The Independence of Central Bank Supervision

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ABSTRACT—The Dodd Frank Act of 2010 gave the Federal Reserve sweeping power to supervise the banking system. Consequently, the Fed as bank supervisor has the ability to steer the allocation of credit in the economy, shape the structure of financial markets, and set the pace of financial innovation. Although this is a mighty power of the State, the Fed's supervision function has become effectively shielded from political direction and control under the law and traditions of "central bank independence." This Article argues that the practice of extending central bank independence—which is properly afforded to the Fed's *monetary policy* function—to Fed *supervision* has insulated Fed supervision from political checks and balances in ways that affront the Constitution's separation-of-powers. Ultimately, the Article explains the Fed's supervision function as an exercise of executive power—not an independent central banking duty. That conclusion implies the need to re-structure supervision at the Fed and re-orient political conventions around the independence of the Fed.

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INTRODUCTION

The most powerful agency in Washington is not formally an agency at all: it is the Fed's supervision function and it sits *within* the central bank. By overseeing, and thus influencing, the nation's largest banks, the Fed's bank supervisors shape the trajectory of major economic issues of the day—including, most recently, those concerning climate change,[1] crypto assets,[2] ESG,[3] and small business lending.[4] Fed supervisors have full discretion to determine what is "safe and sound" for banks to do and conversely, to discourage that which presents a "financial stability" risk.[5] And yet, Fed supervisors are not legally required to present evidence to support those determinations, which trigger supervisory actions that are not subject to

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1 *See* BD. OF GOVERNORS OF THE FED. RESERVE SYS., FINANCIAL STABILITY REPORT 58 (Nov. 2020); Kevin Stiroh, Exec. Vice President, Fed. Rsrv. Bank of N.Y. Fin. Inst. Supervision Grp., A Microprudential Perspective on the Financial Risks of Climate Change, Remarks at 2020 Climate Risk Symposium (Nov. 10, 2020), https://www.bis.org/review/r201110b.pdf.

2 *See* Press Release, Bd. of Governors of the Fed. Rsrv. Sys., Federal Reserve Board Provides Additional Information on Its Program to Supervise Novel Activities in the Banks It Oversees (Aug. 8, 2023), https://www.federalreserve.gov/newsevents/pressreleases/bcreg20230808a.htm.

3 *See Governance & Culture Reform*, FED. RSRV. BANK OF N.Y., https://www.newyorkfed.org/governance-and-culture-reform (last visited Jan. 29, 2024). I am a supportive part of this Reserve Bank effort through my membership on the Education and Industry Form.

4 *See, e.g.*, Notice of Proposed Rulemaking, Regulatory Capital Rule: Large Banking Organizations and Banking Organizations with Significant Trading Activity, 88 Fed. Register 64026 (Sept. 18, 2023).

5 *See infra* Part II.B.

precedent-generating judicial review. [6] Indeed, the Fed's supervisory judgments are commonly known as "secret lore."[7]

At any other U.S. agency, this state of affairs would be a legal nightmare.[8] But Fed supervision has thus far been shielded from significant critique by the Fed's supercharged form of agency independence, known as "central bank independence" or "CBI."[9] This Article argues that the tenets of CBI do not justifiably apply to the Fed's supervision function. Further, the Article urges that the consequences of extending CBI law and norms to Fed supervision is a constitutionally unsettling result: CBI keeps Fed supervision at arms-length from the President's power of removal and affords the Fed's supervision unchecked discretion to interpret the scope of its own mandate.

Generally speaking, it has long been accepted that central banks' *monetary policy* should be insulated from the short-termism associated with the political cycle.[10] Decades of empirical evidence demonstrated that central bankers were more effective at maintaining low and stable inflation when they were insulated from the kind of pressure that politicians tend to exert

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6 *See infra* Part II.B. The Fed's recently issued bank regulatory proposal, supported by assessments of what presents a financial stability risk, would impose 25% higher capital charges on banks, notwithstanding the lack of *any* evidence that banks are undercapitalized. Indeed, when asked JP Morgan Chase CEO Jamie Dimon glibly replied: "We simply have to take it because they're judge, jury and hangman." Bloomberg Television, *Dimon Criticizes Basel III Endgame, Calls It 'Harmful'*, YOUTUBE (Dec. 6, 2023), https://www.youtube.com/watch?v=38Vt9nkpqAI.

7 Letter from Sens. Tim Scott, Mike Crapo, M. Michael Rounds, Thom Tillis, John Kennedy, Bill Hagerty, Cynthia Lummis, JD Vance, Katie Boyd Britt, Kevin Cramer & Steve Daines to Jerome Powell, Martin Gruenberg & Michael Hsu (Jan. 16, 2024), https://www.banking.senate.gov/imo/media/doc/bankinggopbaselletter116241.pdf.

8 *See infra* Part II.

9 For the literature on central bank independence, see, generally, Peter Conti-Brown, *The Institutions of Federal Reserve Independence*, 32 YALE J. REG. 257 (2015); Charles Goodhart & Rosa Lastra, *Populism and Central Bank Independence*, 29 OPEN ECONOMIES REV. 49 (2017); Carola Conces Binder & Christina Parajon Skinner, *The Legitimacy of the Federal Reserve*, 28 STANFORD J. OF L., BUS. & FINANCE 1 (2022).

10 Prior to this time, many if not most of the world's leading central banks operated as agents of the government. Often, the consequence of this arrangement was inflationary. "As is well known, the baseline case for central bank independence stems from the 'time inconsistency problem' inherent in monetary policy – or that policymakers might be tempted to use monetary policy in a distortionary way." Kerstin af Jochnick, Member, Supervisory Bd. of the ECB, Speech at the IMF High-Level Regional Seminar in Sub-Saharan Africa (Mar. 1, 2022), https://www.bankingsupervision.europa.eu/press/speeches/date/2022/html/ssm.sp220301~66eb4805eb.en.html.

before an election in an attempt to boost the economy and win public favor.[11] On that view, most jurisdictions around the world operationalized CBI with various legal structures that separated central bank policymaking and personnel from politics.

Commonly, these structures of independence include long term limits for central bank governors, protections against their removal from office, and self-funding arrangements.[12] Perhaps even more important than these legal arrangements is that CBI compels a 'gentleman's agreement' between finance ministries (e.g., Treasury departments) and the central bank—namely, that the government, acting through its finance minister, will not attempt to pressure or influence the central bank to do the government's bidding and will leave the central bank governor(s) alone to pursue a price stability goal.[13] Over time, in the United States, as in these other jurisdictions, scholars, policymakers, and politicians set CBI on a pedestal, and committed to protecting this manner of independence from all damage or rebuke. Legally, as such, CBI *sub silentio* became a distinct form of agency independence more sacrosanct than the independence that is understood to apply to other public agencies.[14]

After the global financial crisis of 2008, many central banks acquired new supervisory responsibilities and policy tools which they did not have before.[15] Along with these expanded mandates, the notion of central bank independence stretched as well. By the early 2020s, central bankers were confidently asserting that central bank *supervisory* independence had been "broadly accepted" [16] on the ground that "good" and "effective" bank

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11 Renee Haltom & Jessie Romero, *Who's the Boss: How Congress Holds Monetary Policymakers Accountable*, FED. RSRV. BANK OF RICHMOND, ECON FOCUS, Second Quarter 2016.

12 *See* Michael Salib & Christina Parajon Skinner, *Executive Override of Central Banks: A Comparison of the Legal Frameworks in the United States and the United Kingdom*, 108 GEO. L. J. 905, 947-50 (2020).

13 *See* Mark Swinburne & Marta Castello Branco, *Central Bank Independence and Central Bank Functions, in* THE EVOLVING ROLE OF CENTRAL BANKS 414, 417-18 (Patrick Downes & Reza Vaez-Zadeh eds., 1991).

14 *See* Collins v. Yellen, 594 U.S. ___, slip op. at n.21 (2021) (declining to address whether the holding might affect other agencies "not before us"); *see also* Brett M. Kavanaugh, *Separation of Powers During the Forty-Fourth Presidency and Beyond*, 93 MINN. L. REV. 1454, 1474 (2009) ("[I]t may be worthwhile to insulate particular agencies from direct presidential oversight or control—the Federal Reserve Board may be one example, due to its power to directly affect the short-term functioning of the U.S. economy.").

15 Ed Balls, James Howat & Anna Stansbury, *Central Bank Independence Revisited: After the Financial Crisis, What Should a Model Central Bank Look Like?* 2 (Harv. Kennedy Sch., M-RCBG Associate Working Paper Series, No. 87, 2018).

16 af Jochnick, *supra* note 10.

supervision "require[s] operational independence to carry out [central bank supervisors'] tasks free of outside pressure,"[17] just like monetary policy does.

This sentiment has been adopted by the Board of Governors at the Fed. The Fed's current Chair, Jerome Powell, has remarked that "[i]ndependence in this area helps ensure that the public can be confident that our supervisory decisions are not influenced by political considerations,"[18] while the incumbent Vice Chair for Supervision, Michael Barr, has urged that "[i]ndependence helps to protect financial regulatory agencies from political interference and—with some important caveats—arguably helps to guard against some forms of industry capture."[19] The idea of greater political involvement in central bank supervision has been rebuffed by champions of CBI.[20]

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17 Tobias Adrian, Fabiana Melo, Marina Moretti & Jay Surti, *Financial Stability Needs Supervisors with the Ability and Will to Act*, IMF BLOG (Sept. 18, 2023), https://www.imf.org/en/Blogs/Articles/2023/09/18/financial-stability-needs-supervisors-with-the-ability-and-will-to-act; *see also* af Jochnick, *supra* note 10.

18 Jerome H. Powell, Chair, Bd. of Governors of the Fed. Rsrv. Sys., Remarks During the Panel on "Central Bank Independence and the Mandate – Evolving Views" at the Symposium on Central Bank Independence Sveriges Riksbank (Jan. 10, 2023), at 3, https://www.federalreserve.gov/newsevents/speech/files/powell20230110a.pdf.

19 Michael S. Barr, *Comment: Accountability and Independence in Financial Regulation: Checks and Balances, Public Engagement, and Other Innovations*, 78 L. & CONTEMPORARY PROBLEMS 119, 119 (2015). Governor Michelle Bowman has expressed a similar sentiment: "Most often, the independence of the Federal Reserve is discussed in terms of independence in the setting of monetary policy. . . [I]t is also important to emphasize the value of independence in banking supervision and regulation." Michelle W. Bowman, Member, Bd. of Governors of the Fed. Rsrv. Sys., Independence, Predictability, and Tailoring in Banking Regulation and Supervision, Remarks at the American Bankers Association Community Banking Conference (Feb. 13, 2023), https://www.bis.org/review/r230214a.pdf. *But see* Ben S. Bernanke, Chairman, Bd. of Governors of the Fed. Rsrv. Sys., Central Bank Independence, Transparency, and Accountability, Speech at the Institute for Monetary and Economic Studies International Conference, Bank of Japan, Tokyo, Japan (May 25, 2010), https://www.federalreserve.gov/newsevents/speech/bernanke20100525a.htm (last visited Jan. 29, 2023) (remarking that "independence afforded central banks for the making of monetary policy . . . should not be presumed to extend without qualification to its nonmonetary functions," such as "oversight of the banking system").

20 In the U.K., for example, the Treasury sought to introduce an intervention power in the 2023 Financial Services Markets Act, which would have allowed the Treasury to direct bank regulators to make, amend, or revoke rules that were determined to be matters of significant "public interest." Among others, Bank of England's head of supervision (the Prudential Regulatory Authority) told an audience: "A power which allowed ministers to override regulatory decisions just because they took a different view of the issues involved would represent a significant shift away from a model of independent regulation," adding that he would be "very cautious" of any such measure. *See* Laura Noonan, *Regulators Warn*

Yet supervision is fundamentally different from monetary policy in at least five important ways. For one, supervisory power is a coercive power of the State. Whereas the central bank as monetary policymaker is chiefly responsible for pursuing price stability—and does this by steering interest rates or buying securities in the open market—bank supervision entails governmental pressure backed by the threat of negative assessments that could require corrective action, higher regulatory capital charges, cease and desist orders, monetary penalties, or an industry bar where individual bankers are concerned.[21]

Second, the Fed's supervisory mandates are vague, open-ended, and defined nowhere in the law. It is true that "price stability" is also undefined, but the Fed's inputs for determining whether there is inflation presently, forecasting where the economy might be headed, and analyzing how price levels might change in light of different rate paths all involve economic models that are transparent to Congress and the public. The factors that go into the Fed supervisors' decisions about the characteristics of "safety and soundness" or criteria for spotting a "financial stability" risk are totally unknown and probably impossible to pin down. The malleability of these supervisory mandates makes it much more difficult for Congress to assess whether any given exercise of technocratic judgment is appropriately within the Fed's supervisory lane.[22]

Third, and related to this last point, the Fed's supervisory policy is often aligned with or derived from global standard-setting bodies, like the Basel Committee on Banking Supervision ("BCBS") or the Financial Stability Board ("FSB"). These bodies host informal networks of bank regulators and supervisors around the world and produce 'soft-law' standards meant for adoption in each participating jurisdiction. Given their informal character, the Fed's participation in these organizations has not been subject to instructions from or parameters set by Congress, as it has developed outside the treaty-making process.[23] And because the operation of these bodies is almost entirely opaque, Congress has little insight into what interests, considerations, or negotiations shaped the standards that ultimately find

Sunak Off Jeopardising Independence, Fin. Times (Oct. 27, 2022), https://www.ft.com/content/ea03fd72-576b-4a40-9ca2-f9c26f430a4c.

21 *See infra* Part II.A (discussing the debate surrounding a "call in power" of the UK. Treasury to direct the central bank in regulatory matters).

22 af Jochnick, *supra* note 10 (noting that the vagueness of the mandate makes the "ultimate policy goals of banking supervision . . . more difficult to measure than those of monetary policy").

23 *See infra* Part III.C.

their way into Fed supervisory 'law.' Nothing remotely equivalent affects the stance of monetary policy.

Fourth, while effective monetary policy has historically depended on central banks' commitment to doing the politically unpopular thing, supervisory policy trends in the opposite direction. Since 2008, the Fed's supervision has noticeably tracked the President's economic agenda. During the Obama Administration, Fed supervision vigorously pursued the Administration's understanding of systemic risk and expanded its financial stability toolkit accordingly.[24] Then, during the Trump Administration, supervisory policy focused on tailoring and transparency, which many saw as vehicles for the President's de-regulatory agenda.[25] Most recently, during the Biden Administration, the Fed's supervision has been intensely focused on climate risk in banks, in line with the President's "whole of government" approach to tackling climate change.[26]

Fifth, Fed supervision is now led by a single Fed Governor, the Vice Chair for Supervision ("VCS"). Although all seven Fed Board Governors vote on regulation and formal supervisory guidance, the law gives the VCS the sole power to set the supervisory agenda and generally head up this work.[27] Moreover, the Fed Chair has set a precedent of practice of deferring to the VCS, and other Board members may be inclined to do the same.[28] After all, the VCS is typically the only expert on bank regulation and supervision on the Board; the other Fed governors have backgrounds in macroeconomics

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24 *See infra* Part II.B; *see also* Christina Parajon Skinner, *Presidential Pendulums in Finance*, 2020 COLUM. BUS. L. REV. 532 (2020) (discussing these political swings in supervision).

25 *See* Skinner, *supra* note 24.

26 Janet L. Yellen, Sec'y of the Treasury, U.S. Dep't of the Treasury, Remarks at the Leaders Summit on Climate (Apr. 22, 2021), https://home.treasury.gov/news/press-releases/jy0143; *see also* Fin. Stability Oversight Council, U.S. Dep't of the Treasury, *First Principal Meeting* (Mar. 31, 2021), https://treas.yorkcast.com/webcast/Play/a37bd8443e1a48589a66f08f3ab6b68c1d; ENV'T DEF. FUND, RECAPTURING U.S. LEADERSHIP ON CLIMATE (Mar. 2021), https://www.edf.org/sites/default/files/documents/Recapturing%20U.S.%20Leadership%20on%20Climate.pdf.

27 *See infra* Part II.A.

28 During Chair Powell's 2021 confirmation hearing, he stated that he would give the VCS a "degree of deference" on setting a regulatory and supervisory agenda and that he "would not see [him]self as stopping" proposals that the VCS brought forward "since the law seems to indicate that that's the job of the Vice Chair for Supervision." Press Release, Elizabeth Warren, At Hearing, Warren Presses Federal Reserve Chair Powell on Vice Chair for Supervision's Authority to Take Tough Regulatory Action (Nov. 30, 2021), https://www.warren.senate.gov/newsroom/press-releases/at-hearing-warren-presses-federal-reserve-chair-powell-on-vice-chair-for-supervisions-authority-to-take-tough-regulatory-action.

not the law. In sharp contrast, monetary policy is set by the full Federal Open Market Committee—comprised of all seven Board members plus five of the regional Reserve Bank presidents.[29] Consequently, the shape of supervision is likely to be significantly determined by the VCS whereas monetary policy at the Fed is structured to incorporates a fuller range of views.

Indeed, it is far from obvious that Congress intended to make supervision an independent agency within the Fed. When Congress created a new financial stability supervisory council in the Financial Stability Oversight Council ("FSOC") it housed it inside the Treasury and put the Treasury Secretary as its head. Similarly, the primary supervisor for national banks—the Office of the Comptroller of the Currency ("OCC")—is also located within the Treasury and its director—the Comptroller of the Currency—has no express protection from removal from office. Tellingly, where Congress *did* intend to make a bank supervisor independent, it made deliberate institutional design choices. Specifically, the Federal Deposit Insurance Corporation ("FDIC")—a third bank supervisor in the United States—is led by a multi-member commission with statutory requirements for partisan balance.

