FS Regulatory Brief

Banking Supervision at the Federal Reserve....The Times are a Changing

Sarah Dahlgren, the executive vice president responsible for Bank Supervision at the Federal Reserve Bank of New York (FRBNY) recently addressed the New York Bankers Association. Her speech focused on the changes that the FRBNY has made to enhance the supervisory process both in terms of their staffing and supervisory approach. We believe this should prompt Bank Management to reconsider and refine their approach to regulatory relationships and interaction. Ms. Dahlgren signalled the areas of critical supervisory priorities for the near future-recovery and resolution, corporate governance and business strategy/risk appetite. *Given that forewarned is forearmed, we believe firms should be taking actions now to assess their vulnerability and prepare for new supervisory assessments.*

Changes to supervision

FRBNY has introduced two new positions to the on-site teams - Senior Supervisory Officers and Business Line Specialists. These additions expanded the structure of on-site teams and reflect the refined supervisory approach. Firms should expect more frequent and expanded communication and review, including senior management, front office, management committee meetings and the board.

Senior supervisory officers

The Senior Supervisory Officer (SSO) replaces and expands upon the Central Point of Contact role as the lead examiner for the organization. Most SSOs will have a Deputy SSO who will be more of a day to day manager of the onsite examiners as they implement the supervisory plan and develop the supervisory assessment. The SSO will spend significant time interacting with senior, executive and board members to confirm the leadership's knowledge of regulatory concerns and the process by which they develop and understand the firm's risk tolerance, risk appetite, governance and business strategy. SSOs will be keenly focused on how the top of the house interact with risk management functions and are able to hear independent views of the firm's risk.

We believe the SSO's view of the firm's strategy, risk tolerance and risk appetite will be critical to the examination process and assessment because it will strongly influence the testing and expectations around the firm's control processes, governance and infrastructure. Firms should expect that examiners will look closely as to how the stated business strategy, risk appetite and risk tolerance reconciles with the program of controls, limits and revenue production trends.

For example, if a firm's stated strategy for trading is customer facilitation, examiners will expect controls and revenues trends to strongly reflect that of a customer facilitation business (e.g., low risk limits, low VaR utilization and stable revenue streams). A customer facilitation business which is characterized by large limits, high VaR utilization or volatile revenue streams, could come under examiners' scrutiny due to a potential disconnect between the strategy and surrounding controls. Peer analysis will also be incorporated in their review.

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To be best prepared for such dialogues, firms should have documented how the program of controls is mapped to the full range of business risks and that it has a rationale as to how consistent they are, given the risk.

Further, firms should possess a strong understanding of how their firm compares (limits, revenues, strategy and risk appetite) to peer operations.

Business Line Specialists

"Business Line Specialists" are aligned to the firm's material business lines and tasked with understanding the business line's operations, risk appetite, market position and revenues. These individuals will work closely with the pre-existing risk specialists (i.e., market, credit, operations, legal and compliance, etc.); however, they will also work across firms to draw peer comparisons.

We believe that firms should expect examiners to review and question revenue patterns, including how they reconcile with stated risk appetite, limits and stated strategies of individual business lines. These individuals will be building peer comparisons to aid in their assessments. In anticipation, firms should perform their own self assessments of how risk appetite and tolerance are expressed in limits and revenue. Additionally, where firms can assess how their firm compares to peers will also be impactful.

Supervisory objectives

Ms. Dahlgren stated that supervisors will focus on three primary objectives in the near future: (1) reducing the complexity of firms and the system by making firms more recoverable before problems occur and more resolvable in the event of failure;
(2) enhancing the resiliency of the firms and the system through capital and liquidity buffers; and (3) promoting stronger management governance at firms.

Recovery and resolution

Examiners (from the FRBNY, BoG and the FDIC) will be iterating on recovery and resolution plans with firms to ensure they reflect the range and scope of the firm's activities. Dahlgren characterized a safe and sound financial system as one that is less complex and less interconnected.

Firms should expect that supervisors will be keenly focused on understanding the drivers and rationale for their organizational and operating structures including within the banking franchises. We believe that should a firm fail to credibly support its organizational structure, they may hear demands for simplification of the structure or in the more extreme, be subject to additional capital charges.

