against an unsecured loan to two entrepreneurs trying to start a business out of their garage. For that reason, most regulators regard the leverage ratio as a useful backup tool -- to guard against unexpected increases in the riskiness of traditionally safe assets – but not as the primary form of capital regulation.

though the bank is nominally in compliance with the capital regulation.[62] There follow some examples to illustrate the point.

First, there is the possibility of straightforward regulatory arbitrage. A classic example relates to capital charges for lines of credit. Under the original set of capital rules adopted by the international Basel Committee on Banking Supervision and implemented in the United States by the federal banking agencies, credit lines of up to one year were assigned zero risk weights, while those of over a year were assigned 50% weights. Thus, predictably, a high percentage of credit lines came to have a duration of just under a year.[63] The original assignment of risk weights was presumably made on the basis of prior experience with lines of credit ranging from the very short-term to just under a year, with those of relatively longer duration obviously posing a greater possibility of being drawn down. When banks adjusted to the regulation by concentrating their lines at the upper end of the duration range for zero risk weight treatment, the actual risk was greater than would have been the case for a portfolio of credit lines roughly reflecting the duration distribution prevailing when the regulation was drafted.

The relevance of a Lucas critique for the risk weight assigned to credit lines is still with us today. Following the Global Financial Crisis, regulators imposed capital and liquidity charges for all committed credit lines. Now one hears that some banks have offered more credit lines that are formally "uncommitted," but that carry informal assurances to customers that the bank will honor them.[64] Since uncommitted lines are not reported formally to regulators, a supervisory presence within the bank is necessary for regulators to spot the practice.

Second, and relatedly, risk weights are assigned based on the implicit premise of competent underwriting and risk assessment by the bank.[65] If, for instance, the revenue streams

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[62] In reviewing the spring 2023 bank failures, the Basel Committee on Banking Supervision – an international group composed of banking regulators from twenty-seven member jurisdictions, including the United States – offered a similar observation:

> A rules-based approach to regulation . . . is . .. by nature static and necessarily assumes a base level of commonalties in the business model and risks across all the banks to which the rules apply. This approach plays an important role in ensuring a core level of compliance and predictability of the consequences and supervisory actions that follow a breach. But it can also overlook the unique risks associated with novel/outlier business models as well as technological developments. In doing so, it can provide false comfort to supervisors and the public that risks are appropriately addressed and dis-empower supervisor to engage wit banks until a regulatory trigger is exercised, which may often be too late.

Basel Committee on Banking Supervision, Report on the 2023 Banking Turmoil 25-26 (October 2023), http://.bis.org/bcbs/publ/d555.pdf.

[63] This reaction by banks was not visible to the public, but was observed and reported on by two supervisors from the Federal Reserve Bank of New York. *See* Marc Saidenberg and Til Schuermann, The New Basel Capital Accord and Questions for Research, in Benton E. Gup, ed., The New Basel Capital Accord (2004).

[64] During the height of the boom in mortgage-backed securities in the first decade of the 21st century, banks sometimes made contractually binding commitments for "liquidity enhancements" to the special purpose vehicles (SPVs) they had created for buying mortgages, securitizing them, and selling the resulting securities. When SPVs without a contractual right to such an enhancement encountered liquidity strains, the banks that had created the SPVs sometimes provided support anyway, apparently fearing that the failure of SPVs they had created would adversely affect the banks' market reputation.

[65] Sometimes the regulations are explicit on this point. See, e.g., 12 C.F.R. §217.32(g)(1)(ii), which makes a 50% risk weight for first mortgage liens on residential housing contingent upon the loan having been "made in accordance with prudent underwriting standards, including relating to the loan amount as a percent of the appraised value of the property."

with which borrowing firms will make payments on a loan have not been properly verified, and as a result some loans that will eventually default would not have been made with proper underwriting, then the risk weight assigned for that category of loans will not cover the actual risk of the loans. Similarly, if a bank has not competently assessed the likelihood that a homeowner will be able to service her mortgage, it will be exposed to a higher risk of default than assumed in the regulatory risk weight assigned to the type of mortgage written on her house.

Third, if a bank's quantitative risk model is flawed (whether intentionally or unintentionally), then the value-at-risk (VaR) of securities held by the bank may be significantly underestimated, and the regulatory risk weight applied to the VaR will not account for the actual risk entailed.[66]

The supervisory function has been characterized as an information-generating activity – ferreting out unsafe and unsound practices and bank conditions not apparent from publicly available information.[67] From the preceding examples one can see how this function is critical to a prudential regulatory system heavily laden with rules. Supervisors can penetrate a bank's opaque balance sheet to access non-public information on its assets and to evaluate its risk management capacities. They can see where banks arbitrage existing capital rules in ways that raise risk. They can spot shortcomings in banks' underwriting and risk management processes. They can evaluate whether significant changes in external conditions – such as a precipitous decline in value of an asset class by banks – means that existing capital and other prudential regulations no longer provide the level of resiliency intended at the time of their adoption. They can review the performance of a bank's quantitative risk management models. In all these cases the supervisors identify bank practices that undermine the effectiveness of the prudential rules that are used as surrogates for direct regulation of risk.

Supervision can also be used to respond to a bank's adoption of new practices or products that may pose unusual risks, and thereby reduce the resiliency intended by regulators to be reached through capital, liquidity, and other prudential regulations. In such situations, regulators may sensibly prefer to wait for more experience with the new practice or product before dictating specific requirements, especially quantitative requirements such as capital charges.

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[66] The capital requirements for the market risk of large banks may be set by reference to the internal VaR models of those banks. 12 C.F.R. § 217.205.

[67] Thomas Eisenbach and his co-authors describe supervision as developing "soft" information to complement the "hard" (more objective) information that is regulated through rules such as minimum capital requirements or prohibitions on banks engaging in certain activities. Thomas M. Eisenbach, David O. Lucca, and Robert M. Townsend, The Economics of Bank Supervision: So Much to Do, So Little Time, Federal Reserve Bank of New York, Liberty Street Economics, April 12, 2016, at https://libertystreeteconomics.newyorkfed.org/2016/04/the-economics-of-bank-supervision-so-much-to-do-so-little-time/. In a more formal presentation of their views, Eisenbach and colleagues use somewhat different terminology, stating that regulations requires the "verifiability" of information, while supervision requires only "observability." Thomas M. Eisenbach, David O. Lucca, and Robert M. Townsend, The Economics of Bank Supervision 8-9, NBER Working Paper 22201 (April 2016), at http://www.nber.org/papers/w22201. While their framing of the supervisory function is consistent with my own, the authors do not explicitly characterize supervision as a means for protecting the social welfare preferences embedded in prudential regulatory rules. See also Mehdi Beyhaghi, Jiyoung Chae, Filippo Curti, and Jeffrey R. Gerlach, Bank Supervision as Information Production: Evidence from U.S. Bank Holding Companies (January 2026), available at https://papers.ssrn.com/sol3/papers.cfm?abstract_id=5378991.

Although supervision is no longer the sole, or even principal, means for promoting bank safety and soundness, it remains an important part of the bank regulatory system. The regulations apply to a wide range of banks with varying business models. There are myriad ways in which these regulations can fall short of ensuring the intended resiliency because of disparities in the capabilities and circumstances of each of those banks. The regulations that now play so prominent a role in that system depend for their effectiveness on good supervision.

The role of supervision in supporting the risk-limiting effect of prudential regulations itself suggests a limit for the supervisory function. Where there are regulations applicable to some element of bank operations, supervision should be directed toward ensuring that the social welfare calculus reflected in the regulations is not subverted, as illustrated in my earlier examples. Supervisors should not be obliquely raising those requirements.[68] They should not be imposing design rather than performance standards for bank governance and risk management, or channeling banks toward or away from legal activities that do not directly affect a bank's safety and soundness and are not the subject of statutes or notice-and-comment regulations. Where, on the other hand, there are no applicable regulations – as is the case, for example, with the liquidity position of banks not subject to the Liquidity Coverage Ratio[69] and other quantitative liquidity requirements – the supervisors must themselves make the basic trade-off on near-term intermediation versus longer-term stability, hopefully with guidance from banking agency senior officials.[70]

Obviously this formulation of the supervisory role does not mechanically yield a particular supervisory agenda, much less specific prescriptions for supervisory actions. But it can inform the design and operation of an overall supervisory program. A supervisory function that incorporates this principle has several virtues: First, it should be more legitimate, insofar as it blends the supervisory tasks established through legislation with the notice-and-comment statutory and regulatory rules that now dominate banking regulation. Second, it can promote a more efficient bank regulatory system, insofar as targeted supervisory interventions to promote the resiliency sought by rules should come at a lower cost than making the generally applicable

[68] The stress tests administered annually by the Federal Reserve to test the capital resiliency of large banks under unusually stressful conditions do involve supervisory discretion in the selection of stress scenarios. Since their inception following the Global Financial Crisis they have often increased the effective capital requirements of those large banks. However the stress testing regime was grounded in regulations that provided for these additional measures specifically for the most systemically important institutions, which Congress has decreed should have more stringent requirements. 12 U.S.C. §5365(a)(1). In any case, in response to the demands of large banks, in late 2024 the Federal Reserve announced that it would thereinafter adopt scenarios through a notice-and-comment process, thereby providing the banks an early look at the test to which they will be subjected. Board of Governors of the Federal Reserve, 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 https://www.federalreserve.gov/newsevents/pressreleases/bcreg20241223a.htm.

[69] 12 C.F.R. §249.10.

[70] There is a statutory requirement that the banking agencies "prescribe standards, *by regulation or guideline*, for all insured depository institutions relating to asset quality, earnings, and stock valuation that the agency determines to be appropriate." 12 USC 1831p-1(b) (emphasis added) From the text of this provision, it appears that Congress authorized the agencies to make these trade-offs in a manner other than through notice-and-comment regulation – i.e., through a form of supervision. To date, at least, the banking agencies have not been very clear about when they may be acting under that authority.

rules more stringent in anticipation of regulatory arbitrage and related bank responses.[71] Third, embrace of this role for supervision should be more effective in promoting bank safety and financial stability, insofar as it directs supervisory efforts toward the prudential aims embodied in the rules and away from matters of secondary or, arguably, no concern to bank supervisors.[72] In theory, then, there is much to be said for the supervisory function. The question, though, is whether in practice supervision can actually fulfill this role.

III. Evaluating Supervision

A. The SVB Failure

The opacity and confidentiality characteristic of supervision pose challenges in assessing its efficacy – especially from outside the banking agencies, but even to some degree from within. The public's window into the supervisory process usually cracks open only after a bank failure. Since 1991, the Inspector General (IG) of each federal banking regulator must investigate and report on each failure that results in a "material loss" to the Federal Deposit Insurance Fund.[73] The IG has access to confidential supervisory materials and to the supervisors of the failed bank. The resulting reports thus provide at least a second-hand account of supervision. Useful as these reports can be, however, they are overwhelmingly concerned with the failures of small – often very small – banks, for the simple reason that there have been very few failures of larger banks.[74] Government policy has generally been to keep larger banks afloat, for fear of the contagion their failure could inject into the financial system as a whole.[75]

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[71] A related view of the efficiency of supervision is presented by Kevin Stiroh using the concept of an "efficient policy frontier," which is reached when bank resilience cannot be increased except at the expense of reduced intermediation and, conversely, intermediation cannot be increased except at the expense of resiliency. Kevin J. Stiroh, Policy Efficiency in Supervision, Remarks at Bank Regulation, Lending and Growth, The Bank Policy Institute and Columbia University's School of International and Public Affairs, New York City, March 1, 2019, https://www.newyorkfed.org/newsevents/speeches/2019/sti190301

[72] Additionally, as I have suggested elsewhere, these principles for the appropriate role of supervision could assist courts in evaluating the consistency with administrative law of various supervisory activities that do not fit comfortably into the usual categories of administrative action. Bank Supervision and Administrative Law, *supra* note ___, at 383-394.

[73] 12 U.S.C. §1831o(k), added by Pub. L. 103-242, Dec. 19 1991, 105 Stat. 2263. As with material loss reviews of the FDIC Inspector General on the failures of Signature and First Republic banks, these reviews are sometimes contracted out to private consulting firms.

[74] The largest bank failure in U.S. history – that of Washington Mutual in 2008, during the Global Financial Crisis, did not result in a loss to the Deposit Insurance Fund, because the bank was acquired at a distressed price by J.P. Mogan Chase, which assumed all WaMu's deposit liabilities.

