U.S. GOVERNMENT ACCOUNTABILITY OFFICE
441 G St. N.W.
Washington, DC 20548

B-331324

October 22, 2019

The Honorable Thom Tillis
United States Senate

Subject: *Board of Governors of the Federal Reserve System—Applicability of the Congressional Review Act to Supervision and Regulation Letter 11-7*

Dear Senator Tillis:

This responds to your request for our legal opinion as to whether Supervision and Regulation Letter 11-7, "Supervisory Guidance on Model Risk Management" (*SR 11-7*) issued by the Board of Governors of the Federal Reserve System (FRB) is a rule for purposes of the Congressional Review Act (CRA). Letter from Senator Thom Tillis to the Comptroller General (Apr. 26, 2019). As explained below, we conclude that *SR 11-7* is a rule under CRA, which requires that it be submitted to Congress for review.[1]

Our practice when rendering opinions is to contact the relevant agencies and obtain their legal views on the subject of the request. GAO, *Procedures and Practices for Legal Decisions and Opinions*, GAO-06-1064SP (Washington, D.C.: Sept. 2006), *available at* www.gao.gov/products/GAO-06-1064SP. We contacted FRB to obtain the agency's views. Letter from Assistant General Counsel for Strategic Issues, GAO, to General Counsel, FRB (May 13, 2019). We received FRB's response on June 13, 2019. Letter from General Counsel, FRB, to Managing Associate General Counsel, GAO (June 13, 2019) (Response Letter).

[1] In B-330843, issued today, we concluded that two other Supervision and Regulation Letters, SR 12-17 and SR 14-8, are rules under CRA and must be submitted to both Houses of Congress and the Comptroller General before they could take effect. 5 U.S.C. § 801(a)(1). We also concluded that SR 15-7 is not a rule.

BACKGROUND

FRB's authority and responsibilities

FRB has regulatory and supervisory jurisdiction over several types of financial institutions including state-chartered banks that are members of the Federal Reserve System, bank holding companies, and foreign bank holding companies operating in the United States. *See, e.g.*, 12 U.S.C. §§ 325, 1844.[2]

FRB has the authority to inspect the financial condition of an institution under its jurisdiction to ensure the institution is not at risk of insolvency. *See, e.g.*, 12 U.S.C. §§ 325, 1844. When FRB inspects the financial condition of an institution, it inspects the institution's safety and soundness. FRB, *The Federal Reserve System Purposes and Functions* 74 (10th ed. 2016). FRB performs safety and soundness reviews through risk-based examinations. *Id.* These examinations are conducted through on-site examinations and inspections as well as off-site scrutiny and monitoring. *Id.* at 83. For the largest institutions, FRB maintains a continuous supervisory presence and full-time examiners. *Id.*

According to FRB, when examiners believe that guidance on a particular issue is necessary, they issue supervisory statements. Response Letter, at 2. These supervisory statements are called SR Letters. Supervision and Regulations Letters (SR Letters) are intended by FRB to address significant policy and procedural matters related to the FRB's supervisory responsibilities.[3] The letters provide transparency to the industry and FRB staff concerning supervisory insights, practices, and approaches. *Id.* According to FRB, SR Letters are not binding on any institution. *Id.*; *see also* FRB, *Interagency Statement Clarifying the Role of Supervisory Guidance: SR 18-5*, (Sept. 18, 2018). FRB intended the SR Letters at issue to inform financial institutions of the agency's supervisory views. Response Letter, at 2. Active SR Letters are publicly available on the FRB website.

[2] Some non-financial institutions are also subject to FRB's jurisdiction. *See* 12 U.S.C. § 5323.

[3] FRB, *Supervision and Regulation Letters, available at* https://www.federalreserve.gov/supervisionreg/srletters/srletters.htm (last visited Oct. 2, 2019).

SR 11-7

SR 11-7[4] states that its purpose is to provide "comprehensive guidance for banks on effective model risk management."[5] *SR 11-7* at 2. In the document, FRB states, "[A]ll banks should ensure that internal policies and procedures are consistent with the risk management principles and supervisory expectations contained in this guidance." *Id.* Banks model risk to perform activities such as underwriting credits; valuing exposures, instruments, and positions; measuring risk; managing and safeguarding client assets; determining capital and reserve adequacy; and many other activities. *Id.* at 1. *SR 11-7* applies to all banks within FRB's jurisdiction. *See id.* at 2.

The Congressional Review Act

CRA, enacted in 1996 to strengthen congressional oversight of agency rulemaking, requires all federal agencies, including independent regulatory agencies, to submit a report on each new rule to both Houses of Congress and to the Comptroller General before it can take effect. 5 U.S.C. § 801(a)(1). The report must contain a copy of the rule, "a concise general statement relating to the rule," and the rule's proposed effective date. 5 U.S.C. § 801(a)(1)(A). In addition, the agency must submit to the Comptroller General a complete copy of the cost-benefit analysis of the rule, if any, and information concerning the agency's actions relevant to specific procedural rule making requirements set forth in various statutes and executive orders governing the regulatory process. 5 U.S.C. § 801(a)(1)(B).

