JEB HENSARLING, TX , CHAIRMAN

United States House of Representatives
Committee on Financial Services
2129 Rayburn House Office Building
Washington, D.C. 20515

MAXINE WATERS, CA, RANKING MEMBER

May 22, 2014

**BY FIRST-CLASS AND ELECTRONIC MAIL**

The Honorable Janet Yellen
Chair
The Federal Reserve System
20th Steet and Constitution Ave, NW
Washington, D.C. 20429

Dear Chair Yellen,

I write to request information about your agency's use of so-called "reputational risk" in the prudential supervision of the depository institutions subject to your oversight.

The Uniform Financial Institutions Rating System, adopted by the Federal Financial Institutions Examination Council, assigns depository institutions composite and component ratings. This rating system, commonly referred to "CAMELS," relies primarily on objective indicators: capital adequacy, assets, management capability, earnings, liquidity, and sensitivity to market risk. One benefit to this system is that it should reduce the possibility of divergent supervisory outcomes for similarly situated depository institutions. Objectivity delivers fair competition and predictability; predictability fosters market stability; market stability tends to promote economic growth.

In recent months, however, I have become concerned that in conducting their safety-and-soundness supervision, some regulators may be relying not only on the largely objective CAMELS indicators but also on subjective judgments of what constitutes "reputation risk."

For example, this metric was cited in the FDIC and OCC's Guidance on Supervisory Concerns and Expectations Regarding Deposit Advance:

> *Reputation risk* is the risk arising from negative public opinion. Deposit advance products are receiving significant levels of negative news coverage and public scrutiny. This increased scrutiny includes reports of high fees and customers taking out multiple advances to cover prior advances and everyday expenses. Engaging in practices that are perceived to be unfair or

> detrimental to the customer can cause a bank to lose community support and business.[1]

Similarly, the Federal Reserve included a passing reference to "reputational damage" in its Advanced Notice of Public Rulemaking regarding "Complementary Activities, Merchant Banking Activities, and Other Activities of Financial Holding Companies related to Physical Commodities."

> Moreover, several recent events suggest that, even without direct ownership or operational control of an entity that has suffered a catastrophe, the public confidence of a holding company that was engaged in a physical commodity activity with a third party could suddenly and severely be undermined, as could the confidence in the company's subsidiary insured depository institution or their access to funding markets, until the extent of the liability of the holding company could be assessed by the markets. Financial firms, and in particular holding companies of [insured depository institutions], are particularly vulnerable to *reputational damage* to their banking operations. Although the likelihood of a catastrophic event is small in the short term, catastrophes involving physical commodities continue to occur, and the resultant damages are very difficult to measure, even after the event has occurred, and may be extremely large. The fact that a [financial holding company] has not been involved in such an event to date does not reduce the probability that such an event may occur or that the event could have a material adverse impact on the financial condition of the [financial holding company]. In fact, the absence of such an experience may hinder [financial holding companies'] ability to assess the efficacy of their safeguards.[2]

Under the CAMELS supervisory framework, "reputation risk" is not a standalone indicator that, on its own, can warrant a recommendation by your agency that a depository institution cease providing a particular product or service. It is not clear to me that the data that inform analysis of this type of risk—which remains too vaguely defined to deliver any predictability to those institutions you regulate—are not already accounted for in a regulator's analysis of an existing CAMELS indicator, like, for example, liquidity (*e.g.*, whether the bank has enough cash on hand to withstand a "run" caused by negative publicity) or sensitivity to market risk (*e.g.*, how negative publicity will affect a credit union's borrowing costs).

Moreover, it would be an abuse of regulatory discretion to use vague, subjective, and unquantifiable indicators like a firm's reputation to justify regulatory outcomes that

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could not otherwise be justified under an objective CAMELS analysis. For example, "reputation risk" could ostensibly be invoked to compel a depository institution to sever a customer relationship with a small business operating in accordance with all applicable laws and regulations but whose industry is deemed "reputationally risky" for no other reason than that it has been the subject of unflattering press coverage, or that certain Executive Branch agencies disapprove of its business model.[3] The introduction of subjective criteria like "reputation risk" into prudential bank supervision can all too easily become a pretext for the advancement of political objectives, which can potentially subvert both safety and soundness and the rule of law.