Capital and liquidity buffers

Regulators will continue enhancing their assessment of capital and liquidity using more advance techniques a.k.a., stress testing. Supervisors are committed to increasing capital and liquidity buffers at the firms to ensure there is greater flexibility to deal with system shocks and minimize vulnerability.

In the capital space, Supervisors announced the CCAR process which will be more expansive this year including more firms and introducing a more extensive list of economic variables and more severe economic scenarios.

We believe that CCAR submissions and analysis will serve as the cornerstone of supervisors' assessment of capital sufficiency; and, firms should be focused on how these scenarios resonate with their internal stress/scenario tests and their overall capital assessment process. We anticipate that supervisors will spend considerable time assessing the firm's processes by which it evaluates capital adequacy, including the rigor of its stress and scenario process, and assumptions and its projections around capital sources and capital needs.

We expect that examiners will want to ensure that the firm links its risk appetite and risk tolerance in the capital planning assessment.

On the liquidity front, supervisors will continue with their comprehensive and frequent data collection regarding liquidity, funding and funding concentrations. These data sets will allow examiners to assess the impact of market events on the firms on a more timely basis.

We expect that trends in these data sets will likely result in additional inquiries by supervisors particularly those trends which reflect more negative developments and may result in additional scrutiny of liquidity risk management process.

Supervisors are also focused on the recalibration of the liquidity coverage ratio under Basel III so discussions regarding balance sheet liquidity should be expected.

Corporate governance

One of Ms. Dahlgren's lessons learned was that the voice of risk management was at times stifled within some organizations which led to a disconnect between the top of the house and the firm's risks. As mentioned previously, the FRBNY has restructured to ensure that there is increased communication with the supervisory teams and the firm's leaders. We expect that supervisory discussions will focus on the substance, frequency and capabilities of risk reporting throughout the firm but particularly at the top of the house and the quality of board level discussions of risk appetite, risk tolerance and the scope of controls and limits employed to manage risk within stated goals. Firms can also anticipate that supervisors will want to attend board meetings including closed sessions to understand and assess the comprehensiveness of information provide to members and the quality of discussion.

We recommend that firms perform an assessment of the MIS that is provided to the board to understand and manage risk.

We anticipate that supervisors will likely also focus on the authority, both stated and in practice, of critical control units (e.g., risk management and audit) to escalate concerns and enforce risk policies with interference from revenue generating business lines. This will likely be implemented by attendance at risk committee meetings.

Firms should expect that there will be considerable scrutiny on limit increases or breeches among other indicators of a firm which favors revenue generation over risk mitigation.

Impact on regulated firms

- Expect greater visibility and requests for increased discussions particularly with senior management.

  Given their role as the senior driver of supervisory assessment and direction at a firm, SSOs will want to meet regularly with a number of key business line leads, risk management and executive management personnel to discuss strategy, revenue drivers, views of risk trends and the firm's risk appetite. Firms should anticipate that SSOs will want to attend board meetings on some periodic basis. Given the expansion of onsite staff presence and the move to add decidedly more senior members, it is critical that firms have a process to manage information flows including communication channels to ensure messages are on point and accurate. Firms should develop a communication process and strategy regarding communication with supervisors to ensure that they are accurate, comprehensive and beneficial to the firm as well as to the supervisors.

- Anticipate increased scrutiny around stated risk appetite, risk tolerance and business strategy, particularly as it ties to capital planning. Examiners are increasingly skeptical of firms which tout "low risk customer type" businesses and then suffer significant losses as a result of market moves. Firm should be prepared to rationalize the size and breadth of limits in light of the firm's business strategy and risk tolerance. Examiners will also expect that firm revenues will be reflective of the type of strategy both employed and stated in policy. In anticipation of such questions, firms should perform a review of a material business line's allocated limits and revenue results, in light of its stated risk appetite, strategy and risk tolerance.

- As part of the consideration of recovery and resolution, firms should anticipate that supervisors will be particularly critical of operations which are needlessly complex or without a strong rationale for their complexity both at the firm and bank level. Ms. Dahlgren points to a financial system which is less complex as one that is more resilient and; that firm complexity will not only increase the challenges of a resolution but, more importantly, limit the flexibility of a firm to consider action in the face of potential failure. Firms with well supported rationales for their operating environment rooted in more than tax and capital maximization will be better received by supervisors.

Additional information

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