

## **Sarah Bloom Raskin: Community bankers and supervisors – seeking balance**

Speech by Ms Sarah Bloom Raskin, Member of the Board of Governors of the Federal Reserve System, at the Federal Reserve Bank of New York Community Bankers Conference, New York, 7 April 2011.

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Thank you for the opportunity to join you this morning. Let me begin by saying that it's a pleasure for me to be among community bankers. I used to be the banking commissioner in Maryland and will always be grateful to the community bankers there who were crucial to informing my views on effective bank regulation. At the height of the mortgage crisis, those same community bankers partnered with regulators like me to survey the wreckage and to stabilize our communities as best we could. Together, we confronted and weathered that searing experience and learned many lessons along the way. I'm here today to share with you some of those lessons.

Although decisive action by policymakers has been successful in containing the crisis, we should not presume that the experience of the crisis is over. To be sure, the frantic days of rushed mergers of major financial institutions; emergency applications of nonbanks to become bank holding companies; and large-scale, targeted Federal Reserve programs to stabilize markets and restore the flow of credit are behind us. If we were doctors, we'd say that we had successfully treated the worst symptoms of the illness.

But as we've learned from the other crises that are buffeting our world today, both natural and man-made, rescue and containment are only the first steps. Now we must address the aftershocks of the subprime mortgage meltdown: dislocation, joblessness, and loss of confidence.

From a regulatory and supervisory perspective, we will certainly be dealing with the long-term consequences of the crisis for years to come. And, as we head toward an increasingly healthy, but still highly complex and concentrated, post-crisis financial system, we must strive to find the appropriate balance of responsibility between banks and supervisors. I'm hoping to open the dialogue about that today.

A significant backdrop to the post-crisis financial architecture is the expansive federal legislation that is known as the Dodd-Frank Wall Street Reform and Consumer Protection Act (Dodd-Frank). Broadly speaking, Dodd-Frank gives us a roadmap for updating the regulatory framework of our financial system post-crisis, but it does not give us turn-by-turn directions for how to incorporate the new requirements into our supervisory processes. To that end, the Federal Reserve and other federal regulators are devoting considerable time to implementing the requirements of the Dodd-Frank Act. Translating all of the new legislative requirements into rules and regulations, and then into an effective supervisory and examination program, is a massive undertaking, but it is essential to moving beyond the stabilization phase of crisis recovery and into that phase where we address the underlying fault lines in our financial institution landscape.

As we work through Dodd-Frank implementation, we will need to ask: What constitutes effective supervision in the post-crisis world? I expect that the answer will be the subject of debate for months and possibly years.

The process of identifying the factors most important to constructing an effective supervisory and examination program has already begun. For America's community banks, the vast majority of which did not contribute to the subprime crisis, the contours of this program will be of critical importance.

As we have learned all too well, a financial system dominated by a handful of large institutions is unlikely to be resilient in the face of a crisis. My view is that a diffuse financial system – one with a diverse range of institutions of varying size and complexity – is preferable to a system that is highly concentrated.

In fact, the need for diversification is one of the great lessons of the crisis. Indeed, we found that, irrespective of size, those banks most likely to weather the crisis were those with diverse loan portfolios, management information systems capable of monitoring concentrations, reasonably diversified funding sources and liquidity management processes, and forward-looking analyses that considered how loan portfolios might perform and affect bank conditions under periods of stress. We need many, many more banks with these characteristics because these are the banks that absorbed the shocks of the crisis, remained relatively healthy, and, most significantly, now have the potential to thrive as robust sources of credit in their communities after the crisis.

As I see it, we need to create within the Dodd-Frank regulatory architecture a supervisory and examination program that encourages diversification and forward-looking strategies as a means to ensuring a healthy financial system and a steady flow of loans to creditworthy borrowers.

Am I saying that it is the responsibility of examiners, in essence, to guarantee that the banking system becomes more resilient and incapable of failure? No. A regulatory system that guarantees against bank failures is not in my mind desirable, even if such a system could be established in a cost-effective manner.

To illustrate, I'll borrow a concept from the field of statistics. When drawing conclusions based on test results, statisticians and scientists often factor in the possibility of erroneous results, or "false negatives" and "false positives." Some economists have extended this concept to assessing the effectiveness of regulation.