CRA adopts the definition of rule under the Administrative Procedure Act (APA), 5 U.S.C. § 551(4), which states that a rule is "the whole or a part of an agency statement of general or particular applicability and future effect designed to implement, interpret, or prescribe law or policy or describing the organization, procedure, or practice requirements of an agency." 5 U.S.C. § 804(3). CRA excludes three categories of rules from coverage: (1) rules of particular applicability; (2) rules relating to agency management or personnel; and (3) rules of agency organization, procedure, or practice that do not substantially affect the rights or obligations of non-agency parties. 5 U.S.C. § 804(3).

FRB did not submit a CRA report for *SR 11-7* to Congress or the Comptroller General. In its letter to our office, FRB did not provide its views regarding whether *SR 11-7* is a rule under CRA or whether any exceptions would apply. Response

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[4]FRB, *Supervisory Guidance on Model Risk Management: SR 11-7* (Apr. 4, 2011) (*SR 11-7*).

[5] Banks use quantitative analysis and models in financial decision-making such as underwriting credits, valuing exposures, and measuring risk. *SR 11-7* at 1. *SR 11-7* expands upon existing guidance to incorporate all aspects of model risk management. *Id.* at 2.

Letter. FRB explained it is currently reviewing recent guidance from the Office of Management and Budget (OMB) on compliance with CRA.[6] FRB is reviewing the rules it submits to OMB for major rule determinations as well as its obligation to submit guidance documents.

ANALYSIS

To determine whether *SR 11-7* is a rule subject to review under CRA, we first address whether it meets the APA definition of a rule. As explained below, we conclude that it does. The next step, then, is to determine whether any of the CRA exceptions apply. We conclude that they do not.

We can conclude that *SR 11-7* meets the APA definition of rule upon which CRA relies. First, it is an agency statement as it was issued by FRB. Second, it is of future effect because it provides new guidance to banks on modeling risk going forward impacting future financial decisions, and setting expectations for future bank internal policies and procedures. *SR 11-7* at 2; *see* B-316048, Apr. 17, 2008 (finding that an agency action was of future effect because the action was prospective in nature since it was concerned with policy considerations for the future rather than the evaluation of past or present conduct). Finally, *SR 11-7* implements, interprets, or prescribes law or policy as it sets forth supervisory expectations as determined by FRB under its authority to supervise financial institutions to ensure they operate in a safe and sound manner.

SR 11-7 is similar in language and intent to other FRB guidance documents that we have previously determined to be rules under CRA. *See* B-329272, Oct. 19, 2017 (Leveraged Lending). In 2017, we found that interagency guidance on leveraged lending issued by FRB and other agencies was a rule under CRA. *Id.* The leveraged lending guidance also set forth agency supervisory expectations, stating that financial institutions should take certain actions for the sound risk management of leveraged lending activities. For instance, in one part, the leveraged lending guidance states, "A financial institution's underwriting standard should be clear, written and measurable, and should accurately reflect the institution's risk appetite for leveraged lending transactions." 78 Fed. Reg. 17766, 17772 (Mar. 22, 2013). The language indicated that an institution may need to consider changes to its internal operations and procedures to ensure it was in line with the guidance. This language in the leveraged lending guidance is similar to language contained here in *SR 11-7*, which also states institutions should take certain actions to improve their model risk management.[7]

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[6] Office of Mgmt. & Budget. M-19-14, "Guidance on Compliance with the Congressional Review Act" (Apr. 11, 2019).

[7] For example, *SR 11-7* states, "[A]ll banks should ensure that internal policies and procedures are consistent with the risk management principles and supervisory expectations contained in this guidance." *SR 11-7* at 2.

In its response letter, FRB stated SR Letters do not establish binding requirements on any institution but only provide transparency to the industry and FRB staff concerning supervisory insights, practices, and approaches. Response Letter. This fact, however, does not change our analysis. In Leveraged Lending, we also explained how the guidance document in that case was a rule under CRA. B-329272 at 4-6. We reached that conclusion based on our prior opinions and the legislative history of CRA. The legislative history states:

> "Although agency interpretive rules, general statements of policy, guideline documents, and agency policy and procedure manuals may not be subject to the notice and comment provisions of [the APA], these types of documents are covered under the congressional review provisions of [CRA]."

