Sarah Dahlgren: More resilient, better managed, less complex – strengthening FMUs and linkages in the system

Remarks by Ms Sarah Dahlgren, Executive Vice President of the Financial Institution Supervision Group of the Federal Reserve Bank of New York, at the Securities Industry and Financial Markets Association Conference, Boca Raton, Florida, 29 April 2014.

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Good morning and thank you for inviting me to your Annual Operations Conference. This event brings together an important cross-section of market participants – and looking at the attendance, I think there is good representation of nearly every important part of the financial system in the audience. Today, I am going to talk about the progress that the industry has made to address weaknesses identified through the financial crisis and to build resilience to future shocks. I will also offer some observations on areas of remaining challenges, particularly as we focus on the interconnections between and among various market participants. As always, my remarks today reflect my own views and not necessarily those of the Federal Reserve System.

It's hard to believe that it's been over five years since the onset of the worst part of the financial crisis – and I'm not sure whether it feels longer or shorter than that! But one thing I'm certain of is that a lot has changed in those five years, including fundamental changes in rules and regulations, as well as substantive changes in how firms and the system are structured and operate. All of these changes have been designed to achieve a stronger, and more stable, financial system. I think it's fair to say that the financial crisis made it very clear to all of us that stability was about more than just banks. It is also about the safety and soundness of a variety of interconnected – and oftentimes large – financial firms, regardless of charter or organizational type. Post-crisis, we have a much keener appreciation of how financial stability is dependent on both strong financial institutions and on the soundness of the connections and linkages between and across firms, whether those connections are other firms, financial utilities, or even the phone company.

Recognizing these connections, the Dodd-Frank Act expanded the Federal Reserve's authority for supervision. We now supervise a broader range of financial institutions than we did pre-crisis, like insurance companies, savings and loan holding companies and some market utilities. In the remainder of my remarks, I will discuss both the progress made and the remaining challenges for the firms we supervise in the context of three key overarching principles of our supervisory framework:

- First, resiliency. Financial institutions must be resilient to shocks. Significant efforts have been undertaken internationally and domestically to reduce the likelihood that a large, global bank ever reaches the point where it is at risk of failure. Resiliency is also critical for financial market utilities. Those organizations must have failsafes in place to ensure the smooth functioning of the critical operations they provide.
- Second, management. Financial institutions must be well-managed. Governance structures need to be in place to establish the appropriate decision-making processes, behaviors and incentives within these organizations.
- And, third, complexity. Financial institutions must become less complex. This objective speaks to the need to reduce the level of interconnectedness among large financial firms and to ensure that there are credible mechanisms for resolving even the largest firms without causing systemic disruption across the financial system.

Resiliency

Much has been said about the U.S. and international set of regulatory reforms aimed at making global banking organizations more resilient – particularly in the areas of capital and liquidity. The importance of robust capital requirements for financial stability and the serious shortcomings of the pre-crisis regulatory capital regime have been well documented. A lot of work has been done on the capital front through a range of both domestic and international efforts. These efforts have addressed – in most cases – both the quantitative and qualitative elements of capital, and have also addressed the important management processes around capital.

The Basel standards – and resulting U.S. regulation – address both the quantity and quality of capital and raise the bar on both elements for large firms. As well, the new capital rules will also require a capital buffer that increases with a firm's size, complexity, interconnectedness and global footprint. Implementation of these new standards should significantly increase the safety and soundness of the financial system. And, to date, many of the largest firms have considerably improved their capital levels and capital planning processes.

Simply addressing the quantity of capital and the quality of the planning processes isn't enough, though. And without elaborating too much on something I'm sure you are quite familiar with, the reasons include:

- Capital ratios and numerical targets are snapshots in time – and often a lagging indicator of financial condition.
- These snapshots don't incorporate the future – they don't anticipate what might happen in different economic times or in different market conditions.
- Capital ratios don't incorporate the impact on a firm's ability to generate revenues during stress periods – and thus don't indicate a firm's ability to rebuild capital as necessary.
- So, clearly, stronger capital standards need to be combined with a better ability to anticipate the future – to incorporate a more forward-looking element into assessing the financial strength of a firm.