Imagine that you visit your doctor for an annual checkup and have your cholesterol level tested. When the results come back from the lab, they show that all is well. But what if your cholesterol actually was high and an error in the test resulted in a clean bill of health? That would be a false negative, and I'm sure you can see the problems it would pose. You might not change your diet and exercise habits, and your doctor probably wouldn't refer you for further testing or give you that firm lecture that they like to give about the importance of taking better care of yourself. Instead, your rising cholesterol levels would go undetected and untreated until your next checkup, or even worse, until you suffer a heart attack.

In the context of bank supervision, a false negative occurs when an examiner does not identify and address a deteriorating or failing bank in a timely manner. History has shown that the costs of these false negatives can balloon during times of broad economic and financial stress, which results in a significant drag on the economy and weakens banks' ability to lend. There were clearly too many of these false negatives in the recent crisis, particularly among the largest financial firms, both here and abroad.

In addition to the billions of dollars of direct costs to the Deposit Insurance Fund as a result of bank failures, the deep recession of 2007 to 2009 most likely would have been mitigated had the risk of exposure to real estate at many banks been recognized earlier. Many of the reform efforts that regulators and the Congress have undertaken – reforms that are clearly needed – are aimed at improving regulators' ability to identify and address troubled institutions earlier, and to limit the impact of failures when they do happen.

Now, returning to the medical analogy, imagine that your test results show that your cholesterol level is worryingly high, only in this case you are actually the picture of health. This is a false positive, and it poses problems of its own. While there may be some ancillary benefits to improving your diet and exercise habits, the inaccurate test result likely would cause you undue angst and, in an abundance of caution, subject you to a series of expensive, and ultimately unnecessary, follow-up measures.

A false positive in banking supervision occurs when examiners inaccurately identify a sound bank as having significant problems. When this happens, we may then take the step of accelerating onsite examinations even though the bank remains in satisfactory condition. To be clear, we err on the side of accepting some false positives because, as we saw during the crisis, the costs of missing too many problems are so high. Having said that, we recognize that false positives are not free: They impose a real cost on examiners in the form of resource use and also on banks in terms of imposing the burden of an onsite review.

In one way, effective supervision is striking a balance between false negatives and false positives, recognizing the costs of each. As we look forward, I think policymakers will need to find a similar balance between the responsibilities of examiners and the responsibilities of banks to ensure compliance with laws and regulations and to maintain a safe and sound banking system. Make no mistake, the crisis made clear that more effective regulations and more consequential examiner reviews of banks are needed. But, at the same time, banks have a fundamental – arguably *the* fundamental – role to play in improving financial system resilience.

So, how do the responsibilities of banks and examiners meet to maximize safety and soundness? When I imagine the model of a healthy bank – no matter its size or complexity – I picture a series of concentric circles. The inner circles are composed of the systems and functions that keep the bank healthy and allow it to meet the credit needs of its community while remaining financially sound and compliant with its legal and regulatory obligations. Inner circle systems and functions help the bank identify, monitor, and remedy the various problems that arise in its ordinary course of business. These would include, among other things, internal audit, executive management committees, governance by a board of directors, policies and procedures, and critical reporting relationships.

The outer circle, then, is effective supervision. This layering of circles implies that there are multiple internal and external checks on behavior that make timely identification and resolution of problems more likely.

We could probably spend the day arguing about the proper order of the outward progression of these circles, but I think we can all agree that at the core of a healthy bank is an effective corporate governance structure. A bank's board of directors should understand the bank's exposure to risk, and its members should be willing and able to critically question senior management about important matters affecting those risks. In my experience, specific technical financial expertise – which may be somewhat more difficult to find in smaller communities – is not nearly as important in this regard as board members' ability to exercise sound and effective judgment regarding different risks confronting the bank and to take seriously their responsibility for the long-term interests of the bank. The board of directors, along with a strong senior management team, can contribute substantially to the safe and sound operation of the bank by setting the "tone at the top" regarding activities and behaviors that are either encouraged or frowned upon.

Well-informed managers and staff constitute another inner circle. Customer-facing employees who know their business and know their customer base can play a critical role in catching problems at inception. And institutional knowledge of this kind is an area of relative strength for community banks.

