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The Federal Reserve Board Significantly Revises Intra-Agency Appeals Procedures

Pinchus D. Raice, Jeffrey Alberts, and Dustin N. Nofziger [*]

The authors summarize some of the most significant changes to the Federal Reserve System's intra-agency appeals process and offer an analysis of takeaways for financial institutions.

On March 17, 2020, the Board of Governors of the Federal Reserve System ("Board") issued a significant revision of its intra-agency appeals procedures (the "Revised Procedures"),[1] which allow financial institutions to appeal a wide spectrum of material supervisory determinations. The Board had not previously revised its procedures since their initial issuance in March 1995 (the "1995 Procedures").[2]

The Board invited public comment on proposed amendments to the 1995 Procedures more than a year ago[3] and incorporated several changes in the Revised Procedures in response to comments received from industry groups – including comments submitted by Pryor Cashman LLP ("Pryor Cashman") on behalf of the New York League of Independent Bankers ("NYLIB").[4] One of the Board's goals in putting revisions to the intra-agency appeals process out for public comment was to identify changes that would make the process "more

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[1] Internal Appeals Process for Material Supervisory Determinations and Policy Statement Regarding the Ombudsman for the Federal Reserve System, 85 Fed. Reg. 15,175, 15,178-82 (Mar. 17, 2020).

[2] Internal Appeals Process, 60 Fed. Reg. 16,470, 16,472-73 (Mar. 30, 1995).

[3] Internal Appeals Process for Material Supervisory Determinations and Policy Statement Regarding the Ombudsman for the Federal Reserve System, 83 Fed. Reg. 8,391, 8,391-94 (Feb. 27, 2018).

[4] Letter from Pinchus D. Raice, Jeffrey Alberts, and Dustin N. Nofziger to Ann E. Misback, Secretary, Board of Governors of the Federal Reserve System (Apr. 30, 2018) ("Pryor Cashman Comment Letter"), *available at* https://www.pryorcashman.com/news-and-insights/pryor-cashman-submits-comments-to-federal-reserve-in-effort-to.html (follow link).

useful and approachable" for financial institutions.[5] The Board "encourages institutions to make use of the revised [appeals] process."[6]

This article summarizes some of the most significant changes to the appeals process and offers an analysis of takeaways for financial institutions. On the whole, the changes effected by the Revised Procedures are positive for financial institutions in that they make the Board's intra-agency appeals process more useful, fair, and transparent.

EXPANDED DEFINITION OF "MATERIAL SUPERVISORY DETERMINATION"

The 1995 Procedures defined the term "material supervisory determination" as "includ[ing], but . . . not limited to, material determinations relating to examination or inspection composite ratings, the adequacy of loan loss reserves and significant loan classifications."[7] Supervisory determinations for which an independent right of appeal existed (e.g., prompt corrective action directives issued pursuant to section 38 of the Federal Deposit Insurance Act, as amended) were excluded from the definition.[8]

While the use of the phrase "including but not limited to" in the 1995 Procedures suggested that material supervisory determinations in addition to the three listed examples could be appealed, the Board's spare definition created uncertainty as to what additional determinations were in fact appealable. In addition, the 1995 Procedures' specification that "composite" examination or inspection ratings were appealable could have been read to suggest that component examination or inspection ratings (e.g., the "*M*anagement" rating in a CA*M*ELS rating or the "*R*isk Management" rating in a *R*OCA rating) were not appealable.

The Revised Procedures expand on the definition of "material supervisory determination" by making clear that the term "includes, but is not limited to," several additional categories of determinations, namely: "any material determination relating to examination or inspection composite ratings, *material examination or inspection component ratings*, the adequacy of loan loss reserves *and/or capital*, significant loan classification, *accounting interpretation*, *Matters Requiring Attention ('MRAs')*, *Matters Requiring Immediate Attention ('MRIAs')*, *Community Reinvestment Act ratings (including component ratings)*, and *consumer*

[5] 85 Fed. Reg. at 15,178.

[6] *Id.*

[7] 60 Fed. Reg. at 16,473.