Thus, supervisory and risk management tools need to expand to include stress testing – and from this came the supervisory stress test and resulting Federal Reserve Capital Rule and the requirements in Dodd-Frank for stress testing.

I think it's fair to say that the new capital rules will and should change how firms think about risk within their organizations. Whether it's the increases in risk weights of certain types of exposures, or the overall imposition of leverage constraints, the new capital rules are designed to build a more resilient financial system that is better prepared to handle and weather the next crisis.

The capital requirements for large banks are supplemented by a liquidity framework. Thinking back to the financial crisis it's fairly clear from the experiences of most firms during that period of time that liquidity was essential in survival. Those firms that didn't have sufficient liquidity suffered greatly. Here, too, the Basel Committee has played an important role in developing and implementing an internationally-agreed-to-framework for enhancing liquidity across large international firms. The new framework currently includes a short-term requirement – the Liquidity Coverage Ratio (LCR) and discussions are underway to include a longer-term requirement – the Net Stable Funding Ratio (NSFR).

While capital and liquidity rules for large financial institutions are in the process of being implemented – and significant progress has already been made in bolstering levels of both capital and liquidity in banking organizations – there are still areas within the financial system where additional focus on building resilience continues to evolve. In particular, enhanced risk management standards for financial market utilities have been adopted by international

standard setters and, in the U.S., the agencies have recently proposed new rules to adopt these standards for U.S. firms.

Among these new standards are expectations that financial market utilities, including those that act as central counterparties (CCPs), be more resilient to shocks – with a particular focus on enhancing liquidity and liquidity risk management. While CCPs reduce aggregate risk, they also concentrate the remaining risk. That is, CCPs create potential single points of failure in global derivatives markets. Thus, CCPs need adequate capacity to absorb potential losses from the default of one or more of its members, and they need to have access to liquidity so that they can always fully settle their obligations.

The new risk management standards include requirements that CCPs have pre-funded default arrangements, that CCPs measure and collect initial and variation margin even in extreme stress scenarios, and that CCPs be able to withstand, again in a plausible stress scenario, the failure of a member having the largest exposure to the CCP. In some cases, this last element is enhanced to require the ability to withstand the failure of the two largest members.

As these standards are fairly new for the global population of financial market utilities and in many jurisdictions the standards have yet to be issued in new rules and regulations, progress across the industry in meeting these standards is mixed.

- In some cases, liquidity risk management frameworks are underdeveloped, with needed additional focus on measurement and monitoring to make the frameworks more robust.
- Additional work is also needed on the concept of liquidity buffers, with some firms continuing to rely too much on uncommitted sources of liquidity.
- And stress testing and scenario planning remain areas of continued focus, with challenges in designing scenarios that are sufficiently extreme.

Beyond liquidity, additional work is needed in the area of capital planning. While this is not an area that financial market utilities have spent considerable time and resources on in the past, it is an area we will continue to focus on in our reviews and expect continued development and improvement over the coming year.

As the industry continues to build resilience to future shocks, by enhancing the management of and the amount of capital and liquidity, as two important elements of resilience, the financial system will continue to grow stronger. It's essential, though, that all parts of the financial system – banks, non-bank financial firms, market utilities – achieve enhanced resilience. Simply having one part of the system robust to future shocks, with other parts – connected and linked within the system – less robust, leaves the system vulnerable to future shocks and instability.

Management

I'd like to turn now to the second element of our supervisory framework: management. In addition to our focus on resiliency as an essential element in strengthening the financial system, we see enhanced risk management and corporate governance as a complement to resiliency and necessary to achieve stronger firms and a stronger system. As I know you are well aware, there has been renewed attention on the importance of effective corporate governance across the industry. The debate includes examining the merits of familiar structures and practices of corporate governance and increasingly has focused on the corporate cultures of financial institutions.

In this regard, I'd offer that the themes we see across the industry are fairly common. That is, both recognition of the issues and progress in addressing outstanding challenges are resident in all types of institutions, whether banks, non-banks or market utilities. To start, I'll

touch on two elements in particular: risk culture and roles and responsibilities of boards of directors.

