



BOARD OF GOVERNORS
OF THE
FEDERAL RESERVE SYSTEM
WASHINGTON, D. C. 20551

January 13, 2010

BEN S. BERNANKE
CHAIRMAN

The Honorable Christopher J. Dodd
Chairman
Committee on Banking, Housing,
and Urban Affairs
United States Senate
Washington, D.C. 20510

The Honorable Richard C. Shelby
Ranking Member
Committee on Banking, Housing,
and Urban Affairs
United States Senate
Washington, D.C. 20510

Dear Chairman Dodd and Ranking Member Shelby:

Strengthening our financial regulatory system in ways that take the appropriate lessons from the crisis is essential for the long-term economic stability of our country. To this end, as you know, the Banking Committee has compiled an extensive hearing record and has begun considering specific reform proposals.

A number of your colleagues on the Committee have recently asked for the Board's views on the importance of the Federal Reserve's continued role in bank supervision and regulation. In response to these requests, I am enclosing for you and your colleagues a document that discusses (1) how the expertise and information that the Federal Reserve develops in the making of monetary policy enable it to make a unique contribution to an effective regulatory regime, especially in the context of a more systemic approach to consolidated oversight; and (2) how active involvement in supervising the nation's banking system allows the Federal Reserve to better perform its critical functions as a central bank.

Please let me know if you have any questions or if I can be of assistance. I look forward to working with you in the days ahead as the Committee continues its consideration of regulatory reform proposals.

Sincerely,

A handwritten signature in black ink, appearing to be "B. Bernanke", written in a cursive style.

Enclosure

cc: Members, Committee on Banking, Housing, and Urban Affairs

January 13, 2010

The Public Policy Case for a Role for the Federal Reserve in Bank Supervision and Regulation

Like many other central banks around the world, the Federal Reserve participates with other agencies in supervising and regulating the banking system. The Federal Reserve's involvement in supervision and regulation confers two broad sets of benefits to the country.

First, the financial crisis has made clear that an effective framework for financial supervision and regulation must address both safety-and-soundness risks at individual institutions and macroprudential risks--that is, risks to the financial system as a whole. All individual financial institutions that are so large and interconnected that their failure could threaten the functioning of the financial system must be subject to strong consolidated supervision. Both effective consolidated supervision and addressing macroprudential risks require a deep expertise in the areas of macroeconomic forecasting, financial markets, and payments systems. As a result of its central banking responsibilities, the Federal Reserve possesses expertise in those areas that is unmatched in government and that would be difficult and costly for another agency to replicate.

Second, the Federal Reserve's participation in the oversight of the banking system significantly improves its ability to carry out its central banking functions. Most importantly, the Federal Reserve's ability to effectively address actual and potential financial crises depends critically on the information, expertise, and powers that it gains by virtue of being both a bank supervisor and a central bank. In addition, supervisory information and expertise significantly enhance the safety and soundness of the credit the Federal Reserve provides to depository institutions by allowing the Federal Reserve to independently evaluate the financial condition of institutions that want to borrow from the discount window as well as the quality and value of the collateral pledged by such institutions. Finally, its supervisory activities provide the Federal Reserve information about the current state of the economy and the financial system that, particularly during periods of financial crisis, is valuable in aiding the Federal Reserve to determine the appropriate stance of monetary policy. These benefits of the Federal Reserve's supervisory role proved particularly important during the financial crisis that emerged in 2007.

We recognize, of course, that bank supervision, including ours, needs to be more effective than in the past, and we have reviewed our performance and are making improvements at multiple levels. The Federal Reserve is working with other supervisors here and abroad to improve capital and liquidity regulation. In addition, we have begun to make changes to our oversight of large banking organizations, including the development of an enhanced quantitative surveillance program, improving data collection, strengthening financial infrastructure, and implementing a new, centralized approach to supervision that better supports identification and analysis of interconnected risks. These changes are intended to ensure that we fully employ our expertise to implement a more systemic and effective approach to our supervisory activities going forward.

