Confidentially Speaking:
Is It Time to Reconsider CSI Standards?

Remarks by
Esther L. George
President and CEO
Federal Reserve Bank of Kansas City

December 11, 2020

Delivered during panel discussion on "Transparency in Bank Supervision"
at "Bank Supervision: Past, Present and Future," an online conference hosted by
The Federal Reserve Board of Governors, Harvard University and
the Wharton School of the University of Pennsylvania

I appreciate the opportunity to share my views and take part in this discussion. Having spent a significant portion of my Fed career associated with the business of bank supervision, I approach this topic from the perspective of a practitioner.

I joined the Kansas City Fed in 1982 as a bank examiner. Since then, I've observed hundreds of banks fail across the country for a variety of reasons. Yet, I can't recall a single one succumbing to that fate that was well capitalized, well managed, and well supervised. Of course, considerable research has been devoted to the issue of bank capital and the dynamics of governance. Considerably less scholarship has focused on what it means to be "well supervised," and so I look forward to the deliberations of this conference in advancing our thinking on that dimension.

More than two decades ago, the Federal Reserve released a study on improving public disclosure in banking.[1] The report focused on market discipline and transparency as a response to a changing banking landscape. The evolution of the financial system had contributed to growing complexity in financial instruments and services, as well as increasing the scale and scope of the nation's largest banks. At that time, market discipline was viewed as a preferred alternative to large-scale expansion of supervision and regulation as a means of limiting excessive risk-taking by large, complex financial institutions. Proposed changes focused on regulatory reporting and a wider scope of disclosures by large banks.

Improving public access to information on banking organizations could have many benefits, including enhancing market discipline, promoting effective management, and enforcing supervisory accountability. However, the public benefits of transparency must necessarily be

[1] Federal Reserve System. 2000. "Improving Public Disclosure in Banking (Staff Study 172)." Board of Governors of the Federal Reserve System. March.

balanced with the need for confidentiality. This does not mean that more transparency guarantees greater stability or that there are rigid disclosure standards that can be easily applied across all circumstances. Recalibrating the existing boundaries of CSI must be approached through the lens of the public's interest in a fair, stable and sound financial system. Importantly, the value of transparency is not in the volume of information disclosed, but rather in the clarity it provides in promoting responsible, effective management of the supervised entities.

To that end, several questions are worth considering. How do the traditional protections afforded to CSI and other supervisory practices contribute to financial stability? Are there ways in which greater transparency might strengthen both risk management and supervisory accountability? Do the answers to these two questions change during times of crisis or systemic stress? Should there be some additional consideration based on the institution's size, risk profile or systemic importance?

Before continuing, I will remind you that my views are wholly my own.

What's the Big Secret?

Broadly speaking, the rationale for CSI is a sound one in my view. Two reasons are commonly given as the foundation for protecting CSI:[2]

- First, some degree of confidentiality is desirable to ensure the security of financial institutions and to protect against unintended and adverse effects that might result from the disclosure of certain types of sensitive supervisory information. This could include customer data, proprietary market intelligence, or even candid

[2] Department of Justice. 2020. "Department of Justice Guide to the Freedom of Information Act." United States Department of Justice.

supervisory assessments, such as control weaknesses in critical operating infrastructure, the public exposure of which might compromise banks' safety.

- Second, confidentiality can help foster a relationship of trust between supervisors and the institutions, enabling frank dialogue and creating an environment in which bank management may be more likely to cooperate with examiners.

In my experience, both of these are desirable features of effective supervision. Supervisors' detailed access to bank activities and their analysis of proprietary and internal information place them in a unique position to assess risk exposures that may not be available from other independent sources.

Where Might More Disclosure Add Value?

Might we foster a more stable financial system through greater transparency and market discipline, and if so, how? I believe the answer is a qualified yes. Greater disclosure can create incentives for more responsible risk management and contribute to a strong and trusted banking system. There are of course trade-offs, and we should carefully consider how much detail is necessary to promote the outcomes we seek.