In November of last year, the Financial Stability Board (FSB) released a framework for assessing risk culture at financial firms. The FSB's consultative document is set out as guidance for supervisory interaction with firms on risk culture. It effectively outlines the basic elements – the "must haves" or conditions necessary – for a firm to have a strong culture. It provides guidance for supervisors (and, in turn, for firms) in identifying practices and behaviors that can be indicators of a firm's risk culture. And, for each area, the paper provides a set of indicators that can be used to assess where the firm is on the spectrum.

To highlight those areas:

- Not surprisingly, "tone from the top" is the first indicator.
- Accountability – that is, ownership of risk, effective escalation, and consequences.
- Effective challenge – including transparency and open dialogue across and between the board and senior management and senior management and staff.
- And, finally, incentives – both compensation and talent development/promotion processes.

Supervision in this area involves an assessment of the effectiveness of a financial institution's governance, including the extent to which the board and senior management demonstrate effective behaviors that contribute to good governance. This includes consideration of the behavioral dynamics of the board and senior management, such as how the "tone at the top" and the cultural values of a bank are communicated and put into practice, how information flows to and from the board and senior management, and how potentially serious problems are identified and addressed throughout the organization.

I think the FSB's document sets out a good set of reference points for supervisors – and for firms – to explore in evaluating risk culture. As has been noted by others – and is emphasized in the FSB's guidance – assessing culture is not a single point in time event. It should be a regular and ongoing exercise that management teams, boards of directors and supervisors conduct, taking the range of feedback from interactions and work conducted inside the firm, interactions and reactions from the firm's senior management team, and interactions and dialogue with the board of directors.

Alongside risk culture, much work has been done on the roles and responsibilities of boards of directors. The G30 has issued two reports in the last two years. The first report, issued in 2012, set out fresh ways to describe and develop more effective governance at financial institutions. The second report, issued late in 2013, deals specifically with the interactions of boards of directors and supervisors. Both reports place less emphasis on the form of corporate governance – the traditional structures of boards and the like – and focus more on the actual behaviors of the various players involved, be it the chairman, the lead director, the chief risk officer, auditors or senior management.

The 2013 report proposes a new kind of relationship, one that involves far more direct contact and ongoing dialogue between directors and supervisors about the key issues confronting firms and the financial system, such as assessing financial institution strategies, business models, risk vulnerabilities, governance effectiveness and corporate culture.

The Federal Reserve has growing experience in this area. Nearly three years ago, the New York Fed initiated a program of "enhanced engagement" with directors and senior management at the major firms we supervise, very much along the lines now described in the G30 report. We provided additional training for our senior supervisory officers concerning corporate governance and relationship-building with boards, key directors and senior managers. We also gave direction on how to focus their interactions on the most important supervisory matters, particularly with respect to the firm's risk profile and risk management

practices. We also reached out to board chairmen and chief executive officers to enlist their cooperation and support.

This has required everyone involved to step up to the plate in a new way. For our senior supervisors, it has meant taking a higher-level and more encompassing view of the potential problems that a firm might encounter and, when necessary, delivering clearer and more timely supervisory messages and guidance to the firm. For directors and senior managers, it has meant a shift toward greater openness and increased candor with supervisors about the condition of the firm, its business strategies and risks, and the issues that they are most concerned about. It has also required devoting more time and attention to their relationship with supervisors.

After three years, I can report steady progress from both sides at reaching the "new paradigm" discussed in the G30 Report – but there's still more to do. As I said a moment ago, much of the focus of the recent G30 reports has been on behaviors and firm cultures. It is right that these topics should be on the top of all our agendas. Five years after the crisis, headlines about bad actors and corrosive corporate environments continue to be all too common.

So, my first observation about progress is just that – the topics of culture and behavior are "top of mind" for many senior management teams and boards of directors. It's an important step to acknowledge that we have an issue. My second observation is that this is a difficult topic, one that generates very heated discussions, but one that is necessary as the industry tries to tackle the complex issue of what can be done to restore public faith in the financial industry. This begins with questions like:

- What is the source of the problem?
- Are the problems we are experiencing unique to financial services?
- What incentives and disincentives – compensation, fines, prosecutions and other measures – need to be altered for behaviors to really change?

This is a topic that we will surely revisit a number of times over the coming months as both the industry and the supervisory community begin to answer some of the tougher questions.

