SPEECH

A New Era of Bank Supervision

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Introduction

Good morning. Thank you for that kind introduction John. Before I begin, I would like to thank the New York Bankers Association for organizing this financial services forum and for inviting me to speak to you today. I really appreciate the opportunity to engage in a dialogue with all of you. The Federal Reserve Bank of New York has a long history of speaking at NYBA events and we benefit tremendously from our participation in events like this.

I should note now that the opinions I express today are my own, and do not necessarily reflect those of the Federal Reserve Bank of New York or the Federal Reserve System.

Part I: Taking Stock

Today, I'd like to walk you through some of the modifications in our approach to bank supervision that we've made in response to the lessons from the most recent crisis. In order to describe the new era of supervision to you, though, I believe it's important that we first take stock of where we've been, and what we've learned, over the last couple of years.

In a concession to my audience this morning, the title of my speech is "a new era of bank supervision," but I'm afraid that, in my desire to be a good guest, I may have been a bit misleading. One of the very first things we learned during the crisis was that the safety and soundness of the financial system could no longer be guarded through *bank* supervision alone. The reality revealed by the crisis was that systemic risk can also reside and accumulate in a large and diverse set of financial service providers throughout the system. Crucially important financial sector participants, regulated and unregulated alike, were unprepared for the crisis.

This suggests that the new era of supervision must be more inclusive than the old, more capable of identifying and accounting for systemic risk—wherever it resides. With the passage of the Dodd-Frank legislation, our supervisors at the Federal Reserve Bank in New York are now responsible for additional portfolios of firms. Most importantly, this includes firms designated by the Financial Stability Oversight Council as "systemically important," or as a "financial market utility." Our recent name change from the "Bank Supervision Group" to the "Financial Institution Supervision Group" is intended to reflect and underscore the broadened scope of the new era supervision.

Not only did the crisis demonstrate the need to account for a wider array of financial sector actors than we had previously thought necessary, it also revealed the growing complexity of individual firms, and the dense interconnectedness linking them. There certainly wasn't sufficient appreciation of the downside ramifications of a financial system characterized by such complexity and interconnectedness until the crisis began. Only then did it become clear that just as complexity could benefit a firm in good times, it could act as an impediment to disentangling and unwinding troubled firms in bad times; that just as interconnection could speed the flow of strong assets in good times, it could make it difficult to slow or halt the spread of troubled assets in bad times.

Another lesson from the crisis, then, was that the financial system was perhaps *too* complex, *too* interconnected, and its participants *too* vulnerable to shocks. If the past is not to be repeated in a new era of supervision, we must find a way to address the structural characteristics of the financial system that so exacerbated and inflamed the crisis. We must address the complexity and interconnectedness of the system. Firms need to be more resistant to shocks and we must demand more in terms of the quality of management at complex institutions.

Just as the crisis exposed vulnerabilities in the structure of the financial system, it also challenged some of our working assumptions within the supervisory community. As you know, before the crisis our supervisory activities were mainly directed at testing and critiquing risk management, models and controls at supervised institutions. We did not spend as much time working to understand firms' business strategies or key revenue drivers because it was widely believed in the supervisory community that strong control functions were the primary tool for limiting risk and ensuring safety and soundness. As a result of our focus on controls, we were not as familiar as we should have been with some emerging business risks.

One of the more disturbing realities revealed by the crisis was that at some troubled firms, those at the top of the house also at times appeared to have no clear understanding of their firm wide vulnerabilities. In retrospect, it seems this was often the case because the firm's risk management function had been marginalized and the risk-reporting chain ignored, or otherwise impaired. The inability of such firms to quickly and decisively respond to problems was not necessarily due to significant failings within the

risk management function itself—where our supervisory attention had been focused—but rather due to the business side's ability to sideline risk managers' concerns in the interests of greater potential revenue.

