FEDERAL RESERVE BANK
OF DALLAS

DALLAS, TEXAS
75265-5906

July 15, 1999

Notice 99-56

TO: The Chief Executive Officer of each
financial institution and others concerned
in the Eleventh Federal Reserve District

SUBJECT

**Risk-focused Supervision of
Large, Complex Banking Organizations**

DETAILS

The Board of Governors of the Federal Reserve System has issued guidance to supervisory staff and bankers on overseeing large, complex banking organizations during a time of dramatic change in the financial system. The guidance, issued in a supervisory letter, emphasizes the importance of assessing key risk management processes and ongoing monitoring of an institution's risk profile, as well as tailoring the supervision program to an institution's principal business lines and risks.

ATTACHMENTS

Copies of the Board's press release and supervisory letter are attached.

MORE INFORMATION

For more information, please contact Basil Asaro at (214) 922-6066. For additional copies of this Bank's notice, contact the Public Affairs Department at (214) 922-5254.

BOARD OF GOVERNORS
OF THE
FEDERAL RESERVE SYSTEM

WASHINGTON, D. C. 20551

DIVISION OF BANKING
SUPERVISION AND REGULATION

SR 99-15 (SUP)
June 23, 1999

TO THE OFFICER IN CHARGE OF SUPERVISION AND APPROPRIATE SUPERVISORY AND EXAMINATION STAFF AT EACH FEDERAL RESERVE BANK AND TO CERTAIN DOMESTIC AND FOREIGN BANKING ORGANIZATIONS SUPERVISED BY THE FEDERAL RESERVE

SUBJECT: **Risk-Focused Supervision of Large Complex Banking Organizations**

Introduction

The rapid evolution and growing complexity of banking and financial markets calls for continuing refinement of the Federal Reserve System's supervisory approach to ensure the oversight of banking organizations is effective, comprehensive and implemented in a way that does not unnecessarily intrude on an organization's day-to-day management. Specifically, larger domestic and foreign banking organizations with particularly complex operations and dynamic risk profiles demand a heightened level of planning, coordination and innovative techniques to implement an effective supervisory program. These organizations typically have significant on and off-balance-sheet risk exposures, offer a broad range of products and services at the domestic and international levels, are subject to multiple supervisors in the United States and abroad, and participate extensively in large-value payment and settlement systems. These institutions are referred to as large complex banking organizations (LCBOs).

This SR letter builds upon the Federal Reserve's existing risk-focused supervision program by providing more specific guidance on the applicability of this program to LCBOs. Many aspects of the LCBO program are already in place; others are being introduced and refined in line with major developments in banking and financial markets. Given the speed with which risk profiles can change, the Federal Reserve's approach to LCBOs continues the evolution to a more continuous supervisory process, placing increased emphasis on an organization's internal systems and controls for managing risk.

An important aspect of the LCBO program is the assessment and evaluation of banking practices across a group of institutions with similar business lines, characteristics, and risk profiles. This "portfolio" approach to supervision will (i) support and enhance timely judgments about individual institutions, including the identification of possible "outliers"; (ii) facilitate peer group assessments; (iii) provide an improved framework for discerning industry trends; (iv) foster more consistent supervision of institutions with similar businesses and risk profiles; (v) contribute substantially to the maintenance of a highly informed and skilled supervisory staff; and (vi) promote the development and sharing of best supervisory practices within the Federal Reserve and the supervisory community more broadly.

Background

Over the last several years, the federal banking agencies have revised, enhanced, and streamlined their supervisory and regulatory programs in line with rapid changes occurring in domestic and international financial markets. In addressing these changes, the agencies have worked individually and cooperatively at the federal level, and with state banking authorities. Regulators have also worked actively at the international level to strengthen supervisory policies and practices in the major industrial and emerging market countries.

Within this broader context, the Federal Reserve has taken a number of steps in recent years to sharpen the focus, strengthen the substance, and reduce the burden associated with its supervisory programs. Major elements of these changes include: (i) increased emphasis on assessing internal policies and processes for identifying, measuring, monitoring, and controlling risks; (ii) a clearer focus on a banking institution's principal business lines and risks; (iii) improved techniques for monitoring financial developments on an ongoing basis; (iv) sufficient transaction testing to determine a financial institution's compliance with sound banking practices and banking laws and regulations; and (v) introduction of more streamlined, cost-effective and less burdensome supervisory techniques.