[75] During the 2007-2009 Global Financial Crisis, Congress enacted legislation that authorized the Treasury Department to inject capital into banks. Pub.L. 110-343, Oct. 3, 2008, 122 Stat. 3765, Title I. Treasury used this authority to provide more than $200 billion in capital to hundreds of banks, including the nation's largest, in 2008 and 2009. U.S. Government Accountability Office, Troubled Asset Relief Program: One Year Later, Actions Are Needed to Address Remaining Transparency and Accountability Challenges (Oct. 2009), 58-65, https://www.gao.gov/assets/gao-10-16.pdf. Several very large banks might well have failed without that government assistance. This circumstance motivated several Congressional efforts to address the "too-big-to-fail" problem, most notably in the 2010 Dodd-Frank. In addition to requiring more stringent ex ante regulation of larger banks,

The material loss reviews of Silicon Valley, Signature, and First Republic banks thus provided what was essentially the first look into the supervisory process at larger banks (though not, of course, the very largest and most complex).[76] In addition, public and Congressional attention to these significant failures induced the Federal Reserve and the FDIC to conduct their own internal reviews, which were contained in reports issued within a few months of the failures.[77] In an extraordinary effort to provide transparency on the part it played in Silicon Valley Bank's failure, the Federal Reserve also released many of its primary supervisory materials.[78] These reports and materials do not paint an encouraging picture of supervisors' performance. While the supervisory failures were multifaceted,[79] and not necessarily typical of supervisory shortcomings in general, two themes of special relevance to my inquiry stand out – the failure of supervisors to appreciate the severity of risks to which Silicon Valley and Signature banks were exposed, and their failure to follow through on problems they did identify. With the benefit of the primary supervisory materials released by the Federal Reserve, here I will focus on Silicon Valley Bank – the only one of the three that it supervised.

SVB presented an almost textbook example of circumstances that should elicit close supervisory scrutiny: It had quadrupled in size in just a few years, the kind of rapid growth that often outstrips a bank's risk management capacities. Its business was heavily concentrated in a limited sector of the economy – start-ups and tech companies – meaning that it would be especially vulnerable to adverse developments affecting that sector. Virtually everyone who has looked at the SVB failure has zeroed in on the toxic combination of SVB's heavy reliance on uninsured deposits for its funding and large unrecognized losses on its portfolio of longer-duration bonds. As of year-end 2022, a little over 80% of SVB's liabilities were deposits.[80] This was not unusual. What *was* unusual – astonishingly so – was that 94% of SVB's were

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Congress created a special resolution process that was supposed to be able to handle the insolvency of even a large bank. It also placed further constraints on the discretion of the Executive to save failing financial institutions.

[76] Office of the Inspector General, Board of Governors of the Federal Reserve System, Material Loss Review of Silicon Valley Bank (Sept. 25, 2023), https://oig.federalreserve.gov/reports/board-material-loss-review-silicon-valley-bank-sep2023.pdf [hereinafter "SVB Material Loss Review"]; Office of the Inspector General, Federal Deposit Insurance Corporation, Material Loss Review of Signature Bank of New York (October 2023), https://www.fdicoig.gov/sites/default/files/reports/2023-10/EVAL-24-02.pdf [hereinafter "Signature Material Loss Review"]; Office of the Inspector General, Federal Deposit Insurance Corporation, Material Loss Review of First Republic Bank (November 2023), https://www.fdicoig.gov/sites/default/files/reports/2023-12/EVAL-24-03.pdf [hereinafter "FRB Material Loss Review].

[77] Board of Governors of the Federal Reserve System, Review of the Federal Reserve's Supervision and Regulation of Silicon Valley Bank (April 2023), https://www.federalreserve.gov/publications/review-of-the-federal-reserves-supervision-and-regulation-of-silicon-valley-bank.htm [hereinafter "Barr Report"]; Federal Deposit Insurance Corporation, FDIC's Supervision of Signature Bank (April 28, 2023), https://www.fdic.gov/news/press-releases/2023/pr23033a.pdf; Federal Deposit Insurance Corporation, FDIC's Supervision of First Republic Bank (Sept. 8, 2023), https://www.fdic.gov/news/press-releases/2023/pr23073a.pdf.

[78] These materials may be found at https://www.federalreserve.gov/supervisionreg/silicon-valley-bank-review-supervisory-materials.htm. They were mostly supervisory communications to SVB, such as reports of annual ratings exercises, which are generally treated as confidential. Regrettably, the FDIC did not follow suit, so we have primary documents pertaining only to SVB.

[79] Not long after the Federal Reserve and Inspector General reports on SVB were issued, I asked a former senior supervisor what he thought had gone wrong. Without hesitation, he replied in a single word: "Everything."

[80] SVB Material Loss Review at 12.

uninsured.[81] Although the proportion of uninsured deposits has been rising over the past few decades, the aggregate industry number at the end of 2022 was about 45%.[82]

As with its deposit profile, SVB was an outlier on the asset side of its balance sheet. It held about double the proportion of Treasury and agency[83] securities held by its peer group of banks.[84] More worrying was that the bank had invested a large portion of those deposits in longer-dated agency and Treasury bonds, which initially paid higher returns than short-dated issues, but declined in value as interest rates rose rapidly. According to the Federal Reserve, the weighted average duration of its securities portfolio was 6.2 years. Most of these were in its "held to maturity" (HTM) portfolio, meaning they were at least nominally intended not to be used for trading or liquidity-generating purposes.[85]

In addition to these quantitative indicators, there were other red flags. As interest rates rose, the bank had actually given up the interest rate hedges it had originally maintained, presumably because they were becoming costlier. And, to top it all off, the bank left the critical senior management position of chief risk officer vacant for most of the year preceding its failure.

Under the rules applicable to all but the largest banks, the decline in market value of these HTM securities caused by the rapid rise in interest rates in 2022 did not have to be passed through to SVB's regulatory capital position unless they were actually sold.[86] SVB's reported capital ratios were, as a result, well above regulatory minimums,[87] a textbook example of a circumstance where compliance with regulatory rules does not achieve the level of resiliency intended by those rules. Until its reliance on short-term wholesale funding passed a regulatory

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[81] Barr Report at 21.

[82] Federal Deposit Insurance Commission, Options for Deposit Insurance Reform (May 1, 2023), https://www.fdic.gov/analysis/options-deposit-insurance-reforms/report/options-deposit-insurance-reform-full.pdf.

[83] "Agency" securities refer to mortgage-backed securities issued by one of the government-sponsored mortgage enterprises such as Fannie Mae. Repayment of these securities is backed by the U.S. Government

[84] Barr Report at 22.

[85] Signature Bank shared a number of characteristics with SVB: rapid growth, heavy reliance on large uninsured deposits, and a somewhat unusual business model. Not surprisingly, official post-mortems of its supervision also reveal significant shortcomings. First Republic Bank had significantly lower shares of uninsured deposits and exposure to interest rate risk, though both were still above industry averages. Its failure, more than a month after SVB and Signature succumbed, looks to have been a classic case of contagion – those uninsured depositors, seeing what had happened at SVB and Signature, withdrew their funds en masse. As with virtually any bank, First Republic did not have nearly enough liquidity to meet all those depositor demands. But there is a good case to be made that, absent the two earlier failures, First Republic would have survived.

Indeed, the First Republic failure makes the point that the supervisory and, arguably, regulatory mistakes at SVB and Signature created a threat to the whole group of mid-sized regional banks that shared one or more of those banks' characteristics (e.g., relatively high levels of uninsured deposits). The result was a bank crisis – one that was fortunately short-lived, but only because of the actions of the FDIC and Federal Reserve in, respectively, guarantying the funds of those affluent uninsured depositors and providing liquidity on very favorable terms to banks that found themselves under stress.

[86] 12 C.F.R. § 217.22(b)(2). The provision allowing all but the largest banks to opt out of the pass-through of price declines in securities to regulatory capital was proposed for modification in the stillborn July 2023 capital proposal of the three banking agencies. It is also included in the considerably more bank friendly capital proposal of the three banking agencies published in March 2026. Department of the Treasury, Office of the Comptroller of the Currency, Federal Reserve System, Federal Deposit Insurance Corporation, Proposed Rule, Regulatory Capital Rules: Regulatory Capital and Standardized Approach for Riskweighted Assets, ___ Fed. Reg. ___, ___.

[87] Barr Report at 22.

asset threshold in December 2022, SVB was not subject to the Liquidity Coverage Ratio (LCR), a regulatory rule requiring banks to maintain a positive ratio of "high quality liquid assets" to short-term liabilities that might need to be satisfied within a thirty day period. However, in July 2022, as a result of its having exceeded $100 billion in assets during the previous year, SVB became subject to a regulatory requirement that it maintain a thirty-day liquidity buffer sufficient to meet the net outflow of funding projected by its internal liquidity stress test.[88] This requirement parallels the LCR conceptually, but not does not impose the standardized measures of inflows, outflows, and the liquidity of assets qualifying for the buffer. It was not met at the time of the July 2022 internal liquidity stress test, but it appears the supervisors may have accepted management's argument that this was an "operational," as opposed to "real," shortfall.[89] No supervisory action was taken.

Based on the reports and primary documents, the supervisors appear to have focused almost exclusively on SVB's *process* for managing liquidity risk, rather than on its actual – and increasingly parlous – liquidity position. Despite some concerns about details of SVB's interest rate risk management, the publicly released documentation does not reflect awareness of the severity of interest rate risk associated with SVB's substantial holdings of longer-dated securities, even after the Federal Reserve began its extraordinary series of 75 basis point increases in the federal funds target rate at four meetings in 2022.[90] Indeed, the Federal Reserve Inspector General observes that the supervisors were apparently reassured by the fact that much of SVB's increase in assets was accounted for by purchases of highly creditworthy Treasuries and agencies, with no awareness that rising interest rates would reduce the cash they would yield if monetized to meet liquidity needs.[91] Nor is there any evidence that supervisors recognized that the concentration of large depositors in one sector of the economy could place unusual liquidity strains on the bank if that specific sector encountered a significant business challenge.[92]

Even where supervisors did identify problems – as, eventually, with liquidity risk management – they were slow to take action, either in the form of supervisory communications such as "matters requiring attention" notices or through ratings downgrades.[93] This is a recurring theme in the reports covering the failures of the other two banks as well.[94] It is not altogether clear from the official reports how much of these delays was due to excessive patience on the part of the line supervisors of the three banks, and how much was due to slow or excessively

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[88] 12 C.F.R. §252.35(b).

[89] Barr Report at 56.

[90] The publicly available documentation does reveal whether supervisors might have had concerns, but not did not anticipate as steep an increased in interest rates as occurred during 2022. It is also possible that supervisors were somewhat comforted by the expectation – based on past experience – that the damage to SVB's bond portfolio would be offset somewhat by its ability to retain deposits while raising the interest rate paid on those deposits at a much slower pace than it increased the rates *it* charged on new loans (or received on newly purchased bonds). One way or another, the failure to anticipate the potential severity of SVB's problems – whether a failure principally of the line supervisors in San Francisco, or shared with the Board of Governors in Washington – paints a picture familiar from past banking crises of supervisors being surprised by new developments.

[91] SVB Material Loss Review at 27.

[92] In 2022,a sharp reduction in venture capital activity caused many of SVB's large depositors to begin drawing down their deposits to meet business needs in the absence of new inflows of investment capital. Barr Report at 2021.

[93] Barr Report at 5-10.

[94] Signature Material Loss Review at 16-28; FRB Material Loss Review at 26-28.

demanding reviews by more senior officials of recommendations for ratings downgrades or other supervisory action. One clear example of the former was the failure of SVB line supervisors to take quick and tough action when, in response to unfavorable results from SVB's models for liquidity and interest rate risk, the bank changed the assumptions in its models rather than adjusting its practices.[95] A redder flag for supervisors is hard to imagine.

As readers have doubtless already inferred, I have highlighted deposit vulnerabilities and interest rate risk because they played a key role in the failure of SVB.[96] The steady withdrawal of deposits in 2022 was accompanied by the rapid interest rate increases that eventually produced unrecognized losses on SVB's securities portfolio that in turn rendered the bank insolvent on a mark-to-market basis.[97] When, on March 8, 2023, the bank announced that it had sold securities with a book value of $24 billion at a now recognized (and realized) loss of $1.8 billion, and that it was attempting to raise additional equity capital, the large, uninsured depositors recognized that the bank might no longer be viable. They ran with a vengeance. On March 9 the bank lost over $40 billion in deposits.[98] That evening the bank told regulators that it expected a further loss of $100 billion in deposits the next day, a run that would have essentially eliminated all its uninsured deposits.[99] On March 10 regulators closed the bank.

Signature Bank shared a number of characteristics with SVB: rapid growth, heavy reliance on large uninsured deposits, and a somewhat unusual business model that relied substantially on customers within a single industry – in Signature's case, cryptocurrency.[100] Not surprisingly, official post-mortems of its supervision also reveal significant shortcomings.[101] First Republic Bank had significantly lower shares of uninsured deposits and exposure to interest rate risk, though both were still above industry averages.[102] Its failure, more than a month after SVB and Signature succumbed, looks to have been a classic case of contagion – those uninsured depositors, seeing what had happened at SVB and Signature, withdrew their funds en masse.[103]

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[95] Barr Report at 58, 63.

[96] Many accounts of the failure place dominant emphasis on the interaction of these two vulnerabilities. For a particularly nuanced account building on this framework, see Andrew Metrick, The Failure of Silicon Valley Bank and Panic of 2023, 38 J. Econ. Perspectives 133 (2024). There is a view, with which I have some sympathy, that the tech-oriented business model of SVB (and Signature) was an important factor in turning these vulnerabilities into fatal runs of depositors on the banks. See Steven Kelly and Jonathan Rose, Rushing to Judgment and the Banking Crisis of 2023, Federal Reserve Bank of Chicago Working Paper 2025-04 (March 2025), https://doi.org/10.21033/wp-2025-04.