The Benefits to Effective Supervision of the Federal Reserve's Unique Expertise

Two important lessons learned from the current financial crisis are that all financial firms that are so large and interconnected that their failure could threaten the functioning of the financial system must be subject to strong consolidated supervision; and that supervision of financial firms must take account of systemic, or "macroprudential" risks as well as the more traditional safety-and-soundness risks affecting individual firms.

Many of the large, complex, and interconnected financial firms whose collapse contributed importantly to the financial crisis avoided the more stringent consolidated supervision that is imposed on bank holding companies by the Federal Reserve. These firms--which included American International Group, Washington Mutual, Countrywide, Bear Stearns, and Lehman Brothers--were instead subject to consolidated supervision under statutory or regulatory schemes that were far less comprehensive than that applicable to bank holding companies. In addition, an unregulated shadow banking system (including, for example, unregulated mortgage brokers, structured investment vehicles, other asset-backed commercial paper conduits, and securities lenders) had emerged that generated mortgages for distribution, funded highly rated senior tranches of securitizations, and engaged in maturity transformation and other financial activities outside the view of any federal supervisor.

The system for regulating bank holding companies was, in important ways, inadequate as well. One issue of concern was that the Federal Reserve's consolidated supervision of such companies was, by statute, both narrowly focused on the safety and soundness of their bank subsidiaries and heavily reliant on functional supervisors of the bank and regulated nonbank subsidiaries of these companies; in turn, the functional supervisors themselves were statutorily focused only on the safety and soundness of the specific entities they regulated. None of the federal regulators had sufficient authority to focus on the systemic risk that large banking organizations posed.

While it is clear that the framework for financial supervision must address macroprudential risks, the Federal Reserve cannot and should not be responsible for oversight of the financial system as a whole; no agency has the breadth of expertise and information needed to survey the entire system. However, by virtue of the combination of experience and expertise it has developed as consolidated supervisor of bank holding companies and state member banks and as a central bank, the Federal Reserve is well suited to contribute significantly to an overall scheme of systemic regulation, particularly in the areas of consolidated supervision and macroprudential supervision.

It is especially important that consolidated supervision address *both* safety-and-soundness risks at individual institutions and macroprudential risks. Addressing safety-and-soundness risks requires the traditional skills of bank supervisors, including expertise in examinations and off-site surveillance of complex banking organizations. The Federal Reserve has acquired and maintained that expertise as the primary supervisor of banks of all sizes, including community

banks, regional banks, and large banks that are state-chartered member banks, as the consolidated supervisor of all U.S. bank holding companies, and as the supervisor of the U.S. operations of globally active foreign banks. With many nonbank financial firms having reorganized as bank holding companies during the crisis, the Federal Reserve already is quite familiar with the risk profiles of the vast majority of the large interconnected financial firms.

Beyond traditional bank examination expertise, however, macroprudential supervision will require economic sophistication, including knowledge of the macroeconomic environment, as well as substantial expertise regarding money markets, capital markets, foreign exchange markets, and other financial markets. Expertise in these areas is essential for developing stress scenarios and identifying and addressing vulnerabilities to, and posed by, capital and other markets. The Federal Reserve has developed this expertise in the context of macroeconomic forecasting and monetary policymaking. Market knowledge is acquired through daily participation in financial markets to implement monetary policy and to execute financial transactions on behalf of the U.S. Treasury and foreign governments and central banks.

Macroprudential supervision also requires extensive knowledge of payment and settlement systems to understand the interconnections between financial institutions and markets. The Federal Reserve has developed this expertise through its operation of some of the world's largest payment and settlement systems (the Fedwire funds and securities transfer systems), its supervision of key providers of payment and settlement systems (the Depository Trust Company, the CLS Bank, and the government securities clearing banks), and its long-standing leadership role in the international Committee on Payment and Settlement Systems.