Successful business lines are profitable because they are run by those who understand and can manage risk. Risk is best understood, I believe, by those who are engaged in the day-to-day business of the bank. A bank in which every employee understands his or her responsibility for managing risk is likely to be more sound than a bank in which risk management is always seen as someone else's responsibility.

While risk management starts at the business-line level, a well-run bank also has in place an effective program for enterprise-wide risk management that is supported by strong internal controls. I know that many smaller community banks may not have the resources to establish a separate risk management function, but that is not necessarily a problem if senior

management and other key personnel establish a system of internal, independent checks and balances to ensure that risks are regularly identified, controlled or otherwise managed, and monitored. These systems include not only core functions such as credit administration, effective reporting of information to senior management and the board, and policies and procedures that are documented and implemented, but also processes that try to look ahead to potential risks on the horizon.

Another of the inner circles is a strong internal audit function that reviews the bank's operations, risk management, and internal controls. In particular, an effective internal audit function will: identify processes to be audited based on risk exposure, establish a schedule and frequency for performing internal audits, ensure that there is accountability for fixing problems identified in the audit, and escalate significant unresolved issues to the board of directors or its audit committee.

This concentric circle model illustrates my belief that problem identification is first and foremost the responsibility of the bank. A safe and sound banking system starts with banks that take seriously the importance of sound governance, business judgment, risk management, internal controls, and compliance. Banking supervision provides another level of protection, but it was never intended to be a substitute for a bank's own risk management processes, nor should it be.<sup>1</sup>

And this brings us to the outer circle: banking supervision. First and foremost, examiners need to understand and work within the scope of their role. For example, examiners should not substitute their judgment for that of bank management. A bank's board and senior management are responsible for running the bank, and it is not appropriate for examiners to be overly engaged in the routine business of a healthy bank. There will of course be times when examiners are justified in questioning decisions or requiring action when a bank may be operating in an unsafe and unsound manner or is not in compliance with law.

In that regard, we have heard from some community bankers that pressure from examiners may affect a bank's willingness to lend to creditworthy small businesses and consumers. We have worked hard to ensure that our examiners are well-trained and employ a balanced approach to reviewing banks' credit policies and practices. We will continue to monitor this closely.

I would also suggest that examiners are regulators and as such should not view banks as their customers or clients. There are times when the interests of banks and regulators are aligned, and there are many instances where our objectives diverge. This doesn't mean that examiners and banks will inevitably have a contentious relationship. Indeed, I think many banks, particularly those that are well run, would characterize their relationship with examiners as professional and constructive, and would agree that examination findings are not arbitrary and in fact help them to improve their internal systems. That is as it should be. A regulator's relationship with a supervised bank must not get in the way of his or her willingness and ability to make tough calls.

At the end of the day, some regulatory failures may be inevitable. Examiners are smart, well-trained, diligent, and conscientious. They are committed to public service and take their responsibilities seriously. But even the best examiners are no more prescient than the managers of the banks they oversee and cannot be expected to head off every problem or detect every risk. The risk management systems and functions that comprise those inner concentric circles must be the primary mechanisms for heading off problems and detecting risks before they grow.

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<sup>1</sup> Although not discussed here because I would like to focus my brief remarks on the balance of responsibilities between banks and supervisors, market discipline – when appropriate transparency exists – can also play an important role in creating incentives for banks to identify and mitigate risks.

Unfortunately, there is no panacea to eliminating risk: Even the combination of appropriately designed risk management tools and thorough supervision can not completely eliminate the risk of low-probability, high-impact events.

While I realize this sounds somewhat pessimistic, in fact I am quite optimistic about examiners' ability to play a strong and effective role in a healthy banking system. In that regard, let me return to the concentric circle model and describe what we should expect from bank supervisors in the outermost circle.

One of the most important functions of supervisors in a healthy banking system is to set high standards through the establishment of policies and through the design of a strong supervisory program. Of course we should be vigilant about avoiding policies and practices that add little value and impose great burdens on banks, and I can assure you that we take that responsibility seriously, especially as it regards community banks. But we also should set the bar high when it comes to our expectations for acceptable bank risk management and business practices. We should be – and I believe we are – tough but fair.