[8] *Id.*

compliance ratings."[9] The Revised Procedures' definition of "material supervisory determination" still excludes "any supervisory determination for which an independent right of appeal exists."[10] In addition, Revised Procedures specify that the definition of "material supervisory determination" excludes "a referral to another government agency" – such as "written notice of a referral to the Attorney General pursuant to the Equal Credit Opportunity Act ('ECOA')."[11]

REDUCTION FROM THREE TO TWO LEVELS OF APPEAL; INCREASED IMPARTIALITY OF THE INITIAL REVIEW PANEL

The 1995 Procedures provided for three levels of appeal – first to an initial review panel comprised of a qualified person or persons selected by the Reserve Bank that made the material supervisory determination at issue who had not participated in the material supervisory determination and did not report to the person who made the determination; second to the president of the Reserve Bank that made the material supervisory determination; and third to the appropriate governor of the Federal Reserve Board.[12]

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[9] 85 Fed. Reg. at 15,179 (emphases added).

[10] *Id.*

[11] *Id.*

[12] 60 Fed. Reg. at 16,472-73. The Board's 2018 commentary accompanying its proposed amendments to the 1995 Procedures stated that the 1995 Procedures provided that the initial review panel was "comprised of persons who [we]re not employed by the Reserve Bank." 83 Fed. Reg. at 8,391. This statement, which is erroneous, may have been a conflation of the 1995 Procedures and the Board's proposed amendments to those procedures. The 1995 Procedures did not prohibit a Reserve Bank's employees from serving on the initial review panel. *See* 60 Fed. Reg. at 16,472 ("The purpose of these guidelines is to allow each Reserve Bank to administer its own appellate process, but to establish procedures under which all Reserve Banks' appellate process must operate. . . . The appeal shall be considered in the first instance by a person or persons selected by the Reserve Bank (the review panel) who – (A) did not participate in the material supervisory determination; (B) do not directly or indirectly report to the person who made the material supervisory determination under review; and (C) are qualified to review the material supervisory determination."). Moreover, contemporaneous Reserve Bank procedures indicate that a Reserve Bank's own employees could in fact serve on initial review panels for appeals challenging the Reserve Bank's material supervisory determinations. *See, e.g.*, Fed. Reserve Bank of N.Y., Procedures for Appeals of Adverse Material Supervisory Determinations ¶ 7, https://www.newyorkfed.org/medialibrary/media/banking/pdf/appeals_procedures.pdf (last visited April 30, 2020) ("[T]he FRBNY Officer-in-Charge of Financial Institution Supervision will cause the formation of a Review Panel. . . . In forming a panel consisting of people qualified to review the material supervisory determination in question, the FRBNY will generally seek to include staff from the same functional area as that which generated the determination. For example, in the case of an appeal involving a safety and soundness examination rating, the panel would generally consist of staff from the Complex Financial Institutions Function of the FRBNY.

The Revised Procedures provide for a more streamlined, two-level appeal process that provides for increased impartiality at the initial review panel level. A first-level appeal will be heard by an initial review panel comprised of three Reserve Bank employees from a different Reserve Bank than the Reserve Bank that made the material supervisory determination at issue.[13] Rather than being selected by the Reserve Bank whose material supervisory determination is being challenged, these individuals will be selected by the director of the appropriate division of the Board – who will presumably, in many cases, be the director of the Board's Division of Supervision and Regulation.[14] The initial review panel will be advised in the exercise of its responsibilities by an attorney (who also must not be employed by the Reserve Bank that made the material supervisory determination).[15] The initial review panel members and the attorney advisor must have relevant experience, must not have been substantively involved in any matter at issue, and must not directly or indirectly report to any person who made the material supervisory determination under review.[16]

A second-level appeal will be heard by a three-person final review panel.[17] The final review panel will be appointed by the director of the appropriate division of the Board (e.g., the director of the Division of Supervision and Regulation) and will include at least two Board employees, at least one of whom must be an officer of the Board at the level of associate director or higher.[18] The Board's general counsel will appoint an attorney to advise the final review panel

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Similarly, in the case of an appeal regarding a CRA rating, the panel would generally consist of staff from the FRBNY's Legal and Compliance Risk Function.); Fed. Reserve Bank of San Francisco, Division of Financial Institution Supervision and Credit, Policy Statement on Appeals of Material Supervisory Determinations 4, http://www.frbsf.org/banking/files/FRBSF-Appeals-Policy.pdf (updated Nov. 2019) ("The Officer-in-Charge of FISC [the Federal Reserve Bank of San Francisco's Division of Financial Institution Supervision and Credit ('FISC')] shall approve the selection of person(s) to serve as the review panel for the appeal. Generally, the presiding person of the review panel would be a Reserve Bank officer. . . . The Officer-in-Charge responsible for approving the review panel shall select qualified person(s). . . . from eligible staff within FISC, other Reserve Banks, and/or the Board of Governors.").