The Supervisory Capital Assessment Program, or SCAP, also known as the stress test, was critical to restoring confidence in the banking system and was a watershed event for modern macroprudential supervision. The Federal Reserve, which took the lead on the SCAP, drew on its macroeconomic and markets expertise to model potential credit losses and revenues at the SCAP banks. These analyses were essential to assess the amount of capital the SCAP banks would need to absorb potential losses and continue to meet the needs of creditworthy borrowers in a more adverse economic scenario. In the future, macroprudential supervision should feature both increased use of cross-firm, horizontal exams to assess common exposures and vulnerabilities as well as forward-looking stress testing based on alternative projections for the macroeconomy.

The Benefits of the Federal Reserve's Supervisory Role for Its Other Central Banking Functions

The Federal Reserve's central banking functions significantly enhance its ability to conduct its supervisory role, and offer considerable benefits for macroprudential supervision going forward. In addition, the complementarity between narrow central banking activities and supervision creates advantages in the other direction. The Federal Reserve's involvement in supervising

banking institutions of a variety of sizes generates information and expertise that significantly improve the Federal Reserve's ability to effectively carry out its central-bank responsibilities and that cannot be obtained reliably through other means, such as relying on reports from other supervisors. Among the central-bank responsibilities that benefit from the Federal Reserve's supervisory role are crisis management, providing liquidity to depository institutions, and monetary policy. Especially since the start of the crisis in the summer of 2007, the information and expertise that the Federal Reserve has had as a result of its supervisory activities have been essential to its successful performance of these responsibilities.

Crisis Management

The Federal Reserve's supervisory authority has been of greatest importance to its management of financial crises. In particular, its ability to deal with diverse and hard-to-predict threats to financial stability depends critically on the information, expertise, and powers that it has by virtue of being both a bank supervisor and a central bank.¹

An example of how the Federal Reserve's supervisory role contributed to its management of a crisis came in the context of the October 19, 1987, stock market crash. During that chaotic period, banks began to pull back from lending to major securities firms. However, because of increased demand for financing from their customers and the differences in the timing of payments to and receipts from the exchanges' clearing and settlement systems, those securities firms needed access to substantial bank credit in order to make payments and settle trades. As a result, the availability of bank credit was critical to the functioning of equity and securities markets as well as futures and options exchanges. A freezing up of these critical markets would have caused a deeper and more disruptive financial crisis, likely involving further declines in asset values and, ultimately, tighter credit conditions for households and businesses. To combat those risks, the Federal Reserve announced its willingness "to serve as a source of liquidity to support the economic and financial system." Subsequently, Federal Reserve examiners on-site in major banking organizations assessed funding pressures and potential credit losses to help identify emerging problems. Armed with the resulting knowledge and with the benefit of existing supervisory relationships, senior Federal Reserve officials contacted the managements of the major banks and urged them to use liquidity from the discount window to provide loans to creditworthy securities firms. Bank credit was provided to securities firms as requested, allowing those firms in turn to make required payments to counterparties and clearing houses.

¹ In addition to the examples discussed here, the Federal Reserve has taken steps to address strains at financial institutions and in financial markets on a number of other occasions in recent decades, including following the bankruptcy of the Penn Central Railroad in 1970, the collapse of a speculative boom in the silver market in 1980, the failure of Continental Illinois in 1985, and the global financial strains that followed the Russian default and the collapse of Long-Term Capital Management in 1998. See Andrew F. Brimmer (1989), "Distinguished Lecture on Economics in Government: Central Banking and Systemic Risks in Capital Markets," *Journal of Economic Perspectives*, vol. 3 (Spring), pp. 3-16; and Ben S. Bernanke (2007), "Central Banking and Bank Supervision in the United States," speech delivered at the Allied Social Science Association Annual Meeting, Chicago, Ill., January 5, www.federalreserve.gov/newsevents/speech/bernanke20070105a.htm.

These actions allowed systemically critical stock, futures, and options exchanges to function normally, averting a more prolonged and deeper market crisis with its attendant adverse implications for the broader economy.