142 Con. Rec. H3005 (daily ed. Mar. 28, 1996). Based on this statement and others in the legislative history, we have concluded the provisions of CRA are to be interpreted broadly. *See, e.g.*, B-329272 at 5. Consequently, even though *SR 11-7* is a non-binding guidance document similar to the guidance document in our Leveraged Lending opinion, it still meets the APA definition of a rule.

Having concluded that *SR 11-7* meets the APA definition of rule, we now turn to whether any of the three CRA exceptions apply. We conclude that they do not. First, *SR 11-7* applies to all institutions under FRB jurisdiction and is, therefore, a rule of general and not particular applicability. *See* B-287557, May 14, 2001 (determining that all that is required to determine that an agency action is of general applicability is a finding that an agency action has "general applicability within its intended range, regardless of the magnitude of that range"). Second, *SR 11-7* deals with actions the bank should take and not FRB management or personnel and is, therefore, not a rule relating to agency management or personnel.

This leaves the exception for rules of "agency organization, procedure, or practice that do not substantially affect the rights or obligations of non-agency parties." 5 U.S.C. § 804(3)(C). We find that this exception does not apply because *SR 11-7* has a substantial impact on the regulated community. We examined a similar issue in 2017, in our review of the 2016 Amendment to the Tongass Land and Resource Management Plan, finding that the plan at issue did not meet this exception because it had substantive impacts on the regulated community. B-238859, Oct. 23, 2017. In that case, the U.S. Department of Agriculture (USDA) sought to revise the Tongass National Forest Plan to identify the uses that could occur in each area of the forest. *Id.* at 3. Amongst other things, the agency wanted to amend the Tongass National Forest Plan by transitioning timber harvest activities from old-growth to new-growth trees. *Id.* at 5–6. This transition would affect the kind of timber harvesters could take from the forest, impacting the operations of the harvesters in various ways. *Id.* at 13. In doing so, we noted that USDA encoded the agency's substantive value judgment in favor of this transition which would have a substantial impact on the local timber industry. Consequently, because the plan

would have a substantial impact on the regulated community, we found the exception did not apply to the plan.

We reached our conclusion in Tongass relying upon the Fifth Circuit's decision in *Phillips Petroleum Co. v. Johnson*, 22 F.3d 616 (5th Cir. 1994).[8] In that case, the court held that an unpublished agency paper that changed the criteria for valuing liquid natural gas products, used to calculate royalties, was a substantive rule subject to APA notice-and-comment rule making requirements. *Phillips Petroleum*, 22 F.3d at 620–21. Because the agency paper would dramatically affect the royalty values of all oil and gas leases, the court concluded that the paper had a substantial impact on the industry.

As in our 2017 Tongass opinion and *Phillips Petroleum*, *SR 11-7* has a substantial impact on the regulated community. *SR 11-7* lays out actions banks should consider taking when developing, implementing, and using a model for risk management, among other things. *SR 11-7* at 5–9. Banks rely on these models as they make decisions on underwriting credits, determining capital and reserve adequacy, and other activities; all of these are activities at the core of a bank's business and internal operations. *Id.* at 1. The actions in *SR 11-7* affect a bank's model risk which in turn impacts how it conducts its business and internal operations. In Tongass and *Phillips Petroleum*, the agency actions at issue led to changes to what businesses and other regulated entities could expect from the agency, which could lead to changes in the regulated entities' internal operations and polices as needed. Similarly, because the actions listed in *SR 11-7* could lead to and encourage change to an institution's internal operations, *SR 11-7* has a substantial impact on the regulatory community and, therefore, the exception does not apply.

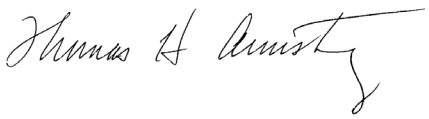
CONCLUSION

SR 11-7 meets the APA definition of a rule and no exception applies. Accordingly, given our conclusions above, and in accordance with the provisions of 5 U.S.C. § 801(a)(1), *SR 11-7* is subject to the requirement that it be submitted to both Houses of Congress and the Comptroller General for review before it can take effect.

[8] Because CRA exceptions are closely modeled and similar to APA exceptions, we have used court decisions on the APA exceptions to guide our analysis of the CRA exceptions. *See* B-329926, Sept. 10, 2018, at 4–5. The APA exempts procedural rules from having to undergo notice-and comment rulemaking. 5 U.S.C. § 553(b)(A). The CRA exemption for rules of agency organization, procedure, or practice that do not substantially affect the rights or obligations of non-agency parties was modeled after this exception. *See* 142 Cong. Rec. S3683-01, S3687 (daily ed. Apr. 18, 1996).

If you have questions about this opinion, please contact Shirley A. Jones, Managing Associate General Counsel, at (202) 512-7227 or Janet Temko-Blinder, Assistant General Counsel at (202) 512-7104.

Sincerely yours,



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