[97] See Metrick, note ___ *supra*, at 136, 143. At the end of 2022, SVB's reporting equity was $15 billion based on face value of its securities portfolio. On a mark-to-market basis, it was negative $3 billion. This calculation in isolation does not account for the effective increase in the value of a bank's deposit franchise when interest rates rise, caused by what is usually a considerable lag before the interest rates paid by banks to their customers catch up with market rates. However, as Metrick explains, this offset depends on the presumed stickiness of deposits. *Id.* If deposits exit the bank quickly, either because customers need the liquidity or depositors' expectations of timely availability of their deposits change, then there is no effective offset, and the paper insolvency of the bank soon becomes manifest.

[98] Barr Report at 24.

[99] Id.

[100] Signature Material Loss Review at 7-14.

[101] Id. at 15-38.

[102] FRB Material Loss Review at 8-21.

[103] As with virtually any bank, First Republic did not have nearly enough liquidity to meet all those depositor demands. But there is a case to be made that, absent the two earlier failures, First Republic would have survived. Indeed, the First Republic failure makes the point that the supervisory and, arguably, regulatory mistakes at SVB and

The six reports on the three bank failures collectively offer an unprecedented look into the supervision of relatively large banks. Even so, they do not provide a fully satisfying account of how the documented supervisory shortcomings occurred. Most importantly, if also understandably, there is very little information on the extensive discussions among supervisors that take place in every aspect of their work – both within the bank-specific teams and with their colleagues and superiors who participated in ratings reviews or other supervisory activities.[104] So, for example, with respect to many issues, it is difficult to determine if one or more line supervisors raised what in retrospect appears a valid concern and was overruled, either by others on the specific bank team or by more senior officials.

Troubling as these case studies of the bank and supervisory failures are, some additional qualifications are in order. First, and most obviously, when the only available data relates to failures, one has no insight into successes. How many banks *didn't* fail because of effective supervision? Or, placing the bar a bit lower, how often do supervisors effectively intervene to head off what might in the future have become significant safety and soundness problems? Second, when the ending (failure) is known, an ex post narrative will almost inevitably be biased toward casting supervisory action or inaction in a critical light. Decisions that in real time might have seemed difficult but reasonable look ill-advised in retrospect, precisely because we know the story ends badly.[105] Third, IG reports and internal reviews are necessarily selective in their accounts. They may reflect an outcome bias and, at the very least, provide to the public only the facts that the reviewers find most important. In some cases, the selectivity may also reflect organizational considerations, such as a desire to insulate particular individuals or offices from criticism (or, conceivably, to direct criticism at such individuals and offices).

There are some published studies of the effectiveness of supervision using broad samples of banks, not just the failed banks documented in IG or agency reports.[106] Most, though not all,

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Signature created a threat to the whole group of mid-sized regional banks that shared one or more of those banks' characteristics (e.g., relatively high levels of uninsured deposits).

[104] Most such discussions are informal preludes to more formal meetings, such as when ratings are assigned or reviewed. And, needless to say, there are no transcripts of even the more formal meetings. There may be internal memos sent among supervisors that could give some insight into the nature of the discussions, but none of the six reports suggests awareness of such documentation. Those who conducted the reviews, both in the offices of the Inspectors General and in the supervisory divisions of the Fed and FDIC, did interview at least some of the individuals involved in the supervision of the three banks. With a couple of exceptions, though, the references to these interviews are more in the nature of reporting the reason a conclusion was reached, rather than recounting the dynamic of the discussions producing that conclusion.

[105] Indeed, it is undoubtedly also the case that many supervisory decisions that in real time might be judged sub-optimal by others will never be known because – as is usually the case – the bank doesn't end up failing.

[106] See, e.g., Beyhaghi et al, Bank Supervision as Information Production, *supra* note ___; João Granja and Christian Lenz, The Death of a Regulator Strict Supervision, Bank Lending, and Business Activity, J. Fin. Econ. 158 (2024) 103871; Ivan Lim, Jens Hagendorff And Seth Armitage, The Effects of Regulatory Office Closures on Bank Behavior, J. Money, Credit and Banking, https://onlinelibrary.wiley.com/toc/15384616/0/0 (Advance online version 2024); Allen N. Berger,, Jin Cai, Raluca A. Roman, and John Sedunov, Supervisory Enforcement Actions Against Banks and Systemic Risk, 140 J. Banking & Fin. 10622 (2022), https://www.sciencedirect.com/science/article/pii/S0378426621001813;
Thomas M. Eisenbach, David O. Lucca , and Robert M. Townsend, Resource Allocation in Bank Supervision Trade-offs and Outcomes, Staff Report No. 769, Federal Reserve Bank of New York (2021); Beverly Hirtle, Anna Kovner and Matthew Plosser, The Impact of Supervision on Bank Performance, 75 J. Fin. 2765 (2020); Manthos D. Delis and Panagiotis K. Staikouras, Supervisory Effectiveness and Bank Risk, 15 Rev. Fin. 511 (2011).

these studies are by researchers who, by reason of affiliation with a federal banking agency, have access to at least some confidential supervisory information – typically bank ratings. Not surprisingly, the studies do not yield consistent conclusions, at least in part because the questions asked by the authors of different studies vary. As a whole, this work suggests that supervision has contributed to the safety and soundness of the banking system. But even if one stipulates that, for example, intense supervision is more effective than light touch supervision, or on-site supervision is more effective than remote supervision, one is still left with the question of whether supervision is effective *enough* to counteract significant vulnerabilities that arise at banks that are compliant with applicable regulatory rules. And even if SVB, Signature, and First Republic are characterized as outliers in their unrealized portfolio losses and dependence on uninsured deposits, the very fact that three of the nation's largest twenty-five banks failed in short order suggests a negative answer to the question.

B. Institutional Context of Supervision

The unusual role for bank supervision arises from the distinctive characteristics of both banking activities and the prudential regulations that govern those activities. The opacity of bank balance sheets means that effective enforcement of prudential regulations often requires supervisory presence inside the bank.[107] The difficulty in regulating risk directly means that supervisors must determine if bank practices that are apparently consistent with existing regulations in fact undermine the level of resiliency, or containment of risk, to which those regulations are directed. The supervisory role thus requires the production of non-public information and the regular exercise of discretion. The discretion inherent in the supervisory function creates at least the potential for conflict with the requirements of the Administrative Procedure Act. Indeed, in recent years representatives of the banking industry have argued that these conflicts are real, and require that the supervisory function be curbed.

Short of narrowly legal arguments, banks have also complained – sometimes, though not always, with justification – that supervisors exercise their discretion too heavy-handedly or unnecessarily. But some of the same characteristics of supervision that raise concerns about overreach may also foster supervisory underreach. In fact, the institutional context within which the supervisory function operates can simultaneously produce supervisory actions that elicit legitimate complaint by banks and yet fail to identify vulnerabilities that undermine bank resiliency.

Concerns about supervisory laxity are hardly new, of course. In addition to the assessments that followed the Spring 2023 failures, there was criticism of supervisory oversight of banks that failed during the Global Financial Crisis (or would have, absent extraordinary government support).[108] Looking further back, the 1980s savings and loan crisis produced not

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[107] At least one empirical study finds that on-site examination increases supervisory effectiveness. John Kandra and Bernd Schlusche, The Effect of Bank Supervision and Examination on Risk Taking: Evidence from a Natural Experiment, 34 Rev. Fin. Studies 3181(2021).
[108] See, e.g., Final Report of the Financial Crisis Inquiry Commission (Jan. 2011), https://www.govinfo.gov/content/pkg/GPO-FCIC/pdf/GPO-FCIC.pdf; Markus Brunnermeier, Andrew Crockett, Charles Goodhart, Avinash D. Persaud and Hyun Song Shin, The Fundamental Principles of Financial Regulation (Geneva Reports on the World Economy 11) (June 2009), https://cepr.org/system/files/publication-files/68579-geneva_11_the_fundamental_principles_of_financial_regulation.pdf.

just criticism of supervisory efforts, but a line of academic analysis identifying institutional factors that contributed to the substantial taxpayer losses that were eventually incurred. Most prominent was the work of Edward Kane, who suggested that the incentives faced by supervisors accounted for their "forbearance" – that is, for their delaying closures of insolvent S&Ls while losses mounted. As I will explain, Kane's argument may overstate some salient considerations and miss some others. But he set an important example in moving beyond simple criticism of supervisors and identifying structural reasons that contributed to supervisory failures. In this Part, I assess the contemporary institutional context within which supervision operates. Although such factors as political economy and incentive structures do not foreclose good supervision, I conclude that they do create the conditions for recurring supervisory failures.

Principals and Agents

The supervisory function involves both the presidentially appointed agency leaders who are responsible for policy and the staff who conduct the actual supervision of banks. Prior work on supervisory incentives has not always been clear which "supervisors" were being discussed. Moreover, while some of this literature quite naturally used a principal/agent framework to explain why supervisors may not adequately advance the public interest, the particular nature of that framework in the supervisory context has not always been precisely explained. Thus, before considering the key factors shaping the institutional context of supervision, it may be helpful to specify relevant principal/agent relationships a bit more fully.

As with all instrumentalities of the government, supervisory agencies are in some sense agents of the public. State authority over banking organizations is delegated to them to protect the interests of the public. Obviously, though, this simple statement does not meaningfully capture the relationship. The "public" can generally act only though its elected representatives in Congress, a relationship that entails considerable principal-agent issues of its own. Even positing Congress as the principal of administrative agencies (especially traditionally independent agencies such as the bank regulatory agencies), the relationship is far from a textbook principal-agent one, as discussed at length in legal and political science scholarship.[109] Among other things, the collective nature of Congress and its inability to exercise formal control except through additional legislation complicate the relationship. And, as the ensuing discussion illustrates, the supervisory function creates some additional complexity. Accordingly, while the concept of agency costs remains useful in explaining how the incentives of agency leadership may undermine the public's interest in a stable financial system, it is important to bear in mind that the interests of the "principal" – whether that is considered to be Congress or the public – are not regularly and reliably communicated by the principal itself. Nor, short of legislation, does

[109] Much of the extensive literature within the Congress/agency-principal/agent framework explores how Congress uses various legal requirements as substitutes for the direct, ongoing control generally associated with principal/agent relations. The canonical work along these lines is Mathew McCubbins, Roger Noll and Barry Weingast, Administrative Procedures as Instruments of Political Control, 3 J. L. Econ. & Org. 243 (1987) (arguing that various APA requirements are control mechanisms designed by Congress to control agency drift from the original purpose of legislation). More or less straightforward adoptions of the principal/agent framework can be found in Evan J. Criddle, Fiduciary Foundations of Administrative Law, 54 UCLA L. REV. 117, 164-65 (2006); Richard L. Revesz, Specialized Courts and the Administrative Lawmaking System, 138 U. PA. L. REV. 1111, 1140 (1990). For a more recent treatment suggesting that the principal/agent relationship is sometimes effectively reversed, see Brigham Daniels, Agency as Principal, 48 Georgia L. Rev. 335 (2014).

Congress as "principal" have regular and dependable means of exercising control over its "agents." As discussed later, however, to the extent the Supreme Court's muscular unitary executive theory compromises the Congressionally-created independence of bank regulatory agencies, there will be a much more straightforward principal-agent relationship between the President and the leadership of those agencies – one that will, quite probably, make fulfillment of the supervisory function even less assured.

On the other hand, the relationship between agency leadership and supervisory staff is much more usefully parsed in traditional principal-agent terms. The analysis that follows will distinguish institutional factors that are relevant to the supervisory function generally from those that apply more discretely to agency leadership or supervisory staff.

Political Economy

Students of banking crises have long worried that the political economy of bank regulation skews toward a regime that is suboptimally lax.[110] The constituencies for rigorous supervision during normal economic times are limited. Most regulatory areas pit opposing constituencies against one another – employers versus employees, shareholders versus management, polluting companies versus people suffering the effects of pollution. But in normal economic times, very few constituents have an interest in reducing the amount of credit extended by banks. A handful of members of Congress, a couple of very small public interest organizations, and various academics may focus on the issue, but most households and businesses care most about the credit they want currently, not on a possible banking crisis sometime in the dim future. Still less will they worry about the potential failure of a single bank, whose borrowers already have their loans and whose insured depositors are already protected by the FDIC.

The upshot is that many legislators and interest groups usually inclined towards stronger government regulation may resist prudential supervisory efforts in the absence of a banking crisis. Indeed, since banking regulations are often strengthened in the wake of a crisis, when Congressional and public awareness of banking risk is still high, supervision during the calmer economic times that follow may be even more susceptible to these political influences, precisely because it does involve so much discretion.[111]

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[110] See, e.g., Panagiota Papadimitri, Fotios Pasiouras, Gioia Pescetto, and Ansgar Wohlschlegel, Does Political Influence Distort Banking Regulation? Evidence from the US, 53 Journal of Financial Stability Article 100835 (April 2021); Marc Quintyn and Michael W. Taylor., 2003, "Regulatory and Supervisory Independence and Financial Stability", 49 CESifo Economic Studies 259 (2003); Edward J. Kane, Principal-Agent Problems in S&L Salvage, 45 J. Fin. 755 (1990).

