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Umbrella Supervision: Emerging Approaches

Thank you for inviting me here today. I would like to discuss with you the opportunities and challenges we face under the Gramm-Leach-Bliley financial modernization legislation, addressing in particular some of the legislation's implications for supervising financial conglomerates.

I believe we can all agree that Gramm-Leach-Bliley, or GLB as it seems to be called, offers exciting opportunities for banking organizations to expand their lines of business and their range of customer services. These opportunities potentially could lead to rewarding organizational synergies. While benefits may be substantial, from a supervisory perspective, GLB means the Federal Reserve, as the umbrella supervisor, needs to reassess its supervisory regime to ensure it remains applicable and appropriate for financial conglomerates. GLB states quite clearly, for example, what the Federal Reserve *cannot* do in its role as umbrella supervisor, yet it is remarkably silent in detailing what we can, or should, do in this role. In these remarks I intend to highlight how the Federal Reserve is interpreting our supervisory responsibilities for financial holding companies and to outline our general strategy for overseeing them in the years ahead.

Overview of the Legislation

As you know, GLB permits certain bank holding companies to affiliate with securities firms and insurance companies. Expanded permissible activities for these holding companies include securities underwriting and dealing, insurance agency activities and insurance underwriting, acting as a futures commission merchant, and merchant banking. The Federal Reserve Board and the Secretary of the Treasury have the authority to determine whether other activities are financial in nature or incidental to financial activities and hence permissible for these holding companies to engage in.

To take advantage of the new powers, a bank holding company must become a financial holding company (FHC), which requires that each of its subsidiary banks is well-capitalized and well-managed and that all of its insured subsidiary banks maintain a Consumer Reinvestment Act (CRA) rating of at least satisfactory. In January and March, the Board issued implementing regulations governing the process of attaining FHC status. Essentially, a bank holding company files a declaration with the appropriate Reserve Bank certifying that it meets the statutory criteria. The Federal Reserve verifies the claim, and, as long as there are no discrepancies or supervisory concerns, the FHC status is approved. As of mid-May, 270 domestic banking organizations and 17 foreign banking organizations had filed to become financial holding companies.

Objectives of the Umbrella Supervisor

So, as noted earlier, financial holding companies are simply a subset of bank holding companies that are authorized to engage in an expanded range of activities. Nonbank subsidiaries of financial holding companies that are engaged in securities, commodities, or insurance activities continue to be supervised by their appropriate "functional regulator." Each functional, bank, or thrift supervisor retains its responsibilities for individual subsidiaries. As the umbrella supervisor, the Federal Reserve will evaluate the consolidated strength and activities of financial holding companies to ensure that their financial condition does not threaten the viability of subsidiary depository institutions.

The Federal Reserve will focus on a holding company's consolidated risk-management process and its overall capital adequacy. Consolidated oversight of such organizations is important because the risks associated with a broad range of financial activities can cut across legal entities and business lines. Even if individual subsidiaries are considered to be financially strong and well managed by bank, thrift, or functional regulators, their risk profiles may change when they are amalgamated into a consolidated organization. The sum of the parts does not always equal the whole. In conducting our oversight, our specific goal will be to assess how a company's activities might affect the safety and soundness of its affiliated depository institutions.

The rationale for umbrella supervision is that most large and sophisticated financial services companies take an umbrella or consolidated approach to managing their risk. As a practical matter, the Federal Reserve expects all FHCs to evolve toward comprehensive, consolidated risk management in order to measure and assess the range of their exposures and the way those exposures interrelate. I think it is worth noting here that although one may think of FHCs as large, complex financial institutions, most bank holding companies that have declared themselves to be financial holding companies are in fact smaller organizations. Of the approximately 270 domestic FHC declarations that have been received to date, roughly three-quarters are organizations with less than $1 billion in assets. And of these, 42 percent have less than $150 million in assets. As some of these smaller organization begin to expand into less traditional activities, their consolidated risk management strategies will become more important.

Umbrella supervision is not intended to impose bank-like supervision on FHCs as a whole, or on either regulated or nonregulated nonbank subsidiaries of FHCs. Rather, it seeks to balance the objective of protecting the depository subsidiaries of increasingly complex organizations engaged in a greater number of interrelated activities and incurring different risk with the objective of not imposing an unduly duplicative or onerous burden on the nonbank entities that are part of the organization. The legislation clearly intends that functional regulators, primary bank and thrift supervisors, and the umbrella supervisor will respect each other's responsibilities and will acknowledge and make use of each other's expertise.

To achieve the objectives I mentioned, umbrella supervision requires strengthened relationships between primary bank and thrift supervisors and the umbrella supervisor and enhanced relationships with functional regulators and foreign nonbank supervisors. Finally, the Federal Reserve needs to place greater reliance on recent initiatives that promote a more risk-focused supervision process and market discipline--two trends that the Federal Reserve has actively pursued in recent years.