Despite these compelling reasons to see central bank supervision as completely distinct from monetary policy, there has been little scholarly critique of the assumption that central bank *supervision* is now entitled to that central bank *independence*.[30]

Accordingly, this Article brings forward the question, why insulate supervision with CBI?[31] In doing so, the Article contributes to the legal literature on central bank independence by joining it with the vast scholarship on agency accountability and, more precisely, the study of presidential power in the administrative state (i.e., removal) and the separation of powers (i.e., delegation).[32] Although interpreting the metes and

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29 *See* Board of Governors of the Federal Reserve Sys., About the FOMC, https://www.federalreserve.gov/monetarypolicy/fomc.htm (last visited Jan. 29, 2024).

30 Other scholars have observed that the Fed's functions should be evaluated on their own terms, PETER CONTI-BROWN, POWER AND INDEPENDENCE OF THE FEDERAL RESERVE (2014), and that "the constitutionality of the Fed's structure depends on what it does," Aditya Bamzai & Aaron Neilson, *Article II and the Federal Reserve* (unpublished manuscript on file with author).

31 *See* Chiara Zilioli, *The Independence of the European Central Bank and Its New Banking Supervisory Competences*, *in* INDEPENDENCE AND LEGITIMACY IN THE INSTITUTIONAL SYSTEM OF THE EUROPEAN UNION 125, 128 (Dominique Ritleng ed., 2016).

32 *See, e.g.*, Ilan Wurman, *Nondelegation at the Founding*, 130 YALE L. J. 1490 (2021); Cass R. Sunstein & Adrian Vermeule, *The Unitary Executive: Past, Present, Future*, 2020 SUP. CT. REV. 83 (2021). For a sample of the legal literature on CBI, see *supra* note 9.

bounds of the removal power and the non-delegation doctrine are longstanding quandaries in administrative and constitutional law, they are now more ripe than ever where financial regulators are concerned.[33] And to date, this body of academic scholarship has not fully discussed the implications of these precedents for the Federal Reserve and its special breed of independence because, as noted, the Fed is often seen as sitting outside traditional bounds of public law.

The Article proceeds in three parts. Part I broadly explains what bank supervision is and how it operates when it is part of a central bank. Further, Part I details the institutional architecture of bank supervision in the U.S. and overviews the long-standing debate about whether supervision is, or is not, properly a central banking function.

Part II makes the claim that as a matter of U.S. law, central bank supervision is best understood as the exercise of executive power and has been *mis*understood as the exercise of an independent duty. It thus argues that the U.S. President should be able to remove officers with key supervisory duties, such as the VCS and Reserve Bank presidents, with whom he disagrees. So understood, Part II further argues that the statutory mandates that confer supervisory power to the Fed have yielded too much discretion to make law-like supervision policy.

Part III discusses a path to reform that involves structurally separating supervision from the rest of the Board and adopting procedural mechanisms for enhancing Congress's ability to constrain the heretofore open-ended use of the Fed's supervision mandates.

Ultimately, this Article makes a key advance in our understanding of central bank independence. Scholars and legislatures have long debated whether supervision should be housed within central banks primarily on policy terms. This Article suggests that, at least in the United States, the legal question—is Fed supervisory independence constitutional?—is first order and dispositive. More broadly, the Article also sheds light on the benefit of disaggregating agencies into their component parts for purposes of evaluating the constitutional status of their independence.

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33 Seila Law v. Consumer Financial Protection Bureau, 591 U.S. ___ (2020); Collins v. Yellen, 594 U.S. ___ (2021); Free Enterprise Fund v. Public Company Oversight Board, 561 U.S. 477 (2010); Bowsher v. Synar, 478 U.S. 714 (1986).

I. SUPERVISION: THE GROWTH OF AN AGENCY WITHIN THE CENTRAL BANK

The question of whether central banks should be tasked with bank supervision—and in what degree and respect—is the subject of a longstanding global policy debate.[34] In the United States, although the Fed's supervision function is now powerful and vast, before 2010, the central bank played a more limited supervisory role. This Part explains the evolution of the Fed's supervision function, from the Fed's founding in 1913 through the present.

A. *Institutional Design and Architecture*

As an original matter, central banks were not designed to be bank supervisors. Rather, at their inception and for quite some time thereafter, central banks were understood as (1) lenders to the government or facilitators of the market for government debt; (2) lenders 'of last resort' to private banks; (3) managers of a smooth and uniform currency.[35] Supervision may have been ancillary to these goals but it was not until the late twentieth century that central banks assumed meaningful bank supervision tasks.

Legislators kept supervision outside of central banks for several reasons. First, they understood that bank supervision would often work in tension with central banks' core duties around monetary policy. More precisely, a responsibility to ensure that banks are operating soundly—and to punish banks if they are not—could undermine a central bank's ability to transmit its monetary policy by, for example, stifling banks' ability or appetite to lend. In addition, a central bank as a monetary policy authority would sometimes inevitably make decisions about interest rates in pursuit of price stability that would undermine banking stability. Raising interest rates could lead to asset-

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34 *See, e.g.*, *Examining the Relationship Between Prudential Regulation and Monetary Policy at the Federal Reserve Joint Hearing Before the Subcommittee on Financial Institutions and Consumer Credit and the Subcommittee on Monetary Policy and Trade of the Committee on Financial Services*, 115th Cong. (2018); Francisco José de Siqueira, *Should a Central Bank Also Be a Banking Supervisor?*, *in* 5 CURRENT DEVELOPMENTS IN MONETARY AND FINANCIAL LAW 43 (Int'l Monetary Fund ed., 2008). As ECB General Counsel Chiara Zilioli described it, as one between "those who considered that prudential supervision is inextricably linked to the central banking function and those for whom it would be entirely wrong to give this task to the same institution that has charge of price stability and who believe that prudential supervision has different objectives and that the dual role could leave the institution with a conflict of interests." Zilioli, *supra* note 31, at 155.

35 The oldest central banks were created to be lenders to the government and only in the 18th century to act as lender of last resort to the banking sector.

liability mismatch and prompt insolvency; lowering rates, meanwhile, would incentivize banks toward riskier lending or investment.

Moreover, some worried that adding bank supervision to the central banks' dossier of tasks would prove distracting. On that view, in a world of finite resources, central banks should focus on price stability only and, when needed, act as an emergency liquidity source to banks. Taking on other large and important tasks, like bank supervision, might lead to gaps and mistakes in one domain or the other.[36] Put another way, although other agencies could deal with supervising banks, only the central bank can perform important monetary tasks.

Bank supervision had also long been viewed as a fundamentally political task. The rigor and format of bank supervision, and the regulation that follows, invariably affects the strength and speed of the economy—something that politicians should and tend to answer to the electorate for. Moreover, the ultimate costs of supervisory failure (bank failures) depend on political choices about whether to rescue failing banks with taxpayer funds. So understood, supervision should be kept separate from the central banks' monetary policy function to avoid tainting the latter's independence with politics.

For some combination of these reasons, the U.K. Parliament removed the Bank of England's supervisory responsibilities when it gave the Bank monetary policy independence in 1997. Likewise, in Europe, although monetary policy became a European task with the creation of the ECB in 1997, supervision stayed within the purview of individual member states and their respective political regimes. Germany today still houses its primary bank supervisors—the Bundesanstalt für Finanzdienstleistungsaufsicht ("BaFin")—in its executive branch.

Similar institutional design choices had been made in the United States when federal banking supervision was first established. Rather than assigning bank supervision to the Federal Reserve, those responsibilities were divided among three different agencies. The first of these agencies was located in the Executive Branch. The National Bank Act of 1864 established the OCC, which statute also created the national banking system.[37] Before that time, banking was largely conducted at the state level by state-chartered banks. But because many of these banks issued their own private

36 *See* Federal Reserve Act, Pub. L. No. 63-43, 38 Stat. 251 (1913) (preamble); *infra* Part II.B.

37 National Bank Act of 1864, ch. 106, 13 Stat. 99 (current version at 12 U.S.C. § 38).

currencies,[38] there was no uniform national currency and considerable economic disarray prevailed as a result. This situation proved detrimental to President Lincoln's ability to finance the North's effort during the Civil War and Congress thus brought forward this important banking legislation. It established a national banking system, whereby newly licensed national banks would issue a new single currency (national bank notes) and the previously existing state bank notes would be taxed out of existence.[39]

The National Bank Act also authorized the OCC to oversee the licensing of national banks—to ensure the criteria for forming this new manner of banking association were adequately met.[40] It also placed a Comptroller of the Currency as the head of this new agency, who would "be under the general direction of the Secretary of the Treasury," and hold office for five years "unless sooner removed by the President, upon reasons to be communicated by him to the Senate."[41]

In terms of supervision, the Act gave the Comptroller express but highly limited authority to examine national banking associations. In addition to the authority to require an annual financial report, the Comptroller "with approbation of the Secretary of the Treasury" could appoint a disinterested person "to make a thorough examination into all the affairs of the association, and, in doing so, to examine any of the officers and agents thereof on oath; and shall make a full and detailed report of the condition of the association to the comptroller."[42] Importantly, at the time, the Comptroller's supervisory power was exclusive: national banks would "not be subject to any other visitorial powers than such as are authorized by this act, except such as are vested in the several courts of law and chancery."[43] As such, the President had complete control of bank supervision, as an executive task, for fifty years.

Even when the Fed was created in 1913, Congress clearly intended it to defer to the Treasury Department's OCC on important issues of national

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38 *See* Hugh Rockoff, *The Free Banking Era: A Reexamination*, 6 J. MONEY, CREDIT & BANKING 141, 143 (1974).

39 *National Banking Acts of 1863 and 1864*, FED. RSRV. HISTORY, https://www.federalreservehistory.org/essays/national-banking-acts (last visited Jan. 30, 2024).

40 The preamble to the statute provides: "That there shall be established in the treasury department a separate bureau, which shall be charged with the execution of this and all other laws that may be passed by congress respecting the issue and regulation of a national currency secured by United States bonds." National Bank Act of 1864, ch. 106, 13 Stat. 99 (current version at 12 U.S.C. § 38).

41 *Id.*

42 *Id.* § 54

43 *Id.*

bank supervision. Though not included in the original draft of the Federal Reserve Act, Senator Robert Owen added a provision to the bill that was eventually passed that aimed to resolve conflicts arising from jurisdictional overlap between the Comptroller's supervision of national banks and the Fed's authority to supervise banks that would become members of the Federal Reserve System. Specifically, that provision, section 10(6) of the Federal Reserve Act, reads: "whenever power vested by this Act in the Federal Reserve Board or the Federal reserve agent appears to conflict with the powers of the Secretary of the Treasury, such powers shall be exercised subject to the supervision and control of the Secretary." [44]

While virtually no scholars have reflected on this sleeper provision, as Professor Skinner and Mr. Salib have elsewhere explained, the legislative history of section 10(6) plainly shows that it was intended to assuage legislators' concerns at the time that the Treasury might be forced to cede bank supervisory power to the Fed. [45] Senator Owen was apparently concerned for the Comptroller's responsibility to supervise the issuance of national bank notes. Section 10(8) of the Act would require the Comptroller to do this "under the general supervision of the Federal Reserve Board" *and* "under the general directions of the Secretary of the Treasury."[46] As Jerome Clifford aptly stated, "Truly, he might have to become a Janus, watching over the doorway to the nation's currency: one face toward the Board and one face toward the Treasury."[47] The Comptroller was also, as just noted, responsible for supervising national banks, which would become member banks in the new Federal Reserve System. But the Federal Reserve Act was otherwise silent as to how to resolve disputes between the Comptroller and the Fed regarding licensing and supervisory criteria for national banks. [48] Section 10(6) would settle disputes in favor of the Treasury where any conflict arose.[49]

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44 Federal Reserve Act of 1913, Pub. L. No. 63-43, § 10(6), 38 Stat. 251, 261.

45 Salib & Skinner, *supra* note 12, at 909-10, 954.

46 Federal Reserve Act of 1913, Pub. L. No. 63-43, § 10(8), 38 Stat. 251, 261. The Federal Reserve Agent is a position in each Reserve Bank.

47 A. JEROME CLIFFORD, THE INDEPENDENCE OF THE FEDERAL RESERVE SYSTEM 77 (2016).

48 *See id.* at 77–78.

49 In particular, 10(6) was meant to safeguard the Treasury's power in three particular arenas: (1) where the Comptroller was to be responsible for the issuing of national bank notes, as he would have to answer to both the Treasury Secretary and the new Board; (2) where the Comptroller would be responsible for setting quality standards for national banks (which would then become member banks); (3) regarding the continued use of the sub-treasury system vs the switch over to the use of the regional banks as depositories for public funds. Owen and his followers wanted to make sure that the Treasury had the upper hand where conflicts might arise in these three situations. But given that neither

Although the Federal Reserve Act clearly contemplated a role for the Federal Reserve System in supervising member banks,[50] that task was given to the regional Reserve Banks at the beginning, not to the Board.[51] Pursuant to the Act, and the public-private power sharing arrangement that undergirded it, the twelve regional Reserve Banks were structured as private entities owned and governed by their respective member banks. Specifically, upon joining the Federal Reserve System, banks would become shareholders in their regional Reserve Bank.[52] These Reserve Banks would be governed by a private board of directors, two-thirds of whom are elected by their member banks.[53] The primary role of the regional Fed Banks, originally, was to act as bankers' banks in the way that private clearing houses had done before the creation of the Fed.[54] Accordingly, the Fed Banks' supervision was limited in its focus to ensuring that member banks were healthy enough to lend to response to the money and credit needs of their communities. With this lending role in view, Reserve Bank supervision was akin to the due diligence that private banks use to monitor their private borrowers.[55]

In the midst of the Great Depression, Congress created federal deposit insurance and another banking agency to oversee it. In the Banking Act of

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national bank notes nor the sub-Treasury system no longer exist, 10(6) is moot for those two purposes.

50 "An Act To . . . establish a more effective supervision of banking in the United States . . . ." Federal Reserve Act of 1913, Pub. L. No. 63-43, 38 Stat. 251, 251.

51 "[E]xaminations shall be so conducted as to inform the Federal Reserve bank of the condition of its member banks and of the lines of credit which are being extended to them." *Id.* § 21.

52 This provision is found in section 4 of the original Federal Reserve Act, Pub. L. 43-63, H.R. 7837, *available at* https://fraser.stlouisfed.org/files/docs/historical/fr_act/nara-dc_rg011_e005b_pl63-43.pdf.

53 Federal Reserve Act, § 4(8). This is found is section 6 of the current Federal Reserve Act.

54 The Fed was created to rectify the chronic money shortages that had resulted from an inelastic money supply that prevailed prior to 1913. The Act created this system of regional Reserve Banks precisely so that they would assist member banks with seasonal liquidity shortages.

55 As Professor Charles Goodhart and Dirk Schoenmaker have pointed out, "While it was regarded as appropriate for them, as for any other commercial banker, to assess the quality of the paper offered by other banks on the market, and to use standard, generally available techniques for assessing (potential) counterparties; credit-worthiness, the idea that the central bank should have a formal duty to inspect and to give regulatory orders to other commercial banks would have been anathema both to those banks and to the central bank at any time prior to 1914." Charles Goodhart & Dirk Schoenmaker, *Should the Functions of Monetary Policy and Banking Supervision Be Separated*, 47 OXFORD ECON. PAPERS 539, 541-42 (1995).

1933,[56] Congress took specific measures to structure this agency, the FDIC, to be independent, in contrast to the way it had designed the OCC[57] The Banking Act required that the Corporation would be led and managed by a three-member board, not more than two of whom "shall be members of the same political party."[58] The Comptroller was an *ex officio* member of the board, and would be accompanied by two additional private citizens who would be appointed by the President subject to the advice and consent of the Senate.[59]

The scope and purpose of the FDIC's supervisory authority was also distinct from that of the Fed Banks and the OCC. Prior to the creation of the federal deposit insurance fund, bank deposits had been protected locally by various private deposit insurance schemes operated on the state level.[60] Most of these schemes had failed due to inadequate bank supervision.[61] Large numbers of bank failures, often related to egregious management misconduct or imprudent risk-taking, had strained many of these state-level insurance funds to the point of breaking. Reflecting on the lessons of that experience, Congress empowered the FDIC not only to administer the insurance fund but also to supervise the banks that would be eligible for insurance in order to safeguard the financial integrity of the fund.

In particular, the Banking Act of 1935 substantially revised deposit insurance law and gave the FDIC explicit supervisory authority over insured

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56 Emergency Banking Act, Pub. L. No. 73-1, 48 Stat. 1 (1933).

57 Congress established key characteristics of an independent agency in 1887 when it established the Interstate Commerce. "An uneven number of commissioners . . . appointed to staggered terms of a fixed period extending beyond the term of the President . . . can only be removed by the President for "inefficiency, neglect of duty, or malfeasance in office"; [and] no more than a bare majority can come from the same political party." Act to Regulate Commerce of 1887, §§ 11-13. The Act also highlighted several other key design features: "Individuals appointed to fill a vacancy can only fill the unexpired term, but there is no prohibition on reappointment; No professional qualifications for office set out in the statute; Federal service is full time and agency members cannot hold any financial interest in a member of the regulated sector; Combination of rule-making, enforcement and adjudication functions."(§§ 15, 20). However, as Professors Sunstein and Vermuele point out, "under the Constitution, the meaning of 'independence' remains highly uncertain." Cass R. Sunstein & Adrian Vermeule, *Presidential Review: The President's Statutory Authority Over Independent Agencies*, 109 GEO. L. J. 637, 639 (2021). *See infra* Part II.