While no system of supervision can be failsafe or preclude "surprises," particularly in an increasingly volatile and complex world, these changes have improved the effectiveness of supervisory programs and made possible a better allocation of limited supervisory resources. By adapting supervisory programs to changing circumstances, these steps advance two fundamental objectives of the Federal Reserve -- promoting a safe and sound banking system and assuring financial stability. These changes also serve as the foundation of the LCBO program, while incorporating approaches specific to the unique characteristics of these large organizations.

Overview of Systemwide Supervisory Approach for LCBOs

The Federal Reserve's supervisory approach recognizes that dramatic changes in the financial, technological, legal, and regulatory environment necessitate a flexible supervisory framework that includes the ongoing review and assessment of LCBO risk profiles and the continual adjustment of supervisory plans and programs for individual institutions. Environmental factors that have had a significant impact on the nature of LCBO operations and the financial system more generally include:

<u>Financial innovation and deregulation</u>
The increased range, volume, and complexity of traditional banking businesses and the movement of banking organizations into non-traditional and potentially more complex financial activities and services, such as securitizations, securities underwriting and dealing, trading, derivatives, and other capital markets activities.

<u>Increasing competitive pressures</u>
The blurring of distinctions between financial products, and intensified competition in national and global markets between banking organizations, nonbank financial firms, and diversified financial services conglomerates.

<u>Geographic expansion and globalization</u>
The continued expansion by banking organizations, both nationally and globally, and the integration of financial markets, increasing the challenges associated with assessing and supervising the worldwide activities of U.S. banking organizations and the U.S. operations of foreign banking organizations.

<u>Revolution in information technology</u>
The dramatic changes in information and telecommunications technology that have increased the speed, complexity, geographic scope, and volume of financial transactions, and that have made possible new techniques for banking organizations to both take on and manage risks.

These environmental factors have resulted in the potential for swift and dramatic changes in the risk profiles of LCBOs and have provided avenues for the more rapid transmission of financial shocks. These developments in turn have required supervisors to employ more continuous and risk-focused supervision processes. Key elements of the Federal Reserve's supervisory approach for LCBOs include the following:

- Greater emphasis on the organization's management processes and core proficiencies for identifying, measuring, monitoring and controlling key risks, including credit, market, and operational risks, and less emphasis on traditional "point-in-time" balance sheet assessments.

- Continuous monitoring and assessment, including a formal re-evaluation of the organization's risk profile and an update of the supervisory plan on at least a quarterly basis.

- Encouragement of banking organizations to continually review and enhance their public disclosures in order to promote transparency and foster effective market discipline.

- Review of internal management and board reports, internal and external audit reports, and publicly available information to supplement existing supervisory processes.

- Communication and, when necessary and appropriate, coordination of the major aspects of the supervisory process among the principal supervisory authorities involved with the LCBO (e.g., banking, securities, and insurance authorities).

- Enhanced information sharing Systemwide and on an interagency basis, and the use of an information technology platform that fosters more effective collaboration and communication.

- Designation of a senior level Central Point of Contact (CPC) for each LCBO as the focal point for developing and implementing the Federal Reserve's supervisory program.

- Assignment to each LCBO of a dedicated supervisory team and staff with specialized skills, knowledge and experience tailored to the unique profile of the particular institution.

- An effective program of regular and meaningful contacts with bank management to maintain a current understanding of the institution's risk profile and risk management processes, without imposing undue burden, interfering with legitimate management prerogatives, or compromising the objectivity of the supervisory process.

The remainder of this SR letter provides additional information on several important aspects of the Federal Reserve's supervisory approach for LCBOs. These include maintaining a current understanding of the banking organization's characteristics and risks; the design, maintenance and execution of an up-to-date supervisory plan; the coordination of supervisory activities among principal regulatory authorities; and the organization and deployment of dedicated supervisory teams.

Understanding a Banking Organization and Assessing Its Risks

The process of maintaining a *current* understanding of an LCBO and its major risks relies heavily on gathering information from a wide variety of public and confidential sources, including supervisory reviews and evaluations and discussions with management and other supervisors. One of the primary objectives of this enhanced supervision method is to generate a flow of meaningful information that promotes, on a continual basis, a comprehensive understanding of the LCBO, its major business lines and strategies, the risks inherent in its business activities, and the quality and effectiveness of its risk management systems. The maintenance of an up-to-date understanding of an LCBO's risk profile reduces the time-consuming and burdensome discovery process associated with conducting on-site examinations. Similarly, it can also facilitate timely and efficient processing of major regulatory applications, including acquisitions and mergers, and other requests from banking organizations.