So what does this outline of umbrella supervision really mean in practice? How is umbrella supervision different from the bank holding company supervision of two-and-a-half months ago, that is, pre-GLB? And, from your point of view, how will it affect banking organizations directly? In just a moment I will try to put more meat on the bones. But let me say first that the Federal Reserve has been supervising bank holding companies for many years. Some of these organizations are quite complex and have been engaged in a wide range of sophisticated activities. The framework for umbrella supervision that the Federal Reserve is implementing builds on that bank holding company supervisory role in a way that is consistent with GLB. The new legislation provides, around the edges, direction as to how some aspects of supervision must be carried out. But ultimately, our longstanding objectives of ensuring the financial viability of associated depository institutions and the federal insurance fund remain unchanged.

Umbrella Supervision in Practice

The activities of the Federal Reserve as the umbrella supervisor fall into three broad categories: information gathering and assessment, ongoing supervision, and promotion of sound practices and improved disclosure. First let me address information gathering. In this regard, the Federal Reserve will interact closely with, and obtain information from, the primary bank and thrift supervisors and the functional regulators as well as from FHC senior management and boards of directors.

To gain an understanding of how risk-management and internal control policies and procedures established at the consolidated level are being implemented, we will use a combination of information gathering and assessments. For example, we will conduct regular examinations of an FHC's centralized risk-management and control processes in coordination, as appropriate, with the primary bank, thrift, and functional regulators. Examiners may conduct targeted transaction testing, when appropriate, to verify that risk-management systems are adequately and appropriately measuring and managing areas of risk for the organization and to confirm that laws and regulations within the jurisdiction of the Federal Reserve are being followed. We will have periodic discussions with FHC senior management and boards of directors and with personnel responsible for centralized management and control functions such as heads of business lines, risk management, internal audit, and internal control.

The interplay between organizational and regulatory structures makes relationships with other regulators quite important. More than in the past, the Federal Reserve will need to coordinate its activities with those of other regulators and to work with them to understand the risk profiles of the individual regulated entities and their relation and importance to the FHC's overall risk profile. The Federal Reserve will review and discuss the examination findings of primary bank, thrift, and functional regulators, together with other relevant information, to arrive at a consolidated assessment of an FHC's financial condition and risk profile, the effectiveness of its risk management, and the implications of its activities for affiliated depository institutions. The Federal Reserve will also make available to other supervisors pertinent information regarding the financial condition, risk-management policies, and operations of an FHC that will have a direct effect on individual regulated subsidiaries within the organization. In addition, the Federal Reserve will participate in the sharing of information among international supervisors to ensure the consolidated supervision of an FHC's global activities and to minimize material gaps in supervision. Many relationships have already been established, and we expect international cooperation and communication to continue to evolve.

In addition to consulting with management and other regulators, the Federal Reserve will review internal audit and management reports and publicly available information (including market information on equity and debt prices of the consolidated organization) as well as reports and data collected by other regulators. To minimize regulatory burden on the company, this material will be gathered, to the extent practicable, from the parent organization, from functional regulators, and from publicly available sources.

As you can tell, great emphasis will be placed on information gathering. However, there is a role for ongoing supervision. Supervision on a day-to-day basis and in the normal course of business will focus on understanding the group's structure, its major business activities, and how well it is managed. This process will require close coordination among the regulators associated with the FHC. The Federal Reserve will need to be kept apprised of material changes at the individual entity level that may ultimately have an important effect on the overall structure of the organization. And by the same token, the Federal Reserve will consult with appropriate functional regulators concerning significant applications, proposals, or transactions by an FHC that involve a functionally regulated entity.

With regard to examinations and reporting, the Federal Reserve, consistent with GLB, will rely to the fullest extent possible on reports that an FHC's subsidiaries are otherwise required to file with federal or state authorities and on the examinations of an FHC's subsidiaries by their appropriate regulators. We will also rely on routinely prepared management reports, publicly reported information, and externally audited financial statements. GLB places some limitations on our ability to obtain reports directly from a functionally regulated subsidiary. If the Federal Reserve requires a specialized report from a functionally regulated subsidiary, we will first request it from the subsidiary's functional regulator. If the requested report is not made available in a timely manner by the functional regulator, we may under certain circumstances seek it directly from the functionally regulated subsidiary. One circumstance may be when the report is necessary to assess a material risk to the FHC or any of its affiliated depository institutions. Other circumstances may be when the report is needed to assess compliance with laws enforced by the Federal Reserve or to assess the FHC's systems for monitoring and controlling risks that may pose a threat to an affiliated depository institution.

General limitations similar to those on the Federal Reserve's ability to obtain reports also apply to defining when the Federal Reserve may or may not directly examine a functionally regulated subsidiary. In any case, we will first seek to obtain the needed information from the appropriate functional regulator. If the information is not provided or an examination is still determined to be necessary, we will coordinate such actions with the functional regulator. It may also be appropriate, when working with a functional regulator or with another associated supervisor, to participate in joint examinations so as to minimize regulatory burden.