58 Banking Act of 1933, Pub. L. No. 73-66, § 8(d), 48 Stat. 162, 168.

59 *Id.* Today, the board is expanded slightly, at five members, and also includes the director of the Consumer Financial Protection Bureau. *See* 12 U.S.C. § 1812(a)(1).

60 *See* Christina Parajon Skinner, *Privatizing Deposit Insurance*, HARV. BUS. L. REV. (forthcoming 2024).

61 *Id.*

banks.[62] If the FDIC board determined that an insured bank—or its directors or trustees—was conducting business in an "unsafe or unsound way," or had otherwise violated the law, it was required to refer the infraction to the relevant bank licensing authority; in the case of national banks, the Comptroller; in the case of state member banks, the Board of Governors of the Federal Reserve.[63] If the bank did not promptly correct the problem, the FDIC's board would "terminate the status of the bank as an insured bank."[64] In order to aid in such ongoing evaluation, the statute gave the FDIC access to all examination reports that had been made by the Comptroller and the Federal Reserve Banks in the course of their supervisory work.[65]

This tripartite system of bank supervision, which arose in response to different economic and financial system needs at different points in time, remains in place today. However, in sharp contrast to the dispersion of power that was established in the early 20th century, by 2010, the Fed had emerged as the dominant bank supervisor—a clear first among equals as the supervisor of the largest, most systemically important banks that owned both insured deposit taking banks and all manner of non-bank financial affiliates.[66]

B. *Objectives and Functions*

Between 1913 and 1956, Fed supervision had been limited with a focus on member banks' health and integrity as would-be discount window borrowers. This changed in 1956 when the Fed acquired responsibility for overseeing Bank Holding Companies and again in 2010 when it became the principal authority responsible for supervising all banking sector risk.

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62 *See* FED. DEPOSIT INS. CO., A BRIEF HISTORY OF DEPOSIT INSURANCE IN THE UNITED STATES 37 (1998).

63 Banking Act 1935, Pub. L. No. 74-305, § 101(i)(1), 49 Stat. 684, 690.

64 *Id.*

65 *Id.* § 101(k)(4).

66 Today, the OCC continues to charter and supervise national banks and federal savings and loan institutions. U.S. GOV. ACCOUNTABILITY OFF., BANK HOLDING COMPANY ACT: CHARACTERISTICS AND REGULATION OF EXEMPT INSTITUTIONS OF REMOVING THE EXEMPTIONS (Jan. 2012). The FDIC has jurisdiction over deposit taking institutions that are members of the FDIC. As will be discussed, the Fed's jurisdiction includes foreign banks that are members of the federal reserve system, bank holding companies, savings and loan holding companies and their nondepository institutions, and any firm designed as systemically important by the FSOC. *Id.*

1. *Microprudential Supervision*

By the mid-1950s, the Federal Reserve began to exercise a supervisory role over a new kind of banking entity, the Bank Holding Company ("BHC").[67] The McFadden Act of 1927 had severely limited the extent to which banks could branch and operate across state lines, and independent unit banking proved a difficult business model to sustain.[68] The practice of group banking arose in response.[69] These groups—BHCs—are structured as parent corporations owning a number of financial subsidiaries and affiliates, including deposit-taking banks, investment advisors and managers, and securities broker-dealers. However, when it arose in the 1920s, this new banking association form fell outside the supervisory jurisdiction of the OCC—which only chartered and supervised national banks—and the FDIC—which supervised only insured deposit taking banks—and the Fed—which supervised its member banks.

To fill that gap, the Bank Holding Company Act of 1956 assigned BHCs to the Federal Reserve Board, which would henceforth act as the principal licensing authority, supervisor, and regulator for BHCs.[70] Further, all of the BHCs' affiliated entities would also fall under the Fed's purview as a "consolidated supervisor" of the BHC. As such, the 1956 Act catapulted the Fed to lead supervisor in the tripartite bank supervision system.[71]

As set out in the Bank Holding Company Act, the objective of the Fed's supervision of BHCs is "microprudential" in nature—that is, the Fed exercises oversight of BHCs' "safety and soundness" and monitors their

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67 These entities control a range of subsidiary entities, including banks (i.e, deposit-taking institutions). As well, the Fed has jurisdiction over financial holding companies. The Gramm-Leach-Bliley Act of 1999 makes it possible for certain BHCs to organize as financial holding companies, which enables those parent entities to own entities engaged in broker-dealing/securities underwriting, merchant banking, and insurance activities. The Fed uses "consolidated supervision" to reach these entities and affiliates. *Id.* Bank Holding Company Act of 1956, 12 U.S.C.A. §§ 1841-48.

68 McFadden Act, Pub. L. No. 69-639, 44 Stat. 1224 (1927). *See The Bank Holding Company Act of 1956*, 7 DUKE L. J. 1 (1957).

69 *The Bank Holding Company Act of 1956*, *supra* note 68. The first independently capitalized bank holding company was established in Seattle, Washington in 1927, the Marine Bank Corporation. *Id.* at n.4 (citing CARTINHOUR, BRANCH, GROUP AND CHAIN BANKING (1931)).

70 Bank Holding Company Act of 1956, Pub. L. No. 84-511, 70 Stat. 133; *see The Bank Holding Company Act of 1956*, *supra* note 68, at 15.

71 Notably, other versions of the bill, including the administration's original bill, would have divided the regulatory responsibility among the three federal supervisory agencies. *See* Donald T. Savage, *A History of the Bank Holding Company Movement, 1900-78*, *in* 21-68, 70 THE BANK HOLDING COMPANY MOVEMENT TO 1978: A COMPENDIUM, 21-68 (Board of Governors of the Federal Reserve System 1978).

compliance with banking regulation and law.[72] Although the Federal Reserve Act had originally given the Reserve Banks authority to examine their member banks, Section 5 of the Banking Holding Company Act gave examination power to the Board in regard to BHCs.[73] As such, a new division of supervisory labor would apply at the Fed going forward: the Board would establish supervisory policy and delegate the "day-to-day supervision" of the BHCs to the regional Reserve Banks.[74] Operationally, the Reserve Banks' developed their supervisory exam process as a combination of on-site and off-site inspections, supervision by supervisory teams assigned to be physically present within a particular bank, ongoing review of bank data and reports, and coordination with other relevant supervisors.[75]

Fed supervisors would also, along with other supervisory agencies, develop a ratings system to assess BHCs' safety and soundness, known as CAMELS. That rubric consists of six dimensions—capital, asset quality, management, earnings, liquidity, and sensitivity to market risk. Supervisors

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72 Thomas Eisenbach et al., *Supervising Large, Complex Financial Institutions: What Do Supervisors Do?*, Staff Report No. 729 FED. RSRV. BANK OF N.Y., May 2015, https://www.newyorkfed.org/medialibrary/media/research/staff_reports/sr729.pdf.

73 Section 5(c)(2) of the Bank Holding Company Act provides: "the Board may make examinations of a bank holding company and each subsidiary of a bank holding company in order to inform the Board of the safety and soundness of the bank holding company or of any depository institution subsidiary of the bank holding company or the stability of the financial system of the United States." The Federal Reserve Act be amended to give the Board of Governors the authority to examine "the accounts, books and affairs of each Federal reserve bank and of each member bank and to require such statements and reports as it may deem necessary." However, this authority focused on the "condition" of the bank as it pertains to "the character of the money held as reserve and the amount, nature, and maturities of the paper and other investments owned or held by Federal reserve banks." Federal Reserve Act, § 11.

74 *See* Fed. Reserve Bank of New York, Supervision, https://www.newyorkfed.org/aboutthefed/org_banksup.html (last visited January 29, 2024). The Fed makes its supervision manuals, which provide guidance to its staff, publicly available (these manuals are updated semiannually. As described in the *Bank Holding Company Supervision Manual*, these documents are: prepared by Federal Reserve supervision personnel to provide guidance to examiners as they conduct inspections of bank holding companies (BHCs) and their nonbank subsidiaries as well as savings and loan holding companies (SLHCs). The manual is a compilation of formalized procedures and Board supervisory policies that examiners and supervision personnel should follow for the supervision of these organizations. It also discusses the relevant statutes, regulations, interpretations, and orders that pertain to holding company supervision. *See* Bd. of Governors of the Fed. Reserve Sys., Supervision Manuals, https://www.federalreserve.gov/publications/supmanual.htm (last visited January 29, 2024).

75 *Id.*

issues a composite score.[76] A CAMELS rating is communicated privately to the bank, along with recommendations for improvement, and not disseminated more widely to the public. The Federal Reserve has never published its methodology for assessing a bank's performance along each of the CAMELS dimensions; rather, it is left to the supervisor's discretion.[77]

Although the Banking Holding Company Act brought supervision in-house in a way that Congress had not obviously intended when it created the Federal Reserve, in practice, this microprudential supervisory function could have remained quite limited. After all, the practice of consolidated supervision still required a good degree of coordination between the other two bank supervisors. The OCC continued to have primary jurisdiction over the national banks within the banking group, as the FDIC's jurisdiction also overlapped with those insured entities. In theory, then, the Federal Reserve Board could have deferred to either of these other agencies rather than taking the lead.

And, in fact, the Board's approach to microprudential supervision was deferential until 2008. Indicative of this philosophy, the Fed's 2005 *Purposes and Functions* document explained, "The goal of the risk-focused supervision process is to identify the greatest risks to a banking organization and assess the ability of the organization's management to identify, measure, monitor, and control those risks."[78] In other words, although the Fed was concerned about overall processes in place for risk-detection and identifying rule non-compliance, firms could otherwise exercise their business judgment. The 2008 financial crisis was a turning point for central bank supervision which shifted the Fed's supervision into a more proactive and prophylactic mode.

2. *Macroprudential Supervision*

The 2008 global financial crisis was a watershed moment for central banks as supervisors. Prior to that point, there had been "no generally accepted answer to the question, where supervision . . . should be undertaken: in-house in the central bank or in a separate purpose-built

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[76] Bd. of Governors of the Federal Reserve Sys., Federal Reserve Supervisions and Regulation Report, Nov. 2021, https://www.federalreserve.gov/publications/2021-november-supervision-and-regulation-report-appendix-a.htm.

[77] As the New York Fed describes this process, "[f]indings from examinations or continuous monitoring can lead to further engagement with the firm in an effort to improve the firm's processes, financial condition or the safety of the financial market."

[78] THE FEDERAL RESERVE SYSTEM: PURPOSES AND FUNCTIONS (June 2005), *available at* http://www.federalreserve.gov/pf/pf.htm.

institution."[79] By 2010, however, most experts had converged on the view that the supervisory failures that contributed to the crisis could be prevented going forward by empowering central banks.[80] The ECB was given new supervisory tasks,[81] the U.K.'s prudential regulation, the Financial Services Authority, was disband and its duties and tools re-assigned to the Bank of England.[82] In the U.S., the Dodd-Frank Act conferred so much additional regulatory and supervisory power to the Fed, it effectively (though not formally) made supervision a new agency with the central bank.

The style of central banking supervision also changed after the crisis. Going forward, central banks would be concerned not only with firm-level microprudential supervision but also system-wide macroprudential supervision. Accordingly, rather than focusing on the bespoke risks presented by individual banks, macroprudential supervision prompted central banks to look for sources of financial stability risk, also referred to as "systemic risk."[83] Consequently, BHCs would be supervised (and regulated) more stringently, on the theory that instability at any one of these institutions could spill over into the rest of the financial system, dragging the economy down with it. It also meant that supervisors should look outside of the banking system for financial stability risks, especially those posed by financial institutions and markets that had heretofore evaded the bank supervisors' jurisdiction.

With that viewpoint in mind, section 165 of the Dodd-Frank Act fundamentally re-shaped bank supervision at the Fed in three important ways. First, it dramatically expanded the Fed's supervisory jurisdiction. Not only would the Fed be responsible for the BHCs, and a small number of other institutions as it had before, it would also be responsible for supervising any nonbank financial company that would in the future be labeled as

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79 Goodhart & Shoenmaker, *supra* note 55, at 544.

80 Ashok Vir Bhatia, *Consolidated Regulation and Supervision in the United* States, IMF Working Paper No. 11/23. https://www.imf.org/external/pubs/ft/wp/2011/wp1123.pdf. *See also* Joe Peek, Eric S. Rosengren, Geoffrey M. B. Tootell, 114 QUARTERLY J. OF ECON. 6629, 629-653 (1999) (making the argument that the information gleaned from bank supervision improves the quality of the FOMC's economic forecasting); Pierre Duquesne, *The Supervisory Role of the Central Bank*, *in* BANKING SOUNDNESS AND MONETARY POLICY (Charles Enoch & J.H. Green eds. 1997); Stephen G. Cecchetti & Kermit L Schoenholtz, *Why the Central Bank Should Be a Leading Supervisor*, Money & Banking, Sept. 12, 2017, https://www.moneyandbanking.com/commentary/2017/9/12/why-the-central-bank-should-be-a-leading-supervisor.

81 *See, e.g.*, Vir Bhatia, *supra* note 80.

82 Financial Services and Markets Act 2000 (FSMA), Part I.

83 *See, e.g.*, Kadija Yilla & Nellie Liang, *What Are Macroprudential Tools*, BROOKINGS, Feb. 11, 2020, https://www.brookings.edu/articles/what-are-macroprudential-tools/.

systemically important by the FSOC (i.e., nonbank "SIFI"s).[84] This kept the gate open to the Fed's supervisory perimeter; at any moment, depending on the FSOC's views, it might inherit responsibility for supervising insurance companies, the financial arms of nonfinancial corporations, asset managers, or big hedge funds.

Second, the Dodd-Frank Act required the Fed Board to develop "enhanced supervision and prudential standards" for BHCs over a certain size and any future nonbank SIFIs.[85] In terms of supervision, section 165 further provided that the Board "shall conduct annual analyses in which nonbank financial companies supervised by the Board of Governors and bank holding companies . . . are subject to evaluation of whether such companies have the capital, on a total consolidated basis, necessary to absorb losses as a result of adverse economic conditions."[86] But it gave the Board full discretion to "develop and apply such other analytic techniques as are necessary to identify, measure, and monitor risks to the financial stability of the United States."[87]

In response, the Fed created a new supervisory "stress test" that would be given to all of the biggest banks. This scenario-based exercise would henceforth be conducted annually for banks with over $250 billion in consolidated assets (and every other year for medium-size BHCs with $100 billion in assets)—it is known as the "Comprehensive Capital Analysis and Review" ("CCAR").[88]

In overview, the stress tests require banks to provide information about their balance sheets in response to a set of scenarios involving some kind of unexpected, drastic economic shock.[89] The purpose is to assess the adequacy

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84 *See* Christina Parajon Skinner, *Regulating Nonbanks*, 105 GEO. L.J. 1379 (2017).

85 Dodd-Frank Act, § 165.

86 *Id.*

87 *Id.*

88 2 C.F.R. pt. 238, subpart O; 12 C.F.R. pt. 252, subpart E. Firms with over $250 billion consolidated assets have to take the test every year. *See* BD. OF GOVERNORS OF THE FED. RSRV. SYS., DODD-FRANK ACT STRESS TEST 2020: SUPERVISORY STRESS TEST RESULTS 1 (June 2020), https://www.federalreserve.gov/publications/files/2020-dfast-results-20200625.pdf [https://perma.cc/XK5R-9ASD].

89 BD. OF GOVERNORS OF THE FEDERAL RESERVE SYS., 2022 STRESS TEST SCENARIOS, https://www.federalreserve.gov/newsevents/pressreleases/files/bcreg20220210a1.pdf. The first scenario, for example, "hypothesized a deep recession in the United States, with GDP contracting sharply, unemployment reaching a peak of more than 13 percent, equity prices falling by half, and house prices declining by an additional 20 percent from their 2011 levels. In addition, given the potential for financial stress in Europe, the scenario included a global recession and a global financial market shock. The latter, applied to the trading, derivatives, and private equity positions of the six firms with the highest volumes

of banks' capital, in other words, to see how resilient their balance sheets are to serious economic distress. The Fed develops and uses its own models to determine the effect of the hypothetical shock on the regulatory capital ratios of the firms based on the information that the banks provide them.[90] Essentially, although the stress test is a supervisory exercise, it is effectively used to set these banks' capital requirements. This is because, in order to pass, a bank is required to demonstrate to the Fed supervisor that it has sufficient capital to avoid insolvency in light of the various scenarios presented in the test, without taking any defensive action, like reducing dividends.[91]

Third, section 165(d) of the Dodd-Frank Act required these large BHCs to submit resolution plans—or "living wills"—to the Federal Reserve and the FDIC.[92] Resolution planning also has a distinct financial stability goal. The purpose of the plans is to set out how the firm would wind down its operations in the event of insolvency, such that the failure would be "orderly" and not impose costs on depositors or third parties. Accordingly, part of the Fed's new financial stability supervisory role involves reviewing, and identifying shortcomings, in the firm's living will.

The ethos of microprudential supervision also changed after the Dodd-Frank Act. In particular, the Fed established a separate regime for supervising the largest BHCs that had been singled out in the statute for enhanced supervision.[93] In 2010, it created the Large Institution Supervision Coordinating Committee ("LISCC") that took financial stability as its

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of trading, included a dramatic widening of credit default spreads for both European sovereigns and financial institutions, as well as sharp increases in spreads for European sovereign bonds." Daniel K. Tarullo, *Developing Tools for Dynamic Capital Supervision*, Speech at the Federal Reserve Bank of Chicago Annual Risk Conference, Apr. 10, 2012, https://www.federalreserve.gov/newsevents/speech/tarullo20120410a.htm,

90 Stress testing assumes a dynamic balance sheet—that is, it models the impact of a shock on banks' balance sheets over a nine-quarter time horizon.