A similar example emerged in the case of the failure of Drexel Burnham Lambert in February 1990. Drexel's rapid collapse posed a risk of gridlock in the financial markets. Notably, because of their parent's failure, Drexel's solvent broker-dealer and government securities dealer subsidiaries experienced serious difficulties liquidating their positions. Because of its ongoing supervisory relationships with the banks that provided settlement services to Drexel's subsidiaries and its knowledge of the payment and settlement system's infrastructure, the Federal Reserve had the access, contacts, and in-depth knowledge that enabled it to obtain the information it needed to evaluate this complex problem and formulate a plan to address it. The Federal Reserve understood the potential problems of Drexel's counterparties and clearing banks and was able to work with the banks and securities firms to identify developing problems and fashion procedures that enabled an orderly winding down of Drexel without adverse effects on other market participants or further disruption to financial markets.

In the aftermath of the September 11, 2001, terrorist attacks, supervisory information and supervisory powers to compel the provision of information allowed the Federal Reserve to understand the damage incurred by, and estimate the recovery time for, a large banking institution that played a major role in key financial markets. Following the attacks, Federal Reserve examiners were sent to the institution's contingency site. This on-site supervisory presence proved crucial in helping to obtain necessary information and clarify conflicting information in a highly confused and uncertain situation. Similarly, on-site Federal Reserve examiners at other key institutions proved to be valuable sources of information about the difficulties those institutions were facing. With this information in hand, senior Federal Reserve policymakers took the lead in assessing the damage to specific financial institutions and the implications for the government securities market and in taking remedial actions--including the provision of liquidity by the Federal Reserve--to restore financial market functioning relatively quickly. The ability of the Federal Reserve to respond promptly and effectively mitigated the adverse effects on broader financial conditions and the national economy of those tragic events.

During the current crisis, the Federal Reserve's supervisory role has not only given it timely access to information about the banking sector, payments systems, and capital markets, but also has been essential to its understanding of the emerging strains on financial firms and their possible implications for financial markets and the broader economy. This information has been critical to the Federal Reserve's efforts to identify the difficulties facing depository institutions of all sizes and to take steps to address those problems. In particular, over the course of the crisis, the Federal Reserve has used supervisory information to monitor the liquidity needs of banking organizations in response to the disruptions in a range of short-term funding markets and mounting market pressures on firms perceived to be in a weak financial condition. This information allowed the Federal Reserve to take steps to address pressing liquidity needs with

monetary policy and lending programs, thereby avoiding larger dislocations in financial markets and an even greater deterioration in economic conditions--which the Federal Reserve continues to monitor.

The Federal Reserve's supervisory information also contributed importantly to the design of a number of Federal Reserve credit programs. In particular, the development of the Primary Dealer Credit Facility was greatly aided by the understanding of the triparty repurchase agreement (repo) market and the information regarding its functioning that the Federal Reserve had as a result of its supervision of the banking organizations that handle the clearing and settlement of such transactions. In addition, its understanding of the workings of the credit markets along with its involvement in the supervision of banking institutions helped motivate the Federal Reserve's decision to implement the Term Asset-Backed Securities Loan Facility, which is a broad-based facility that provides liquidity to support auto lending, small business lending, credit card lending, student loans, and commercial real estate lending. The Federal Reserve's credit programs provided significant support to key financial institutions and markets, easing the impact of the financial crisis on the economy.

Liquidity Provision to Depository Institutions

Supervisory information and expertise also contribute to the Federal Reserve's management of the risks that it confronts in its role as liquidity provider to depository institutions, large and small--a critical central-bank function. Reserve Banks must be able to assess the financial condition of the institutions that want to borrow from the Federal Reserve and must be able to assess as well the quality and value of the collateral pledged by borrowing institutions. Active involvement in supervising financial institutions contributes significantly to such assessments because they require substantial knowledge of banking practices as well as the expertise gained from the hands-on review of loans and other assets at banking organizations. In addition, the Federal Reserve's assessment of the condition of an institution or the quality of its collateral may differ from that of other supervisory agencies.