Looking back at these episodes, it is clear that it is insufficient to look at risk management practices in isolation if we are to fully discharge our supervisory mandate going forward. The prospect of a marginalized or ineffective risk function requires supervisors to develop an independent view of revenue-driven risk-taking, and to be capable of making an informed comparison of risk-taking activity against the firm's stated risk appetite. In short, the first component of a more holistic, comprehensive approach to understanding supervised firms in a new era of supervision is an expanded supervisory focus encompassing business risk and revenue drivers.

The specter of a marginalized or ineffective risk-management function suggests that a second component of a more comprehensive approach to supervision is a better understanding of the relationship between risk managers, business line decision makers, and top-of-the-house management. To the extent that robust governance processes would have required business managers to heed risk warnings, or would have at least ensured that failures to do so were communicated up the organizational chain, these governance processes are of legitimate interest to supervisors. While it is impossible to know with certainty how decisions made up to and during the crisis would have differed had more robust governance processes been in place, it seems clear that, going forward, an enhanced voice for risk management will ensure that business decisions are based on a more complete understanding of risk at the top of the organization.

Part II: Looking Forward

Looking forward, we have to begin by acknowledging that it is impossible to predict the nature or timing of a future crisis event. This was another take-away from the financial crisis, and it is precisely why it is vital that we—as financial institution supervisors and as financial institutions—be better prepared for the next crisis event, whatever its character, source or timing.

A new era of supervision begins with asking, "What does a financial system better prepared to weather all storms look like? What features do we, as supervisors, think a financial system and its participants need in order to be considered safe and sound?" I cannot guarantee that we will avoid another crisis event, but, drawing on the lessons of the crisis that I've outlined for you today, I can begin to identify features of a financial system that is more safe and sound than the one we had going into the last crisis. This financial system, as you may have guessed, is less complex and less interconnected; more resilient; and, importantly, better managed.

To support the financial system I envision, we'll need to establish and maintain a deep understanding of how firms and the financial system are operating; to take actions to reduce the probability of failures; and to work to lessen the impact to the public when problems do occur. In practice, this means focusing our supervisory efforts on three broad areas: (1) reducing the complexity of firms and the system by making them more recoverable and more resolvable before problems occur; (2) enhancing the resiliency of firms and the system by ensuring that strong buffers are in place to prevent potential problems and to increase the capacity to absorb shocks when problem do happen; and (3) strengthening the management of firms and the system.

Over the next 12 to 24 months, we will continue to work toward these objectives by focusing our supervisory activities on certain key areas. For example, and this list is by no means exhaustive, to reduce the complexity of the system, we will work with firms to develop recovery and resolution plans—as mandated by Dodd-Frank—a process that is in fact already underway. As you no doubt know, the challenges in dealing with the resolution of financial firms with large international footprints are numerous, including complex cross-border legal issues. While the legal issues will take time to sort through, supervisors across the globe will need to identify ways to collaborate and communicate in the near-term to make recovery and resolution more possible.

To enhance the resiliency of firms and the system, we will continue to focus on ensuring robust levels of capital at supervised firms, as well as focusing attention on capital planning processes to ensure that firms build appropriate buffers to withstand a range of stressful conditions in the future. Similarly, we will continue the work we've begun on liquidity and liquidity risk management, with an eye to ensuring that firms build sufficient pools of liquidity to better weather periods of stress and to provide additional time for firms to consider recovery options.

Finally, to strengthen the management of firms and the system, we will continue to work with firms to bolster risk management practices, leveraging our horizontal perspective to identify and promote better and best practices, and we will expand our supervisory focus to encompass risk taking activities and broader governance processes.

These objectives—less complex, more resilient, better managed—apply to all the firms in our portfolio, including smaller regional and community banks. This does not mean we are taking a "one size fits all" approach. That is actually quite contrary to our intention. It does, however, reflect my belief that it is reasonable for us to expect that each of our firms be well capitalized, attentively managed, and no more complex than is governable with the resources at hand.