91 *See* Bank Pol'y Inst., CCAR Issue Summary, https://bpi.com/wp-content/uploads/2019/05/BPI-CCAR-One-Pager.pdf.

92 *See* Dodd-Frank Act, § 165(d). *See also* Bd. of Governors of the Federal Reserve Bd., *Resolution Planning and Living Wills*, https://www.federalreserve.gov/supervisionreg/resolution-plans.htm#:~:text=The%20Dodd%2DFrank%20Act%20requires,the%20Federal%20Deposit%20Insurance%20Corporation..

93 The group of LISCC firms includes the large financial institutions, "LFIs", with over $100 billion in consolidated assets. *See* Bd. of Governors of the Federal Reserve Sys., Large Institution Supervision Coordinating Committee, https://www.federalreserve.gov/supervisionreg/large-institution-supervision.htm (last visited Jan. 30, 2024).

overriding goal. LISCC supervision takes in a broad—potentially subjective—universe of information and data to assess a banks' resilience. Specifically, LISCC exams include "horizontal" review, which incorporates information about similar firms (not only the facts specific to the institution under exam), and refers to "multiple sources of data and information to identify and *explore* risks and trends in the portfolio."[94] The LISCC uses its a distinctive ratings system for these large financial institutions, which assess the firm's (1) capital planning and positions; (2) liquidity risk management and positions; and (3) governance and controls."[95]

As such, today, the Fed's supervisory function now extends to over 5,000 BHCs and 200 foreign banking operations which it monitors for potential "financial stability" risk as well as "safety and soundness" issues.[96] As part of that role, Fed supervisors gain full access to these financial firms' balance sheets, their governance and decisionmaking frameworks, and their strategic plans—along with express statutory power to require change to any of these facets of the institution's business model and investment practice. Practically, the Fed's supervision function requires banks to participate in routine desktop exercises to assess their resilience—against any manner of catastrophic risk the Fed determines feasible—and to regularly report their funeral arrangements in the case of failure.

Overall, then, the Fed supervision function is considerably more burdensome for the banks it oversees than it was before 2010, and its supervisory discretion has grown much more subjective. Yet few have questioned whether it is appropriate for the Fed to wield these powerful supervisory tools in pursuit of such an open-ended objective. More striking still, the notion that central bank independence extends to the Fed's new financial stability—macroprudential—role has been assumed without any serious legal or policy debate.

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94 *Id.*

95 Bd. of Governors of the Federal Reserve Sys., Supervision and Regulation Letters, SR 19-3, https://www.federalreserve.gov/supervisionreg/srletters/sr1903.htm#:~:text=The%20LFI%20rating%20system%20represents,through%20a%20range%20of%20conditions.

96 *See* Cecchetti & Schoenholtz, *supra* note 80. In February 2014, the Fed issued a final rule—Regulation YY—which requires any FBO with over $50 billion in U.S. assets to establish an intermediate holding company for all of its U.S. subsidiaries and affiliates, which holding company is subject to the Fed's jurisdiction. This was also required by the Dodd-Frank Act. Dodd-Frank Act, § 165; Enhanced Prudential Standards (Regulation YY), 12 C.F.R. pt. 252 (2016). Importantly, as will be discussed, the Dodd-Frank Act prohibited the Board from delegating supervisory policy to the Reserve Banks. Pub. L. No. 111-203, § 1108.

II. SUPERVISION, INDEPENDENCE, AND THE CONSTITUTION

Central bank independence may well have started as an economic rationale, but in the United States, it also has certain legal footing. In pursuit of its price stability objective,[97] the Federal Reserve is directly exercising Congress's exclusive power to "regulate the value" of money in Article I, section 8 of the Constitution.[98] The Framers and ratifiers of the Constitution plainly intended for this particular power to be kept out of presidential hands.[99] On that understanding, Congress justifiably afforded the members of the Board of Governors with a considerable degree of insulation from the Chief Executive[100] with fourteen-year terms of office,[101] "for cause" protection from removal from office before that term expires,[102] and an exemption from the appropriations process.[103] In practice, even beyond these legal structures, conventions and norms support robust CBI: every U.S. President has refrained from attempting to fire the Fed Chair and most avoid overt influence; Congress, for its part, tends to defer to monetary policy decisions as they are made.[104]

Supervision has been grandfathered into this regime of central bank independence. However, as this Part will explain, the independent exercise of the Fed's supervisory functions is inconsistent with the Constitution's separation-of-powers.

A. Presidential Removal

Thanks to some ambiguity in the law, and established convention, the Fed supervision function has become effectively insulated from the President's removal power.

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97 12 U.S.C. § 225a.

98 U.S. CONST., Art. I, § 8.

99 *See* Christina Parajon Skinner, *The Monetary Executive*, 91 GEO. WASH. L. REV. 164 (2022)

100 Congress has defined the Fed Board as an "independent agency." 44 U.S.C. § 3502(5).

101 Banking Act 1935, § 201, amending section 10 of the Federal Reserve Act.

102 *Id.*

103 *See* Andrew T. Levin & Christina Parajon Skinner, *Central Bank Undersight* (unpublished manuscript, on file with author) (discussing the Fed's exemption from the appropriation process).

104 *See* Salib & Skinner, *supra* note 11.

1. *Vice Chair for Supervision*

The Dodd-Frank Act consolidated supervision under a single Fed Governor—the Vice Chair for Supervision ("VCS").[105] Specifically, "The Vice Chairman for Supervision shall develop policy recommendations for the Board regarding supervision and regulation of depository institution holding companies and other financial firms supervised by the Board, and shall oversee the supervision and regulation of such firms."[106] The VCS is appointed by the President, with advice and consent of the Senate, for the role, which has a four-year term of office.[107]

One oddity of this arrangement is that the VCS also, upon his or her appointment, becomes a full Board member which office comes with its own fourteen-year term. Although the first VCS, Randall Quarles, resigned his office and place on the Board after a change in presidential administration, nothing in the law requires as much.[108] A VCS' term might extend into a new administration and nothing legally would require his or her departure. The Federal Reserve Act protects Board members from removal from office unless the President can show "cause" for that removal.[109] It remains unclear whether this "for cause" protection extends to the VCS, role and if so what it means.

What qualifies as "cause" has never been determined for the officers of the Fed. No sitting President has ever attempted to fire a Board Chair and the role of VCS is so new that this issue has never been tested in regard to that particular seat. With that being said, if one subscribes to the view that CBI extends to supervision, then almost certainly one would assert an argument that the VCS role is also one protected from removal except "for cause." If the "for cause" protection were urged upon a President as a reason for restraint, then if history is any guide, the President would be highly unlikely to attempt to remove the VCS for ordinary policy disagreements.[110]

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105 Pub. L. No. 111-203, § 1108.

106 *Id.* (codified at 12 U.S.C. § 242)

107 *Id.*

108 The first VCS, Daniel Tarullo, resigned when President Obama let office and the second VCS, Randall Quarles, resigned upon President Biden's inauguration. The third VCS is Michael Barr who was appointed by President Biden and still holds his office.

109 The Banking Act of 1935 amended the Federal Reserve Act to state that the President may not remove a Board member unless "for cause."

110 *See* Sunstein & Vermeule, *supra* note 59, at 648 ("Strictly as a matter of statutory interpretation, if the INM standard means anything, it means that the President cannot discharge a member of an independent agency simply because he disagrees with the agency's conclusions about policy or fact.").

But this byproduct of extending CBI expectations to the new VCS seems constitutionally unsupported. Article II, Section 2 of the Constitution vests the President with the power to appoint officers of the United States and, attendant to that power, the authority to remove them.[111] As the administrative state has grown, the threat of removal has become central to the legitimacy of agency power. Specifically, the threat of removal from office disciplines agency directors from exceeding their statutory mandates; the ability to swiftly remove an agency head acting ultra vires can stop a power grab in its tracks.[112] As Professor Cass Sunstein and Professor Adrian Vermeule have explained, the agency accountability rationale for a robust removal authority has a grounding in constitutional common law. In their words,

> [i]t is one thing to say that in (say) 1800, Congress had the constitutional authority to immunize certain agencies and institutions, not so fundamental to national life, from plenary presidential control. It is quite another to say that Congress can carve out an assortment of crucial agencies affecting the economy in multiple ways, such as the Federal Communications Commission, the Federal Trade Commission, the Nuclear Regulatory Commission, and the CFPB, and let them do their work without control from the constitutionally specified executor of the laws.[113]

In 2020, the Supreme Court considered the "outermost constitutional limits of permissible congressional restrictions on the President's removal power" in *Seila Law v. CFPB*.[114] There, the Supreme Court considered the "for cause" removal protection that had been granted to the director of the Consumer Financial Protection Bureau ("CFPB").[115] The Court underlined that the Constitution vests all executive power in the President, who must accordingly "take Care that the Laws be faithfully executed."[116] It confirmed that, as such, "the President's power to remove—and thus supervise—those

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111 U.S. Const., Art. 2, § 2.

112 *See* Application of Section 9(a) of the Hatch Act to a Federal Reserve Agent at 9 (Mar. 6, 1964) (concluding that, for Appointments Clause purposes, and "consistent with the history of its establishment and on the basis of precedents, the Board of Governors of the Federal Reserve System constitutes a department and the Governors the head thereof").

113 Sunstein & Vermeule, *supra* note 32, at 96. (further noting that "the founding commitments to accountability, dispatch, coordination, and energy call for strong unitariness [today], even if those commitments authorized weak unitariness two centuries earlier").

114 Seila Law LLC v. Consumer Fin. Prot. Bureau, 140 S. Ct. 2183, 2206 (2020) (slip op. at 16).

115 *Id.*

116 *Id.* at 27.

who wield executive power on his behalf follows from the text of Article II" and is therefore "the rule, not the exception."[117]

The Court acknowledged only two exceptions to that rule. The first was for "expert agencies led by a *group* of principal officers" with partisan balance.[118] The simple fact that the CFPB was headed by a single director cast that agency's structure outside of this exception. Although the Fed Board is a multi-member body, supervision at the Fed is now de facto led by one Board member. To be clear, the VCS is not formally a single director because he or she is still required to win the votes of the other board members to pass regulations and supervisory guidance. And sometimes, those other board members cast dissenting votes.[119] Nevertheless, as the VCS role has developed over the past five years, deference to the VCS has become the practiced norm. The current Fed Chair, Jerome Powell, explained his view on the VCS during his 2021 confirmation hearing:

> Senator Warren: The press also reported this as your agreement to defer to the Vice Chair for Supervision, so I want to ask you a specific example of how that deference would work in practice.
>
> Chair Powell: So, let me just say that what the law does is, the law gives the Vice Chair for Supervision the authority to set the regulatory and supervisory agenda, and I would expect to have a perfectly normal, good, constructive working relationship with a new Vice Chair for Supervision. I would not see myself as stopping those kinds of proposals from reaching the Board, since the law seems to indicate that that's the job of the Vice Chair for Supervision.
>
> . . .
>
> Chair Powell: First, respect the authority to bring these proposals. I also think a person who arrives, nominated by the President, confirmed by this body, with particular views, I would say that that person is entitled to a degree of deference, but I wouldn't overstate

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117 *Id.* at 1-2.

118 *Id.* at 1-2 (emphasis added). This is essentially the only aspect of *Humphrey's Executor* that the Supreme Court preserved. Regardless, according to some constitutional law scholars, *Humphrey's Executor* has been over relied upon to justify for cause removal since its holding. According to them, "Humphrey's Executor has absolutely nothing to say about whether Congress has the authority to make rulemaking agencies independent of the President. . . [W]e might say that the Court held that the Constitution allows Congress to immunize adjudicative officers from at-will discharge by the President but did essentially nothing more than that to authorize Congress to exempt policy-making officials from plenary presidential control." Sunstein & Vermeule, *supra* note 32, at 102.

119 *See* Bd. of Governors of the Federal Reserve Sys., Board Votes, https://www.federalreserve.gov/aboutthefed/board-votes-2023.htm (last visited Jan. 31, 2024).

that. The person still will have to convince the members of the Board to vote for whatever that person is proposing.[120]

The Board's July 2023 proposed rule to implement the remaining aspects of the third Basel Accord confirms precisely the degree of deference the Chair has afforded the VCS in regulatory rulemaking. That rule was complicated, spanning over 1,000 pages, and significant, proposing to increase capital requirements for banks over 25%.[121] Although the rule lacked evidence, cost-benefit analysis, or reasoned justification for making key departures from the commitments made by the prior VCS, the Fed Chair chose not to dissent when the proposed rule was voted on.[122] Given the outsized influence that the Chair plays on the Board, it is likely that deference on his part will shape the behavior of the other governors as well. In any case, there is no indication that the VCS is required to gain the rest of the Board's approval for other supervisor matters—like speeches that set informal expectations, supervisory steers given to the Reserve Banks, the establishment of new stress testing methodology, or the creation of new scenario analysis.[123]

The second exception to the removal power that the *Seila* Court acknowledged applies to "inferior officers with narrowly defined duties."[124] In the case of the CFPB director, the Court concluded that the CFPB director's responsibility for significant policymaking and coercive enforcement was properly understood as an exercise of executive power, not some middling power.[125] As indicia of executive power, the Court referred to the CFPB

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[120] Warren, *supra* note 28.

[121] Bd. of Governors of the Federal Reserve Sys., Memo from Staff to Board, Re Basel III, July 18, 2023, https://www.federalreserve.gov/aboutthefed/boardmeetings/gsib-memo-20230727.pdf.

[122] *See* Bd. of Governors of the Federal Reserve Sys., Board Votes, https://www.federalreserve.gov/aboutthefed/boardvotes.htm (votes on the controversial Basel III "endgame" proposal).

[123] As Peter Conti-Brown and Simon Johnson characterized the VCS power, that officer enjoys "the broadest grant of authority to an individual in the Federal Reserve Act—greater than even the explicit authority given to the Fed Chair" and can "set the tone for the Fed's entire regulatory apparatus." Peter Conti-Brown & Simon Johnson, *Governing the Federal Reserve System After the Dodd-Frank Act*, Peterson Inst., Oct. 2013.

[124] Seila Law v. Consumer Fin. Prot. Bureau, 140 S. Ct. 2183, 2206 (2020).

[125] *Id.* slip. op. at 17-18. Whether the exercise of power is properly understood as "executive" is a functional analysis. *See* Bowshar v. Synar, 487 U.S. at 689–91 (1986) (holding that "[t]he analysis contained in our removal cases is designed not to define rigid categories of those officials who may or may not be removed at will by the President, but to ensure that Congress does not interfere with the President's exercise of the 'executive power' and his

director's authority "to promulgate binding rules fleshing out 19 federal statutes, ... [to] issue final decisions awarding legal and equitable relief in administrative adjudications," and to seek "daunting monetary penalties" in enforcement actions in federal court.[126]

The Fed supervision function is no less sweeping or coercive. To start, the Board's financial stability supervisory programs—specifically, the stress test—have considerable punitive force because they determine the set point for regulation. If the Board objects to a financial institution's capital plan in the CCAR, that firm cannot pay dividends and its ability to make share repurchases is restricted. There could be restrictions on its expansion.

Furthermore, the outcome of the CCAR determines a bank's capital charge in what is known as the stress capital buffer.[127] Capital rules are likely the most expensive Fed regulations a BHC complies with. Importantly, because the Board has full discretion to alter the scenario in the stress test, or the models used to evaluate the banks performance, he or she also in turn has the power to unilaterally raise the amount of capital a firm requires.

Moreover, the Board oversees a range of enforcement actions that follow on the heels of the Reserve Banks' supervisory exams.[128] In consultation with the relevant Reserve Bank, the Board can issue a "written agreement." These are broad and flexible tools. A written agreement "may relate to any of the problems found at the institution or involving affiliated persons."[129] If terms of a written agreement are violated, the Fed can appeal to a federal district court to enforce it.

The Board also has the power to issue a cease-and-desist order upon a finding that the entity "is engaging, has engaged, or is about to engage" in a violation of law or regulation or otherwise engaged in "unsafe or unsound practice in conducting the business of the institution."[130] Alternatively, or in

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constitutionally appointed duty to 'take care that the laws be faithfully executed' under Article II").

126 *Seila Law*, 140 S. Ct. at 2200.

127 Press Release, Bd. of Governors of the Federal Reserve Sys, Mar. 4, 2020, https://www.federalreserve.gov/newsevents/pressreleases/bcreg20200304a.htm.

128 Section 2110.0.1 of the Bank Holding Company Manual sets out the statutory tools available to the Fed for taking formal supervisory enforcement actions against the banking entities or individuals "affiliated" with those entities, referred to by the Fed as "institution-affiliated parties".

129 Technically, it is the Reserve Bank that enters into the agreement with the supervised bank pursuant to authority that is legally delegated to it from the Board 12 C.F.R. 265.11(a)(15).

130 12 U.S.C. § 1818(b). This authority was added in 1966, Financial Institutions Supervisory Act of 1966, Pub. L. 89-965, § 202(b)(1), 80 Stat. 1028 (codified at 12 U.S.C. § 1818 (b)). Bank Holding Company Supervision Manual, § 2110.0.2.1. (July 2016).

addition, the Board has the power to impose civil monetary penalties if it finds that the institution has engaged "in any unsafe or unsound practice."[131] The fines scale according to the seriousness of the infraction—some are quite considerable.[132] These penalties are serious restrictions on liberty, in the case of removals, and property, in the case of activity restrictions and fines.

