William C Dudley: Supervising large, complex financial institutions – defining objectives and measuring effectiveness

Opening remarks by Mr William C Dudley, President and Chief Executive Officer of the Federal Reserve Bank of New York, at the Conference on "Supervising Large, Complex Financial Institutions: Defining Objectives and Measuring Effectiveness", Federal Reserve Bank of New York, New York City, 18 March 2016.

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Welcome. It is great to see all of you here today to discuss the objectives and measurement of supervision for large, complex financial institutions.

Nearly eight years have passed since the financial crisis hit, pushing the financial system and the U.S. economy to the brink, and leaving scars that are still evident today. The hardships of the financial crisis are unfortunately still open wounds for too many people, especially those who lost their jobs, homes or businesses, or those who struggled with the sharp fall in value of their homes and with staying current on their debts and bills. Understanding what went wrong and how to avoid severe financial crises in the future is, I am sure, an issue foremost in the minds of all the distinguished speakers here today, and I am no exception. Before continuing, let me indicate that what I have to say today reflects my own views and not necessarily those of the Federal Open Market Committee or the Federal Reserve System.[1]

A central part of the financial crisis was the failure or near-failure of many large financial institutions – both institutions that were supervised by the Federal Reserve and many that were not – which constrained their ability to play their crucial role in supplying credit and financial services to businesses and consumers. In the wake of the crisis, considerable attention has been devoted to the role that supervisors – including those here at the New York Fed – played in this meltdown. But much of this discussion has taken place without a broad understanding of what supervisors actually do – the scope, breadth, and limits of their activities and authorities. Within the official sector, we make a distinction between *regulation* – the rules governing what financial institutions must and must not do, and *supervision* – which involves monitoring, oversight and enforcing compliance with law, regulation and supervisory expectations for firms' governance, internal processes and controls, and financial condition. This distinction between regulation and supervision is often not well-understood, and thus their complementary roles are not always fully appreciated.

Addressing this distinction, as we see it, is one important motivation for this conference. Through the papers presented today and the discussions by noted academic researchers, policymakers and senior supervisors from the U.S. and overseas, we hope to broaden the understanding of the role and objectives of supervision. The goal is to spur conversation and new research on what supervision should be trying to achieve and the best means for achieving those ends. Just as important, we want to generate ideas for how to better assess the effectiveness of supervisory activities. In a world of limited resources, how do we deploy our people and technology in the most effective way to limit disruption and distress at individual firms and to the financial system, while still fostering an efficient and innovative financial system?

In considering these questions, a good starting point is to understand more fully what supervisors do and how they do it in the current environment. The papers that are being presented here today are largely aimed at achieving this goal. As described in the first paper – "Supervising Large, Complex Financial Institutions: What do Supervisors Do?" – bank supervision has long been an integral component of the Federal Reserve's

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1 Beverly Hirtle, David Lucca and Joseph Tracy assisted in preparing these remarks.

responsibilities. At a broad level, Federal Reserve supervision of large financial institutions is guided by two key objectives: "enhancing the resiliency of a firm to lower the probability of its failure or inability to serve as a financial intermediary [and] reducing the impact on the financial system and the broader economy in the event of a firm's failure or material weakness."[2] In addressing these objectives, bank supervisors enforce laws and regulations, but there is much more to supervision than just enforcement. The activities and practices at large, complex financial organizations are simply too intricate and evolve too quickly to be fully described *ex ante* in regulation. Banking supervision works in concert with regulation as the more flexible element of banking policy. Supervisory policy and standards can, and do, evolve over time to reflect the evolution in practice in the banking industry and in financial markets.

Overall, supervisors are guided by the mandate to identify any practices or conditions at supervised firms that are a threat to the safety and soundness of those firms – and, of course, to ensure that the firms take all necessary steps to promptly remediate any such conditions. Critically, the definition of what constitutes "safe and sound" is not hard-coded into regulation, but is guided by the information and analysis done by supervisors and other Federal Reserve staff, such as economists, attorneys and market analysts. Supervisory expectations and standards are expressed through public guidance such as Supervision and Regulation Letters (SR Letters), publicly-posted examination manuals and other guidance.