Monetary Policy

The information that the Federal Reserve obtains in its supervisory role has been useful for the making of monetary policy, especially in periods of financial stress. For example, in the early 1990s, the Federal Reserve recognized that elevated loan losses were putting pressure on bank balance sheets, thereby contributing to very weak bank lending that was weighing on spending by households and businesses. In this context, mounting evidence of tightened lending standards and credit concerns at banks, much of it gained through the supervisory process, contributed to the Federal Reserve's decision to ease the stance of monetary policy more aggressively than it otherwise would have.

Supervisory information has played a particularly important role in monetary policymaking since the outbreak of the financial crisis in the summer of 2007. As the crisis intensified, supervisory

information helped the policymaking Federal Open Market Committee (FOMC) to understand the extent of the dislocations in credit markets and led the Federal Reserve's monetary policy response to the crisis to be more timely and decisive than it otherwise might have been. For example, Federal Reserve staff calculated estimates of potential aggregate credit losses under alternative economic scenarios and drew on supervisory information and expertise to evaluate implications for the health of the banking system. This work helped the FOMC to assess the risks to the financial system and the economy arising from worsening credit conditions and to take such risks into account in its policy decisions.

More broadly, information and expertise obtained as a result of the Federal Reserve's supervisory role have been reflected in FOMC meeting discussions of economic conditions and the outlook. Supervisory staff has attended these meetings during the crisis, and in these discussions there have been regular references to information about banking institutions gained both from examination staff and from industry contacts resulting from the Federal Reserve's supervisory role. This information has contributed to the Committee's understanding of likely loan losses, the effects of such losses and other factors on bank lending behavior, and their implications for economic activity. Moreover, given the global nature of the financial crisis, the Federal Reserve's interactions with supervisors abroad, which reflect its role as a U.S. supervisor, have provided helpful information on the health of key foreign banking firms, allowing the FOMC to judge more accurately the likely strains on U.S. financial firms and markets emanating from outside the United States.

The Federal Reserve faces challenging decisions regarding the timing and pace of the exit from the considerable monetary accommodation put in place during the crisis. These critical policy decisions will require particularly careful assessments of developments at financial institutions and in financial markets, and their resulting implications for the real economy. For example, losses on commercial real estate loans may continue to undermine some community and regional banks and will have uneven effects across different regions of the country. At the same time, however, the improving economy may strengthen the balance sheets of other banks and conditions in many financial markets may continue to improve. Information from the supervisory process will help policymakers to assess overall credit conditions and the stability of the financial sector, and so to time appropriately the shift to reduced policy accommodation.

Could the Federal Reserve Obtain What It Needs from Another Supervisor?

A natural question is whether the Federal Reserve could obtain the supervisory information and expertise it needs for its central-bank responsibilities from other agencies. While it seems clear that this is possible to some extent--indeed, the Federal Reserve obtains information regarding the firms to which it lends from their primary supervisors--elimination of the Federal Reserve's role in supervision would severely undermine the Federal Reserve's ability to obtain in a timely way and to evaluate the information it needs to conduct its central banking functions effectively.

First, active involvement in supervision ensures that the Federal Reserve will have experts on its staff with significant knowledge of banking practices and financial instruments gained from the hands-on review of banking organizations and their operations, practices, activities and balance sheets. This expertise is critical to making effective use of information about financial firms and cannot be quickly created when needed. For example, without staff expertise in bank lending practices and evaluating bank asset quality, the Federal Reserve would be unable to assess independently and rapidly the condition of borrowing institutions and the value of the collateral they pledge at the discount window. This capability has been especially valuable since the Federal Reserve began providing credit at longer maturities during the crisis. Indeed, in some cases, it has been necessary for the Federal Reserve to deploy supervisory experts to provide up-to-date assessments of the condition of borrowing firms and to evaluate the collateral they were providing. Owing in part to the supervisory expertise it has been able to bring to bear in its discount window operations, the Federal Reserve has maintained its record of never bearing a loss on credit it has extended to depository institutions, despite the spike in such lending to more than \$500 billion in early 2009.