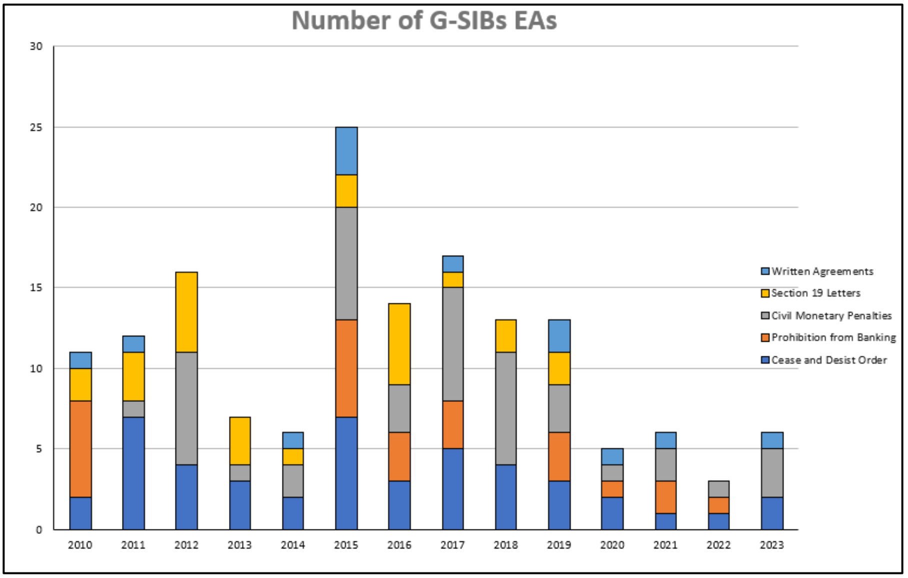
Figure 1 shows the distribution of these various enforcement actions ("EAs") between 2010 and 2023 for the globally systemically important banks ("G-SIBs"), which banks populate the LISCC category.[133]

131 Financial Institutions Regulatory and Interest Rate Control Act of 1978, Pub. L. No. 95-630, 92 Stat. 3641 (codified as amended in scattered sections of 12 U.S.C.) added section 29 to the Federal Reserve Act.

132 Fines are set at $7,500 per day for 'ordinary' violations of laws, regulations, final cease and desist orders, or terms of written agreements; but up to $37,500 per day for reckless violations or practices that are unsafe or unsound, or breach of fiduciary duty *if* the conduct is part of a "pattern of misconduct," or is likely to cause immaterial loss or accrue to the financial benefit of the offender." Where the offender knowingly or recklessly causes "substantial loss[es]" to the institution or receives "substantial" gain, then the Fed can assess a fine of up to $1.375 million per day. Finally, the Board the power to remove bankers from office and bar them from the ever working in the industry again upon a finding of "a willful or continuing disregard for the safety or soundness of the institution." 12 USC § 1818(e). This power was added in the 1933 Banking Act, Banking Act of 1933, Pub. L. No. 73–66, §§ 8, 30, 48 Stat. 162, and expanded in 1966, Financial Institutions Supervisory Act of 1966, Pub. L. 89-965, § 202(b)(1), 80 Stat. 1028. The Fed also issues Section 19 letters, in reference to section 19 of the FDI Act, which provides that any person convicted of a criminal offense involving dishonesty or a breach of trust or money laundering may not "become, or continue as" affiliated person with any insured depository institution; own or control an insured depository institution, or "otherwise participate . . . in the conduct of the affairs of any insured depository institution." The Reserve Banks issue these letters; though, strictly speaking, one could argue that these letters are merely follow-on consequences to a criminal conviction and not necessarily independent Fed supervisory enforcement action. Prohibition from Banking and Section 19 actions are directed to individuals, whereas cease and desist orders and written agreements are directed toward the bank holding company or one of its subsidiary entities. While a CMP is usually directed toward an entity, it can also be issued against an individual.

133 This data was hand collected by the author from the Federal Reserve's website publishing historical information on enforcement actions.

Figure 1.



The VCS is responsible for passing initial judgment on the use of these various supervisory enforcement powers of the Board.

The VCS also directs the Reserve Banks' examination priorities by shaping the focus and content of the Fed's supervisory guidance.[134] The subject of supervisory guidance is a sensitive one for agencies to deal with.[135] Supervisory guidance does not follow the same process that a formal rulemaking does. Yet practically, banks tend to perceive guidance just like a formal rule. To avoid legal confrontation, collectively, all three banking agencies have committed to using their guidance only to "provide[] examples of practices that the agencies generally consider consistent with safety-and-soundness standards" and foreswear that these documents are

134 But, after the Dodd-Frank Act, the buck stops with the Board were supervisory policy is concerned. Section 1108 of the Dodd-Frank Act provided that "the Board of Governors may not delegate to a Federal reserve bank its functions for the establishment of policies for the supervision and regulation of depository institution holding companies and other financial firms supervised by the Board of Governors." Pub. L. 111-203, § 1109(d).

135 The Fed publishes guidance dating back to the 1990s; presumably, this is when the practice of issuing supervisory guidance began. *See* Bd. of Governors of the Federal Reserve Sys., Supervision & Regulation Letters, https://www.federalreserve.gov/supervisionreg/srletters/1990.htm.

treated with "the force and effect of law."[136] These agencies claim that the guidance merely "outlines the agencies' supervisory expectations or priorities and articulates the agencies' general views regarding appropriate practices for a given subject area."[137]

It may be true that guidance cannot serve as the basis for a formal enforcement action. Nevertheless, in practice, guidance does alter industry behavior the same as a rule. Banks understand that if they do not comply with their supervisors "expectations," a more heavy-handed regulation could follow. Moreover, expectations set out in guidance could in theory also serve as the basis for *informal* supervisory action, which evade the public eye completely. Reserve Banks routinely turn to informal actions like the "matters requiring attention" ("MRAs") and "matters requiring immediate attention" ("MRIAs")[138] to identify deficiencies in an institution's risk management, governance, or other controls.[139]

Ostensibly, the MRA/MRIA is a more collegial way of nudging banks to fix behavior. It is styled as a non-public agreement between a Reserve Bank and a bank's senior management or board of directors.[140] Yet precisely because these documents are never made public, supervisors may well use

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136 Interagency Statement Clarifying the Role of Supervisory Guidance, Sept. 11, 2018, https://www.fdic.gov/news/press-releases/2018/pr18059a.pdf.

137 *Id.*

138 MRAs "constitute matters that are important and that the Federal Reserve is expecting a banking organization to address over a reasonable period of time, but the timing need not be 'immediate.'" MRIAs, meanwhile, are "matters of significant importance and urgency that the Federal Reserve requires banking organizations to address immediately and include: (1) matters that have the potential to pose significant risks to the safety and soundness of the banking organization; (2) matters that represent significant noncompliance with applicable laws or regulations; [and] (3) repeat criticisms that have escalated in importance due to insufficient attention or inaction by the banking organization." Thomas Eisenbach et al., *Supervising Large, Complex Financial Institutions: What Do Supervisors Do?*, FRBNY ECON. POL'Y REV. 72 (Feb. 2017), https://www.newyorkfed.org/medialibrary/media/research/epr/2017/epr_2017_what-do-supervisors-do_eisenbach.pdf?la=en

139 As one Fed scholar put it, MRAs are the "bread and butter of modern supervisory enforcement." Menand, AMS. The use of MRA appears to have begun in the late 199s. ""As best we can tell, the documentary origin of the MRA was the introduction of a "Matters Requiring Board Attention" page to the then-four Federal banking agencies common core Report of Examination. https://bpi.com/the-mra-is-the-core-of-supervision-but-common-standards-and-practices-are-mia/. *See* Interagency Policy Statement of the Uniform Common Core Report of Examination (1993), *available at* www.occ.gov/static/news-issuances/bulletins/pre-1994/examining-bulletins/eb-1993-7a.pdf.

140 *See* Eisenbach et al., *supra* note 138, at 12.

them to cajole bank behavior that goes beyond accepted understandings of what are "unsafe and unsound" practices or significant violations of law.[141] Although such shadow enforcement of guidance would be an abuse of supervisory power, such situation would be virtually impossible to check. Informal actions, and the reasons for them, are not subject to judicial review under the Administrative Procedure Act, which requires agency action to be "final" before it is justiciable.[142] As such, Fed supervisors might speak softly but carry guidance as a big and heavy stick.

Notably, Congress made a deliberate choice when it exempted informal supervisory judgments from the judicial review provisions of the APA. When Congress passed the APA, it assumed that supervisors' and banks' interests were aligned: "Because the banks are so important in an industrial-commercial economy, compulsive steps [by the agencies] which might shake confidence [in the banks] are withheld. Although there is in fact an iron hand within the velvet glove of the banking authorities, the glove is seldom removed."[143] On that view, trying to shoehorn slippery informal supervisory action into the more rigid framework for agency review was seen as unnecessary in 1946.[144]

This reasoning, of course, depended on the premise that bank supervisors do in fact believe that banks are important to the nation's economic health. But today, that view cannot be taken for granted. In consolidating supervisory authority in the VCS, Congress gave this one officer the power to unilaterally shift the ideological orientation of banking law; if, in the view of the VCS, banks should be weakened and made more like state-run enterprises or public utilities, that Board member has the full weight of the supervisory toolkit—including guidance, stress testing, and indirectly, informal agency action—at his disposal to alter banking market structure.[145]

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[141] Greg Baer & Jeremy Newell, *The MRA is the Core of Supervision, but Common Standards and Practices are MIA*, Banking Pol'y Inst. (Feb. 8, 2018), https://bpi.com/the-mra-is-the-core-of-supervision-but-common-standards-and-practices-are-mia/ [https://perma.cc/8BJK-RD9W]

[142] 5 U.S.C. §704.

[143] *See* Administrative Procedure in Government Agencies, Monograph of the Attorney General's Comm. On Admin. Procedure, part 9, Federal Reserve System, part 13, Federal Control of Banking: Comptroller of the Currency and Federal Deposit Insurance Corporation, S. Doc. No. 186, 76th Cong., 3d Sess. (1940).

[144] *Id.*

[145] For example, the Vice Chair for Supervision Randall Quarles, who occupied the role from 2017-2021, went to significant lengths to exorcise such manner of opacity and vagueness from Fed supervisory practices. *See, e.g.*, Randall K. Quarles, Spontaneity and Order: Transparency, Accountability, and Fairness in Bank Supervision, Address before the

Taken together, it is difficult to escape the conclusion that Congress could not legitimately "vest[] significant governmental power in the hands of a single individual accountable to no one" in creating the VCS.[146] Accordingly, the presumption that a President cannot remove the VCS from office is a problematic consequence of assuming that CBI applies to supervision.

2. *Reserve Bank Presidents*

As already discussed, the daily on-the-ground work of examining BHCs and relevant FBOs is conducted by the regional Reserve Banks on delegated authority from the Fed. In that capacity, the reserve banks work shoulder to shoulder with the bankers and their management teams. The Reserve Banks make the initial judgment about whether any formal or informal supervisory judgment is warranted—and have considerable discretion to do so. The term "unsafe and unsound" is not defined in the Bank Holding Company Act and the Fed has never promulgated a definition in its BHC supervisory manual.[147]

Each Reserve Bank is led by a "chief executive officer," the Reserve Bank president.[148] In structurally important ways, these Fed Bank presidents work as private citizens and thus avoid the constitutional clauses that apply to "officers of the United States."[149] Reserve Bank presidents are selected by the

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American Bar Association Banking Law Committee Meeting (Jan. 17, 2020), https://www.federalreserve.gov/newsevents/speech/quarles20200117a.htm https://perma.cc/7YBY-GXMU.

146 Seila Law LLC v. Consumer Fin. Prot. Bureau, 140 S. Ct. 2183, 2206 (2020) (slip op at 3).

Bamzai and Neilson similarly arrive at the conclusion that it is "hard to see a logical difference between the head of a single-headed agency and the chair of a multi-member agency when, by statute, that chair has its own unilateral authority, as is the case for the Fed chair. The same is true for the Vice Chair for Supervision." Bamzai & Neilson, *supra* note 30.

147 The term is, however, defined in the analogous section in the supervisory manual for commercial banks, which are the state member banks. "An unsafe or unsound practice is defined as any action that is contrary to generally accepted standards of prudent operation, the possible consequences of which, if continued, would be abnormal risk or loss or damage to an institution, its shareholders, or the agencies administering the insurance fund."

Bd. of Governors of the Fed. Reserve Sys., *Commercial Bank Examination Manual* § 5040.1 (Apr. 2013), *available at* https://www.federalreserve.gov/boarddocs/supmanual/cbem/5000.pdf. In any case, the Fed's own definition of this term would be subject to considerable judicial deference under the so-called *Auer* deference doctrine. Auer v. Robbins, 519 U.S. 452 (1997).

148 Federal Reserve Act, § 4(5).

149 Scholars like Professor Peter Conti-Brown have previously argued that, given their role as voting members on the Federal Open Market Committee Reserve Bank presidents should

Reserve Banks' private boards of directors—more specifically, by the three directors from Class A (representing the stock-holding member banks) and three directors from Class B (representing an assortment of local economic interests).[150] The Class C directors, who are appointed by the Fed Board of Governors, do not formally participate in the selection of presidents.

A Reserve Bank president can be removed from that office by the Reserve Bank's private board of directors for any reason whatsoever.[151] Attendant to its oversight, the Fed's Board of Governors may also remove a Reserve Bank president provided it shows the "cause" for that removal in "writing . . . to the removed officer or director and to said bank."[152]

However, there is no direct way for the U.S. President to remove a Fed Bank president. The President would first have to instruct the Fed Chair to remove the Reserve Bank president and the Fed Chair would then have to comply. But if the President's ability to remove a Fed Chair for policy disagreements is circumscribed by conventional understandings of the Chair's own "for cause" protection,[153] it would be nearly impossible for a sitting U.S. President to cause a Reserve Bank president's removal for disagreement over the how the Reserve Bank handled its supervisory discretion.[154]

The Supreme Court has clearly held that Congress may not add more than one layer of insulation between any authority *acting functionally like* an officer of the United States and the President.[155] At issue in *Free Enterprise v.*

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be subject to the rigors of the appointments clause, as set out in Article II, section 2. *See* CONTI-BROWN, *supra* note 30.

150 Class B directors are selected with "due but not exclusive consideration to the interests of agriculture, commerce, industry, services, labor and consumers." *See* Bd. of Governors of the Fed. Reserve Sys., Eligibility, Qualifications, and Rotation Policy, https://www.federalreserve.gov/generalinfo/listdirectors/PDF/eligibility-qualifications-rotation.pdf [https://perma.cc/8M26-3HE2].

151 Federal Reserve Act, § 4(4) provides the authority of each reserve bank: "To appoint by its board of directors a president [and other officers] . . .and to dismiss at pleasure such officers."

152 The Fed Board's authority to suspend or dismiss Fed Bank officers is stated in Federal Reserve Act, 12 U.S.C. § 248(f). On this score, the 2019 OLC memo was also sanguine: "we think that "cause" in this context means whatever reasons (if any) the Board has for removing the officer, and therefore permits the Board to remove the officer at will. The requirement that the Board notify certain parties of the reasons for removal does not displace the default rule that the appointing authority retains plenary removal authority." 43 Op. O.L.C. __ (Oct. 23, 2019) at 11.

153 *See supra* note 110.

154 *See supra* notes 128-133.

155 Free Enterprise Fund v. PCAOB, 561 U.S. 477 (2010).

PCAOB was a newly created public accounting oversight body (the "PCAOB") that was housed within the SEC, as a separate component of that agency with its own review and enforcement power.[156] The five-member body had been created by the Sarbanes-Oxley Act of 2002, and assigned the responsibility of overseeing all accounting firms that participate in auditing public companies under the U.S. securities law.[157] Although the statute did not expressly designate the PCAOB board members as officers of the United States, they nevertheless were given significant examination and rulemaking power: to "regulate every detail of an accounting firm's practice, including hiring and professional development, promotion, supervision of audit work, the acceptance of new business and the continuation of old, internal inspection procedures, professional ethics rules" and any other rules the PCAOB prescribed.[158]

The PCAOB was placed "under the SEC's oversight," much like Reserve Bank's operate under the oversight of the Fed Board. Likewise, similar to the Fed Board's authority to remove Reserve Bank presidents "for cause," the SEC could remove the PCAOB members only "for good cause shown."[159] The Court concluded that this removal restriction, which "passes through two levels of control," was contrary to the Constitution's separation of powers by unduly constraining the President's power to oversee the execution of the laws.[160]

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156 *See id.* slip op. at 2 (the question presented was "whether these separate layers of protection may be combined. May the President be restricted in his ability to remove a principal officer, who is in turn restricted in his ability to remove an inferior officer, even though that inferior officer determines the policy and enforces the laws of the United States").

157 *Id.* at 3.

158 *Id.* at 4.

159 *See id.* at 5. With that being said, the restrictions on the SEC's ability to remove a PCAOB member were more onerous than the Fed Board's vis-à-vis reserve bank presidents. Sarbanes-Oxley required a procedural hearing attendant to a finding that a PCAOB member had willfully violated a provision of the act or failed to enforce accounting standards. *Id* at 5 (citing 15 U.S.C. § 7217(d)(3).

160 *Id.* at 14-15. The Court relied on an original understanding of the removal power. Citing the so-called decision of 1789, and Madison's words therein, Citing James Madison, and the infamous decision of 1789, the Court repeated "The view that 'prevailed, as most consonant to the text of the Constitution' and 'to the requisite responsibility and harmony in the Executive Department,' was that the executive power included a power to oversee executive officers through removal; because that traditional executive power was not 'expressly taken away, it remained with the President.'" *Id.* at 11.