[13] *See* 85 Fed. Reg. at 15,179 ("Within ten calendar days of receipt of a timely appeal, the director of the appropriate division of the Board. . . . must appoint three Reserve Bank employees to serve as an initial review panel to consider the appeal. . . . The members of the initial review panel. . . . must not be employed by the Reserve Bank that made the material supervisory determination under review. . . . ").

[14] *See id.*

[15] *Id.*

[16] *Id.*

[17] *Id.* at 15,180.

[18] *Id.*

in the exercise of its responsibilities.[19] The members of the final review panel and the attorney advisor must not be employed by the Reserve Bank that made the material supervisory determination under review; must not have been members of the initial review panel; must not have been personally consulted regarding the issue being determined and provided guidance regarding how it should be resolved; and must not directly or indirectly report to the person or persons who made the material supervisory determination under review.[20]

RECORD ON APPEAL

The 1995 Procedures did not clearly specify what the record was that would be reviewed by the president of the Reserve Bank (at the second level of appeal) or the appropriate governor (at the third and final level of appeal).[21] While it was clear that the record included the materials submitted by the appealing institution, it appears that the initial review panel could consider materials to which the institution did not have access (e.g., examination workpapers), and presumably the Reserve Bank president and governor could as well.[22] In addition, while the institution was required to present "all the facts and arguments that the institution wishe[d] to present" to the initial review panel, the Reserve Bank staff were under no such requirement, suggesting that they might have been able to supplement the record with new evidence at subsequent stages of appeal.[23]

The Revised Procedures provide that the scope of the final review by the final review panel will be confined to the record upon which the initial review panel made its decision.[24] The Revised Procedures also provide that the initial review panel must "identify the information upon which the panel relied in reaching its conclusion," and further require it to "promptly provide that information to the institution upon the institution's request to the extent permitted by law."[25] An appealing financial institution thus will have access to the record upon

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[19] *Id.*

[20] *Id.*

[21] *See* 60 Fed. Reg. at 16,472-73.

[22] *See id.* at 16,472 ("The review panel shall also solicit the views of the Reserve Bank staff involved in the determination under appeal Board staff, and, where appropriate, the staff of other supervisory agencies (for example, in case of joint examinations or inspections). Nothing in this appeals process shall create any discovery or other such rights [in the appealing financial institution].").

[23] *See id.*

[24] 85 Fed. Reg. at 15,181.

[25] *Id.* at 15,180.

which the initial review panel made its decision (and to which the final review panel's review will be limited) as it is drafting its appeal to the final review panel.

The Revised Procedures' requirement that the initial review panel identify the information upon which it relied and provide that information to the appealing financial institution was added by the Board in response to the comment letter that Pryor Cashman submitted on behalf of NYLIB. The comment letter opined that "[r]easoned decision-making and fairness would be promoted if the initial review panel is required to provide the appealing financial institution with a copy of the record."[26] The Board described its response to this recommendation as follows in its commentary to the Revised Procedures:

> One commenter suggested that the appealing institution be provided the record on appeal from the initial review panel. In many instances, the record will include the voluminous and confidential examination work papers, the majority of which are not pertinent to the determination being appealed and not appropriate for dissemination to the appealing institution. The final appeals process has been revised to require that the initial review panel be precise in identifying the information upon which it relied in reaching its conclusion, and that it promptly provide such information to the institution upon the institution's request to the extent permitted by law.[27]

In other words, while an appealing financial institution still will not be permitted to access the entire volume of examination workpapers, the appealing financial institution should be able to review and cite to the examination workpapers relied upon by the initial review panel in the institution's appeal to the final review panel.

STANDARD OF REVIEW

The 1995 Procedures did not specify a standard of review at any of the three levels of review.[28] The Revised Procedures, in contrast, provide a standard of review for the initial and final review panels.