Second, obtaining information from another agency would be slower and more cumbersome than obtaining it directly from financial firms. Information provided by other supervisory agencies may be stale or incomplete, particularly in a crisis, when the condition of institutions and the value of collateral can deteriorate rapidly. An independent supervisor would have its own concerns and priorities on which its supervisory staff would naturally focus, slowing the Federal Reserve's access to information in other areas. Even if the supervisory agency's staff were willing and able to provide assistance, the back-and-forth process in which the Federal Reserve must explain exactly what is needed, evaluate the information that is received, and return to the supervisor with clarifying questions and requests for additional information could slow the process appreciably.

Finally, having the legal authority to directly obtain information--through on-site examinations or otherwise--can prove critical to understanding and responding quickly to a financial crisis. While in some cases financial institutions that the Federal Reserve does not supervise may be willing to provide information to the Federal Reserve on a voluntary basis, in other cases they have not been willing, and there is no guarantee that they will be willing in future crises. For example, senior managers with relevant knowledge about the nature of the problems facing an institution or arising in financial markets may well be focused on those problems and therefore might not want to meet with, or provide information to, the Federal Reserve in a timely manner unless the Federal Reserve had the supervisory authority to require them to do so. Also, an institution may not readily recognize or acknowledge the possible adverse effects of its actions for other market participants or the financial markets and economy more generally, or it may expect the authorities to deal with such adverse effects. In such cases, it can be essential for the Federal Reserve to have the ability to compel the disrupted institution to provide timely

information that would assist the Federal Reserve in addressing the crisis through its monetary policy, lending, and other policy and operational tools.

Besides the experience at the Federal Reserve, international developments suggest that a central-bank role in supervision can be important. For example, many have suggested that the problems with Northern Rock in the United Kingdom were compounded by a lack of clarity regarding the distribution of powers, responsibilities, and information among the Bank of England, the U.K. Financial Services Authority, and the U.K. Treasury. In response, the Bank of England was given statutory responsibilities in the area of financial stability, its powers to collect information from banks were augmented, and many have called for it to be given increased supervisory authority. In the European Union, a new European Systemic Risk Board is being established under which national central banks and the European Central Bank will play a central role in efforts to protect the financial system from systemic risk. More broadly, in most industrial countries today the central bank has substantial bank supervisory authorities, is responsible for broad financial stability, or both.

Steps the Federal Reserve Is Taking to Strengthen its Regulatory and Supervisory Performance

Supervision by financial regulators, including the Federal Reserve, clearly had significant shortcomings in the period leading up to the financial crisis. Among other things, regulators did not insist on sufficiently strong and comprehensive risk management by private firms, and inadequate attention was paid to the risks that could arise from the interactions of firms and markets, such as the collective dependence of many firms on similar wholesale funding sources or hedging strategies. The Federal Reserve has been and continues to be engaged in an intensive self-examination of its supervisory functions with two objectives: to address weaknesses in its supervisory function that became apparent as a result of the financial crisis, and to become a better supervisor in an environment that requires supervisors to be attentive to macroprudential as well as individual-institution safety-and-soundness risks.

The Federal Reserve is seriously engaged in measures to strengthen its regulatory and supervisory performance. For example, working through the Basel Committee on Bank Supervision and the Financial Stability Board, the Federal Reserve has played a key part in efforts to ensure that systemically critical financial institutions hold more and higher-quality capital and employ more robust liquidity management. The Federal Reserve also played a key role in international work to ensure that banks use compensation structures that provide appropriate performance and risk-taking incentives. Domestically, it has taken the lead in addressing flawed compensation practices, issuing proposed guidance that would require banking organizations to review their compensation practices to ensure that they do not encourage excessive risk-taking, are subject to effective controls and risk management, and are supported by strong corporate governance, including oversight by their boards of directors.