The separation-of-powers problem is virtually identical as it concerns the exercise of Reserve Banks' supervisory power.[161] The judgment whether to remove a Reserve Bank president whose deputies are "discharging" their supervisory duties "improperly" rests in the first instance with the Reserve Bank's private board—who, as private citizens, are entirely outside a U.S. President's control—or, in extreme cases, with the Fed Board—which members are statutorily insulated from presidential removal. There are, in short, no legal means for the U.S. President to supervise or control a Reserve Bank president.[162]

Arguably, the single most powerful thing that Reserve Banks do today is examine and recommend punishment or corrective action for the banks within their districts. *Free Enterprise* confirmed that the President must be able to supervise and control this kind of work.[163] Accordingly, it is difficult to escape the conclusion that Reserve Bank presidents' double-insulation "contravenes the President's constitutional obligation to ensure the faithful execution" of the banking law.[164]

Going forward, this analysis suggests that Presidents should be confident in their legal authority to, and the democratic legitimacy of, removing the VCS or a Reserve Bank president for reasons of supervisory policy disagreement.

B. *Broad Delegations*

In addition, the supervisory authority that Congress has delegated across the Federal Reserve System appears unconstitutionally over-broad. As

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161 *Id.* at 2. ("Here the President cannot remove an officer who enjoys more than one level of good-cause protection, even if the President determines that the officer is neglecting his duties or discharging them improperly. That judgment is instead committed to another officer, who may or may not agree with the President's determination, and whom the President cannot remove simply because that officer disagrees with him.").

162 *See* Morrison v. Olson, 487 U.S. 654, 696-96 (1988).

163 U.S. CONST., Art. II, § 2, cl. 2. Scholars have previously recognized Article II, section 2 problems inherent in allowing Reserve Bank presidents to vote on the FOMC without having passed through the constitutional appointments process. *See* CONTI-BROWN, *supra* note _. The point here is rather focused on supervision, removal and separation-of-powers. Notably, when the White House Office of Legal Counsel ("OLC") considered the issue in 2019, they opined that the arrangement did not present Appointments Clause problems because the Board of Governors exercised sufficient control over the Reserve Bank presidents, had an effective veto over the choice of Reserve Bank president, and the members of the Board of Governors were themselves appointed by the U.S. President. O.L.C., *supra* note 152.

164 *Id.*

just discussed, quite unlike the setting of monetary policy, bank supervision is best understood as an executive—not a legislative—task. As such, the extent to which Congress has transferred its legislative power to the Fed's supervision function in constrained by the structural separation between the legislative and executive branches.

Problematically, on that score, the terms "safety and soundness" and "financial stability" are not defined anywhere in law;[165] the Federal Reserve Board has not offered its own definition of these terms. As such, there are no legal demarcations of the boundaries of the Fed's supervisory discretion. Consequently, the Fed's supervision function has for several years now used its considerable policy autonomy to engage in policy entrepreneurship with little accountability to Congress.

Specifically, the Fed Board has issued supervisory guidance in regard to banks' exposure to *climate change* and banks' exposure to *crypto assets*. Meanwhile, one Reserve Bank—the New York Fed—has taken a forward-leaning approach to supervising *culture* in the biggest banks. However, these are issues that Congress continues to consider; it has not assigned statutory responsibility for Fed supervisors to address let alone preempt them.[166] The Fed's pursuit of guidance on these matters, notwithstanding Congress's undecided posture on them, thus implies another separation-of-powers problem.[167]

1. *Climate*

Beginning in late 2020, the Board's supervision function became increasing interested in climate risk. In its November 2020 *Financial Stability Report* (*FSR*), the Fed discussed climate change as a potential financial

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165 The origin of the safety and soundness term is the New York Safety Fund Act, which governed a 19th century state level private deposit insurance scheme. *See* Act of Dec. 4, 1847, ch. 419, § 3, 1847 N.Y. Laws 519, reprinted in THE BANKING SYSTEM OF THE STATE OF NEW YORK (2013)

166 *See* West Virginia v. EPA, 142 S. Ct. 2587 (2022) (holding that agencies may not make rules that impact major questions of the economy without a clear statement from Congress).

167 Agencies may help the President "fill in the details" of a statute by operationalizing it as such, but, given that agencies are part of the Executive Branch, they may create new law *See, e.g.*, Whitman v. Am. Trucking Ass'ns, 531 U.S. 457, 475 (2001) ("[T]he degree of agency discretion that is acceptable varies according to the scope of the power congressionally conferred. While Congress need not provide any direction to the EPA regarding the manner in which it is to define 'country elevators,' . . . it must provide substantial guidance on setting air standards that affect the entire national economy.").

stability risk for the first time.[168] In particular, it dissected how climate-related risks might be transmitted to the financial system and create certain financial system vulnerabilities.[169] Prior to this point, the Fed had refrained from taking a position on climate change, given its lack of express authority to incorporate matters of environmental sustainability into its supervisory policy.

The 2020 shift in the supervisory agenda seemed somewhat motivated by the political environment. In 2021, President Biden began to take significant action on climate change—some of which impacted the Fed. Most significantly, the President issued an Executive Order in May 2021 regarding climate-related financial risk.[170] For the Fed, the key provision in that Executive Order was found in section 3, which addressed "Climate-Related Financial Risk by Financial Regulators."[171] It directed the Treasury Secretary as Chair of the FSOC to (i) assess the financial stability risks of climate change; (ii) facilitate climate related data sharing among members of the FSOC and executive departments and agencies and (iii) issue a report to the President outlining the efforts by FSOC "member agencies to integrate considerations of climate-related financial risk in their policies and programs."[172]

Around the same time, central banks around the world became highly focused on developing their supervisory powers to facilitate a transition to a low carbon economy, by setting supervisory expectations that banks should be reducing their exposure to carbon-emitting companies.[173]

Although the Fed lacked any express mandate to pursue greening, sustainability, or transition, it did have an open-ended mandate to supervise banks for "safety and soundness" and prevent them from creating "financial stability risk." Because those terms had never been defined, the Fed was free to define them however it so chose. And, starting in 2021, both the VCS and

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168 Board of Governors of the Federal Reserve System, Financial Stability Report (Nov. 2020), https://www.federalreserve.gov/publications/files/financial-stability-report-20201109.pdf [https://perma.cc/SU62-UM5A] [hereinafter 2020 *FSR*].

169 *Id.* at 58-59.

170 Executive Order on Climate-Related Financial Risk, Exec. Order No. 14030, 86 F.R. 27967 (2021), https://www.federalregister.gov/documents/2021/05/25/2021-11168/climate-related-financial-risk [https://perma.cc/MDD5-C582].

171 *Id.*

172 *Id.*

173 For a comparative discussion about central banks' approach to sustainability since 2020, see Rosa Maria Lastra & Christina Parajon Skinner, *Sustainable Central Banking*, 63 VA. J. INT'L L. 397 (2022).

one other Board member began to characterize climate change as a financial stability risk.[174]

From there, policy innovation began in earnest. At the firm-level—or in regard to 'microprudential' supervision—the Fed started to focus on asset quality in the context of climate risk. Supervisors confirmed that, to the extent climate risk is like any other credit risk, Fed supervisors would be prompting banks to address it. To that end, the Fed first signaled to firms that "Federal Reserve supervisors expect banks to have systems in place that appropriately identify, measure, control, and monitor all of their material risks, which for many banks are likely to extend to climate risks."[175]

More substantively, in January 2021, the Fed announced the creation of a Supervision Climate Committee ("SCC)," which the New York Federal Reserve Bank described as a "newly formed System-wide group bringing together senior staff across the Federal Reserve Board and Reserve Banks."[176] The Reserve Bank offered a high-level work description of the SCC: "to strengthen our capacity to identify and assess financial risks from climate change and to develop an appropriate program to ensure the resilience of our supervised firms to those risks."[177]

On the macroprudential or system-wide level, the Fed took similar supervisory strides. Mirroring the SCC, in March 2021, the Fed created a supervisory committee dedicated to studying the financial stability risks of climate change—the Financial Stability Climate Committee. According to the Fed, "The Federal Reserve staff committee complements the microprudential nature of the SCC and is undertaking work to identify links between climate change and financial stability, including by investigating how climate change can increase financial-sector vulnerabilities and looking for climate-related

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174 As Governor Brainard described the Fed's posture in 2021, the Fed is at work "building the requisite institutional capacity and knowledge to deepen [its] understanding of these [climate-related] risks and vulnerabilities." Governor Lael Brainard, Financial Stability Implications of Climate Change, Address at Ceres 2021 Conference (Mar. 23, 2021), https://www.federalreserve.gov/newsevents/speech/brainard20210323a.htm In that March 2021 speech, Governor Lael Brainard made clear her belief that "robust risk management; scenario analysis; consistent, comparable disclosures; and forward plans can help ensure the financial system is resilient to climate-related risks and well positioned to support the transition to a sustainable economy." *Id.*

175 2020 *FSR*, at 59.

176 Press Release, Federal Reserve Bank of New York, Kevin Stiroh to Step Down as Head of New York Fed Supervision to Assume New System Leadership Role at Board of Governors on Climate (Jan. 25, 2021), https://www.newyorkfed.org/newsevents/news/aboutthefed/2021/20210125 [https://perma.cc/AVK8-78E2].

177 *See id.*; Brainard, *supra* note 174.

amplification channels."[178] This committee aims to (i) "promote the resilience of the financial system to climate-related financial risks," (ii) "to ensure coordination with the Financial Stability Oversight Council (FSOC) and its member agencies," and (iii) "and to increase the Federal Reserve's international engagement and influence on this issue."[179]

The 2022 *Supervision and Regulation* report to Congress was the first one issued under the new Vice Chair Michael Barr. In it, Barr indicated climate change as one of his key priorities and thus committed the full Fed to providing guidance on the financial risks of climate change and to piloting a new climate stress test.[180]

Shortly thereafter, in January 2023, the Fed announced details on a new climate-changed-focused stress test. Unlike the CCAR, this stress test was not authorized or required by statute.[181] Instead, this stress test would formally be referred to as a "scenario analysis"; similar to stress-testing in that it would require banks to respond to a hypothetical shock scenario, but different in that it would examine banks' plans and performance in relation to the shock over a longer-term horizon.[182] Also unlike the CCAR stress testing, which is used to set an important component of capital requirements for large banks, the climate scenario analysis would not have any capital implications.

Still, the climate scenario analysis imposes costs on the participating firms and alters their behavior. The questions posed in the scenario signal to

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178 Board of Governors of the Federal Reserve System, Financial Stability Report (Nov. 2021), https://www.federalreserve.gov/publications/files/financial-stability-report-20211108.pdf [https://perma.cc/CR6H-UX8A].

179 Brainard, *supra* note 174

180 In 2020, the Fed alerted Congress and the banking sector that it would develop more analytical tools geared toward climate risk. In particular, it noted in its *Supervision and Regulation Report*, that it "will seek to better understand, measure, and mitigate climate-related financial risks including through analysis of transmission channels of climate change risk to the banking sector, measurement methodologies, and data gaps and challenges." Board of Governors of the Federal Reserve System, Supervision and Regulation Report 26 (May 2020), https://www.federalreserve.gov/publications/files/quarles20200512a.pdf [https://perma.cc/X7HE-3TP6]. Notably, the 2021 report did not mention climate change at all; 2021 was a transition year between Vice Chair Quarles and Vice Chair Barr. It was also a year with very high inflation.

181 *See supra* notes _ - _.

182 As Governor Brainard describes it, "[f]or scenario analysis, we would anticipate long time horizons, substantial uncertainty, the use of qualitative elements, and reliance on external data and models. To capture the potential for complex interactions across the financial system, such scenario analysis would consider the effects on bank and nonbank financial intermediaries and financial markets broadly." Brainard, *supra* note 174.

bank management which kinds of assets might eventually be considered "unsound" by Fed supervisors, because they are too brown, and thus are likely to incentivize banks to begin divesting from these disfavored assets (and otherwise altering their underwriting frameworks). Further, in anticipation of the scenario analysis, banks are likely to invest resources into thinking through ways to demonstrate to their Fed supervisor that they are greening lending and in-house operations.

Shortly after the launch of the climate scenario analysis, the Fed Board promulgated new supervisory guidance concerning climate risk in banks in October 2023. The guidance document, *Principles for Climate-Related Financial Risk Management for Large Financial Institutions*,[183] set out significant expectations for banks in regard to their risk-management and lending. For one, the document underscored the need for banks to develop more of their own internal scenario analysis regarding climate change.[184] Moreover, the document stated that bank management "should" establish "lending limits related to material climate-related financial risks."[185] Third, it clearly cautioned firms to develop plans for transitioning away from high-carbon lending in anticipation of policy changes at the federal level—these are known as transition plans.[186]

The Fed may disclaim the fact that guidance has the force of law but, to be certain, banks will heed it as they always do in order to manage their 'regulatory risk.' Not only will complying with these new principles have significant cost for banks and alter their behavior, the impact of these shifts in banking business practices will inevitably prompt accompanying shifts in the economy, which Congress may not have intended. Indeed, choices about which sectors of the economy thrive relative to others—in large measure due to their access to and cost of credit—are inherently political choices which

183 Board of Governors of the Federal Reserve System, *Principles for Climate-Related Financial Risk Management for Large Financial Institutions,* BD. GOV. FED. RSRV. SYS. (Oct. 24, 2023), https://www.federalreserve.gov/supervisionreg/srletters/SR2309a1.pdf [https://perma.cc/W37M-HF9B]

184 "For the purposes of these principles, climate-related scenario analysis refers to exercises used to conduct a forward-looking assessment of the potential impact on a financial institution of changes in the economy, changes in the financial system, or the distribution of physical hazards resulting from climate-related financial risks. These exercises differ from traditional stress testing exercises that typically assess the potential impacts of transitory shocks to near term economic and financial conditions." *Id.* at 5.

185 *Id.* at 6.

186 The guidance document noted that "sound operational risk management includes . . . the evolving legal and regulatory landscape." *Id.*

must be reserved for democratically responsive institutions, like the Congress.

While some may well think that this manner of private carbon-reducing action is beneficial to society overall, the fact remains that the Fed has no express authority to compel such behavior from banks and, as such, should not be using supervisory "analysis" and guidance premised on a finding of financial stability risk to reach the same result.[187]

2. *Crypto and Digital Assets*

The future of money and payments is also playing out in Congress. In broad strokes, for the past several years the landscape for payments has changed—the development and rise of stablecoins and other forms of unbacked crypto assets has opened new frontiers for retail payments and novel ways for households to store value.[188] In particular, U.S. dollar stablecoins—with their value pegged 1:1 to the value of the U.S. dollar—offer retail customers an alternative to using banks and bank deposits or currency (i.e., cash) as a medium of exchange and store of value.[189] To date, these stablecoins have been issued by financial intermediaries outside the banking sector, and therefore outside the Fed's supervisory purview.[190]

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187 As Skinner has argued in analyzing the Fed's mandate in respect of climate change: there are "legal limits to the lines along which the Fed can evaluate the banks during the stress test." Christina P. Skinner, *Central Banks and Climate Change,* 74 VANDERBILT L. REV. 1301, 1345 (2021). More broadly, VCS Barr has indicated that he will continue to expand the use of scenario analysis to other nascent financial stability risks. Michael S. Barr, *Multiple Scenarios in Stress Testing,* Speech at the Stress Test Research Conference at the Federal Reserve Bank of Boston (Oct. 19, 2023), https://www.federalreserve.gov/newsevents/speech/barr20231019a.htm [https://perma.cc/45NX-F6B3] ("exploratory scenarios will be used to inform the Board's supervisory assessments of firms' risk management and our understanding of different risks in the banking system").

188 Economists often define money as a "unit of account," "store of value," and "medium of exchange." *See* CHARLES PROCTOR, MANN ON THE LEGAL ASPECT OF MONEY 11-13 (7th ed. 2012).

189 *See* Christina Parajon Skinner, *Coins, Cross-Border Payments, and Anti-Money Laundering Law,* 60 HARV. J. LEGIS. 285, 315 (2023).

190 *See* Michael S. Barr, *Supporting Innovation with Guardrails: The Federal Reserve's Approach to Supervision and Regulation of Banks' Crypto-related Activities*, Speech at the Peterson Institute for International Economics (Mar. 9, 2023), https://www.federalreserve.gov/newsevents/speech/barr20230309a.htm [https://perma.cc/87Q9-RLAN] (taking issue with the fact that stablecoin "[i]ssuers are not supervised by the Fed and lack capital and liquidity as a backstop. The banks we regulate, in contrast, are well protected from bank runs through a robust array of supervisory requirements").

Parallel to developments with stablecoins, the crypto asset sector has continued to evolve. Unlike stablecoins, unbacked crypto assets[191] are more often owned as an investment and less so as a medium of exchange. Accordingly, unlike a stablecoin whose reference value is pegged to a fiat currency, unbacked crypto assets have value that fluctuates based on supply similar to other commodities, like gold.[192] Perhaps one of the most well-known unbacked crypto assets is Bitcoin; though today, there are a multitude of smaller cap coins in circulation.[193]

For the most part, legislators consider stablecoins to be an important step forward in payments sector innovation, affording an opportunity for cheaper, faster, and more widely accessible payments options.[194] On that view, many lawmakers are hesitant to impose rigid rules on stablecoin issuers that could inadvertently stifle that experimentation and innovation. To be certain, although most in Congress do appreciate that unregulated stablecoins can present risks to their investors, they are proceeding with statutory design slowly to ensure that a new legal regime will be appropriately tailored to the relevant risks. Likewise, although Congress sees

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[191] According to the IMF, "unbacked crypto assets are the oldest and most popular type of crypto assets." PARMA BAINS, ARIF ISMAIL, FABIANA MELO & NOBUYASU SUGIMOTO, REGULATING THE CRYPTO ECOSYSTEM: THE CASE OF UNBACKED CRYPTO ASSETS 13 (Sept. 2022), https://www.imf.org/en/Publications/fintech-notes/Issues/2022/09/26/Regulating-the-Crypto-Ecosystem-The-Case-of-Unbacked-Crypto-Assets-523715 [https://perma.cc/DB6P-EE4M]

[192] Another important difference between stablecoins and unbacked crypto is that stablecoins' value is supported by the value in a pool of assets, similar to shares in a money market fund. There are no assets "backing" the value of the crypto; it is purely a result of investor beliefs and psychology and, as such, limited supply and demand. *See supra* note 189.