Specifically, the Revised Procedures provide that the following standard of review is to be applied by the initial review panel:

> The panel must consider whether the Reserve Bank's material super-

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[26] Pryor Cashman Comment Letter 5.

[27] 85 Fed. Reg. at 15,178.

[28] *See* 60 Fed. Reg. at 16,472-73.

> visory determination is consistent with applicable laws, regulations, and policy, and supported by a preponderance of the evidence in the record. In doing so, the panel shall make its own supervisory determination and shall not defer to the judgment of the Reserve Bank staff that made the material supervisory determination though it may rely on any examination workpapers developed by the Reserve Bank or materials submitted by the institution if it determines it is reasonable to do so.[29]

The Board stated in its commentary to the Revised Procedures that the standard of review applied by the initial review panel may be considered a *de novo* (non-deferential) standard of review.[30]

The standard of review for the final review panel is as follows:

> The final review panel shall determine whether the decision of the initial review panel is reasonable. In reaching this determination, the panel should consider whether the decision was based on a consideration of the applicable law, regulations, and policy, and whether there has been a clear error of judgment. The final review panel may affirm the decision of the initial review panel even if it is possible to draw a contrary conclusion from the record presented on appeal.[31]

The Board's commentary to the Revised Procedures indicates that rather than performing a *de novo* review of the record without deference to the initial review panel, "[t]he role of the final review panel . . . is to serve a role analogous to that of an appeals court that corrects errors in the decision made by the initial review panel."[32]

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[29] 85 Fed. Reg. at 15,180.

[30] *Id.* at 15,177.

[31] *Id.* at 15,181.

[32] *Id.* at 15,177-78 ("The proposal provided that the final review panel will consider whether the decision of the initial review panel is reasonable. One commenter [Pryor Cashman on behalf of NYLIB] suggested that the final review panel standard of review should be *de novo*. The role of the final review panel in the proposal is to serve a role analogous to that of an appeals court that corrects errors in the decision made by the initial review panel. Accordingly, a *de novo* standard is not appropriate given the panel's function."); *see generally* Pryor Cashman Comment Letter 7 ("NYLIB respectfully submits that . . . the second and final review panel should review the record de novo.").

PUBLICATION OF DECISIONS

The 1995 Procedures did not require the publication of intra-agency appeals decisions, and such decisions were not published by the Board.[33] Counsel for financial institutions prosecuting intra-agency appeals therefore could not cite to prior decisions as precedent. In addition, there was no way for industry participants to assess overall success rates for intra-agency appeals.[34]

The Revised Procedures provide, for the first time, for the publication of decisions of the final review panel. Decisions of the final review panel will be published on the Board's public website with appropriate redactions to avoid disclosure of exempt information, such as the identity of an appealing financial institution.[35] Alternatively, final review panel decisions will be presented in summary form if redaction is deemed insufficient to prevent improper disclosure of exempt information.[36]

TAKEAWAYS FOR FINANCIAL INSTITUTIONS

On the whole, the Board's revisions to the 1995 Procedures are positive for financial institutions.

A significantly wider array of material supervisory determinations are now explicitly appealable. For example, while the 1995 Procedures explicitly allowed for the appeal only of composite examination and inspection ratings, the Revised Procedures now explicitly allow the appeal of both composite *and* component ratings. The inclusion of "accounting interpretation" and of MRAs and MRIAs in the definition of appealable "material supervisory determina-

[33] *See* 60 Fed. Reg. at 16,472-73.

[34] Notably, even when final, top-level appeals decisions are published, the win/loss ratio can be misleading. If only top-level appeals decisions are published (e.g., in the case of decisions of the FDIC's Supervision Appeals Review Committee ("SARC") or as provided for by the Board's Revised Procedures), financial institution wins at initial levels of appeal remain unknown. In addition, and in the authors' experience, examination staff have responded to appeals by significantly modifying, or even withdrawing, challenged material supervisory determinations. In one particularly instructive example, a federal banking agency withdrew a report of examination in its entirety in response to an intra-agency appeal filed by Pryor Cashman, stating in a written communication that the report of examination no longer constituted an "official communication" of the agency. Because the agency had withdrawn the report of examination, the financial institution's appeal of the material supervisory determinations contained therein was considered moot, and no intra-agency appeals decision documenting the financial institution's success was ever issued by the agency.