For subsidiaries of an FHC that are not functionally regulated, the Federal Reserve will obtain information directly from the subsidiary, as appropriate and necessary, to assess the financial condition of the organization as a whole.

Part of the overall assessment of an FHC will include an analysis of the consolidated capital adequacy of the organization. Consolidated capital adequacy is particularly important to ensure that undercapitalization at the parent level does not create problems for depository subsidiaries. Capital adequacy will be assessed in relation to the risk profile of the overall organization. We will review the overall risk assessment and related capital analysis process that the FHC uses internally to determine the adequacy of the company's consolidated capital position. The review will include consideration of present and future economic conditions, plans for future business development, possible stress scenarios, and internal risk controls and audit procedures.

The Federal Reserve's responsibility for assessing the consolidated capital adequacy of the FHC is aimed, in particular, at any potential negative effects on affiliated depository institutions. The legislation is quite clear, however, that functional supervisors of regulated entities within an FHC will continue to set and enforce applicable capital requirements for the entities within their jurisdictions. The Federal Reserve may not establish separate capital adequacy requirements for functionally regulated subsidiaries that are in compliance with their respective individual capital requirements. In reaching a consolidated assessment, we will rely heavily on the functional regulators' analyses of the capital adequacy of functionally regulated subsidiaries. We do need to keep in mind, however, that the different regulatory capital regimes for banking, securities, and insurance entities established by their respective regulators reflect varying definitions of the elements of capital and varying approaches to asset and liability valuations. This is another instance in which the sum of the parts may not adequately reflect the condition of the whole.

Another area that will be particularly important from the umbrella supervisor's perspective is intra-group exposures and risk concentrations. Again, the Federal Reserve's focus will be on the potential impact of such exposures on depository subsidiaries of an FHC. Accordingly, we will work closely with the appropriate bank or thrift supervisors to monitor and ensure compliance by the insured depository institutions with sections 23A and 23B of the Federal Reserve Act. To achieve this end, the Federal Reserve plans to begin collecting data from depository institution subsidiaries of FHCs (and BHCs generally) on their covered transactions with affiliates and subsidiaries.

Intra-group exposures may be significant at large, complex FHCs, especially those that operate their businesses on global lines that cut across legal entities within the firm. One of the key factors in overall risk assessment is an evaluation of risk exposures to the same counterparty by more than one legal entity in the organization. Functional regulators will continue to monitor any restrictions on intra-group exposure that may apply to the entities they regulate. The Federal Reserve, to the fullest extent practicable and appropriate, will support functional regulators in this regard. In particular, the Federal Reserve will seek to understand and monitor related-party exposures at the group level, including exposures in such areas as servicing agreements, derivatives, and payments systems, with an important focus on the extent to which a depository institution subsidiary's risk management is dependent on transactions with affiliates. We will also take into account whether capital or income is being improperly transferred within the group and whether intra-group transactions are being used as a means of supervisory arbitrage.

It has long been the approach of the Federal Reserve to promote sound practices for banking organizations--and that is my third topic. It is particularly important that the Fed continue this focus on sound practice in its role as umbrella supervisor over potentially very complex institutions. As a foundation, the Federal Reserve monitors developing trends in risk and management practices across the FHC population through regular discussions with FHC management centered around specific issues and emerging risks; regular meetings with primary banking and functional regulators to explore issues of mutual interest and concern; interagency working groups or specialty teams to gain early insight into risks that cut across legal entities of a conglomerate or group of conglomerates; and industry conferences on various topics of interest. I expect these initiatives will contribute to the development of sound practices that the umbrella supervisor and the functional and banking regulators can communicate to senior management and boards of directors at the FHC level and to the senior management of bank and nonbank subsidiaries.

Finally, let me note that greater transparency can meaningfully supplement the efforts of supervisors to monitor the increasingly complex and global activities of diversified banking organizations. As the umbrella supervisor, the Federal Reserve will, consistent with sound accounting principles and practices and with considerations of bank safety and soundness, participate in efforts to enhance disclosures that reflect group-wide activities, risk exposures, and risk management.

Conclusion

Many of the concepts I have outlined are already being applied, and have been for some time, by the Federal Reserve in the context of the consolidated supervision of bank holding companies. So, part of the good news is that we are not starting from scratch. A risk-focused approach and heightened coordination and communication with other supervisory authorities are two of the major practices that will continue as the Federal Reserve performs its role as umbrella supervisor.

Still, the supervision of more diversified FHCs presents new challenges and opportunities for development. We will continue our efforts to develop and enhance strong cooperative relationships with other supervisors. We will also strive to strengthen our relationships with FHC management and key personnel. Information flows and effective communication will be critical for all these relationships. I am confident that, together, we can fulfill our individual and collective responsibilities in a way that enables institutions to make the most of the opportunities available through the passage of the Gramm-Leach-Bliley Act.

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