[193] Igor Makarov & Antoinette Schoar, *Blockchain Analysis of the Bitcoin Market* 1 (Nat'l Bureau of Econ. Rsch., Working Paper No. 29396, 2021) https://www.nber.org/system/files/working_papers/w29396/w29396.pdf [https://perma.cc/FJ9G-E74V] (noting that "Bitcoin, the original cryptocurrency, is still the largest and most popular coin, with a market cap that is larger than all the other coins combined.").

[194] *See, e.g.*, Press Release, Financial Services Committee, McHenry Delivers Opening Remarks at Markup of Stablecoin, ESG Legislation (July 27, 2023), https://financialservices.house.gov/news/documentsingle.aspx?DocumentID=408941 [https://perma.cc/3YPQ-VWAB]e; Press Release, U.S. Senator Kirsten Gillibrand, Lummis, Gillibrand Reintroduce Comprehensive Legislation To Create Regulatory Framework For Crypto Assets (July 12, 2023), https://www.gillibrand.senate.gov/news/press/release/lummis-gillibrand-reintroduce-comprehensive-legislation-to-create-regulatory-framework-for-crypto-assets/ [https://perma.cc/RP99-LNQW]. *See also* Dan Awrey, *Unbundling Banking, Money, and Payments*, 110 GEO. L.J. 715, 717-19 (2022).

national security (i.e., money laundering) risks to unbacked crypto assets,[195] and problems related to customer fraud,[196] it seems disposed to otherwise let the market determine the crypto sector's fate.

Fed supervisors, however, see stablecoins and unbacked crypto as a definitive financial stability risk. [197] According to the current VCS "[s]tablecoins . . . need to be regulated" "so they do not threaten financial stability or payments system integrity."[198] Similarly, unbacked crypto-assets "can cause harm to investors and consumers as well as to our financial system."[199] On the basis of that assessment—that stablecoins and unbacked crypto are financial stability risks—the Fed has already developed a bespoke "approach to supervising banks' engagement with crypto" which consists of a series of supervisory guidance. [200]

In August 2022, the Fed published its first piece of crypto supervisory guidance, "remind[ing]" firms that they could only involve or affiliate themselves with crypto activity that is already "legal."[201] Given the emphasis on money laundering, sanctions and tax evasion, and other kinds of illicit

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195 Skinner, *supra* note 189.

196 In November 2022, crypto exchange FTX collapsed when investors became aware that it had been diverting customer funds toward its owner, Sam Bankman-Fried's separate crypto research/hedge fund entity, Alameda. Patricia Kowsmann et al, *Troubles at Sam Bankman-Fried's Alameda Began Well Before Crypto Crash*, WALL ST. J. (Dec. 31, 2022) , https://www.wsj.com/articles/alameda-sam-bankman-fried-ftx-crypto-crash-11672434101 [https://perma.cc/3S5G-SZ3Z]; Carolina Mandl, *Sam Bankman-Fried Says he 'Didn't Ever Try to Commit Fraud'*, REUTERS (Nov. 30, 2022), https://www.reuters.com/technology/sam-bankman-fried-says-he-didnt-ever-try-commit-fraud-2022-11-30/ [https://perma.cc/7YNU-4E8R].

197 Regarding stablecoins, Fed supervisors worry that without a supervisory and licensing regime imposed on stablecoin issuers—similar to what exists for banks—a stablecoin failure or fraud could cause some sort of disruption of instability in the financial system that could cause broad economic harm. *See supra* note 190; *see also* Jon Cunliffe, *Is 'Crypto' a Financial Stability Risk*, BANK ENG. (Oct. 13, 2021), https://www.bankofengland.co.uk/speech/2021/october/jon-cunliffe-swifts-sibos-2021 [https://perma.cc/7TD4-PL7T]

198 Michael S. Barr, Opening Remarks, Address at the Economics of Payments XII Conference (Oct. 27, 2023), https://www.federalreserve.gov/newsevents/speech/barr20231027a.htm [https://perma.cc/PM3B-VVUQ].

199 Barr, *supra* note 190.

200 "The federal bank regulatory agencies, including the Federal Reserve Board, have a statutory responsibility to ensure that the activity of the entities we supervise is conducted in a safe and sound manner, and in compliance with all applicable laws. While the effects of the events in the crypto sector on Federal Reserve-supervised banks have been limited in the aggregate thus far, recent experience has made it clear that crypto could pose risks to those banks." Barr, *supra* note 190.

201 SR Letter No. 22-6 (Aug. 16, 2022).

finance risk associated with crypto, this reminder to obey the law no doubt deterred any prudent BHC from providing custodial services for crypto assets to their legitimate clients. Lest there remained any doubt, that guidance "also lets banks know that they are expected to notify the Federal Reserve if they intend to engage in crypto-asset related activities and to engage in a robust supervisory conversation."[202] That message is very clear—no crypto activity unless the Fed supervision function approves it first.

In January 2023, the Fed, along with the other banking agencies, issued a "joint statement" on crypto-asset risks posed to banks re-confirming the message in the August 2022 guidance. It alerted the banks (as if they did not know) to the "risk of fraud and scams of crypto participants to money laundering and terrorist financing, to stablecoin run risks."[203] That statement promised to "closely monitor crypto-asset-related exposures of banking organizations."[204] A subsequent February 2023 guidance flagged liquidity risks associated with hosting deposit accounts for stablecoin issuers or other crypto-asset related entities. The concern expressed in that letter related to the possibility that if a large number of stablecoin or crypto asset holders sought to exchange their digital assets for cash, this would force the issuers/exchanges/intermediaries to draw down on their deposit accounts held at regulated banks, thus straining the banks' liquidity in something like a run.[205]

In addition to this guidance, the Fed's negative view of stablecoins as a financial stability risk has translated in other ways. Specifically, unstated Board policy for the past several years appears to be one of cautious reluctance to grant stablecoin issuers access to the Fed's balance sheet through a master account at their regional Reserve Bank. To summarize the issue broadly, in order for any payment to be legally final, it must "settle" in central bank money. This means that payments processed for customers of two banks are only truly finalized once the banks settle up between one another in central bank reserves, by effectuating credits and debits between

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[202] Barr, *supra* note 190.

[203] Press Release, Board of Governors of the Federal Reserve System, Agencies Issue Joint Statement on Crypto-Asset Risks to Banking Organizations (Jan. 3, 2023), https://www.federalreserve.gov/newsevents/pressreleases/bcreg20230103a.htm [https://perma.cc/GP24-PURZ].

[204] *Id.*

[205] Press Release, Board of Governors of the Federal Reserve System, Joint Statement on Liquidity Risks to Banking Organizations Resulting from Crypto-Asset Market Vulnerabilities (Feb. 23, 2023), https://www.federalreserve.gov/newsevents/pressreleases/files/bcreg20230223a1.pdf [https://perma.cc/VQ2L-6WN2].

their reserve accounts held at their regional Reserve Banks. Stablecoin issuers—which are not banks—do not have direct access to these accounts, so instead they must use their own accounts at banks to accomplish settlement finality. This extra layer of intermediation is an added cost to stablecoin issuers that impedes their ability to compete with the incumbent banking system.

Not surprisingly, stablecoin issuers began pressing the Fed for master accounts. The Fed's stated criteria for granting a master account included (1) legal eligibility as a state- or nationally-licensed bank (2) eligibility for deposit insurance; (3) the ability to operate safely and soundly; (4) without posing risk to the overall payment system; and (5) without creating "undue risk to the stability of the U.S. financial system."[206] Yet some stablecoin issuers who had received a state special purpose banking charter, thus satisfying criteria one and two, and seemingly demonstrating a safe and law abiding operation, were nonetheless denied master accounts.[207]

Overall, the guidance, tenor of VCS speeches, and implicit master account policy for stablecoin issuers reflect a Fed supervisory policy aimed at discouraging the growth and proliferation of non-central-bank sponsored digital asset payments.[208] To be sure, there may be good reasons to stymie the rapid advance of stablecoins and crypto assets in their current form.[209] But from a separation-of-powers perspective, the Fed supervisors' ability to preempt digital asset legislation by occupying the entire field first suggests that Congress has delegated too much legislative power.

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[206] Guidelines for Evaluating Account and Services Requests, OP-1747 (Mar. 7, 2022), https://www.federalreserve.gov/newsevents/pressreleases/files/other20220815a1.pdf; *see also* Randall Guynn, *Davis Polk Discusses Who Can Have a Federal Reserve Master Account,* CLS BLUE SKY BLOG (May 12, 2021), https://clsbluesky.law.columbia.edu/2021/05/12/davis-polk-discusses-who-can-have-a-federal-reserve-master-account/ [https://perma.cc/5B8L-KAST].

[207] The Federal Reserve Bank of Kansas City decision to deny Custodia Bank's request for a master account is a case in point. Press Release, Board of Governors of the Federal Reserve System, Federal Reserve Board Announces Denial of Application by Custodia Bank, Inc to Become a Member of the Federal Reserve System (Jan. 27, 2023), https://www.federalreserve.gov/newsevents/pressreleases/orders20230127a.htm]. This litigation is ongoing.

[208] *See* Christina P. Skinner, *Central Bank Digital Currency as New Public Money,* 172 U. PA. L. REV. (2024).

[209] Skinner, *supra* note 189.

3. *Culture*

Shortly after the peak of the 2008 financial crisis subsided, central banks began to focus on one of the more abstract causes of those events—widespread misconduct in the largest, systemically important banks. Prior to the crisis, the conventional understanding was that compliance with banking law was an appropriate focus for microprudential supervision but broader approaches to dealing with the governance and culture of a banking institution were best left to bank management and their boards.[210] The embrace of the macroprudential philosophy of banking supervision, however, broadened the supervisors' informal remit to include bank culture as well. Reflecting this new sentiment, Bank of England Governor Andrew Bailey remarked in March 2018, "As supervisors, our objective is to prevent misconduct, not just clear up the messes when they happen."[211]

Globally, central banks began to suggest that their new macroprudential authorities allowed them to supervise banks' culture.[212] This view was dominant in Europe (especially in the U.K., The Netherlands, and Ireland) and among the international financial regulatory institutions.[213] In the United States, although the Fed Board never took a position on bank culture—and whether it should be formally supervised or not—some of the regional Reserve Banks did, and the New York Fed in particular. That regional bank dedicated considerable resources to developing a link between supervisory

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210 *See, e.g.*, Mark W. Olson, *Compliance Risk Management in a Diversified Environment,* Speech at the Financial Services Roundtable and the Morin Center for Banking and Financial Services (May 16, 2006), https://www.federalreserve.gov/newsevents/speech/olson20060516a.htm. [https://perma.cc/DHF6-4EY4].

211 Andrew Bailey, *Transforming Culture in Financial Services,* Speech at the Transforming Culture in Financial Services Conference (Mar. 19, 2018), https://www.fca.org.uk/news/speeches/transforming-culture-financial-services [https://perma.cc/G5N2-GFUS]

212 *See, e.g.*, Mark Carney, *Worthy of Trust? Law, Ethics and Culture in Banking,* Remarks at the Banking Standards Board Panel 4 (Mar. 21, 2017), https://www.bankofengland.co.uk/-/media/boe/files/speech/2017/banking-standards-board-worthy-of-trust-law-ethics-and-culture-in-banking.

213 *See, e.g.*, Christopher Woolard, *Financial Conduct Regulation in a Restless World*, Address at the Deloitte Conduct Risk Roadshow (May 8, 2019)https://www.fca.org.uk/news/speeches/financial-conduct-regulation-restless-world. [https://perma.cc/YL6B-ETAV]; Wijnand Nuijts, *Looking Forward: Effective Supervision of Behavior and Culture at Financial Institutions,* Address at Tropeninstiuut, Amsterdam (Sept. 24, 2015), https://www.dnb.nl/binaries/WN%20speech_tcm46-326581.pdf?2019102017 *See* DE NEDERLANDSCHE BANK, SUPERVISORY STRATEGY 2018-2022 (Dec. 21, 2018), https://www.dnb.nl/en/binaries/DNB_Visie%20op%20Toezicht_ENG_tcm47-366240.pdf?2019032701.

goals of safety and soundness and financial stability and firm culture.[214] This work included annual conferences, podcasts, research, and an "education-and-industry" forum that aspired to teach bank analysts how to be ethical and good.[215] Given that all of the largest, systemically important BHCs are domiciled in New York, they fall under the New York Fed's supervisory jurisdiction; its supervisory and exam approach is, as such, almost as significant in practice as if the Board had issued guidance or supervisory policy itself.

There may also have been shifts in supervisory practice at the New York Fed Bank, which would be less in the public eye. As earlier discussed, the Fed Reserve Banks assign BHCs a confidential rating after examination. The composite rating is "based on an evaluation and rating of its managerial and financial condition and an assessment of future potential risk to its subsidiary depository institutions." The BHCs also get scores for "risk management, financial condition, and potential impact of the parent company and nondepository subsidiary on the BHC's subsidiary depository institutions." The rating is referred to as RFI/C(D).[216]

After the tilt toward supervising culture in 2018, New York Fed supervisors certainly had the discretion to begin evaluating bank culture within this framework, and specifically as part of their evaluation of "risk management."[217] That assessment, after all, includes a review of how well board and senior management monitor for, control, and address various risks. Institutions that do not have a "management structure" that can

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214 *See, e.g.*, Stephanie Chaly et al., *Misconduct Risk, Culture, and Supervision*, FED. RSRV. BANK N.Y. (Dec. 2017), https://www.newyorkfed.org/medialibrary/media/governance-and-culture-reform/2017-whitepaper.pdf [https://perma.cc/PJ5R-WFGW]; Kevin J. Stiroh, *Reform of Culture in Finance From Multiple Perspectives*, Remarks at the GARP Risk Convention (Feb. 26, 2019), https://www.newyorkfed.org/newsevents/speeches/2019/sti190226 [https://perma.cc/NG3G-GKSM].

215 Federal Reserve Bank of New York, *Governance and Culture Reform*, FED. RSRV. BANK N.Y. https://www.newyorkfed.org/governance-and-culture-reform [https://perma.cc/CMT6-J4KZ] (last visited Oct. 15, 2019).

216 *See* Fed. Reserve Bank, Bank Holding Company Supervision Manual, § 4070.5.2, Interagency Advisory on the Confidentiality of the Supervisory Rating and Other Nonpublic Supervisory Information, 2 n.3 (July 2008). As explained in a helpful paper by Fed staff, "[t]he work of the supervisory teams is guided by a series of written policies and procedures, guidance, and manuals that codify supervisory expectations and provide direction to the teams in structuring their work at the firms. These materials include the Bank Holding Company Supervision Manual . . . as well as a series of SR Letters." Eisenbach et al., *supra* note 133, at 22.

217 *See* Bank Holding Company Supervision Manual, § 4070.1.1 (July 2016), at 2.

appropriately deal with risk are generally considered unsafe-and-unsound, according to the BHC Supervisory Manual.[218] In the context of the Fed's guidance for supervisors who focus on large financial institutions—the supervision of conduct and culture could have been imported into the supervisors' consideration of how well boards and management work toward ensuring a sound corporate culture which "promote[s] . . .compliance with laws [and] regulations."[219]

The Reserve Banks also have discretion in their interpretation of "operational risk."[220] In particular, the Supervisory Manual singles out operational risk in its discussion of risks a financial institution should manage—and it adopts the definition used by the Basel Committee on Banking Supervision, *Principles for the Sound Management of Operational Risk*: "the risk resulting from inadequate or failed internal processes, people, and systems or from external events."[221] In theory, culture could fall under this concept of operational risk as well.[222]

Discerning the nexus between a bank's "culture" and a financial stability risk seems to be the apex of supervisory discretion. Neither term is capable of objective definition and, as such, linking the two together allows the Fed supervisors to target aspects of a bank's behavior they simply do not like. It opens the door to subtle and not observable pressure on banks to satisfy the supervisory preferences discussed above, namely, the cessation of lending to brown companies, or involvement with stablecoins or digital assets. Because these supervisory determinations are completely outside the public eye, this creates a tremendous amount of open-ended risk for supervised institutions and incentivizes costly avoidance behavior. Moreover, this list of supervisory preferences and prerogatives can continue to grow outside the control of Congress so long as "financial stability" continues to provide a catch-all tool that need not be defined.

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218 *Id.* at 1.

219 Bd. of Governors of the Federal Reserve Sys., Supervision and Regulation Letters, SR 12-17/CA 12-14: Consolidated Supervision Framework for Large Financial Institutions (Dec. 17, 2012), https://www.federalreserve.gov/supervisionreg/srletters/sr1217.htm.

220 *Id.* at § 4071.0 (July 2016), at 1.

221 *Id.*

222 It bears noting that the OCC has taken culture into its supervisory approach explicitly. The OCC considers a bank's culture as part of its core knowledge and urges examiners to consider ethical conduct as part and parcel of a bank's corporate culture. OFFICE OF THE COMPTROLLER OF THE CURRENCY, COMPTROLLER'S HANDBOOK EXAMINATION PROCESS, LARGE BANK SUPERVISION 9 (1.1 ed., 2019) https://www.occ.treas.gov/publications-and-resources/publications/comptrollers-handbook/files/large-bank-supervision/pub-ch-large-bank-supervision.pdf.