[35] 85 Fed. Reg. at 15,181.

[36] *Id.*

tions" is also significant for financial institutions, which are now assured that they can appeal those important determinations.

The reduction from three to two levels of appeal is neutral for financial institutions. Financial institutions may have preferred to have three bites at the intra-agency appeals apple rather than two. Yet a streamlined appeals process will allow financial institutions to reach the top-level appellate authority more quickly.

What is more important than the number of levels of appeal is that the appellate arbiters are impartial. The Revised Procedures provide for a substantially more impartial appeals process at the initial review panel level. The 1995 Procedures provided that first-level appeals were made to an initial review panel selected by the Reserve Bank that had issued the material supervisory determination being appealed, and they simultaneously allowed the Reserve Bank to comprise the panel of its own employees. While Reserve Bank employees selected to serve on initial review panels doubtless did their best to be fair, one imagines that it may have been difficult for them to be completely impartial when considering the determinations of their Reserve Bank colleagues located in the same office (perhaps even down the same hallway). At the very least, the 1995 Procedures created the appearance of partiality at the initial review panel level. In contrast, the Revised Procedures provide that all members of the initial review panel must come from *outside* of the Reserve Bank that made the material supervisory determination at issue. Financial institutions that historically have questioned the impartiality – and thus the utility – of the Board's intra-agency appeals process should be heartened by this change.

The requirement – added in response to a comment letter submitted by Pryor Cashman on behalf of NYLIB – that the initial review panel must specifically identify the information it relied upon in reaching its decision and promptly provide this information to the appealing financial institution upon request also is very positive for financial institutions. Financial institutions appealing to the final review panel now will be able to review the record upon which the final review panel will make its decision for evidence supportive of their arguments or that undermines or contradicts the findings and judgments of the initial review panel. This change substantially levels the playing field between appealing financial institutions and Reserve Bank staff at the final review level.

The addition of standards of review will allow counsel for financial institutions to emphasize to the initial review panel that it is required to "make its own supervisory determination" and that it is prohibited from " defer[ring] to the judgment of the Reserve Bank staff that made the material supervisory determination." While a financial institution that loses at the initial review

panel level might have preferred a standard of review at the final review panel level that is less deferential to the initial review panel, the Revised Procedures' articulation of the standards of review at both levels of appeal will provide counsel for appealing financial institutions with new avenues of argument at the final review level.

Last, the fact that the Board will publish final review panel decisions will prove helpful to financial institutions. Counsel for financial institutions will be able to cite to prior final review panel decisions as supportive of their arguments, and financial institutions and their counsel will also be able to make more informed assessments of potential chances of success as they consider potential appeals. Conceivably, financial institutions may even be able to avert the necessity of an appeal entirely by making a successful argument to Reserve Bank staff based on published appeals decisions.

Notably, one thing that did not change in the Revised Procedures is that the deadline for a first-level appeal is short – 30 calendar days from the material supervisory determination. Financial institutions considering intra-agency appeals should consult with counsel promptly and should keep in mind that – in response to a comment submitted by Pryor Cashman on behalf of NYLIB – the final appeals procedures permit a financial institution to file a written request for an extension of time to file an appeal.[37]

In short, the Board's revisions to the 1995 Procedures are positive for financial institutions in that they make the Board's intra-agency appeals process more useful, fair, and transparent. Financial institutions confronted with problematic or unwarranted material supervisory determinations should consider utilizing the Board's revised appeals process – as the Board has explicitly encouraged them to do.

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[37] *See* 85 Fed. Reg. at 15,177 ("One commenter [Pryor Cashman on behalf of NYLIB] suggested that an institution be permitted to seek a 30-day extension of the time to file an initial appeal or a final appeal. Given that the appeals process is intended to be efficient and provide a swift resolution of disputes, in most circumstances extensions will not be warranted. Nevertheless, the final appeals process has been revised to permit an institution to seek reasonable extensions of time to file the initial appeal or the final appeal for good cause, which may be granted in the discretion of the appropriate division director in consultation with the Board's General Counsel or his designee."); Pryor Cashman Comment Letter 2 ("NYLIB respectfully submits that the Proposed Guidelines be amended to continue to acknowledge that extensions of the 30-day deadline for filing an initial appeal may be granted in appropriate circumstances.").