[111] The position of supervisors is nicely captured in a quote from a senior bank supervisor following the Global Financial Crisis: "'Hindsight is a wonderful thing,' said Timothy W. Long, the chief bank examiner for the Office of the Comptroller of the Currency. 'At the height of the economic boom, to take an aggressive supervisory approach and tell people to stop lending is hard to do.'" Eric Dash, Post-Mortems Reveal Obvious Risk at Banks, N.Y. Times, Nov.18, 2009, https//www.nytimes.com/2009/11/19/business/19risk.html. One recent empirical study using confidential supervisory information concludes that "examiner stringency varies systematically over the business and financial cycle, becoming more conservative following periods of stress and more permissive during expansion." Beyhaghi et al., Bank Supervision as Information Production, *supra* note ___, at 6.

A striking example is the Congressional response to proposed guidance on commercial real estate lending issued by the banking agencies in January 2006. This proposal elicited strong, if predictable, opposition from banking groups.[112] More notable for present purposes were the number and intensity of Congressional complaints, which began shortly after the proposal was issued and culminated in a Congressional hearing in September.[113] At the hearing a broad, bipartisan group of Members expressed strong complaints that the supervisors' efforts to rein in commercial real estate lending would harm economic growth. This Congressional pressure on regulators is especially ironic in light of the events of just a few years later, which included the failure of over 500 banks, many of which had incurred substantial losses in their commercial real estate lending.[114] A more recent example is the opposition of numerous community groups to a proposal by the banking agencies to increase the amount of capital required for residential mortgages with smaller down payments.[115] Though a regulatory (as opposed to supervisory) measure, the pushback reflected the awareness of these groups that higher capital requirements for mortgage lending – even if empirically justified based on the greater default rates of mortgages with smaller down payments -- would mean fewer mortgages for less affluent loan applicants.

At first blush, the dearth of constituencies favoring rigorous supervision might suggest that a relatively lax system of supervision is consistent with societal policy preferences. Needless to say, though, constituency pressures shift dramatically when widespread bank failures or a full-blown financial crisis occur. As recounted at the beginning of this article, the substantial, and lasting, damage done to the economy in such circumstances produces recriminations directed at the banking agencies for failures of regulation, supervision, or both. Those recriminations are especially sharp when, as is usually the case, dramatic bank failures are followed by some form of government assistance for the banks or, as was the case in 2023, affluent uninsured depositors (both corporate and individual) in the failed institutions. There is thus a conflict between the usual self-perceived interests of the public in having more credit available, and their self-perceived interests when some economic shock results in a high level of defaults that threatens significant bank failures.

In this respect, bank regulation bears some similarities to monetary policy: Most of the time the public prefers the looser monetary policy that makes purchases using credit more affordable and, in general, strengthens near-term growth, with limited concern about inflationary consequences. But, when such policies do lead to higher non-transitory inflation rates, the public reacts strongly. Likewise, in most states of the world the public would prefer more intermediation and tends not to worry about possible consequences in the form of bank failures or a banking crisis. Like good monetary policy, good bank regulatory policy pushes against short-run preferences in the interests of longer-term welfare.

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[112] See H. Gary Pannell and Robert L. Carothers, Jr, Regulatory Guidance On Concentrations In Commercial Real Estate Lending, 11 N. Car. Banking Institute 33, 41-48 (2007).

[113] Review of Proposed Financial Services Regulations: Hearing Before the H. Subcomm. on Financial Institutions and Consumer Credit of the H. Comm. on Financial Service, 110th Cong. (2006). For a summary of the hearing, see Pannell & Carothers, supra note __ at 48-49.

[114] *See* Federal Deposit Insurance Corporation, Crisis and Response: An FDIC History, 2008-2013 181-183 (2017)., https://www.fdic.gov/resources/publications/crisis-response/book/crisis-response.pdf.

[115] Zoe Sagalow, US Banks Find Unlikely Allies in Basel III Fight, S&P Global Market Intelligence (Jan. 24, 2024).

This characteristic of bank regulation explains the emphasis on regulatory independence in various appraisals of regulatory effectiveness.[116] But financial regulatory independence does not appear to command the kind of political support that has developed in recent decades for the law and custom of monetary policy independence. At the very least, then, during normal times bank supervisors feel direct or mediated pressure not to discourage lending, regardless of the degree of risk associated with it. And, again, to the degree the current trend towards more political control over bank regulatory agencies is consolidated, these pressures could well become formalized within the governance of those agencies.

Congress has empowered, and sometimes required, the bank regulatory agencies to adopt prudential regulations of various sorts, usually with substantial discretion as to their content (subject, of course, to the APA requirement that they not be arbitrary or capricious). It has also created supervisory powers and responsibilities to complement those regulations. Finally, it has given the banking agencies substantial operating independence from both the President and itself (the latter because all three agencies are self-funding and thus not subject to the substantive constraints that can be imposed during Congressional appropriations processes).

One might understand the combination of these three features of banking regulation as Congress having legislated a commitment device to promote continued rigorous oversight of bank safety and soundness, even in the face of anticipated pressures for laxer supervision as the memory of a crisis fades.[117] The question of whether members of Congress consciously had this tie-themselves-to-the-mast intention matters less than the fact that this scheme is a possible way to deal with the reality that politics favors looser supervision in normal times, but that after a banking crisis there will be serious negative repercussions for those perceived to have permitted banks to overextend themselves. Whether this conjectured approach can succeed depends substantially on the capacities and incentives of the supervisors, both agency leaders and line staff.[118]

Resource Constraints

Resource constraints – both qualitative and quantitative – are a significant obstacle to supervision effectively complementing regulatory rules. Bank supervision is a difficult job. Although much academic work evaluating supervision has focused on incentive issues, it has also long recognized the challenges for supervisors in understanding how financial innovation may increase risk at the same time it offers new opportunities for credit extension.[119] Even the enforcement of capital, liquidity, and other prudential rules requires considerable knowledge of the financial transactions being overseen. The specifically *supervisory* function further requires

[116] *See* Fraccaroli, N., Sowerbutts, R., & Whitworth, A. (2025). Does regulatory and supervisory independence affect financial stability? Journal of Banking & Finance, 170, 107318. https://doi.org/10.1016/j.jbankfin.2024.107318 Marc Quintyn & Michael W. Taylor, Robust Regulators and Their Political Masters Independence and Accountability in Theory, in Designing Financial Supervision Institutions: Independence, Accountability, and Governance, Donato Masciandaro and Marc Quintyn, eds., 1-40 (2007).
[117] Cf. Daryl Levinson and Banjamin I. Sachs, Political Entrenchment and Public Law, 125 Yale L. J. 400 (215).
[118] The dynamic hypothesized here is a variant on the idea that "coalition drift" can be anticipated by the original actors in a legislative process. *See* Kenneth A. Shepsle, Bureaucratic Drift, Coalitional Drift, and Time Consistency: A Comment on Macey, 8 J. L. Econ & Org. 111 (1992).
[119] See, e.g, Edward J. Kane, Changing Incentives Facing Financial-Services Regulators, 2 J. Fin. Services Research 265, 266 (1989) (positing supervisory "recognition lags").

both the ability to identify bank practices that may compromise the resiliency intended by those rules and the exercise of judgment as to what remediating actions by banks will keep risk within acceptable bounds.[120]

Supervision of larger banking organizations has become immeasurably harder in the last few decades. The removal in the 1990s of most restrictions on branching allowed for the emergence of multistate banks with hundreds of branches or, in the cases of Wells Fargo and Bank of America, truly national commercial banks with thousands of branches.[121] Even adjusting for inflation, the assets of these banks dwarf the largest U.S. banks in the 1990s. In 1999, the five largest bank holding companies had combined assets of approximately $2.3 trillion, and combined trading assets of approximately $340 billion. By 2024 the comparable figures were $13.2 trillion and $2.1 trillion, a more than threefold increase in real terms.[122] Even at its peak – after the post-GFC augmentation of supervisory staffs, and prior to the announced intentions of Trump Administration appointees to slash existing supervisory headcounts – the ratio of supervisors to banking system assets had not kept pace.[123]

Of perhaps greater significance is the increased complexity of larger banking organizations. Traditionally, bank supervision mostly involved oversight of traditional lending and deposit-taking activities. The 1999 repeal of the Glass-Steagall separation of commercial and investment banking has allowed the emergence of financial behemoths with deep involvement in capital markets that are themselves considerably more complex and volatile than in the quiet half century following the enactment of the Glass Steagall Act in 1933.[124]

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[120] A former Comptroller of the Currency characterized supervision as a "craft":

> [E]ffective supervision requires a special mix of skills, techniques, and experience: curiosity, a nose for b.s., fluency with numbers (especially ratios), an ability to think critically, tolerance for tough conversations with bankers, situational awareness, good judgment, emotional intelligence, communications agility, and an unwavering commitment to public service. . . . While quantitative analysis looms large in any supervisor's tool kit, the ability to ask probing questions and draw out new, insightful information from stakeholders is what differentiates good from great supervisors.

Acting Comptroller of the Currency Michael Hsu, Evolving Bank Supervision, Remarks Before the Joint European Banking Authority and European Central Bank International Conference (Sept. 3, 2024), https://www.occ.gov/news-issuances/speeches/2024/pub-speech-2024-95.pdf. Just to

[121] As of 2025, Wells Fargo had over 4000 branches in 40 states, and Bank of American had over 3600 branches in 39 states. See Federal Deposit Insurance Corporation, FindBank Suite, https://banks.data.fdic.gov/bankfind-suite/bankfind (searched January 4, 2026). In both cases the growth of the branch network owed much to acquisitions of other banks, as well as internal expansion

[122] The growth referred to in the text is illustrated in Appendix A.

[123] The reporting of supervisory headcounts in the three federal banking agencies is neither standardized nor regularized, so it is difficult to make precise comparisons. However, one can draw data from several different sources to make some rough comparisons. The number of financial institution examiners at the OCC grew about 27% during the 1999-2024 period. The number of supervisory staff in the Federal Reserve System (the Board of Governors and the twelve regional Reserve Banks) grew from 2448 in 2001 to approximately 3700 in 2022, an increase of about a half. It should be noted that during this period the number of insured depository institutions has decreased substantially (largely because of mergers with other banks). There are some scale economies in supervision – it doesn't take as many supervisor hours to examine one $10 billion bank as it does five $2 billion banks. But the enormous increase in the total assets of supervised banking organizations and in non-commercial bank subsidiaries, many of which are engaged in capital markets activities, more than outweighs this modest offset.

[124] Dafna Avraham, Patricia Selvaggi, & James Vickery, *A Structural View of U.S. Bank Holding Companies*, 18 Fed. Reserve Bank N.Y. Econ. Pol'y Rev. 65 (2012) document the dramatic increase in assets of bank holding companies outside their commercial bank subsidiaries in the decade following passage of Gramm-Leach-Bliley.

JPMorgan, Citi, Bank of America, Goldman Sachs, Morgan Stanley and – increasingly – Wells Fargo and superregional banks such as PNC pose supervisory challenges of a sort that simply did not exist a quarter century ago. It is one thing to review loan files to ensure that the borrower's ability to repay and the value of any collateral have been carefully analyzed by a bank. It is quite another to evaluate a firm's use of derivatives to hedge against interest rate changes or to manage exposures created by sophisticated total return swaps.[125]

There are certainly some outstanding supervisors at the banking agencies – individuals with impressive credentials who as public servants forego the much higher remuneration available at the kinds of firms they supervise or at the consulting firms that service those firms. But it seems very unlikely that the average supervisor at a large banking organization has the expertise and acumen necessary to detect latent risks that are not effectively contained by applicable regulatory rules. The reports on the Spring 2023 failures reinforce this inference. The FDIC's report on its supervision of Signature Bank placed considerable weight on resource issues in explaining the agency's inadequate oversight. It identified quantity problems -- difficulties in fully staffing the team assigned to Signature -- and quality problem in the form of a "lack of commensurate experience . . . given how quickly the institution was evolving and inadequate "skillsets."[126] The report of the Federal Reserve Inspector General noted the lack of expertise among supervisors assigned to SVB when it was still a smaller regional bank but growing rapidly.[127]

Monitoring Limitations

The accountability of agency officials is, of course, a principal concern of administrative law. Traditionally, and especially in recent decades, the judiciary has been dominantly concerned with agency officials overstepping their statutory authority. Remedies for failures of agencies to enforce the law or, more generally, to perform their assigned jobs adequately, have generally been limited to institutional and political forces. Whatever the relative effectiveness of those forces for most administrative functions, monitoring limitations and incentives issues make them less effective in influencing bank supervisors. These limitations affect both the public's ability to scrutinize the efforts of the bank regulatory agencies and the ability of senior banking agency officials to oversee the efforts of line supervisors.