Publicly available information, internal management reports, discussions with management, regulatory reports, information from internal and external auditors, and information from other supervisors are examples of the sources used to develop and maintain a current understanding of the organization. With respect to management reports, electronic access by supervisors may be less burdensome for the banking organization and should be employed where feasible and appropriate.

It is important that the principal risk-focused supervisory tools and documents, which include an institutional overview, risk matrix, and risk assessment for the LCBO remain current.[1] Accordingly, the CPC should distill and incorporate significant new information into these documents on at least a quarterly basis. Factors such as emerging risks, new products, and significant changes in business strategy, management, condition, or ownership may warrant more frequent updates. In general, the more dynamic the LCBO's operations and risks, the more frequently the CPC should update the risk assessment, strategies, and plans.

Design and Execution of a Supervisory Plan

Effective risk-focused supervision requires the development and maintenance of a supervisory plan that is current and relevant to the organization's changing risk profile. In addition to addressing all key supervisory objectives, the supervisory plan should also be individually tailored for each banking organization to reflect its particular organizational and operational structure, as well as, where appropriate, the activities of other principal or functional supervisors. The supervisory plan and attendant supervisory activities, including on-site examinations and supervisory reviews, should be sufficiently robust to maintain an up-to-date and thorough understanding of the banking organization's operations and risks, as well as the quality of its risk management systems.

Ongoing assessments of the LCBO's major risks (e.g., credit, market, liquidity, operational, legal, and reputational risks) should be used to formulate, revise and update the supervisory plan. The Federal Reserve's supervisory plan should endeavor to take into account the nature and scope of major activities conducted by other regulators involved in the LCBO, and any actions necessary to address existing or emerging supervisory concerns, including follow-up on past supervisory issues. For institutions supervised by the Federal Reserve, a combination of full and limited scope examinations, targeted reviews, meetings with management, and analyses of public and supervisory information should be used to maintain an up-to-date risk assessment and to reduce unnecessary regulatory burden. The necessary level of transaction testing and the degree of reliance on sampling should be fully explained in the supervisory plan's scope documents and should adequately address the types and level of risks in the organization's business lines. Instances in which efficiencies can be gained through reliance on the work of other regulators, internal and external auditors, and the internal risk management function should, where appropriate, also be specified in the plan and incorporated in the supervisory program.

The CPC should review and revise the supervisory plan whenever necessary (but in no case less frequently than quarterly) to reflect any significant new information or emerging banking trends or risks. The supervisory plan and any revisions should be periodically discussed with representatives of the principal regulators of major affiliates to reconfirm agreement on the overall plan and to coordinate its implementation, where warranted.

This communication process can serve as the basis for executing a comprehensive supervisory approach that capitalizes on the mandates and resources of the various supervisory authorities, while minimizing possible duplication and burden on the institution. The objective is for supervisors to work cooperatively in developing supervisory plans and scope documents and, where possible and appropriate, carry out important supervisory activities on a joint or coordinated basis. Coordination and communication among supervisors can reduce the burden on banking organizations and result in a more efficient deployment of supervisory resources.

An important element of the LCBO program is effective communication between the Federal Reserve and the banking organization's management throughout the supervision cycle. Communication with the LCBO can take various forms, including formal and informal meetings with management and the board of directors, as well as the issuance of periodic and annual supervisory reports, including examination reports, to the organization's management and board. The objective of these reports is to identify significant risks and summarize the Federal Reserve's view of the financial condition and effectiveness of the LCBO's risk management processes.

As part of the LCBO program, bank management should be encouraged to continue and, if warranted, strengthen communications with Reserve Bank management, CPCs, and the supervisory teams, particularly with respect to providing information to supervisors on a timely basis regarding material financial or operational issues or problems. Prompt notification to supervisors of emerging problems can facilitate their resolution in a way that minimizes disruptions. Strong two-way communications and information flows between supervisors and the LCBO's senior management, including key business line and risk managers, are essential to the success of the LBCO program. In carrying out this program, the Federal Reserve will continue to attach the highest priority to information security and to protecting the integrity of sensitive, confidential supervisory and examination information.

The success of the LCBO supervisory framework also requires that results and findings of supervisory activities conducted throughout the supervisory cycle be continually evaluated and reflected in the Federal Reserve's current understanding and assessment of the organization's risk profile. Reports of examination/inspection or letters to the LCBO's management and board of directors should routinely be prepared when examinations and targeted reviews are completed and, if necessary, the organization's supervisory ratings should be revised in a timely manner based on the findings of these examinations and reviews.[2] Management and composite supervisory ratings should be adjusted appropriately if material weaknesses in risk management systems or controls exist, even if these weaknesses have not yet affected the organization's reported financial results.

