SPEECH

The Theory and Practice of Supervision

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Introduction

Good afternoon. I'm Kevin Stiroh, the head of the Supervision Group at the Federal Reserve Bank of New York. I'd like to thank SIFMA for the opportunity to speak today about the theory and practice of supervision.

By way of background, I took over my current role in October of 2015, after spending time in the New York Fed's Research, Markets and Integrated Policy Analysis Groups, as well as earlier positions within Supervision. I am an economist by training and I spent much of my career studying the performance and function of financial institutions in the U.S., the critical role of bank capital, and the potential link with financial stability.

I'd like to cover three topics today related to the theory and practice of supervision. First, what is supervision? Second, why is it necessary? Third, what are some of the emerging issues in the execution of supervision?

Before beginning, let me emphasize that my comments today are my own and do not necessarily represent those of the Federal Reserve Bank of New York or the Federal Reserve System.

What is Supervision?

The Federal Reserve has many responsibilities, most closely linked to the execution of U.S. monetary policy and the regulation and supervision of the U.S. financial system. In fact, the official title of the Federal Reserve Act includes the phrase "to establish a more effective supervision of banking in the United States," so supervision has been a core responsibility of the Federal Reserve from the beginning.

But what does "a more effective supervision of banking" mean? At the highest level, the Federal Reserve's mission for supervision and regulation is to promote a safe, sound, and stable banking and financial system that supports the growth and stability of the U.S. economy and a fair and transparent consumer financial services market. That's a lot, so it is useful to drill down a little; I can do that by describing what we do on an ongoing basis at the Federal Reserve Bank of New York.

At the New York Fed, we operate under delegated authority to supervise the financial institutions in the Second Federal Reserve District, which encompasses New York, parts of New Jersey and Connecticut, the Commonwealth of Puerto Rico, and the U.S. Virgin Islands. This area includes enormous diversity in institutions from state member banks with total assets of less than $100 million operating in a local community to bank holding companies with trillions of dollars of assets operating on a global scale.

Our staff assesses the safety and soundness of domestic banking institutions and operations of foreign banking organizations in the district through onsite evaluations and offsite financial analysis and surveillance. One of our fundamental responsibilities is to ensure that each institution has in place the appropriate risk identification and risk management processes that are necessary for prudent banking. We also analyze issues and industry developments to identify emerging risks and to contribute to the development of domestic and international supervisory policy. I'll return to a discussion of emerging risks later in my talk.

The Supervision Group at the New York Fed works with our colleagues around the Federal Reserve System to develop and implement the System's supervisory programs. This includes working through governance structures like the Large Institution Supervision Coordinating Committee (LISCC) that oversees supervision for the largest, most systemically important institutions in the U.S. We are also involved in similar System-wide committees for other types of institutions such as community banks, regional banks, foreign banks, and other large banking institutions, as well as consumer protection. I'll speak mostly today about our supervisory responsibilities for the largest firms, but will note that we recently hosted a conference at the New York Fed focusing on the role of community banks.

For the largest firms, we actively participate in System-wide horizontal examinations such as the Comprehensive Capital Analysis and Review, or CCAR, which is the annual process for evaluating capital adequacy of the largest firms that began last week. We are actively involved in other horizontal programs such as the Comprehensive Liquidity Analysis and Review (CLAR), and the Supervisory Assessment of Recovery and Resolution Preparedness (SRP). CLAR is the Federal Reserve's annual, horizontal, forward-looking program to evaluate the liquidity position and liquidity risk management practices of LISCC firms. SRP is the Federal Reserve's annual horizontal review of the LISCC firms' options to support recovery and progress in removing impediments to orderly resolution. These three programs form the foundation for the horizontal aspects of the System's supervisory program for the largest firms. The Supervision Group at the New York Fed plays a strong role in developing and executing these initiatives.

In parallel to the horizontal work for the largest firms, the Federal Reserve has a dedicated supervisory team for each of the largest firms. These teams execute supervisory strategies for each firm that align with Federal Reserve System priorities. Through the execution of firm-specific supervision, these dedicated supervisory teams play a critical role in helping to achieve these objectives. Given the location of the headquarters of many of the largest firms in New York, the Supervision Group at the New York Fed plays a central role within the Federal Reserve System in the execution of supervisory activities through the dedicated supervisory teams.

To conclude this section, I'll note that my colleagues in the Research Group at the New York Fed recently hosted a conference entitled "Supervising Large Complex Financial Institutions: Defining Objectives and Measuring Effectiveness."[1] This conference brought together academic economists, policymakers and senior supervisors to talk about the goals and objectives of supervision and different approaches to assessing supervisory success and effectiveness. While this conference focused on the largest institutions, the main themes apply more broadly to the objectives of supervision.

One important theme of the conference was the conceptual distinction between regulation and supervision. Both are designed to help the Fed achieve its objectives and they are mutually reinforcing, complementary efforts. Broadly speaking, regulation involves writing the rules that govern what financial institutions can and cannot do. Supervision focuses on monitoring, oversight and enforcing compliance with law, and supervisory expectations for firms' governance, internal processes and controls, and financial condition.