The underperformance of supervisors is usually not visible to legislators, investors, or the public – at least not in a timely fashion. The very opaqueness of bank balance sheets and activities that motivates the supervisory function means that, other than perhaps banks themselves, no one is well-positioned to determine if the supervisors have performed competently. Banks sufficiently aggrieved with supervisory actions can find a way to pursue their complaints – if not in court or with senior banking agency officials, then through a friendly Member of Congress. As explained earlier, in normal economic times the dominant politics will likely not reflect deep concern with supervisory laxity. Yet those academics and public interest

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[125] The qualitatively different, and more challenging, tasks involved in overseeing large commercial banks, much less extensive broker-dealer and other capital market activities, means that the experience of junior supervisors in a small bank whose business is essentially the traditional one of taking deposits and making loans is no longer especially relevant training for supervising large banks and their non-commercial bank affiliates.
[126] FDIC Report on Signature at 37. The discussion of the resource issues is at pp. 36-39.
[127] SVB Material Loss Review at 34.

groups who *do* care will usually have limited ability to determine if there are grounds for worry.[128] There is, for example, no way for outsiders to know if supervisors have appropriately identified significant deficiencies in a bank's quantitative risk modelling, or whether they are rigorously enforcing complex capital rules. There is thus a decided asymmetry in the oversight of supervision – while banks will be fully aware of arguable supervisory overreach, the public will not be aware of arguable supervisory underreach.

The monitoring problem is exacerbated by the fact that there will usually be a considerable lag before supervisory shortcomings become evident. When EPA officials are underperforming, third parties can often observe the resulting increase in air or water pollution fairly quickly. When OSHA inspectors are too lax, employees may observe at least some uncorrected hazards in their workplaces. But the flaws in a bank's risk model, for example, will likely not have negative effects until some later event, such as an exogenous shock to an asset class (e.g., commercial real estate mortgages) that leads to losses beyond what the bank's inadequate risk management had projected under stressed economic circumstances. Thus the precise nature and effect of the 2025 refocusing of supervisory attention away from all but "material financial risks" may well not be known unless and until some future market shock leads to unexpectedly high bank losses.[129] The delayed nature of possible adverse consequences also means that supervisors may get little in the way of real-time feedback.

In some cases, problems that have not been addressed by supervisors *are* visible externally. A case in point is SVB itself. The huge holdings of longer-dated bonds that carried unrecognized losses were well-known to bank analysts and, by extension, institutional investors. But, unlike residents living next to a polluted river or employees working in unsafe conditions, they did not have any particular motivation to take their concerns to the banking agencies, much less to enlist their representatives in Congress to pressure the agencies to do something. The parties that were at greatest risk – large uninsured depositors – apparently remained mostly unconcerned until the public admission by SVB that it needed more capital precipitated an unprecedented run by those depositors. As Gary Gorton has explained repeatedly over the

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[128] Investors – especially holders of long-term debt issued by banking organizations – do have at least some incentive to collect information on the banks, and may have more influence in getting banks to release relevant information than do academics or self-styled public interest advocates. Still, the problem of information that cannot be uncovered even with considerable diligence remains.

[129] This shift in supervisory policy would be formalized by the FDIC and OCC in a proposed rulemaking that would define the term "unsafe or unsound practice" in 12 U.S.C. §1818(b) to "focus on material risks to the financial condition of an institution and would generally require that an imprudent practice, act, or failure to act, if continued, would be likely to materially harm the institution's financial condition.. Department of the Treasury Office of the Comptroller of the Currency and Federal Deposit Insurance Corporation, Notice of Proposed Rulemaking, Unsafe or Unsound Practices, Matters Requiring Attentio, 90 Fed. Reg. 48835, 48837 (Oct. 30, 2025). While the Federal Reserve did not join this proposed rulemaking, Vice Chair for Supervision Michelle Bowman has indicated that the Federal Reserve has aligned its supervisory policies with this standard. In a speech explaining her supervisory policies, she emphasized that the focus on material financial harm was meant to deemphasize supervisory attention to "processes" and "documentation." Vice Chair for Supervision Michelle W. Bowman, Taking a Fresh Look at Supervision and Regulation, June 6, 2025, https://www.federalreserve.gov/newsevents/speech/bowman20250606a.htm.

years,[130] those who hold liquid, apparently safe (i.e., money-like) assets such as deposits are essentially information insensitive until some event forces them to become intensely information *sensitive*, at which point they run. This dynamic holds – perhaps especially so – when the suddenly information-hungry investors/depositors do not have the facts that would clarify the bank's condition. The initial flight of some depositors who run in the face of incomplete information becomes self-fulfilling, as other depositors hasten to exit before the bank's liquidity is depleted. That is precisely what happened in the space of just a few days in March 2023.

The same characteristics of banking supervision that make public monitoring challenging also limit intra-agency monitoring of line supervisors by their career and political superiors, albeit to a lesser degree. Supervisory activities not only provide opportunities for staff to exercise discretion; they require it. A key assumption in supervision is that information developed by supervisors based on their close observation of, and interaction, with banks will permit them to supplement generally applicable regulations and guidance with more focused questioning and guidance directed at the specific risks created by a bank's often opaque and rapidly changing activities.

So too, supervisory actions specific to individual banks are usually premised on firm-specific knowledge and judgment. The assignment of ratings was traditionally heavily reliant on this kind of supervisory judgment and, to a considerable extent, still is for smaller banks. More objective metrics now play a greater role in determining some elements of larger bank ratings, but the judgment of on-site teams and other single-bank-dedicated staff have – at least until very recently – remained important in assessing a bank's risk management capacities and performance.[131] And, of course, idiosyncratic or ad hoc supervisory actions by on-site teams necessarily begin from their observation and judgment.

In all these examples, supervision will entail an information asymmetry between principals and supervisory staff. In some instances, such as the development of generally applicable supervisory priorities or guidance in response to trends across a wide part of the banking industry, more senior supervisors and principals can be briefed and participate in decisions. Indeed, in these cases principals may have the benefit of multiple sources of information, including standardized data on industry practices and commentary by private

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[130] *See, e.g.,* Gary Gorton and Andrew Metrick, Securitized Banking and the Run on Repo, 104 J. Fin. Econ. 425 (2012); Gary B. Gorton, Slapped By the Invisible Hand: The Panic of 2007 (2010). For an account of how this dynamic played out at SVB, see Andrew Metrick, The Failure of Silicon Valley Bank, *supra* note ___.

[131] The new leadership at the three bank regulatory agencies, especially the Federal Reserve, have echoed the concerns expressed by banks that management ratings should be mostly derived from financial indicators. In accordance with this view, the Federal Reserve has formally changed its ratings system for large banks so that its management rating cannot be deficient so long as its current capital ad liquidity positions are satisfactory. Thus the somewhat paradoxical situation that a bank can now be rated "well managed" even if its rating for Governance and Controls is "deficient." Board of Governors of the Federal Reserve System, Revisions to the Large Financial Institution Rating System and Framework for the Supervision of Insurance Organizations, 90 Fed. Reg. 51329 (Nov. 17, 2025) This perspective, while perhaps building on the correct perception that supervisors have sometimes overlooked financial conditions because they were too focused on risk management processes, may also reflect a misunderstanding of the point made earlier in this article that the resiliency at which regulations of financial indicators such as capital levels aims can be undermined even where a bank appears to be compliant with the regulations.

analysts on observed trends in financial markets.[132] In many other cases, including much bank-specific supervision and enforcement, it will just not be feasible for senior supervisors or principals to acquire the knowledge needed to effectively oversee the supervisory choices.

As with public awareness of agency supervision, overreach will likely be detected. Banks can complain to agency higher-ups, and will certainly do so when they perceive that agency leadership is more bank-friendly than line supervisors. But, as with the public, senior agency officials are less likely to learn of the failure of line supervisors to spot, for example, a serious deficiency in bank underwriting standards or flawed management of derivatives exposures. Although not common, line supervisors disagreeing with a supervisory emphasis taken by their superiors, including agency leadership, have been known to dilute – or even ignore – application of the directive to the firm they supervise while reporting that they (and the firm) have complied. Of course, senior agency officials are better positioned than the public. They can, if they wish, access confidential supervisory information. They can, and do, put in place systems for overseeing supervisory efforts. But precisely because, as Eisenbach and colleagues suggest,[133] the essence of supervision is ferreting out soft information from scrutiny of a bank's operations, a significant information asymmetry remains.

Incentives and Opportunities

The preceding sections have in some sense been opening acts for the main event . The political economy of bank regulation and supervision sets the external context for an inquiry into the incentives of supervisors. Monitoring difficulties mean that, to the degree the incentives and opportunities of supervisors make practice deviate from some ideal view of the supervisory function, detection of those deviations will be relatively more difficult for those members of Congress and the public who do care. Monitoring limitations also constrain principals' ability to determine if line supervisors are – in the jargon of agency cost analysis – "shirking."

Although the literature on supervision sometimes elides the distinction between agency principals and supervisory staff, the incentives and opportunities of these two groups differ in some important respects. This section will consider first an opportunity that supervision presents specifically for agency principals. Then it will consider some possible motivations such as regulatory capture that are applicable to both groups. Finally, it will turn to what is arguably the most important, and least appreciated, dynamic – the undermining of the conceptual role of supervision that results from the interaction of the incentives of supervisory staff and the efforts of agency principals to keep them accountable.

[132] A broader view of this sort has traditionally been provided by so-called horizontal examinations, which assess a particular asset class or banking practice across of a range of banks. Leadership at the Federal Reserve has recently sharply limited the ability of supervisors to conduct horizontal reviews. *See* Memorandum from Randall D. Guynn and Julie Williams, Board of Governors of the Federal Reserve System Division of Supervision and Regulation, Updated Statement of Supervisory Operating Principles, April 21, 2026, https://www.federalreserve.gov/supervisionreg/files/statement-of-supervisory-operating-principles-20260430.pdf. To the extent supervisors were using these reviews to impose specific procedures on banks (i.e., design, rather than performance, standards), some limitation is certainly justified. But the requirement in this document for specific approval of any horizontal exam suggest a more far-reaching constraint on their use.
[133] *See* Eisenbach et al., The Economics of Bank Supervision, *supra* note ___.

Principals. Principals of the banking agencies set overall supervisory policy.[134] They do so by identifying or endorsing supervisory priorities. Directly or indirectly they set the "tone from the top," conveying to staff their preferred intensity of enforcement and scrutiny of bank practices. They also, of course, set overall regulatory policy within legislative bounds and authorities – adopting new notice-and-comment rules or modifying those previously adopted. The political economy factors described earlier can certainly influence principals to adopt a more permissive regulatory posture. Regulatory changes or, for that matter, statutory changes may reflect an unwise discounting of the potential for serious problems later. But they may also reflect reasonable differences in deciding on the trade-off between near-term growth and longer-term risk. Even within traditionally independent agencies, the principals will have been selected by the President and confirmed by the Senate – presumptively reflecting approval of the policy orientations of those individuals. To the degree their policies eventually prove ill-advised, the resulting societal harm may be attributed to the tendency of democratic polities to favor near-term benefits over longer-term interests. In the terms introduced earlier, the available commitment devices are not, and probably should not be,[135] *guaranteed* to succeed.

Those policies will be relevant for decisions on both regulatory rules and supervisory practice. However, the less formal and less transparent character of much supervision may incentivize principals to implement their policy preferences disproportionately through that channel. The opacity of supervision creates the opportunity to effectively change the prudential policies reflected in the regulatory rules. Agency principals can instruct staff to relax enforcement efforts and oversight of bank practices not covered explicitly in regulatory rules. They can impose a high burden of proof in internal processes for deciding whether to take an enforcement action. In doing so, the principals can effectively alter the degree of rigor inferred from the texts of the rules without the transparency of notice-and-comment rulemaking. That is, change in supervisory practice can be a kind of stealth deregulation that undermines the level of resiliency at which those rules aim.[136]

Even with some public awareness of a change in supervisory practice, as was the case in the second half of 2025, it is not easy for outsiders to understand the effect on the safety and soundness of banking organizations. So, for example, in their 2025 policy changes, banking agency principals announced that supervisors should focus mostly, or only, on "financial risks" to banking organizations, to the exclusion of "process" concerns. But an outsider cannot determine whether the processes being deemphasized includes such key tasks as validation of the internal models banks use to calculate their exposure to loss – and thus capital requirements – for their holdings of traded market

[134] Generally speaking, principals will take a proactive approach. If they don't, the agency essentially defaults to the policies of senior staff. In such a situation, though, it is reasonable to impute the resulting policies to the principals who have declined to exercise their authority and thereby permitted the policies preferred by the senior staff.
[135] *Cf.* Levinson & Sachs, *supra* note ___, at 457-467.
[136] As banks have argued, the non-transparent and discretionary character may also facilitate a form of stricter regulation that should, under administrative law principles, have been accomplished through notice-and-comment regulation. Again, though, the bank on the receiving end of such a questionable supervisory practice *will* be aware of it and has at least potential avenues of recourse.

Principals and Supervisory Staff: Some observers of bank failures offer arguments about supervisory incentives that have long been familiar in other areas of regulatory failure.[137] These contentions are often variants of regulatory capture arguments (or, in this case, supervisory capture): In hopes banks will give them higher-paying jobs, supervisors curry favor by taking a light touch in their oversight. Supervisors, especially those assigned to a bank on a long-term basis, adopt the mindset of the bankers with whom they deal on a daily basis and develop sympathy for the business challenges those bankers face. Among other purported benefits, this approach leads to an "easy life," without unpleasant conflicts with the bankers.