So that members of this Committee may better understand what "reputation risk" is and how regulators use it (whether on its own or in conjunction with other components of the CAMELS assessment), please respond in writing by not later than June 12, 2014, to the following questions:

1. Does your agency consider "reputation risk" in its supervision of depository institutions? If so, please state the legal basis for such consideration and please explain why your agency believes that "reputation risk" is an appropriate element of your supervisory program.

2. If your agency considers "reputation risk" in its supervisory activities, please explain what data are analyzed to determine the effect of "reputation risk" on a depository institution's safety and soundness. Please further explain how and why the data used to inform this analysis are not already accounted for under one of the traditional CAMELS indicators.

3. If your agency considers "reputation risk" in its supervisory activities, please state whether a poor rating under this analysis could be sufficient to warrant a recommendation to management that the depository institution change its business practices even if it had strong ratings under a traditional CAMELS analysis.

Sincerely,

JEB HENSARLING
Chairman

cc: Hon. Maxine Waters, Ranking Member

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United States House of Representatives
Committee on Financial Services
2129 Rayburn House Office Building
Washington, D.C. 20515

MAXINE WATERS, CA, RANKING MEMBER

May 22, 2014

**BY FIRST-CLASS AND ELECTRONIC MAIL**

The Honorable Thomas Curry
Comptroller of the Currency
Office of the Comptroller of the Currency
400 7th Street SW, Suite 3E-218
Washington, D.C. 20219

Dear Comptroller Curry,

I write to request information about your agency's use of so-called "reputational risk" in the prudential supervision of the depository institutions subject to your oversight.

The Uniform Financial Institutions Rating System, adopted by the Federal Financial Institutions Examination Council, assigns depository institutions composite and component ratings. This rating system, commonly referred to "CAMELS," relies primarily on objective indicators: capital adequacy, assets, management capability, earnings, liquidity, and sensitivity to market risk. One benefit to this system is that it should reduce the possibility of divergent supervisory outcomes for similarly situated depository institutions. Objectivity delivers fair competition and predictability; predictability fosters market stability; market stability tends to promote economic growth.

In recent months, however, I have become concerned that in conducting their safety-and-soundness supervision, some regulators may be relying not only on the largely objective CAMELS indicators but also on subjective judgments of what constitutes "reputation risk."

For example, this metric was cited in the FDIC and OCC's Guidance on Supervisory Concerns and Expectations Regarding Deposit Advance:

> *Reputation risk* is the risk arising from negative public opinion. Deposit advance products are receiving significant levels of negative news coverage and public scrutiny. This increased scrutiny includes reports of high fees and customers taking out multiple advances to cover prior advances and everyday expenses. Engaging in practices that are perceived to be unfair or

> detrimental to the customer can cause a bank to lose community support and business.[1]

Similarly, the Federal Reserve included a passing reference to "reputational damage" in its Advanced Notice of Public Rulemaking regarding "Complementary Activities, Merchant Banking Activities, and Other Activities of Financial Holding Companies related to Physical Commodities."

> Moreover, several recent events suggest that, even without direct ownership or operational control of an entity that has suffered a catastrophe, the public confidence of a holding company that was engaged in a physical commodity activity with a third party could suddenly and severely be undermined, as could the confidence in the company's subsidiary insured depository institution or their access to funding markets, until the extent of the liability of the holding company could be assessed by the markets. Financial firms, and in particular holding companies of [insured depository institutions], are particularly vulnerable to *reputational damage* to their banking operations. Although the likelihood of a catastrophic event is small in the short term, catastrophes involving physical commodities continue to occur, and the resultant damages are very difficult to measure, even after the event has occurred, and may be extremely large. The fact that a [financial holding company] has not been involved in such an event to date does not reduce the probability that such an event may occur or that the event could have a material adverse impact on the financial condition of the [financial holding company]. In fact, the absence of such an experience may hinder [financial holding companies'] ability to assess the efficacy of their safeguards.[2]

Under the CAMELS supervisory framework, "reputation risk" is not a standalone indicator that, on its own, can warrant a recommendation by your agency that a depository institution cease providing a particular product or service. It is not clear to me that the data that inform analysis of this type of risk—which remains too vaguely defined to deliver any predictability to those institutions you regulate—are not already accounted for in a regulator's analysis of an existing CAMELS indicator, like, for example, liquidity (*e.g.*, whether the bank has enough cash on hand to withstand a "run" caused by negative publicity) or sensitivity to market risk (*e.g.*, how negative publicity will affect a credit union's borrowing costs).