Why Is Supervision Necessary?

I think it is useful to take a step back and talk about what motivates the need for public sector intervention in the form of ongoing supervision. Why doesn't the market provide sufficient discipline on financial intermediaries as is presumed for some other industries? In the language of an economist, what are the frictions that lead to a market failure so that financial institutions, left to their own incentives and choices, won't necessarily make optimal choices from a societal perspective?

I'll talk about two types of market frictions that create the need for public sector intervention. The first is asymmetric information —the difference in what the borrower knows about an investment opportunity and what the lender or funder of that investment knows. The second is externalities—the ability of one firm's decisions or actions to affect other unrelated market participants. Both of these forces can drive a wedge between private and socially—desired outcomes and motivate the need for public sector intervention. Conceptually, either supervision or regulation can help solve these problems and their relative efficacy depends, in part, on the type of information being assessed or the problem being solved.

- **Asymmetric Information**

  There is considerable academic research describing how asymmetric information can create a special role for financial intermediaries. The basic issue is that lending requires the production of private information about things like the probability of a successful investment outcome, but this can be difficult to convey to third parties who might be providing the funding. This creates a role for a financial institution to bridge the gap between borrowers and savers.

  Moreover, these information asymmetries create the scope for two problems endemic to credit markets: adverse selection where the riskiest borrowers are the most likely to seek credit and moral hazard where borrowers pursue riskier behavior after credit has been extended because their own funds are not invested. In both cases, mitigation requires costly screening and monitoring, which creates a role for a specialized financial intermediary.

  Asymmetric information also creates issues on the liability side of a bank's balance sheet. The banks' creditors—depositors or providers of funding—don't have as much information about the health of the institution as insiders do. This asymmetry makes banks opaque and inherently fragile, which can subject them to runs. This type of "run risk" has been largely mitigated, at least in the case of retail depositors, by deposit insurance, access to lender of last resort facilities, and other elements of the bank safety net. Importantly, however, a broad safety net weakens market discipline of banks and can create incentives for excessive risk-taking. This contributes to the need for risk-sensitive regulation and supervision.

  Regulations can control risk-taking through a variety of means such as setting minimum requirements for capital and liquidity positions, while supervision can identify and constrain activities that are not well-captured through regulation but still affect a firm's risk management, governance and control infrastructure. One common objective is to counter the incentive for excessive risk-taking by intermediaries.

- **Externalities**

A second and distinct type of market failure that creates a need for public sector intervention stems from the externalities that the failure of a large, systemically important bank failure can have on the rest of the financial sector or the economy as whole. For example, the financial crisis vividly demonstrated how the distress of a large financial firm can destabilize broader financial markets and impact other financial firms. These effects can be seen through direct linkages via counterparty exposures. They can also be seen through less direct linkages such as confidence-related behaviors that are manifest in higher haircuts and margins or reluctance to do business with certain firms or types of firms, uncertainty about the true health of a firm, or the impact of fire sales on the valuation of a broad class of assets held by a broad range of investors. The fact that these costs are external to a given financial firm can lead to excess risk-taking.

The realization of these externalities during the financial crisis has had a profound impact on the Federal Reserve's approach to supervision. Most specifically, they provided the practical experience to support the conceptual case for tightened prudential requirements for the largest, most systemically important institutions. This focus is seen in the mandate from the Dodd-Frank Act for the Federal Reserve to implement enhanced prudential standards, including higher capital standards, to mitigate the risks posed to financial stability by systemically important financial institutions.

For example, both the Basel Committee for Banking Supervision and the Federal Reserve System have identified factors that contribute to a financial firm's systemic importance through these types of externalities. These mechanisms are proxied for by observable metrics such as the size of the balance sheet, interconnectedness between firms, complexity of the business, cross-jurisdictional activity, short-term wholesale funding, and substitutability of certain activities. These metrics then determine the capital surcharge for systemically important banks as outlined in the Federal Reserve rule and white paper from July 2015.[2]

More generally, these types of differences across firms provide one of the conceptual underpinnings for differentiating supervisory expectations for different types of financial institutions. This concept—often referred to as "tailoring"—has long been part of the supervisory approach, and has received considerable attention recently. It is reflected in our organizational structure as seen in things like the LISCC and in application of supervisory guidance across different types of firms.

As a specific example, the Federal Reserve issued two Supervisory and Regulation letters in December of 2015 that consolidate previously-issued guidance on capital planning and more clearly differentiate supervisory expectations between financial institutions with more complex operations and those with less complex operations. This tailoring of guidance applies to capital planning expectations related to governance, risk management, internal controls, capital policy, scenario design and projection methods. This guidance further clarifies how capital planning expectations are moderated for firms that pose more limited risk to financial stability.

Key Issues

I've discussed some of the conceptual underpinning of supervision and I'll now turn to some of the practical implications and issues that I'm thinking about.

We continue to strive to provide clarity and transparency on our supervisory expectations and concerns. This can be seen through a variety of mechanisms, including public discussion and private communications with supervised firms. I've mentioned some of the most useful sources of information such as Supervision and Regulation letters that provide public guidance on specific topics to supervised firms, rules and white papers that outline and implement the underlying conceptual thinking on key issues such as the surcharge for systemically important banks or the expectations around CCAR, and public speeches by policymakers.