These variations on the theme of regulatory capture are surely possible and, almost as surely, applicable to some individual supervisors. But, at least as presented in such simple terms, they are not especially convincing as structural explanations. The intuition that supervisors may go soft on a bank in order to increase their chances of being hired by that (or another) bank can be countered by the intuition that banks are most likely to want employees who are analytically rigorous – not yes men and women. And, while empirical research on the internal thoughts and motivations of supervisors is obviously hard to conduct, there is some work casting doubt on the notion that supervisors take a light touch so as to obtain lucrative employment with a bank they have overseen.[138]

Post-mortems of the Savings & Loan crisis of the 1980s, notably by Edward Kane, postulated an incentive structure that systematically led to "forbearance" by supervisors when confronted with possibly failing depository institutions.[139] These analyses, though not wholly satisfactory explanations of contemporary supervisory dynamics, are important starting points for understanding the incentive structures that exist for supervisors today.

As would be expected given the context within which this line of scholarship developed, the focus was on supervisory delays in closing failing insured depository institutions. The basic idea was that supervisors were incentivized to forbear from closing S&Ls in a timely fashion because in doing so they would be seen as having failed as regulators. While some analyses simply referred to reputational costs for the supervisors,[140] Ed Kane was explicit in positing that supervisors wanted higher paying jobs after their government service, and thus were incentivized to keep failing S&Ls afloat until they left government so as to preserve their reputations for

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[137] *See, e.g.,* Pierre C. Boyer and Jorge Ponce, Regulatory Capture and Banking Supervision Reform, 8 J. Fin. Stability 206 (2012); Elena Carletti, Competition and Regulation in Banking, in Anjan V. Thakor & Arnoud W. A. Boot (Eds.),
Handbook of Financial Intermediation and Banking 449–482 (2008); James R Barth, Gerard Caprio Jr, and Ross Levine Bank Regulation and Supervision: What Works Best?, 13 J. Fin. Intermediation 205 (2004).

[138] *See* David Lucca, Amit Seru, Francesco Trebbi, The Revolving Door and Worker Flows in Banking Regulation, 65 J. Monetary Economics 17 (2014) (concluding that the movement of bank supervisors to banking jobs is driven not by "quid-pro-quo" factors, but by "regulatory schooling" – the need of banks for expertise in the face of increased or new forms of enforcement). Evern intuition unaided by empirical work should produce skepticism about the quid-pro-quo argument. At the principal level, most appointees who enter finance following their government service came from finance – or worked for financial institutions in law or consulting firms – before entering government. More generally, it seems more logical that a bank hiring a supervisor would want the brightest, most rigorous people it could find with requisites expertise.

[139] *See* Edward J. Kane, The S&L Insurance Mess: How Did It Happen 95-143 (1989) [hereinafter "S&L Insurance Mess"]; Arnoud Boot and Anjan Thakor, Self-Interested Bank Regulation, 83 Amer. Econ. Rev. 206 (1993).

[140] Boot & Thakor, *supra* note ___

competence.[141] As Kane (among others) noted, these delays increased the ultimate cost to taxpayers of the eventual resolutions of the failed S&Ls (notably including payouts to the insured depositors of those firms).

This explanation had some limitations, even at the time. Kane himself argued that Congress was an unhelpful influence -- both in resisting regulators' calls to authorize a more risk-sensitive deposit insurance system and in pressuring supervisors not to close S&Ls[142] -- thereby describing what I have referred to as the political economy of bank supervision and regulation. He also acknowledged that supervisors may not have recognized the growing risks of capital depletion and interest rate risk until many S&Ls were already severely compromised, despite some academic work identifying those risks[143] -- a parallel to my earlier point about the difficulty of the supervisory task and the capabilities of many supervisors. And none of the prominent exponents of the forbearance thesis distinguished between agency principals (who knew their government tenure was limited by their statutory term) and line supervisors (many of whom may not necessarily have aspired to lucrative non-government jobs and who were, in any case, not in a position to resist forbearance decisions made by principals).

Removed from the context of the case-specific context of the S&L failures, the forbearance explanation seems further limited. While there is a logic to reasoning that supervisors may join troubled banks in "gambling for resurrection" rather than moving quickly to resolution actions, it is intuitively less compelling in explaining supervisory laxity for banks not facing obvious near-term risks to solvency. Indeed, as part of a regulatory reform package enacted following the S&L failures, Congress required the Inspector General of the primary federal regulator of a failed insured depository institution to review the agency's supervision of the bank to "ascertain why the institution's problems resulted in a material loss to the Deposit Insurance Fund."[144] As with the material loss reviews of Silicon Valley, Signature, and First Republic Banks, these reports typically assign at least some blame to the line supervisors for a failure to identify problems and, where problems were identified, to act early and forcefully enough to prevent failure. Thus there is the prospect that supervisors may later be called out for laxity during periods when a bank was not in imminent danger of failing. In these circumstances, it would seem that to the degree fear of external reputational damage motivates the behavior of supervisors, they would be incentivized to be tougher, rather than more permissive.[145] Understanding why this external labor market explanation, even if a genuine

[141] S&L Insurance Mess at 101-106.
[142] S&L Insurance Mess at 68-70, 105.
[143] S&L Insurance Mess at 103.
[144] 12 U.S.C. §1831o(k)(1)(A)(i). At present, a "material" loss is one over $50 million, 12 U.S.C. §1831o(k)(2)(B)(iii), though there may be reviews of failures resulting in smaller losses to the Federal Deposit Insurance Fund when "unusual circumstances exist." 12 U.S.C. §1831o(k)(5)(A)(ii)(II).
[145] There are other qualifications on the original forbearance hypothesis, less relevant to normal supervisory practice. For one, unlike during the S&L crisis, it does not appear that supervisors forbore from closing banks during the Global Financial Crisis in 2007-2009. Second, after Kane and others offered their theories during and after the S&L crisis, a number of commentators have suggested that, even from a public interest perspective, decisions on forbearance during an emerging banking crisis may be more nuanced than suggested by Kane and others. See, e.g., Isabelle Roland, Yukiko Saito and Philip Schnattinger, Forbearance Lending as a Crisis Management Tool: Evidence from Japan, Bank of England Staff Working Paper No. 1,102 (Dec. 2024), available at https://www.bankofengland.co.uk/-/media/boe/files/working-paper/2024/forbearance-lending-as-a-crisis-management-tool-evidence-from-japan.pdf; Linda Schilling, Optimal Forbearance of Bank Resolution, Becker

consideration for line staff, may not be enough to ensure supervisory rigor requires an inquiry into the *internal* labor market within which supervisory staff function.

Supervisory Staff: Once again, information asymmetries and monitoring challenges are important factors in shaping the incentives of both principals and line staff within the internal labor market for supervisors.

As discussed earlier, agency leadership cannot realistically monitor most of what supervisory line staff does on a daily basis. In order to advance its supervisory policies under these conditions, leadership can put in place various governance mechanisms to help compensate for the infeasibility of adequate direct monitoring. These measures may be motivated by, on the one hand, concerns that line staff may miss bank problems or be too complacent in pursuing them or, on the other hand, concerns that staff will be too aggressive in their supervision – either in general or with respect to specific matters that leadership regards as inappropriate. Leadership may simultaneously have both kinds of concerns – worrying that line staff may miss some important bank vulnerabilities as they focus excessively on other, less pressing issues.

Like staff at all agencies and, for that matter, nearly all employers, supervisors' career prospects depend heavily on their standing with agency leaders, either directly or as mediated through senior career staff. Promotions, bonuses, favorable assignments and other tangible benefits are of course more likely to go to staff perceived as doing a good job in implementing the agency's policies. But less tangible patterns of reinforcement – positive and negative – also affect the approach taken by line supervisors. Criticism from agency superiors can affect line supervisors' standing among their peers, diminishing their influence within supervisory teams.

Potentially even more troubling for line supervisors is the prospect of the banks they oversee learning that they have lost standing within their agencies. That information may embolden a bank to resist, or even ignore, subsequent direction from supervisors now perceived as not backed by their own agencies. Aware of these risks, line supervisors are often at pains to avoid circumstances where their actions or recommendations may be rebuffed by agency superiors. This self-protective instinct will certainly inhibit line supervisors from pushing concerns on a topic they know agency leadership to disfavor. At the limit, the supervisors may also be inhibited even from raising issues on which agency leadership has not yet opined, out of fear that the response may be to dismiss their concerns. Indeed, in some respects the silence of leadership is more challenging for line supervisors, as it causes them to spend a lot of time trying to determine just what the leadership thinks and wants.

As noted earlier, where leadership is concerned that line staff may be too aggressive in demanding changes in bank practices, it can raise the bar for approval of formal enforcement actions – either in general or with respect to certain issues (e.g., the adequacy of a bank's various

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Friedman Institute, University of Chicago Working Paper No. 2018-15 (March 2018), available at https://bfi.uchicago.edu/wp-content/uploads/WP_2018-15.pdf; Alan D. Morrison and Lucy White, Reputational Contagion and Optimal Regulatory Forbearance, 110 J. Fin. Econ 642 (2013).

"lines of defense" in its risk management systems).[146] Based on information contained in the Inspector General's report, this appears to have been the case in the supervision of Silicon Valley Bank.[147] In making formal enforcement actions harder for line supervisors to initiate, leadership may not be able to stop them from raising certain issues with the banks they oversee, but they can stifle the escalation from informal to formal supervisory actions that may be needed to force banks to remediate the criticized practices. This approach – which will generally remain opaque to the public – is useful for implementing the kind of stealth deregulation discussed earlier.

While making enforcement more difficult is obviously useful only where agency leadership wishes to contain supervisory initiative, the setting of supervisory priorities is a governance mechanism useful for both limiting and encouraging line supervisory activity. Leadership understandably attempts to provide direction and increase line supervisors' accountability by specifying priorities. Where leadership wants to restrain supervisors, the career incentives of line supervisors may be relatively aligned with those of leadership, since the self-protective instincts of line supervisors may already be pushing them to relative passivity.[148] But even where leadership's articulated priorities reflect a preference for more rigorous supervision, the career driven incentives of staff can deter them from performing the core task of a distinctly supervisory function.

Here is how this somewhat paradoxical dynamic can play out: Leadership may have very good reasons for creating a top-down supervisory program, rather than relying principally on line supervisors' assessments of the circumstances of the specific banks they are overseeing: With the benefit of the broader view they gain from seeing all supervisory reports and utilizing quantitative information on industry trends, leadership may identify potential vulnerabilities that may not yet have grown into obvious problems at banks in a supervisory portfolio. This inclination toward specifying the supervisory agenda may be strengthened where leadership is not confident of the ability and/or willingness of at least some line supervisors to detect and tackle issues at their banks. More generally, agency principals usually take seriously their position as policymakers, and thus naturally try to formulate policies that integrate regulatory rule initiatives, enforcement, and supervision into a coherent regulatory agenda.

When leadership identifies a supervisory priority – whether indefinite or a shorter-term response to some market development – it is added to an existing list of priorities. Sometimes quite literally, and at least figuratively, the accumulated list of priorities becomes a checklist for line supervisors to follow. The supervisory bureaucracy puts in place a framework to ensure that the line supervisors have made appropriate examinations of banks' conditions and practices relevant to the priorities – e.g., the capacity of a bank to manage properly the risks entailed in a fast-growing asset class with which the bank has limited past experience.

With checklist in hand, the line supervisors have a reasonably good answer to the question of what their superiors want them to be doing. By conscientiously examining for each

[146] This can be accomplished by effectively raising the burden of proof, such as by requiring line supervisors to demonstrate a more immediate risk to a bank's capital adequacy or demonstrating that the practice has continued over a prolonged period.
[147] SVB Material Loss Review at 25.
[148] But even agency leadership inclined towards less rigor in supervision would presumably want potentially serious emerging vulnerabilities brought to their attention.

item on the list, the line supervisors are, as good career employees, implementing the policies articulated by agency principals. But they are also protecting themselves. Failure to examine thoroughly one or more of the existing priorities in favor of pursuing an idiosyncratic vulnerability not included on the checklist may subject the line staff to explicit or tacit reprimand (especially, though not only, if something related to the priority item causes later problems at the bank). Further, by concentrating on the matters included in the checklist, line supervisors avoid a potential rebuff if they seek approval for a formal enforcement action directed at some other matter. If some vulnerability not on the checklist does prove troublesome later on, the line supervisors have at least the partial insulation that comes from having faithfully carried out the direction they had received from leadership.

This last possibility reminds us that there will indeed be reputational consequences for line supervisors if their bank fails and a material loss review by the agency's Inspector General points to their failure to identify or carry through on a vulnerability that contributed to the institution's eventual failure. In fact, in a decidedly unscientific but anecdotally revealing exercise, I have asked numerous supervisors over the years about just this point. The answers I have received are general variations on the reasoning that most of the time the failure of a bank sometime in the future is a low probability, whereas the career consequences from supervisors not aligning with the expressed priorities of agency leadership are quite immediate.

Note also that the longer the checklist, the greater the opportunity costs for supervisors both able and inclined to scrutinize bank practices and policies not on the list. It will often take considerable time for supervisors to gather information and then analyze the risks that may be associated with a new bank product or practice. That time may just not be available to line supervisors already charged with assessing many other practices. And, again, prudent career considerations will disincentivize most lines supervisors from giving short shrift to a priority specified by their supervisors in order to pursue some new concern.