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So that members of this Committee may better understand what "reputation risk" is and how regulators use it (whether on its own or in conjunction with other components of the CAMELS assessment), please respond in writing by not later than June 12, 2014, to the following questions:

1. Does your agency consider "reputation risk" in its supervision of depository institutions? If so, please state the legal basis for such consideration and please explain why your agency believes that "reputation risk" is an appropriate element of your supervisory program.

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Sincerely,

JEB HENSARLING
Chairman

cc: Hon. Maxine Waters, Ranking Member

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May 22, 2014

**BY FIRST-CLASS AND ELECTRONIC MAIL**

The Honorable Martin Gruenberg
Chairman
Federal Deposit Insurance Corporation
550 17th Street NW
Washington, D.C. 20429

Dear Chairman Gruenberg,

I write to request information about your agency's use of so-called "reputational risk" in the prudential supervision of the depository institutions subject to your oversight.

The Uniform Financial Institutions Rating System, adopted by the Federal Financial Institutions Examination Council, assigns depository institutions composite and component ratings. This rating system, commonly referred to "CAMELS," relies primarily on objective indicators: capital adequacy, assets, management capability, earnings, liquidity, and sensitivity to market risk. One benefit to this system is that it should reduce the possibility of divergent supervisory outcomes for similarly situated depository institutions. Objectivity delivers fair competition and predictability; predictability fosters market stability; market stability tends to promote economic growth.

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Similarly, the Federal Reserve included a passing reference to "reputational damage" in its Advanced Notice of Public Rulemaking regarding "Complementary Activities, Merchant Banking Activities, and Other Activities of Financial Holding Companies related to Physical Commodities."

> Moreover, several recent events suggest that, even without direct ownership or operational control of an entity that has suffered a catastrophe, the public confidence of a holding company that was engaged in a physical commodity activity with a third party could suddenly and severely be undermined, as could the confidence in the company's subsidiary insured depository institution or their access to funding markets, until the extent of the liability of the holding company could be assessed by the markets. Financial firms, and in particular holding companies of [insured depository institutions], are particularly vulnerable to *reputational damage* to their banking operations. Although the likelihood of a catastrophic event is small in the short term, catastrophes involving physical commodities continue to occur, and the resultant damages are very difficult to measure, even after the event has occurred, and may be extremely large. The fact that a [financial holding company] has not been involved in such an event to date does not reduce the probability that such an event may occur or that the event could have a material adverse impact on the financial condition of the [financial holding company]. In fact, the absence of such an experience may hinder [financial holding companies'] ability to assess the efficacy of their safeguards.[2]

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Sincerely,

JEB HENSARLING
Chairman

cc: Hon. Maxine Waters, Ranking Member

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JEB HENSARLING, TX, CHAIRMAN

United States House of Representatives
Committee on Financial Services
2129 Rayburn House Office Building
Washington, D.C. 20515

MAXINE WATERS, CA, RANKING MEMBER

May 22, 2014

**BY FIRST-CLASS AND ELECTRONIC MAIL**

The Honorable Debbie Matz
Chairman
National Credit Union Administration
1775 Duke Street
Alexandria, VA 22314

Dear Chairman Matz,

I write to request information about your agency's use of so-called "reputational risk" in the prudential supervision of the depository institutions subject to your oversight.

The Uniform Financial Institutions Rating System, adopted by the Federal Financial Institutions Examination Council, assigns depository institutions composite and component ratings. This rating system, commonly referred to "CAMELS," relies primarily on objective indicators: capital adequacy, assets, management capability, earnings, liquidity, and sensitivity to market risk. One benefit to this system is that it should reduce the possibility of divergent supervisory outcomes for similarly situated depository institutions. Objectivity delivers fair competition and predictability; predictability fosters market stability; market stability tends to promote economic growth.

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Sincerely,

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Chairman

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