At least annually, a comprehensive summary supervisory report should be prepared that supports the organization's assigned ratings and encompasses the results of the entire supervisory cycle. This report should convey the Federal Reserve's view of the condition of the LCBO and its key risk management processes; communicate the composite supervisory rating(s); discuss each of the major business risks; summarize the supervisory activities conducted during the supervisory cycle and the resulting findings; and assess the effectiveness of any corrective actions taken by the LCBO. This report will satisfy supervisory and legal requirements for a full-scope examination. Reserve Bank management, as well as Board officials, where warranted, will meet with the LCBO's board of directors to present and discuss the contents of the report and the Federal Reserve's assessment of the condition of the banking organization.

Coordination Among Supervisory Authorities

Information sharing and coordination within the Federal Reserve and with supervisors of major affiliates are critical elements of the LCBO program and are essential to successful supervision of LCBOs. Most LCBOs, regardless of their business lines and functional management structure, operate through a variety of legal entities that may be under the jurisdiction of different licensing and supervisory authorities in the United States and abroad.

To maximize efficiency and reduce regulatory burden, the risk assessment and supervisory planning processes should make use of and leverage off the efforts of other principal supervisors to the extent possible and consistent with achieving the Federal Reserve's key supervisory objectives. The Reserve Bank responsible for the supervision of the LCBO should have regular contacts with supervisors of important affiliates of the organization to discuss and coordinate matters of common interest, to develop supervisory plans and, where appropriate, to coordinate the scheduling and conduct of examinations and targeted reviews. Consistent with the supervisory needs and responsibilities of the Federal Reserve and the other supervisors, information may be exchanged as permitted by law, and in accordance with applicable rules and policies of the Board. In addition, meetings should be held at reasonable intervals with internal and external auditors to review audit plans, evaluate significant audit findings and other control assessments, and foster opportunities to leverage off the auditors' work. Building on the work of auditors, where appropriate, can enhance supervisory efficiency and reduce burden on the LCBO.

The Federal Reserve's supervisory approach for LCBOs will continue to utilize enhanced information technology. Timely and user-friendly access to a full range of internal and third-party information and mechanisms to foster collaboration among Federal Reserve staff and other supervisors are essential to effective risk-focused supervision for LCBOs. The Banking Organization National Desktop (BOND), an information technology platform currently under development, is intended to provide the high degree of automated information access and collaboration necessary for supervision of individual LCBOs, as well as to facilitate the comparative analysis of institutions with similar business lines and risk characteristics.

Effective and timely information flows, facilitated by the use of enhanced information technology, can provide a way for supervisors to "harvest" and share the core knowledge and experience gained through the conduct of supervisory activities and through ongoing contacts with banking organizations. Ready access to the collective knowledge, insights, and current assessments of fellow supervisors, bank management, financial markets, and other relevant third parties can enhance the ability of supervisors to identify problems in a timely manner and formulate effective supervisory responses. To this end, the Federal Reserve's information sharing and information technology strategies will continue to be aimed at broadening and strengthening the role of the CPCs and others responsible for conducting and overseeing the System's supervisory programs, including the LCBO program.

Organization of Federal Reserve Supervisory Teams

A principal component of the supervisory framework is the assignment to each LCBO of a dedicated supervisory team comprising individuals with specialized skills based upon the organization's particular business lines and risk profile. This full time, dedicated cadre will be supplemented by other specialized System staff, as necessary, to participate in examinations and targeted reviews.

In addition to designing and executing the supervisory strategy for an LCBO, the CPC also has responsibility for managing the supervisory team. Important objectives in managing the supervision resources for a particular LCBO are to maximize institutional knowledge and minimize burden to the banking organization, while maintaining an objective ongoing understanding of the institution's risk profile. The CPC serves as the Federal Reserve's primary day-to-day contact for a particular LCBO and has, together with other members of the Reserve Bank management team, primary responsibility for communicating with senior officials of the LCBO.

The supervisory team's major responsibilities are to maintain a high level of knowledge of the banking organization and to ensure that supervisory strategies and priorities are consistent with the identified risks and the LCBO's institutional profile. The team should include supervisors with broad-based knowledge and experience in banking, as well as specialists with technical skills and market knowledge that bring depth and perspective to highly focused reviews of selected LCBO activities.