Thus the paradox: Agency principals committed to rigorous supervision are incentivized to identify potential bank vulnerabilities for supervisory attention. Line supervisors, in turn, are incentivized to scrupulously use the checklist as the basis for their supervisory program. Yet, as argued earlier, the role of the supervisory function is to identify, and seek changes in, bank activities that threaten to undermine the resiliency at which capital, liquidity, and other regulatory rule aim. Sometimes, to use now familiar terminology, the problems in a bank may result from "known unknowns." If so, then the supervisory process just described can, if executed competently, be an effective complement to regulatory rules. But, if not, then vulnerabilities arising from "unknown unknowns" will continue to lead to bank failures and, in extreme cases, crises.

Before leaving this factor, it is worth noting that the checklist approach may also contribute to unnecessary, or unnecessarily inflexible, supervisory interventions. When a bank practice or activity is on the list, the line supervisors will usually scrutinize it carefully, possibly issuing a "Matter Requiring Attention" notice[149] for relatively minor issues implicated by the

[149] As the term implies, a "Matter Requiring Attention," or MRA, is a written notice to a bank that it should take remedial action to correct a problem identified by supervisors in the banks condition or practices. MRAs are routinely issued to banks and, in themselves, carry no immediate consequences. If the problem identified is left

practice to show their superiors that they are on the case. Moreover, especially where risk management or governance processes are concerned, the supervisors may incline toward an insistence that each bank adopt a process that conforms to some notional "best practice." That may understandably frustrate banks that have developed processes that they believe are equally effective in containing risk but work more efficiently within their particular bank.[150] Although, as noted earlier, the view of current banking agency leadership that supervision should address only "material financial risks" is badly misguided, the leadership (acting, presumably, on complaints from banks) do have a point about supervisory overreach of this kind. Thus it is possible for the current regulatory system to simultaneously produce both Type 1 and Type 2 errors.

Harking back to the SVB case: Whether because of a signal from the top (the stealthy, opportunistic deregulation by principals) or because of the staff's incentives in the face of bureaucratic processes intended to advance certain supervisory priorities, the lack of follow-through on the supervisory concerns that *were* identified in the primary supervisory materials seems to corroborate the dynamics hypothesized here.

Administrative and Constitutional Law Complications

The critical element of discretion in the supervisory function naturally raises the question whether administrative law requirements create obstacles for its role as a complement to regulatory rules. To date, at least, the answer is that the judiciary has not created any significant impediments to fulfillment of this role. As I have argued elsewhere,[151] the statutory foundations of supervision and traditional administrative law doctrines provide ample justification for the exercise of supervisory discretion. Still, banking interests have argued otherwise, and it is not unreasonable to think that the long-running campaign of the Roberts Court to restrict the regulatory discretion of administrative agencies could eventually yield decisions that, for example, required banking agencies to engage in notice-and-comment rulemaking for some traditional forms of supervisory guidance. An important reason we are unlikely to see such decisions in the foreseeable future is that the banking agencies have given the banking interests essentially everything they have asked for, including limitations on the use of supervisory guidance,[152] a narrow definition of what constitutes an "unsafe or unsound" banking practice,[153] and the Federal Reserve's public release of the scenarios and supervisory model used to conduct its annual stress test of large banking organizations.[154]

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uncorrected, however, the supervisors may escalate the supervisory concern into a more formal action, take the problem into account in assigning ratings to the bank, or both.

150 In terms familiar from other regulatory areas, the supervisor may be de facto insisting on design standards, rather than performance standards.

151 Tarullo, Bank Supervision and Administrative Law, *supra* note ___.

152 Role of Supervisory Guidance, 86 Fed. Reg. 9260 (Feb. 12, 2021) (to be codified at 12 C.F.R. pt. 4) (OCC final rule); Role of Supervisory Guidance, 86 Fed. Reg. 120,79 (Mar. 2, 2021 (to be codified at 12 C.F.R. pt. 302) (FDIC final rule); Role of Supervisory Guidance, 86 Fed. Reg. 18,173 (Apr. 8 2021) (to be codified at 12 C.F.R. pt. 262) (Board of Governors final rule).

153 Office of the Comptroller of the Currency, Department of the Treasury and Federal Deposit Insurance Corporation, Notice of Proposed Rulemaking, Unsafe or Unsound Practices, Matters Requiring Attention, 90 Fed. Reg. 48835 (Oct. 30, 2025).

154 In explaining its decision to change its practice and use notice-and-comment rulemaking for the models and scenarios for its supervisory stress tests, the Federal Reserve explicitly cited changes in administrative law. Board of

The acquiescence of the banking agencies to the demands of banks relates to a second legal threat to an effective supervisory role – one of constitutional dimensions. The Court's decision last term in *Trump v. Slaughter*[155] has quite likely heralded the end of independence for virtually all administrative agencies. Specifically, as a core part of its embrace of a strong Unitary Executive theory, the Court has invalidated the for-cause removal protections granted by Congress to Senate-confirmed principals at traditionally independent regulatory agencies. Though the Court technically limited its holding in *Slaughter* to the FTC,[156] the agency at issue in that case, there is nothing in Chief Justice Roberts' majority opinion suggesting that the OCC and FDIC fall outside this muscular doctrine that has emerged as a core tenet in the Court's remaking of separation of powers jurisprudence. On the contrary, given the Court's view of what constitutes "executive power" that must be subject to presidential control, it seems quite likely they will be covered.[157] The Federal Reserve may escape, insofar as the Court indicated in *Trump v. Cook*, a case handed down the same day as *Slaughter,* that the Fed's institutional lineage exempts it from the *Slaughter* doctrine.[158]

Assuming that the OCC and FDIC, at least, no longer have the insulation granted by Congress,[159] one of the incentive problems discussed in the preceding section will be exacerbated, insofar as agency principals serving at the pleasure of the President will presumably be strongly motivated to conform with the Administration's supervisory preferences. As noted earlier, the shorter policy horizon of elected politicians will typically lead them to value near-term economic stimulus even more than officials who were appointed by that Administration but then enjoyed for cause protection from dismissal.

Governors of the Federal Reserve System, Press Release, December 23, 2024, https://www.federalreserve.gov/newsevents/pressreleases/bcreg20241223a.htm ("The framework of administrative law has changed significantly in recent years. The Board analyzed the current stress test in view of the evolving legal landscape and determined to modify the test in important respects").

[155] No. 25-332 (U.S. June 29, 2026).

[156] Slip op. at 27

[157] The Court found the FTC an easy case because it has rule-making, administrative adjudication, and enforcement powers. Slip op. at 25-27. So too do the bank regulatory agencies.

[158] Cite. Though the Court's justification for exempting the Federal Reserve seemed to rest entirely on what the Court found to be a tradition of monetary policy independence, dating back before the Constitution, Chief Justice Roberts appeared to indicate in a footnote that the constitutionality of for-cause protection for the Fed extends to all its current functions:

> In upholding the constitutionality of the Federal Reserve as currently structured and with its existing enforcement authorities, we do not suggest that Congress could assign the Federal Reserve additional regulatory powers that are attenuated from monetary policy.

Trump v. Cook No. 25A312, slip op. at 22, n.6 (U.S. June 29, 2026). In doing so, the Court may have avoided some awkward legal issues, while perhaps creating others. *See* Daniel K. Tarullo, Can the Federal Reserve Be Split in Two? An Emerging Dilemma for the Supreme Court's Unitary Executive Policy, Hutchins Center on Fiscal and Monetary Policy at Brookings, October 2025, https://www.brookings.edu/articles/can-the-federal-reserve-be-split-in-two.

[159] The Comptroller does not have statutory for cause removal protection, but Congress did insulate that office from political interference:

> The Secretary of the Treasury may not delay or prevent the issuance of any rule or the promulgation of any regulation by the Comptroller of the Currency, and may not intervene in any matter or proceeding before the Comptroller of the Currency (including agency enforcement actions), unless otherwise specifically provided by law.

12 U.S.C. § 1b)(1).

In the event, President Trump's second-term appointees to the banking agencies acquiesced in Administration control even before *Slaughter* was handed down.[160] Those appointees are on their way to substantially confining the supervisory function. For the time being, then, the degradation of the supervisory function is a reality. Whether the Court ultimately allows some of the independence the banking agencies created by Congress to continue, how the appointees of future Administrations will approach the supervisory function, and whether a workable supervisory apparatus can be readily reconstituted are at this point matters for speculation. The arguments in this article suggest that, even hypothesizing answers most favorable to a robust supervisory function, that function may not in practice be up to the task of fulfilling the role assigned to it in theory. If one or more answers prove to be significantly less favorable, the supervisory function will be even more compromised.

IV. Potential Paths for Reform

In this article I have argued that the institutional context within which supervision occurs presents structural hurdles to its success as a complement for notice-and-comment rules in contemporary bank regulation. I do not mean to have argued that supervision as it exists today is ineffectual. Far from it. At least where agency leadership encourages line supervisors to exercise rigorous oversight of banks, there are real safety and soundness benefits. The question, rather, is whether the institutional context creates so much potential for breakdown as to warrant serious consideration of significant change.

To that question, my answer is a reasonably confident yes. Precisely because they reflect some of the institutional factors examined here, the supervisory shortcomings that contributed to the failures of Silicon Valley and Signature and, to a lesser extent, First Republic Banks are hard to dismiss as anomalies. We saw more serious shortcomings in the run-up to the Global Financial Crisis and, as much of the literature on forbearance demonstrates, in the Savings & Loan crisis as well. The difficulty of the job, the unfavorable political economy, monitoring obstacles, relevant incentive structures, and potential administrative law constraints together make supervision a less reliable tool than the current approach to bank regulation demands. The obvious next question is what an appropriate policy response might be. While development of a full reform program is beyond my scope here, the foregoing analysis suggests that the promise of policy options can be evaluated by the degree to which they could efficiently mitigate the problems identified here. This section briefly considers various reform possibilities by filtering them through this lens.

Sole Reliance on Regulatory Rules

The most straightforward option would be to eliminate, or at least dramatically reduce, the supervisory function as an integral element of banking regulation. Capital, liquidity and other regulatory rules could be significantly increased to take account of the dynamic risk-

[160] Early in his second Administration, President Trump issued an Executive Order purporting to subject all regulatory activities, including bank regulation by traditionally independent agencies, to Presidential control. Executive Order 14215 of February 18, 2025, 90 Fed. Reg. 10447 (Feb. 24, 2025). The President's appointees to the regulatory agencies do not appear to have resisted that exercise of control.

increasing process that can occur once those rules are in place. That is, to achieve roughly the same constraints upon risk as rules currently adopted with the assumption of supervisory backup, minimum capital and liquidity requirements in a regime without supervision would need to be considerably higher.

The elimination of the supervisory function would render mostly irrelevant the structural impediments to an effective supervisory function.[161] But the rationale for having supervision in the first place explains why this option is decidedly unpromising. Recall that core banking rules do not directly measure and constrain risk, the limitation of which is the aim of bank regulation. The rules are surrogates, whose effectiveness depends on a mechanism that can identify and, as needed, correct for the increases in risk that banks may create even when they are in formal compliance with the rules.

The stringency of regulations required to compensate entirely for the role assigned supervision under the current system would almost surely result in a sizeable reduction in credit extension, drive much more maturity transformation into unregulated domains or, possibly, both. The former outcome would significantly reduce economic growth, while the latter could significantly increase the risk of serious financial dislocation.[162] So, while it might be prudent to moderately increase capital requirements in recognition of the limits on effective supervision, the more dramatic route of eliminating a supervisory function altogether, while greatly increasing regulatory requirements, falls short of being an efficient alternative, much less one that is politically practicable.[163]

If, as thus seems probable, supervision will remain an essential complement to regulatory rules, it will be important to continue the search for measures that address the structural problems discussed in this article. While reforms by the banking agencies cannot much affect the unfavorable political economy and legal factors, there may be changes that could materially offset the resource, monitoring and incentive problems.

Incremental Changes

There is certainly a range of possible incremental reforms to address some of the structural problems of supervision. So, for example, the agencies might establish a clear process

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[161] "Mostly" because the Supreme Court's invalidation of independent regulatory agencies and the political economy factors discussed earlier also affect the rule-making functions of bank regulatory agencies.

[162] The precise risks would depend on the nature of the unregulated intermediation that would increase. In the worst case, lending dependent on short-term funding could precipitate system wide runs and fire sales.

[163] A variation on this approach would be a return to the bank regulatory regime that prevailed between the 1940s and 1970s, when stringent constraints on banks' geographic reach, activities, and ability to pay interest kept traditional banking reasonably safe, but not especially efficient. Ultimately, of course, that regulatory approach collapsed in the face of competition from firms using capital markets to attract both savers and borrowers. Competition from non-banks is an order of magnitude more severe today. Traditional competitors such as finance companies and money market funds have been joined by the likes of fintechs, private credit funds, and – even more recently – by stablecoin and other crypto asset issuers. Indeed, the financial stability risks posed by non-bank financial intermediaries (NBFIs) are arguably already as great as those presented by prudentially regulated banking organizations. Any policy that confined those organizations to the traditional roles of deposit-taking and lending would lead to a massive increase in financial activities in NBFIs. In the process, it would quite possibly doom the remaining commercial bank business model.

for considering requests for line supervisors to escalate a concern with bank practices. Such a process would, among other things, specify the officials to be involved in the review and set deadlines for a decision. Although this step would not in itself overcome the incentive problems for line supervisors discussed earlier, it could increase accountability by making clear who acted or failed to act in a given situation. Something along these lines was suggested by the Government Accountability Office following the 2023 failures.[164] At the margin, such a step could certainly be helpful.