As I alluded to earlier, achieving these objectives for our firms and across the financial system will require modifications in our supervisory approach. In support of these objectives, then, we are going to work to enhance our knowledge, oversight, and interaction with systemically important banks and nonbanks, including financial market utilities, and other supervised firms within our portfolio.

Restructuring our organization and our supervisory teams to enhance supervision has been a focal point of our efforts over the past year. In order to understand our firms more holistically—a key lesson of the crisis—we've created new positions on our onsite supervisory teams in order to expand our supervisory focus to encompass front office revenue generation and risk-taking activity at supervised firms. It is the responsibility of these "business line specialists" to understand a firm's revenue drivers, business strategy, and competitive position, and to evaluate the implications of these activities for a firm's risk profile.

In addition to creating the business line specialists role, we are elevating the visibility, stature, and seniority of the leaders in charge of the supervision of the largest firms. Not only will our "Senior Supervisory Officers" lead and manage an expanded onsite presence, they will enhance the quality and increase the frequency of our engagement with senior managers and directors at supervised firms.

More—not less—engagement with directors and senior management is indeed a cornerstone of our new approach to supervision, which is fundamentally meant to give us a deeper view into firms and the risks they are taking.

By establishing a more intensive supervisory relationship with those overseeing the health of the firm, we hope to improve the flow of information, and thus gain an earlier and clearer view into emerging business trends and risk strategies. Our new approach also supports our goal of better understanding firms by providing us a richer understanding of firms' corporate governance processes and weaknesses that, when combined with our cross-firm perspective, will allow us to come to a nuanced comparative view.

Fundamentally, this approach is consistent with our need, revealed by the crisis, to better understand our firms—and for our firms to better understand themselves. To the extent that we can help firms better understand and better manage themselves through enhanced engagement, we can bolster what I consider to be a critical first line of defense.

Part III: Working Towards a More Stable Financial System

In this environment of macroeconomic uncertainty, enhanced engagement—including enhanced communication and transparency—is more important than ever. We are committed to applying this approach to our interactions with all stakeholders in our efforts to understand the common challenges we face in the pursuit of creating a more stable financial system.

The challenges are many. As was reinforced by regional and community bankers on an upstate visit earlier in the year, consumer confidence remains mixed, and consumer lending is still weak. Housing prices are flat in some areas, and continuing to decline in others. Reports on small business lending and construction are also mixed. In some cases, the demand for loans simply hasn't picked up; in others, it's difficult to find borrowers, battered by the recession, who meet underwriting standards. And that's just the regional economy—I haven't even mentioned the uncertainty associated with regulatory reform; the slow pace of the national recovery; and, the effects on our economy of developments abroad.

In addition to the Upstate and other district-wide visits, which allow us to hear from, among others, regional and community bankers in their own backyards, we're working to create additional venues where you can share your views on the issues that most concern you.

At our largest and most complex institutions, that point of contact is our Senior Supervisory Officer. At our regional and community banks, we're creating forums, like the Community Depository Institution Advisory Council, where our community bankers can provide us with information, ideas, and suggestions on a wide range of topics—from local community issues to regional economic issues to the impact of national policies.

This information helps to better inform us as we work to ensure safety and soundness in the financial system, while at the same time appropriately adapt our approaches and focus to reflect the challenges facing the broad range of institutions we supervise.

Conclusion

To summarize, if we are to produce a "new era of supervision" in the future, we absolutely must begin by applying the lessons of the past. These lessons, which pertain both to the structure of the financial system and the methods we use to supervise, point towards a financial system that is more resilient, less complex, and better managed, and a supervisory method that takes a more macroprudential view and is deeply engaged with firms.

If there's any unifying theme to this I think it has to be the need for balance. Whatever the new era of supervision ultimately looks like, it cannot be considered successful unless it produces an environment that allows supervised firms to grow and flourish in a way that is consistent with the broad public good. I hope you've found the new era of supervision that I've described to you today compelling, and I look forward to working with you and your institutions towards a safe, sound, and accessible financial sector that also contributes to the health, vitality, and dynamic growth of the real economy.

Thank you.