Complexity

Let me now turn to the third element of the supervisory framework: reducing complexity. In large measure, this translates into sound recovery and resolution planning. The development and implementation of a credible resolution mechanism for large, global banks is a must. By credible, I mean that if a failure of one of these financial institutions arises, then home authorities will proceed with the resolution plan, rather than intervene to prevent a failure. Although the specifics of the resolution mechanisms will necessarily vary to some extent across jurisdictions, the goal is common: to be able to resolve any large, global firm regardless of its home jurisdiction without taxpayer funds and in a way that minimizes the knock-on effect to financial markets and other financial institutions.

In the area of recovery and resolution, I'd again offer that some good progress has been made by many of the banking organizations, although the remaining challenges are quite daunting. And, for the most part, this area is a new one for the other parts of the financial system, such as financial market utilities (FMUs), so the thinking is still evolving.

Firms have made good progress in better understanding the complexity of their own operations, including strengthening the overall management of organizational/legal structures, identifying all legal entities (and this was huge for some firms), and beginning the difficult task of identifying additional impediments to resolving a large internationally active firm. In some cases, firms have already begun the daunting task of simplifying their organizational and legal entity structures – with an eye to being less complicated and easier to understand – and resolve – should the need arise.

Although there has been progress, there is still quite a bit of work to do. Earlier this year, the Federal Reserve issued guidance for the largest firms that outlined five "capabilities" that should be at the top of the list of "to dos":

- Collateral management: firms should have effective processes for managing, identifying and valuing collateral it receives;
- Effective management information systems (MIS) around payment, clearing and settlement activities: firms should have a comprehensive understanding of obligations and exposures associated with payment, clearing and settlement activities;
- Stronger analytics around funding: firms should have the ability to analyze funding sources, uses and risks of each material entity and critical operation, including under stress;
- MIS by legal entity: firms should have demonstrated MIS capabilities for producing key data on a legal entity basis; and,
- Arrangements for shared or outsourced services: firms should have robust arrangements in place for the continued provision of shared or outsourced services needed to maintain critical operations.

While there are many other areas that supervisors/regulators and legislators need to continue to work on to make cross-border resolution a reality, these five areas are ones that we have highlighted for near-term focus by firms.

Another important element to preventing the failure of a firm is ensuring that firms can respond to any weakness by having recovery plans that are implemented well before resolution becomes necessary. Such recovery plans should:

- Identify actionable options that the firm can take in response to financial weakness that will restore the confidence of the firm's counterparties in the firm without the need for extraordinary official sector support;
- Incorporate processes that analyze the root causes of their problems and identify longer-term strategies that will need to be employed as other recovery options to restore capital and liquidity are being executed; and,
- Be regularly tested and updated to ensure they remain reasonable.

For some types of firms – like financial market utilities, recovery planning is actually an even more important issue. Because FMUs provide critical services to the industry, experiencing a major disruption that could lead to resolution – or dissolution – is unacceptable. It is important, then, that a CCP be structured in a way, and develop and have tools available, to enable it to recover from losses and continue operations under extreme scenarios. Simply put, the debate on 'less complex' for financial market utilities is much more about recovery than it is about resolution. Steadfast resiliency may include casting a more critical eye on the resources needed for a single CCP to withstand a plausible, severe shock.

Conclusion

While there is still work that needs to be done to make financial institutions more resilient, better managed and less complex, we have also made a great deal of progress. I'd like to close my remarks by highlighting some of the practical steps we are taking on the supervisory side to continue that progress.

- First, through collaboration and communication with other supervisors, both domestic and foreign, we are continuing to work across global firms to address issues together and break down barriers to sharing information and coordinating better among supervisors. I'd say this is still a work in progress.

- Second, we need to continue to communicate our relevant supervisory findings in a timely manner and our communication needs to be candid and direct. Still too often I find that we don’t say what we mean the first time – and this leads to confusion and, at times, bad outcomes.
- Lastly, we need to be more proactive in establishing an open dialogue with the directors of the financial institutions we supervise. We look to the directors to flag for us the key risks that keep them up at night. And, it is our obligation to explain the intuition behind our supervisory concerns and the rationale for needed change.

Thank you for your attention today. I would be happy to answer a few questions.