Similarly, while proposals to make more supervisory information public may have some merit as complementary measures to increase market discipline, they gloss over the problem that supervisory failure will often be the result of what supervisors *fail* to see. After all, the opacity of bank balance sheets is a principal reason why a supervisory function is needed in the first place. Moreover, even if one thinks that release of supervisory information will produce market reinforcement of both positive and negative observations about a bank, the dynamic effect of such a regime could well be that supervisors resort to more informal communication with the banks.

There are numerous other possible incremental steps, many of which were mentioned in the Barr Report and the Material Loss Reviews of the Inspectors General. Indeed, there is an all too familiar ring to these proposals. It is disheartening to see how much of the Federal Reserve's internal criticism of its own pre-Global Financial Crisis supervision[165] was essentially echoed in these reports. This recurrence of supervisory shortcomings suggests that incremental measures do not get to the core factors that give rise to periodic, serious consequences. As such, consideration of more basic changes would seem warranted.

Incentive Compensation

This idea periodically recurs in the literature, often after a banking crisis that has revealed unwise supervisory forbearance or other shortcomings. The basic argument behind these proposals is the familiar one that civil servants need to be incentivized by means other than public spiritedness. Typical of these proposals is one that would give financial incentives for good supervision by paying supervisors a bonus based on the market price of a bundle of equity and debt securities of the bank they supervise.[166] Proponents of such proposals are obviously focused on the incentive issue, though generally not in quite the way I have described it. In that

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[164] U.S. Government Accountability Office, Bank Supervision: More Timely Escalation of Supervisory Action Needed, GAO-24-106974 (March 6, 2024), https://www.gao.gov/assets/gao-24-106974.pdf.

[165] Internal reviews of pre-Crisis supervisory shortcomings were conducted at both the Board of Governors and the Federal Reserve Bank of New York. Neither was formally adopted at the time, much less published, but both have subsequently become available. The Board's April 2010 draft, entitled "Enhancing the Effectiveness of Supervision" is available on the Board's website, https://www.federalreserve.gov/supervisionreg/files/enhancing-the-effectiveness-of-supervision-draft-201004.pdf. The New York Fed's August 2009 draft was included in the materials attached to the Report of the Financial Crisis Inquiry Commission created by Congress in May 2009. It is available at /https://fcic-static.law.stanford.edu/cdn_media/fcic-docs/2009-08-05%20FRBNY%20Report%20on%20Systemic%20Risk%20and%20Supervision%20Draft.pdf.

[166] *See* M. Todd Henderson & Frederick Tung, Paying Bank Examiners for Performance, 35 Regulation 32 (2012). Available at: https://scholarship.law.bu.edu/faculty_scholarship/107.

respect, the idea is responsive to part of the problem. However, the practical difficulties are legion. Here are a few:

First, market prices cannot reflect information they do not have. It is precisely the opacity of bank balance sheets and operations that supervisors are supposed to be penetrating on behalf of the public and, to some degree, bank investors. Second, bank underperformance or failure often occurs well after a particular supervisor has been on the job. Third, isolating responsibility for a bank's performance in any specific supervisor is just not realistic. The IG and agency reviews of the March 2023 bank failures provide a good illustration of how difficult it is to allocate responsibility for a failure. How much was due to the failure of the on-site teams to recognize the vulnerabilities? And might there have been individual supervisors who *did* worry, but whose concerns were overridden by other members of the team? Conversely, how much of the problem was due to the slow or excessively demanding review processes, either at the regional level or in Washington?

It is possible, if not especially likely, that one could construct an intricate system that workably accounted for all these difficulties. But, even so, it would not in itself address the issues of career incentives and failure to identify vulnerabilities.

Resource-Intensive Supervisory Organization

In theory, the problems of limited capacity and expertise among supervisors could be solved by hiring many more well-credentialed staff. And the incentive problems discussed earlier might be addressed through overlapping peer processes that encouraged informal presentation of concerns about a bank's activities, in a setting that did not carry high risk of negative career consequences if a supervisor's concerns were dismissed. An approach along these lines was in fact created by the Federal Reserve after the Global Financial Crisis for supervision of the eight U.S. banking organizations with global systemic importance (GSIBs).[167] The Large Institution Supervision Coordinating Committee, now renamed the GSIB Committee, included senior supervisory staff from the Federal Reserve Banks that supervised the GSIBs, senior supervisor staff from the Supervision & Regulation Division of the Board of Governors, a representative of the Markets Group from the Federal Reserve Bank of New York, and senior staff from other Board Divisions (including Financial Stability, International Finance, Monetary Affairs, and Research & Statistics). Five subordinate program committees, each of which includes both members of the eight dedicated supervisory teams and Board staff, coordinate day-today supervision.[168]

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[167] The eight are Bank of America, Bank of New York Mellon, Citigroup, Goldman Sachs, JP Morgan Chase, Morgan Stanley, State Street, and Wells Fargo. *Global Systemically Important Banks,* Bd. of Governors of the Fed. Rsrv. Sys. (Feb. 25, 2026), https://www.federalreserve.gov/supervisionreg/global-systemically-important-banks.htm. This new supervisory portfolio originally included the U.S. operations of four foreign G-SIBs, but they were subsequently removed. Board of Governors of the Federal Reserve System, SR 20-30, Financial Institutions Subject to the LISCC Supervisory Program, Dec. 18, 2020 (rev. March 31, 2021), https://www.federalreserve.gov/supervisionreg/srletters/sr2030.htm?utm_source=chatgpt.com

[168] *See* Board of Governors of the Federal Reserve System, LISCC Program Operating Manual, April 21, 2025, at 4, https://www.federalreserve.gov/publications/files/liscc-program-operating-manual-202512.pdf.

This structure creates a coordinated supervisory system for the eight GSIBs, promoting both consistency in oversight by the dedicated teams and information exchanges that provide insight into trends and potential emerging vulnerabilities across this group of banks whose well-being is important to the overall health of the financial system. The involvement of other parts of the Federal Reserve allows the program to draw on information sources beyond the supervisory process to identify new or underappreciated risks. Through this combination of bottom-up and top-down channels, the GSIB Committee program is better positioned than the supervisory frameworks for the portfolios of other banks to discover bank practices that may be eroding the level of resiliency at which the regulatory rules aim. The multiple committee structure also allows – and even encourages — supervisors to raise issues informally, sometimes even before they have given a preliminary expression of concern to a bank.

It is difficult to evaluate how successfully the LISCC/GSIB Committee program has overcome the analytic and incentive problems. In itself, it surely does not offset explicit instructions (or, more likely, more indirect signals) from agency principals to ease supervisory expectations. And it is possible that the very complexity of the program recreates the phenomenon of priority lists squeezing out supervisory focus on genuinely new or unexpected issues. Indeed, conversations with some staff who have participated in the program in recent years suggest that a certain ossification had set in even before the recent policy measures to reduce the scope of, and resources devoted to, supervision.

Whatever its relative success, however, the overwhelming obstacle to extending this program to the thousands of other supervised banking organizations is one of resources. Again, the resource issue is both quantitative and qualitative. Although one would need proportionately fewer staff to replicate the GSIB level of oversight for those less complex institutions, in absolute terms there would have to be substantial increases in staff in both the supervisory function and the other parts of the Federal Reserve that contribute to the GSIB program. These staff would need to have the credentials and experience of the top supervisors and other staff who participate in the GSIB Committee. It would have been hard to assess this augmentation of resources as realistic even before recent policy measures that have led to the departure of so many experienced supervisors. And, in any case, the two other federal banking agencies do not have the research and analytic capabilities of the Federal Reserve. Still, as suggested in the next section, there may be an alternative means of providing the analytic support needed.

Artificial Intelligence

The banking agencies – especially the Federal Reserve – already make some use of models in their supervisory programs. As noted earlier, a model used by Fed supervisory staff in Washington had indicated a potential liquidity concern with SVB. Regrettably, for reasons not obvious in the publicly available record, there was no follow-up. Banks themselves have, over the past several years, increasingly incorporated AI into their own risk management systems.[169] Might the use of AI be the kind of transformative step that could reduce the incidence of significant supervisory failures? The answer to that question is necessarily a matter of

[169] *See* McKinsey & Co., How Generative AI Can Help Banks Manage Risk and Compliance, March 1, 2024, https://www.mckinsey.com/capabilities/risk-and-resilience/our-insights/how-generative-ai-can-help-banks-manage-risk-and-compliance.

speculation. But, in light of the limited promise of other supervisory reforms and the rapid advances in AI, the banking agencies would do well to explore the possibility.

As an illustration of how AI might be used to mitigate the resource and incentive problems, consider a revamped supervisory function that included a proprietary AI model, a mechanism for incorporating AI identification of potential vulnerabilities into the supervisory process, and a system creating accountability for disposition of supervisory inquiries prompted by AI output.

Unlike the models currently used at the Fed, a proprietary AI model could incorporate non-quantitative as well as quantitative information – including data on the financial system, assessments of banks and the financial system from private sources, the financial data regularly provided to the banking agencies, confidential supervisory information, public and confidential communications by the banks themselves. The AI model would use all this information to identify – among other things – concerns, correlations, and anomalies in the current financial condition of the banks, potentially troublesome activities, and significant shortcomings in their risk management. Even with considerable training, the output might be unrefined in the early stages of the program. Thus a trial run or simulated supervisory exercises might be needed. But the self-learning capacity of the model, fed by the continuous input of information on the condition of banks over time, should eventually allow the platform to provide more useful correlations of certain conditions or practices with later problems, as well as to identify novel issues.

Vulnerabilities identified by AI would be investigated through the supervisory process. Supervisors would be charged with determining whether an issue flagged by AI was in fact cause for concern. If so, the supervisors would need to develop a remediation program with the bank. They would file reports of their proposed disposition of the issue, as well as any proposed remedial process and, if the bank's response is insufficient, recommended follow-up actions. Over time, the AI model might also usefully develop a proposed remediation program where needed.

The extent to which issues identified by AI constituted the overall examination program would of course depend on experience. At the outset, certainly, they would be add-ons to a supervisory template developed in a traditional fashion. And it would presumably be only on the basis of extended and favorable experience that the supervisory system would become driven, rather than supplemented, by AI.

A third, critical element of this illustrative approach would be a clear system for documenting the conclusions of line supervisors and the reviews of their reports by more senior supervisors or agency principals. At least in the early stages of AI usage, the model's identification of vulnerabilities would create an item for examination on the supervisors' agenda, not a presumption that required a convincing rebuttal, much less a definitive finding of a safety and soundness problem. The report of the line supervisors on their consequent examination would be documented So, too, there would be clear documentation of the any reviews of the line supervisors' reports – i.e., whether the conclusions, actions, and recommendations of line supervisor had been approved, modified, or rejected.

The informational capacities of the model could progressively overcome the resource and analytic limitations that afflict the current supervisory system. But the reorganized supervisory framework could also exploit the literally dehumanized nature of AI to neutralize current disincentives that human supervisors have to pursue matters not previously endorsed as supervisory priorities. AI will not care if a problem it has identified is not ultimately deemed worthy of supervisory action. And the documentation of decisions by the superiors of line supervisors (something that might usefully be done under the existing framework) might change the incentives of agency superiors, who would understand that a later review of a failed or troubled bank would clearly indicate who made what decision.

V. Conclusion

The organizational, political, and legal environment within which supervision operates creates structural impediments to its effectiveness. Yet the bank regulatory system, dependent as it is upon surrogate regulatory measures to achieve its aim of containing bank risk, needs the complement of the supervisory function. While that function is usually fairly effective, the structural impediments described in this article will make it prone to periodic, sometimes spectacular, failure. A suggestion that Artificial Intelligence is the most promising approach to successful reform admittedly has a certain *deus ex machina* feel. Such a transformation, even if it proves viable, would not come quickly or easily. But the persistence of patterns of supervisory dysfunction after several banking crises suggests that another round of incremental reforms, while perhaps the best option in the short run, will not ultimately do the trick.

APPENDIX A

Bank Growth 1999-2024

1999

Bank	Total Assets ($M)	Total Trading Assets ($M)
Citi Group	716, 937	109,155
Bank of America	632,574	38,460
Chase Manhattan	406,105	63,269
JP Morgan & Co.	260,898	117,592
First Union	253,024	14,946
Average	453,908	68,684

2024

Bank	Total Assets ($)	Total Trading Assets ($M)
JP Morgan Chase	4,002,814	637,784
Bank of America	3,261,519	314,460
Citigroup	2,352,945	442,747
Wells Fargo	1,929,845	163,832
Goldman Sachs	1,675,972	570,555
Average	2,644,619	425,876
% Growth of Average (1999-2024) **Inflation Adjusted**	483% 213%	520% 235%