In addition to setting high expectations, examiners should strive for balance and consistency throughout the business cycle – that is, we should be careful not to be too hands-off when times are good and not to overreact when times are bad. If you're driving a car on a curving mountain road, accelerating too fast on the straight stretches leaves you with three choices when the road bends: either you slam on the brakes, end up in a ditch on the side of the road, or get lucky and make it through. It's far safer to maintain a relatively steady speed, accelerating and decelerating gently as necessary, than to swing between extremes. So it is with examination. If examiners do not evaluate banks' practices with sufficient rigor during the boom years, then it may be necessary to take a more draconian approach during the bust years, when problems are revealed.

It has emerged that a number of regulators and examiners became concerned about concentrations in commercial real estate lending several years before the financial crisis. Despite the red flags raised by this lending, it was difficult for examiners to challenge bank management at a time when these loans were performing well and banks were generating record profits. There was also strong pushback from the industry when the banking regulators began raising alarms about the potential risks of excessive concentrations. Regulators finally issued guidance on concentrations in commercial real estate in late 2006, but in retrospect I think it is fair to wonder whether action should have been taken sooner.

That brings me to my next point, which is that examiners have a key role to play in reviewing and assessing the quality of a bank's internal controls, compliance, internal audit, et cetera. A central element of the Federal Reserve's supervisory programs is assessing the effectiveness of these processes and functions. We should understand where a bank's primary risks arise and use enforcement tools as necessary to ensure that management is sufficiently focused on these risks. Examiners should clearly communicate their findings to banks and maintain a regular dialogue about their risks and their risk management processes. When examiners find weaknesses in any of these areas, we expect that banks will address them in a timely manner.

One thing I would note here is that if done properly, effective examination requires looking behind the numbers. The crisis made clear that a bank that appears to be in sound financial condition may actually have a ticking time bomb on its books. As I said before, it can be difficult for an examiner to tell a profitable bank with strong financial indicators that there are management weaknesses. But that is exactly what we should empower our examiners to do because we know that the seeds of financial crisis are planted during the good times. When conducting an examination, an examiner should be attuned to weaknesses in governance, risk management, and internal controls that may not pose a current problem but that may expose the bank to losses in the future. And ultimately, as you know, it is easier to fix a problem during the good times.

Finally, one of the key roles that examiners play in a healthy financial system is to provide context and perspective. This is natural given the number of banking organizations that we examine and inspect, and I believe the Federal Reserve's renewed financial stability mandate under the Dodd-Frank Act will enhance our ability to assess not just individual banks, but also the system as a whole. Examiners have a longstanding practice of assessing a bank's performance and practices relative to its peers. This should not be a purely mechanical exercise where the examiner demands that a bank meet or exceed financial indicators for its peer group. Instead, we should use these assessments to understand a bank's performance relative to peers in the context of its own unique facts and circumstances.

The expectations that I have described for both banks and examiners are not just hypothetical. You may have *heard* much more about the banks that faltered under intense credit and liquidity pressures, but the Federal Reserve has also been focused on the performance of those community banks that have remained in sound condition throughout the crisis. Many of the community banks supervised by the Federal Reserve that entered the crisis with a supervisory rating of "1" or "2" – the highest ratings on the 1-to-5 scale used by bank supervisors – have managed to keep these ratings. Most of these banks entered the crisis with moderate exposures to commercial real estate, and continued to report strong earnings and net interest margins throughout the crisis. They reported very limited reliance on noncore funding and strong capital levels as they entered the crisis. They earned solid, though not spectacular, returns and they reported steady performance. And, while this is less quantifiable, many of these banks have effective boards of directors and strong and experienced management teams. It is important that examiners keep this in mind as they evaluate and refine their supervisory processes in the wake of the crisis.

## **Conclusion**

I certainly don't claim to have all the answers when it comes to delineating the appropriate roles and responsibilities between management and examiners in a healthy bank, but I hope my remarks today will at least start a conversation about how best to structure a regulatory and supervisory framework for the banking system that effectively supports the real economy and encourages sound and sustained lending to creditworthy borrowers. We know that those community banks that weathered the storm during the crisis are already doing this in their own communities and we can learn from their experience. In order to sustain the economic recovery, we need strong, well-run community banks that operate in a framework of smart and effective supervision. I commend you for the work that you are doing every day in your communities, and I look forward to continuing the dialogue on our respective priorities and concerns.