When considering transparency, drawing distinctions between institutions based on their size, complexity and risk profile should be a consideration. For example, during the financial crisis, stress testing the nation's largest banks was introduced as a way to enhance public confidence in the nation's financial system. The announcement of the Supervisory Capital Assessment Program (SCAP) results in 2009 provided information to the public regarding the scale of potential losses that the largest banks might incur if the economy were to continue to deteriorate.[3] Continued disclosure of firm-specific information regarding capital adequacy through the annual CCAR and DFAST exercises has been viewed as valuable in supporting public confidence in the banking sector and stronger capital planning practices. Should we go even further? Given these firms' systemic importance, and the history of government support provided in prior financial crises, one might argue that more transparency might be beneficial and even justified. Increased transparency is likely to be most effective in providing market discipline for the largest banks, who have an active and attentive investor base to monitor their activities and risk-taking.[4]

On the other hand, for smaller banks where the capital is closely held or not widely traded it might be more problematic to apply the same standard of transparency without risking harm to the institutions themselves and to the communities, and people, they serve. For example, disclosing certain types of information might reveal potentially sensitive details about a smaller institution's customers. And given many of these institutions' size and governance structures, disclosure might not result in the same positive effects possible in the case of larger institutions. An individual smaller institution is unlikely to pose risk to financial stability, so without a systematic way to disclose relevant information, the value of disclosure may be limited.

A second consideration is the degree of detail included in disclosure and the types of information disclosed. The Federal Reserve's Board of Governors has recently sought to increase accountability and transparency in aggregate through the publication of the Financial Stability Report and the Supervision and Regulation Report.[5] These reports offer the public greater insight into the Federal Reserve's approach to supervision, including observations on trends and broad

---

[3] Board of Governors. 2009. "The Supervisory Capital Assessment Program: Overview of Results." May 7.
[4] George, Esther. 2013. "Effective Supervision: Balancing New and Traditional Approaches." Paris, November 22.
[5] Board of Governors. n.d. "Financial Stability Report" and "Supervision and Regulation Report." Board of Governors of the Federal Reserve System, Publications.

themes in supervision for both large and small institutions, and views on systemic risks. While these reports include neither detailed nor firm-specific information, there may be opportunities for greater transparency in sharing aggregated information about supervisory themes and trends.

Considering the type of information to be disclosed is important given that CSI is broadly defined and includes information contained in exam reports, ratings, sensitive customer information, or proprietary business information, among others.[6] One aspect of this confidential information that frequently surfaces as a candidate for disclosure is key or material findings from examinations.

Typically, supervisors disclose material matters at the point of seeking corrective action, such as those included in formal enforcement actions. However, absent risks to financial stability, requiring banking organizations to disclose material findings could be useful. This would also necessitate a careful consideration of the process by which such disclosure might occur and what, if any, standards might govern it. For example, would disclosure of supervisory criticisms be best shared categorically by risk area, or verbatim?

Finally, approaches for disclosure must contemplate how markets could react in times of crisis or systemic stress. As already noted, the disclosure of stress testing results for larger institutions during the 2008 financial crisis played an important stabilizing role in reassuring the public. However, no two crises are exactly alike, and it is difficult to know beforehand precisely what kind of information might help restore confidence in the financial system during the next crisis. For example, in the late 1980s, Citi was the first bank to make a large provision against its

[6] For the Board of Governors' definition of CSI, see the Rules Regarding the Availability of Information, 12 C.F.R. § 261, which describe the Board's procedures for protecting confidential information as per the Freedom of Information Act, 5 U.S.C. § 552(b)(8).

Latin American exposures, and many thought the market would react negatively.[7] Instead, the news had a positive effect, as markets wondered whether big banks were reserving enough or had the capacity to do so.

Conclusion

Supervisors and the industry need to weigh the implications of greater transparency for both stability and better management of risk. Incorporating some degree of supervisory discretion rather than prescriptive statements or standards will likely be necessary.

I look forward to the discussion and research coming out of this conference to guide our thinking on this important issue.

[7] Sachs, Jeffery D. 1989. "New Approaches to the Latin American Debt Crisis." Princeton University, International Economics Section, Studies in International Economics, Essays in International Finance, No. 174. July.