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In summary, these examples of policy entrepreneurship demonstrate that supervisory guidance and practice meaningfully affects private rights—banks' property interest in their assets, their resources dedicated to compliance with guidelines that do not have the force of law, and their liberty to make independent business risk-analysis and underwriting judgments.[223] Moreover, the practice of macroprudential supervision yields principles that are sweeping in nature, applied on an industry-wide basis, and, as such, assume the character of law.

In 2022, the Supreme Court took up the issue of agency innovation where private rights were concerned. As one Justice put it, the "framers believed that the power to make new laws regulating private conduct was a grave one that could, if not properly checked, pose a serious threat to individual liberty," so they "insist[ed] that two houses of Congress must agree to any new law and the President must concur or a legislative supermajority must override his veto."[224]

Like the Court's concern for protecting the integrity of the removal power, its attention to non-delegation is thus grounded in its concern for preserving liberty. As James Madison explained the issue in his *Report of 1800*, if only a "general conveyance of authority, without laying down any precise rules," could justify sweeping agency action, "it would follow, that the whole power of legislation might be transferred by the legislature from itself, and proclamations might become substitutes for laws."[225] The power of the Fed supervision function is precisely what the non-delegation doctrine, at its core, is supposed to prevent.

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223 Delegations are most problematic when they "contains such details, definitions, and rules, as appertain to the true character of a law; especially, a law by which personal liberty is invaded, property deprived of its value to the owner, and life itself indirectly exposed to danger." James Madison, The Report of 1800, in 17 The Papers of James Madison 303, 324 (David B. Mattern, J.C.A. Stagg, Jeanne K. Cross & Susan Holbrook Perdue eds., 1991). (cited in Ilan brief in Jakarskey)

224 *Id.* at 2618 (Gorsuch, J., concurring).

225 Brief for Ilan Wurman as Amicus Curiae, Jarkesy v. Sec. & Exch. Comm'n, 34 F.4th 446 (5th Cir. 2022), cert. granted, 143 S. Ct. 2688, 216 L. Ed. 2d 1255 (2023), and cert. denied, 143 S. Ct. 2690, 216 L. Ed. 2d 1256 (2023).

III. RIGHT-SIZING FED SUPERVISION: PATHS TO INSTITUTIONAL REFORM

Thus far, the Article has discussed the reasons why ascribing central bank independence to Fed supervision is problematic under U.S. law and, before 2010, unprecedented in U.S. banking history. Even so, proponents of central bank supervision independence continue to point to the "output legitimacy" of this arrangement. [226] This viewpoint emphasizes that central banks have succeeded in preventing another global financial crisis since acquiring their de facto supervisory CBI. It also advocates the benefits of central banks' access to reliable information about banks' health, which may prove particularly important when central banks need to lend quickly during a crisis. This camp of supervisory CBI supporters also stresses the importance of having an agency with a bird's eye view on financial system safety.[227]

To be fair, some of these points are quite compelling.[228] Attempting to thread the needle, Part III suggests a path to institutional reform that would preserve the legitimate benefits of keeping supervision within the central bank, without affording Fed supervision a manner of independence that affronts the Constitution's separation of powers. Specifically, this Part suggests both the structural separation of Fed supervision, in order to make it more accountable to the President, as well as three legal means of narrowing the Fed's discretion to interpret "safety and soundness" and "financial stability risk."

A. *Structural Separation*

As discussed, insofar as bank supervision as conducted by the Federal Reserve System is an exercise of executive power, it should be accountable to the President. Indeed, Congress took a small step in that direction when it created the FSOC. The FSOC is formally the United States' macroprudential authority with the responsibility to monitor the financial system for emerging financial stability risk. The FSOC can designate nonbank financial companies as systemically important and thus subject them to bank-like

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[226] Michael A. Strebel et al, *The Importance of Input and Output Legitimacy in Democratic Governance: Evidence from a Population-Based Survey Experiment in Four West European Countries*, 58 EURO. J. POLI. RSCH. 488 (2018).

[227] Cecchetti & Schoenholtz, *supra* note 80; af Jochnick, *supra* note 10.

[228] *See id.*

supervision by the Fed.[229] It can also recommend that the Fed take certain measures to address other financial stability risks in the system, namely, "activities," undertaken by banks or their affiliates.[230] Although the FSOC is a council of various bank and capital market supervisors, it is spearheaded by the Secretary of the Treasury who reports directly to the President.[231]

Still, creating the FSOC was only a half-measure to increase the responsiveness of supervision to the President. The FSOC's power to designate nonbank SIFIs can increase the jurisdiction of the Fed's supervision function by casting nonbanks into it, but it cannot dictate the terms of that supervision.[232] Further, it's power to make recommendations to primary regulators in regard to actionable financial stability risk is not compulsory for the recipient agency, and there is no duty for agencies to explain why or why not they heed a FSOC recommendation.[233] In any case, the FSOC has not been a successful innovation of an agency overall.[234]

Not only does the current structure isolate Fed supervision from the President, it is also conducive to conflicts between the Fed's mandates. Referring back to figure 1,[235] the data on formal enforcement actions suggests that Fed supervision was leveled down during the inflationary episode of 2021-2022, probably in light of the fact that banks were already strained by raising rates. How trade-offs are handled between the executive nature of the supervision mandate and the independent exercise of monetary policy duties is not transparent to the public even if the outcome of those choices are.

This problem is exacerbated by the fact that the VCS is also a voting member of the FOMC and, vice versa, all other Board members are ultimately asked to cast votes on regulation and formal supervisory guidance. With this structure in place, even if the President's removal power were interpreted to be unrestricted in regard to the VCS, it would be difficult for the President to

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[229] Dodd-Frank Act § 120; *see*U.S. Department of the Treasury, *Designations*, U.S. DEP'T TREASURY, https://home.treasury.gov/policy-issues/financial-markets-financial-institutions-and-fiscal-service/fsoc/designations [https://perma.cc/6HQ3-HTAW].

[230] *Id.*

[231] Dodd-Frank Act § 111(b)(1)(A).

[232] Dodd-Frank Act §§ 113, 115, 165.

[233] Marc Labonte, *Financial Regulation: Systemic Risk*, CONG. RSCH. SERV. (Feb. 1, 2022), https://crsreports.congress.gov/product/pdf/R/R47026.

[234] *See* Skinner, *supra* note 84.

[235] *See supra* Figure 1.

fully assess where the monetary policy work of the VCS stops and the supervisory work begins.[236]

Recommendation. The Fed should be re-structured to follow a statutory committee model similar to that which is in place at the U.K. central bank, the Bank of England. After the 2008 financial crisis, the U.K. took a different approach to re-organizing statutory responsibilities for bank supervision. Among other things, the Financial Services Act 2012 created the prudential regulatory authority ("PRA") as a structurally separate entity within the Bank of England; it acquired the microprudential responsibilities that were formally owned by the Financial Services Authority ("FSA") (which agency was completely separate from the Bank of England).[237]

To facilitate structural separation from the Bank's monetary policy function, a "prudential regulatory committee" ("PRC") was created to steer microprudential policy. A separate financial policy committee ("FPC") was created by the Banking Act 2009.[238] The FPC does work similar to the FSOC, in monitoring for and assessing financial stability risk.[239] These committees are meant to have regard to the work of one another but legally they proceed with only their own mandates in mind. Each of the three Bank of England Committees—the MPC, FPC, and PRC—is accountable to the executive branch by, among other ways, including officials from the HM Treasury as nonvoting but participating members. The Committees remain accountable to the industry and public (and avoids group think) by including several external members with relevant expertise on monetary policy, banking, and macro legal and policy issues, respectively.

Congress should consider adopting the U.K. statutory committee approach. In particular, the Fed's supervision function, which combines microprudential and financial stability roles, should be structurally separated from the Board through amendments to the Dodd-Frank Act.

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236 Precisely as two prominent Fed experts and academic economists noted, "The Federal Reserve . . . is set up as a matrix organization, so it is nearly impossible to say where one function stops and another starts." Cecchetti & Schoenholtz, *supra* note 80.

237 Financial Services Act, 2012, c. 21 (U.K.). The Banking Act 1998 transferred responsibility for regulating the banking sector under the Banking Act 1987 to the Financial Services Authority (FSA). Banking Act, 1998, c. 11 (U.K.). (The Banking Act 1987 was later superseded by the *Financial Services and Markets Act 2000* (FSMA). *See* Financial Services and Markets Act, 2000, c. 8 (U.K.).

238 Banking Act 2009, c. 1, § 9H (U.K.), Banking Act 2009, c. 1, § 9O (U.K.), Banking Act 2009, c. 1, § 9Q (U.K.)., 9O, 9Q.

239 Donald Kohn, *Comparing UK and U.S. Macroprudential Systems: Lessons for China,* BROOKINGS (May 11, 2014), https://www.brookings.edu/articles/comparing-uk-and-u-s-macroprudential-systems-lessons-for-china/.

Ideally, this reform would involve adding an eighth board seat to the Board to accommodate the VCS and stripping the VCS of authority to vote as a member of the FOMC. In addition to the VCS, a new Fed supervision committee should include two ordinary Board members who serve on a rotating basis, two external members who are experts on banking law, and the Treasury Secretary (or Under Secretary for Finance) and the Comptroller. The Treasury Secretary and Comptroller could be *ex officio* members; though it bears noting that section 10(6) of the Federal Reserve Act still sits on the statute books. Based on the above analysis, that power to "supervise and control" Fed supervision could justifiably be used if it were deemed by the President to work at cross-purposes to the Treasury's economic policy or national economic security interests.

Creating structural separation between supervision and monetary policy would allow the Fed to retain the most important benefit of in-house supervision—the collection and maintenance of real-time information about the health of banks—while allowing supervisory policy development to proceed with input from the President's Treasury officials.

B. *Burden Shifting*

Naturally, some might worry that even a modest inclusion of Treasury officials in the making of supervisory policy will lead to pendulum swings each time the administration changes. Pendulum swings in financial supervision and regulation should certainly be avoided.[240] However, because insulating the VCS from presidential supervision and control is not constitutionally supported, the more legitimate measure for avoiding swings is to place some parameters around the breadth of the delegated power.[241] Realistically, Congress cannot do the work of defining "safety and soundness" or "financial stability risk" because it is impossible for that body to anticipate all future permutations of micro or macro risk. Far better to require the Fed's supervisors to carry the burden of proof in demonstrating to Congress, though an informal cost-benefit or conceptual analysis, the legitimacy of any novel interpretation of the term that is used to support the extension of supervision to new activities.

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240 Skinner, *supra* note 24.

241 As Justice Kavanaugh has noted in regard to the practice of judicial deference to agency interpretation of their mandates; *Chevron*, he complained, "ushers in shocks to the system every four or eight years when a new administration comes in" and implements "massive change" in key areas of administrative law. Amy Howe, *Supreme Court Likely to Discard Chevron*, SCOTUSBLOG (Jan. 17, 2024), https://www.scotusblog.com/2024/01/supreme-court-likely-to-discard-chevron/.

Recommendation: Congress should require testimony each time the Fed advances or relies upon a novel interpretation of the terms "safety and soundness" of "financial stability risk" around the following framework:

1. *How does the law support the novel form of supervision?* The first question for the VCS to answer is whether the possible target of supervision is a problem *for the Fed*. Inevitably, there will be a range of important social and economic issues that may stand to implicate the real or financial economies; and yet, they may not all be the lawful targets of Fed power.[242]

Second, with what concrete and verifiable facts, does the Fed see this new manner of supervision as required to ensure the safety and soundness of a bank?[243] This conversation would offer Congress some idea of what data and evidence the Fed could or should marshal to make a safety and soundness intervention case. Should a new supervisory intervention implicate the Fed's macroprudential powers (like stress testing, for example), the Fed should similarly be called upon to demonstrate a sufficiently concrete—not speculative—link to financial stability risk.[244]

Any other terms of art relied on by the supervisor to justify supervisory action should also be discussed and defined—this would include, among others, terms like "contagion," "exposure," and "systemic risk," which are all byproducts of the 2008 global financial crisis and the post-crisis legislation.

2. *How will the supervision be implemented?* The second question is a mixed examination of facts and law. Here, the Fed would be called upon to answer how a newly proposed or considered supervisory regime accomplishes the goals it has set out.

2a. Transmission channels. The big-picture issue for Fed policymakers to grapple with is the nature of the transmission channel from supervisory policy to the mitigation of any given risk. One could envision various ways

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242 "Given that the legal framework governing the banking sector has become much more complex, the work of the examination staff has become more legally infused and yet the supervisory culture has become increasingly unmoored from the legal framework itself." Guidance, Supervisory Expectations, and the Rule of Law: How do the Banking Agencies Regulate and Supervise Institutions, Hearing before the S. Comm. On Banking, Housing, and Urban Affairs, 116th Cong. (2019) (statement of Margaret E. Tayhar).

243 As Margaret Tahyar eloquently reminded Congress in April 2019, while the safety and soundness mandate is broad and provides discretion, "[i]t is not, however, unlimited and does not create 'inherent authority.'" *Id.* at 17, n.68.

244 *See, e.g.*, Andrew Bailey, Governor, Bank of England, Response to Government on Remit of the Financial Pol'y Comm. (U.K.), https://assets.publishing.service.gov.uk/government/uploads/system/uploads/attachment_data/file/895235/2020_Response_to_FPC_remit_letter.pdf.

that the Fed might go about analyzing this question. For instance, the Fed could choose to explain how the novel supervision fits within existing assessments of banking sector vulnerability which evaluates banks capital, fire-sale, liquidity, and run vulnerability vis-à-vis a certain kind of risk.[245]

2b. Design choices. It would also be beneficial for the private sector and public to know, and have some input into, the design choices involved in the development of a new supervisory apparatus. There are standard options to be sure, such as bank exams, balance-sheet models, and stress testing. But to the extent other options are considered or suggested, the Fed may also do well to make those details known and invite conversation about feasibility, costs, and benefits.[246] This would have been useful, for example, in connection with scenario analysis.

2c. Informal norms. In addition to spelling out the basic mechanism of the new approach, the Fed would also need to make plain—to the extent it can anticipate—any soft law or conventions that might influence the application of the regime, around the edges of what is designed. For example, supervisors around the globe dialogue for the purposes of sharing ideas and best practices. To the extent other central banks can and do influence the Fed, at least some of that should be transparent as it can lead to shifts in supervisory direction.[247]

2d. Communication strategy. The VCS should also explain how it will communicate with the public about its supervisory policy in ways that comports with current academic and policy conversations about central bank transparency.[248]

For instance, as with monetary policy and other areas of financial stability policy, the Fed's interest in transparency in supervision might be understood in two different ways. In the case of monetary policy transmission, the Fed has an interest in being transparent about its plans so as to make its policies more effective.[249] Are there lessons or strategies that apply and could be borrowed in the realm of supervision? In addition,

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245 Kristian Blickle et al., *How Has Covid-19 Affected Banking Sector Vulnerability*, LIBERTY ST. ECON. (Nov. 16, 2020), https://libertystreeteconomics.newyorkfed.org/2020/11/how-has-covid-19-affected-banking-system-vulnerability.html. [https://perma.cc/36M3-TP6H].

246 For instance, if the Fed were to consider a revamp of stress testing to address climate change, one would expect that expansion of stress testing to be subject to the rigors of the proposal here.

247 *See infra* Part III.C.

248 That literature generally conceptualizes central bank transparency in terms of reasons why the central bank would relinquish some of its privately held information (about the real economy or the credit cycle) in the interest of enhanced welfare.

249 This is why the Fed engages in forward guidance in connection with inflation targeting.

transparency is also used to shore up the accountability of the Fed's decisions. This rationale has accompanied the Fed's decision to publish *Financial Stability Reports* as well as to increase the amount of public information concerning the models and scenarios behind stress testing.[250]

3. How does the new supervisory regime interoperate with other central banking frameworks? Third, the Fed should be clear about how any Fed supervisory actions will or will not affect monetary policy goals. Central bankers have already begun to worry about the interaction between monetary and prudential policy—noting, for instance, the trade-offs between 'lean against the wind' policies and inflation; and between capital and liquidity requirements and inflation targeting.[251] Will a new kind of supervisory approach to safety and soundness complement or detract from other central bank interventions?

This level of granularity in reporting has established precedent in former statutory reporting requirements that the Fed used to inform Congress about its money and growth aggregates and targets, which used to guide monetary policy.[252]

CONCLUSION

Central bank independence has long been interpreted to insulate the Federal Reserve from political instruction and interference. Economically, this deference is rationalized on the basis of good outcomes—central bankers cannot fight inflation if they are pressured to keep interest rates low and monetary policy in an accommodative (i.e., "easy money") state. Legally, this CBI is justified in regard to the Fed's special independent duty to "regulate the value" of money. Neither of these justifications applies to the supervision function that the Fed carries out today. Supervision is executive power, exercised pursuant to broad delegation of authority. Ultimately, this analysis compels the conclusion that Fed supervision should be structurally

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250 As Vice Chair for Supervision Randall Quarles remarked, "one of the reasons for transparency . . . is just a basic view of the right relationship between the government and the governed . . . I do think we can be much more transparent about the regulatory process generally." Randall K. Quarles, *Spontaneity and Order: Transparency, Accountability, and Fairness in Bank Supervision*, Address at the American Bar Association Banking Law Committee Meeting (Jan. 17, 2020), https://www.federalreserve.gov/newsevents/speech/quarles20200117a.htm.

251 Bussière et al., *The Interaction Between Macroprudential Policy and Monetary Policy: Overview* (Bank of England Working Paper No. 886, 2020).

252 *See* Pub. L. 95-523, §108(a).

separated from the rest of the Board, with input from the Treasury and external expert members, and that Fed supervisors should be required to report to Congress more precise explanations for novel forms of financial stability supervision.