Implementation and Other Considerations

Management of the CPCs and the supervisory teams will continue to reside at the Reserve Banks, which have responsibility under delegated authority from the Board of Governors for carrying out the Federal Reserve's day-to-day supervisory activities. With regard to LCBOs, the Board will continue to provide program direction, as well as oversight and coordination of Reserve Bank supervision activities in order to foster consistency, quality, and compliance with Board policies and procedures. In addition, Board staff will continue to work closely with Reserve Banks in monitoring developments affecting individual LCBOs and industry trends.

Board analysts will be assigned to work with the LCBO supervisory teams and participate in the development and execution of supervisory plans and programs, including, where appropriate, the conduct of examinations and other supervisory reviews. Board staff will continue to facilitate an understanding of risks and risk management practices across the portfolio of LCBOs with similar business activities. Board officials will also continue to play an active role with respect to any situations or institutions that pose significant risks, or that are otherwise of special interest or importance to the Board of Governors, or the System more generally. A major objective of the LCBO program will remain keeping the Board and Reserve Bank presidents informed of significant banking developments on a timely basis.

The arrangements described in this letter are intended to provide a flexible framework that can respond to changes taking place in the financial system and adapt to the risk profile of individual banking organizations, while still achieving all key supervisory objectives. The LCBO program should also improve supervisory coordination and efficiency and lessen burden on banking organizations. Looking ahead, supervisory programs will have to continue to adjust to changing financial practices and risk management techniques, and to the revolution in telecommunications and information technology. By focusing on risk and risk management processes, the framework outlined in this letter can provide a basis for addressing the broad array of developments affecting the banking and financial system.

The effectiveness of the LCBO program will depend on continued close collaboration, communication and coordination within the Federal Reserve and among the supervisory community more broadly. It will also depend on the continued commitment of adequate resources and individuals with the requisite expertise, skills and experience. Another factor critical to the program's success is effective and timely communication between bank management and supervisors. In this regard, Reserve Banks are asked to distribute this SR letter to Federal Reserve-supervised domestic and foreign institutions with LCBO characteristics.

Reserve Banks, in close collaboration with the Board of Governors, are responsible for ensuring that the program discussed in this letter is successfully and fully implemented. Questions regarding the implementation of this program may be addressed to the Office of the Director at (202) 452-2773; William A. Ryback, Associate Director, at (202) 452-2722; Stephen M. Hoffman, Jr., Deputy Associate Director, at (202) 452-5271; or Deborah P. Bailey, Manager, Global Supervision Section, at (202) 452-2634.

Richard Spillenkothen
Director

Cross reference: SR 97-24 (SUP)

Notes:

1 These tools and documents are discussed in more detail in SR letter 97-24, “The Framework for Risk-Focused Supervision of Large Complex Institutions.” SR letter 97-24 describes the Federal Reserve’s general risk-focused framework for institutions with assets in excess of $1 billion, including the documents and supervisory tools necessary to the program’s success.

2 The supervisory ratings include the BOPEC, CAMELS, and an FBO’s combined U.S. operations rating.

Federal Reserve Release

Press Release

Release Date: *June 24, 1999*

For immediate release

The Federal Reserve has issued guidance to supervisory staff and bankers on overseeing large complex banking organizations during a time of dramatic change in the financial system. The guidance, issued in a supervisory letter, emphasizes the importance of assessing key risk management processes and ongoing monitoring of an institution's risk profile, as well as tailoring the supervision program to an institution's principal business lines and risks.

Key elements of the program include designating a senior supervisor as the central point of contact for each institution and establishing a dedicated supervisory team with specialized skills and experience suited to each institution.

The approach recognizes that a small number of large and highly complex institutions account for a growing share of total banking assets. These institutions have moved into nontraditional activities including securities underwriting and dealing, derivatives trading, and loan securitizing. They are expanding their activities across both state and international borders. And, ongoing advances in information technology have increased the speed, complexity and volume of financial transactions, and thus have heightened the potential for swift changes in the risks confronting these institutions.

Under the approach outlined in the letter, the supervisory team will update its supervisory plan at least quarterly by reviewing a steady flow of relevant information, including internal management reports, internal and external audits and publicly available information. In some cases, supervisors may have direct online access to management information.

These streamlined techniques, emphasizing oversight of an institution's internal procedures for identifying and managing risk in contrast with traditional point-in-time examinations, should reduce the cost and burden of regulation. This approach also considers an institution's performance and risk-management procedures in relation to the performance and procedures of its peers.

To minimize duplicative regulatory effort, the approach requires close consultation with other domestic banking agencies, state insurance commissioners, securities regulators and foreign bank supervisors. The Federal Reserve is developing an information system, the Banking Organization National Desktop, to be introduced next year, to provide supervisors a user-friendly way of sharing information.

The supervisory letter is attached.