In the fall of 2008, the Federal Reserve updated its guidance on consolidated supervision, reaffirming the importance of such supervision, particularly for large complex firms, and emphasizing the importance of bringing a macroprudential perspective as well as an individual-institution safety-and-soundness perspective to consolidated supervision. Of considerable importance, the Federal Reserve has taken steps to ensure that, when risk-management shortcomings are identified, its supervisors hold managers accountable and make sure that weaknesses receive proper attention at senior levels and are resolved promptly. This requires routinely and promptly communicating important supervisory concerns to the highest levels of bank management, including through more frequent involvement of senior bank managers and boards of directors and senior Federal Reserve officials. This approach proved especially effective during the SCAP and in other circumstances when clear expectations for prompt remediation were forcefully communicated to large banking organizations.

The Federal Reserve has also begun to make fundamental changes to its supervision and regulation of large bank holding companies to include a macroprudential, as well as an individual-institution safety-and-soundness, perspective to supervision. For example, the Federal Reserve is developing a program of enhanced quantitative surveillance of large bank holding companies. Enhanced quantitative surveillance combines aggregate economic data, firm-level market-based indicators, and supervisory information to provide a fuller picture of the financial condition of firms, the risks they face, and their potential effects on the broader system. Examples of this approach are the indicative systemwide loss and pre-provision net revenue estimates that were developed for the SCAP and used in the subsequent analysis of Troubled Asset Relief Program redemption requests, and the firm-specific loss and revenue estimates that were developed by combining these systemwide estimates with supervisory information.

The Federal Reserve is working with other domestic and international regulators and market participants to overcome the collective action problems that often plague efforts to strengthen market infrastructure. Since 2005, the Federal Reserve has been leading efforts by market participants and domestic and international regulators to strengthen the infrastructure of the credit derivatives and other over-the-counter derivatives markets. While further progress is needed, without the progress that was achieved since 2005, the failures of major dealers and defaults by some of the very largest names traded in the credit derivatives markets surely would have been far more disruptive than they were. Likewise, this year the Federal Reserve took the lead in organizing a private-sector group that is developing recommendations for cooperative measures to strengthen margin and settlement practices in the triparty repo markets.

The Federal Reserve is also making changes designed to fully employ its expertise to effectively supervise large banking firms. The new supervisory framework will better accommodate a macroprudential orientation that goes beyond the traditional focus on individual institutions and better supports the identification and analysis of interconnected risks and sources of financial contagion. The new approach will implement a more centralized approach to the supervision of large, complex banks that are potentially systemically important.

In particular, strategic and policy direction for the supervision of large, complex financial institutions will be coordinated through a newly formed multidisciplinary committee led by senior officers representing various functions at the Board and Reserve Banks. Supervisors, economists, and market specialists, combined with officials responsible for quantitative surveillance activities, will define supervisory priorities and examination plans for large, complex banking organizations. Supervisory teams will be constructed around portfolios of firms with similar business lines and risks, and cross-firm examinations will consider interconnected risks, such as spillover and feedback effects.

As in the SCAP, representatives of primary and functional supervisors will be fully integrated in the process, participating in the planning and execution of horizontal exams and consolidated supervisory activities. As was evident in the recent crisis, interconnected risks can span several operating entities. Subprime mortgage exposures, for example, were dispersed across mortgage banks, broker-dealers, and off-balance-sheet vehicles, as well as insured depositories. Effective supervision of complex holding company structures must involve greater coordination among consolidated and functional supervisors and an integrated assessment of risks across the holding company, including bank and nonbank subsidiaries.

While supervisory authorities here and abroad are still developing the tools and instruments needed to fully implement a macroprudential approach to supervision, recent experience has shown that such an approach is critical to avoiding financial imbalances that can result in severe financial and economic dislocations. The Federal Reserve will continue to strengthen its supervisory efforts and to learn from events as they unfold, with the goal of doing all in its power to identify and address risks that may imperil the financial system.