Of course, we engage regularly in private communications with supervised firms. This is both to provide feedback on a firm's progress relative to supervisory expectations and to gain information about the developments in the financial industry and the efficacy or our supervisory programs. We do this on a regular and continuous basis through both formal and informal channels, and this is a key part of the supervisory program for firms of all sizes.

I also want to highlight three specific developments that are relevant for us as we execute our supervisory responsibilities. I expect these topics—cybersecurity, fintech and reputational risk—will be familiar and I'll provide a supervisory perspective on each.

- **Cybersecurity**

  The Federal Reserve, in its supervisory role, collaborates with the Federal Financial Institutions Examination Council (FFIEC) to coordinate work on enhancing cybersecurity supervisory programs. We are also interested in working with the industry on a coordinated approach for cybersecurity to strengthen the resiliency of the financial services sector against cyberattacks.

  Internally, the Federal Reserve has organized a supervisory program on cybersecurity that consists of subject matter experts from across the Federal Reserve System. Work is underway to enhance the analysis of IT examination data in conjunction with threat information to enhance risk-focused reviews during examinations.

  Through our discovery work with financial institutions, we have found that the state of cybersecurity readiness varies across firms. Supervisors are seeking to develop common principles to address cybersecurity issues and will work with other agencies to ensure that firms are dedicating resources and taking the appropriate actions to defend the operations that are critical to the financial services sector against cyber threats. This is particularly true for those risks that could be channeled through interconnected organizations and that could potentially have an impact on other firms and more broadly across the sector.

- **Fintech**

  The financial sector, like the broader U.S. economy and society, is becoming increasingly digital and there is considerable discussion of "fintech"—defined simply as the intersection between financial services and new technologies. A recent industry study, for example, reports that investment in fintech companies grew from $1.8 billion in 2010 to $19 billion in 2015.[3] It is unclear, however, whether fintech will enhance or fundamentally disrupt the financial service and payments industries, or perhaps it is some combination of both. In any of these cases, however, supervisors will have a keen interest in monitoring the impact on the business models and risks of financial institutions and the way financial intermediation is done.

  We observe financial firms engaging in a variety of ways with fintech companies. This can be through the development of in-house projects such as setting up innovation labs or encouraging developers to code on open application program interfaces (APIs). This can also be through collaboration with industry consortiums to come up with unified industry standards that enhance operability and enable future technological advancements, or it can be through partnering with or investing directly in fintech companies.

  Some of the interesting questions for supervision revolve around things like: what new benefits might these new technologies bring? Will they enhance existing processes or bring about entirely new solutions to existing financial sector problems? Will they create risk, mitigate risk, or simply reallocate existing risks? How should the current supervisory framework evolve to incorporate these types of developments?

  The New York Fed is assessing the implications of fintech developments through participation in a wide range of Federal Reserve System, interagency, and international efforts. In addition, we meet regularly with supervised firms, fintech companies, and industry groups to follow these developments. Our supervisory program will continue to evolve with the underlying technologies.

- **Reputation Risk**

  Over the past few years, the New York Fed has been challenging the financial industry to consider the many factors that have contributed to recent, widespread misconduct and the perceived lack of trust in the financial sector.

  The various forms of misconduct impose direct costs such as fines, legal fees in investigating allegations and defending lawsuits, and internal monitoring costs that should matter to firms. In this view, a principal benefit to a financial firm of having a strong culture that builds trustworthiness is the avoidance of the bad behavior that can carry significant monetary costs and can inflict destructive damage to the organization's reputation. Firms should have every incentive to manage and internalize those potential costs.

  More broadly, there may be additional adverse effects on other firms or the financial sector as a whole if there is a widespread lack of trust in financial services. Similarly, my colleague Michael Strine has argued that the financial industry exists, in part, to enhance the public good and thus faces a higher degree of social responsibility due to its role in supporting the broader economy.[4] Both of these effects suggest a role for the public sector in facilitating appropriate behavior and conduct in the financial services industry. Supervision can contribute to this through support for the development of effective internal governance regimes, prudent risk management policies, and strong compliance and control structures, all within a framework of effective oversight from the Board of Directors.

Conclusion

To conclude, I've spoken today about the conceptual rationale for public sector intervention through supervision and some practical issues related to how we execute on our supervisory responsibilities at the Federal Reserve Bank of New York. Our goal is to promote a safe, sound, and stable banking and financial system that supports the growth and stability of the U.S. economy, and we will continue to strive to meet these responsibilities.

Thank you very much for your attention this afternoon. I'd be happy to take some questions.

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[1] Supervising Large, Complex Financial Institutions: Defining Objectives and Measuring Effectiveness

[2] Calibrating the GSIB Surcharge, July 20, 2015, Board of Governors of the Federal Reserve System.

[3] "Digital Disruption: How Fintech is Forcing Banking to a Tipping Point," March 2016.

[4] Forming the Next Generation of Bankers: The Future of Business Education and Ethics, Michael Strine, March 22, 2016.