On a day-to-day basis, banking supervisors collect information on financial institutions through examinations and analysis. Examiners look at key aspects of a supervised firm's businesses and risk management functions. They use this information to assess the adequacy of the firm's systems and processes for identifying, measuring, monitoring and controlling risks at the firm and in the financial sector more generally. That said, the ultimate responsibility for risk identification and risk management remains with the supervised institution. The Federal Reserve's role is to ensure that the institution has the necessary strong processes in place to achieve this objective. As risks emerge, supervisors intervene, within the realms of their safety and soundness mandates, to require that banks take corrective actions as necessary. Supervision can reduce the chance that a financial firm fails, but it can never provide a guarantee against failure.

Supervisory policies have undergone important changes over the past few years, especially in the context of the largest financial institutions. Banking supervision no longer focuses solely on the safety and soundness of individual institutions – so-called micro-prudential supervision – but now also focuses on the implications for financial stability more generally. The evolving supervisory framework has resulted in a number of organizational changes in the way supervision is conducted at the New York Fed and in the Federal Reserve System more broadly. A very important change in the Federal Reserve System is that supervision of the largest, most systemically important financial institutions are now coordinated across districts through the Large Institution Supervision Coordinating Committee (LISCC). The LISCC is a System-wide committee, chaired by the director of the Board of Governors of the Federal Reserve's Division of Banking Supervision and Regulation, and composed of senior officers at the Board and Reserve Banks.

In addition, the Federal Reserve has instituted three major horizontal evaluations, which are a key element of the new enhanced supervisory framework for large banking companies. These horizontal evaluations, which focus on capital adequacy, liquidity resiliency and preparedness for recovery and resolution, examine practices and conditions across a group of firms simultaneously, enabling supervisors to develop peer perspectives about best practices and approaches. These programs involve a consistent and systematic assessment

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2 Board of Governors of the Federal Reserve System. "Consolidated Supervision Framework for Large Financial Institutions." Supervision and Regulation Letter 12–17. December 17, 2012. http://www.federalreserve.gov/bankinforeg/srletters/sr1217.htm.

of the financial strength and operational resiliency of the largest and most complex financial institutions, addressing both micro-prudential safety-and-soundness supervisory goals and broader macro-prudential financial stability objectives.

Specifically, in the Comprehensive Capital Analysis and Review (CCAR), which applies to firms with at least $50 billion in total assets, Federal Reserve supervisors assess whether bank holding companies have sufficient capital to continue operations through times of economic and financial stress, and whether they have robust, forward-looking capital-planning processes that take into account whatever unique risks they might face. By including forward-looking elements, the CCAR complements the enhanced Basel capital requirements now being implemented in the United States. In addition, the Comprehensive Liquidity Analysis and Review (CLAR), which applies to LISCC firms, reviews the liquidity positions and liquidity risk management of large, complex banking organizations, including internal stress-testing practices. Finally, the Federal Reserve does an annual evaluation of the LISCC firms' options to support recovery and progress in removing impediments to orderly resolution in the Supervisory Assessment of Recovery and Resolution Preparedness (SRP).

While these evaluations form the core of the supervisory program for large, complex banking companies, they are far from the only important activities pursued by supervisors. Day-to-day oversight of individual firms is a critical complement to these cross-firm, horizontal evaluations. There are three key channels that generate insight on firms: 1) continuous monitoring through meetings with bank senior management, business line management, risk managers, auditors and others; 2) review and analysis of internal reports; and 3) independent analysis by supervisory teams. These insights guide supervisory assessments and supervisory actions for individual institutions, as well as contributing to the assessments made as part of CCAR, CLAR and other horizontal exercises.

We have come a long way since the financial crisis, and the financial sector today is much more resilient as a result of the evolving supervisory framework. However, more work still lies ahead. A key challenge in assessing the effectiveness of supervision is that much of what supervisors do, by necessity, is confidential. This reliance on confidential information and confidential actions can make supervision seem mysterious to outsiders, which complicates the evaluation of what policies may be effective or ineffective. For example, if a bank fails, is this evidence of poor supervision, or instead evidence that even good supervision can't prevent all bank failures? Improving our ability to do this diagnosis is critical. I am confident that today's panels and paper discussions will help us move forward in this direction.

Thank you for participating in this conference.