Effective Supervision: Balancing New and Traditional Approaches

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I'm honored to have the opportunity to participate in this 50th anniversary conference. Thank you to Governor Noyer for his kind invitation. Forums such as this one provide a valuable opportunity to hear a wide range of perspectives from policymakers and others on key challenges facing us today. I also want to thank Deputy Governor Anne Le Lorier, who joined us in Jackson Hole, Wyoming, this summer for our program on the global effects of unconventional monetary policy.

Considerable attention has been focused on fixing the problems that caused tremendous damage to the global financial system and economy. More than five years later, we are still feeling the effects of the financial crisis, and, at least in the United States, questions remain as to whether we are taking the right steps. Certainly, the stakes are high and, therefore, many policymakers around the world have committed themselves to improving the durability and resiliency of the financial system.

Like you, the United States is committed to finding a way forward and doing so in a manner that serves both domestic and global objectives. American policymakers and regulators are working intently to finalize and to implement numerous regulatory changes. Of course, it will be some time before the full effects of these changes—both intended and unintended—are understood.

As we focus on new tools and approaches to supervision and regulation and bolster our ability to assess risks to financial stability, my own view is that macroprudential supervision and the identification of systemic risk can be most effective when it serves as a complement to a rigorous microprudential regime. It is at the firm level where the validation of risk-management policies and governance can offer a window into the incentives that drive decision-making and risk appetite. This foundation can provide important context and confidence in our macroprudential views of the system. Assuring that we allocate scarce resources and serve the public's interest, we must balance today's regulatory innovation with existing prudential standards. In my remarks today, I will address three aspects of a supervisory framework that bring such balance and enhance both firm-level supervision and system-wide assessments: informed judgments by examiners, supervisory transparency and regulatory cooperation.

The role of examiner judgment in the new supervisory framework

Much of our efforts to reform the supervisory framework in the United States have centered on such features as macroprudential supervision, stress-testing, enhanced prudential standards of supervision for systemically important financial institutions, and orderly liquidation authority. These features place new demands on the central bank and other regulatory bodies to apply more rigor in how we supervise certain financial institutions as well as to create a more comprehensive understanding of systemic risk. Quantifying and measuring risk has become core to this task. In addition, the international capital framework continues to rely heavily on very detailed formulations and risk models, and the scenarios that many countries will use to test the capital adequacy of major banks will require access to massive data sets to make the necessary calculations.

These developments suggest a different supervisory regime than what we have used in the past. The trend toward a more highly quantitative and model-driven approach to risk measurement and capital adequacy offers a more forward-looking assessment of financial institutions and the impact of macro risks to the economy. No doubt, as we gain experience with such tools, they will be further refined to bring additional insights to vulnerabilities in the financial system.

Notwithstanding the potential of these new approaches, our enthusiasm to become macroprudential supervisors should be tempered with a healthy recognition that these methods are not a substitute for microprudential supervision. I believe we must be careful to appreciate the crucial role that informed judgments by experienced examiners can continue to play in the supervision of financial firms. Many of the key contributors to this crisis—lax lending standards, risky funding strategies, poor governance and overly optimistic risk management strategies—are shortcomings that can best be detected through traditional examination and supervisory processes when properly supported by the supervisory framework.

It is too easily assumed that financial models, stress tests and macroprudential supervision will provide "smarter" supervision and identify what is presumed to have been missed by examiners in the run-up to the 2008 financial crisis. However, a more thorough analysis suggests that the largest banks were more vulnerable because regulators relied too heavily on erroneous assumptions about the quality of governance and controls over incentives, sophistication and measurement of risk management, and the strength of market discipline. As a result, regulators had already given up on the type of full-scope examinations that smaller institutions typically experience. Prior to 2008, most of the supervisory emphasis centered on a large institution's models and risk weights, and far less effort was given to a thorough examination and critical analysis of its loan portfolio, funding strategies and exposure to exotic risks such as synthetic derivatives.

The Dodd-Frank Act requires enhanced prudential standards for firms in the United States that pose elevated risk to financial stability. These macroprudential efforts are worthy exercises, but no matter the tool, experience and informed judgments provided by trained and experienced staff are required to meet today's heightened supervisory expectations. Data and models provide information and choices that must be evaluated in the context of the more subjective or qualitative elements of the organization, such as the quality of internal controls and protocols, management and organizational culture.

We must be mindful that macroprudential supervision is not yet a proven tool in the work of financial supervision. Prior to the crisis, a number of central banks conducted their own versions of macroprudential supervision and stress-testing of major institutions using their Financial Stability Reports and the detailed analysis behind these reports. While these reports identified potential risks, they were not able to provide a clear, advance warning of the crisis or a timely signal to financial supervisors and monetary authorities to take corrective action.

A successful supervisory framework thus will require a blending of new quantitative macrosupervisory approaches with the qualitative judgments that examiners can contribute at the firm level. As we adopt new and yet untried programs, we should not draw resources away from microprudential supervision. We must assimilate these approaches and not confuse their roles. Asking plumbers to do the work of electricians risks burning something down. On the other hand, allowing plumbers and electricians to work together is likely to deliver reliable functionality.

Enhancing market discipline with transparency in supervision

A second point I would like to explore is how we might use supervision to increase transparency in financial markets and thereby restore something that was missing in this crisis—an effective framework of market discipline and a set of incentives for the financial industry that does not encourage excessive risk-taking again. Central banks have for some time regarded transparency as essential to accountability and the effective transmission of monetary policy. While there are some aspects of supervision that may be best left confidential, there are other areas where we should think about how we can make our goals and actions more systematic, predictable and transparent.

We have taken several steps in this direction in the United States. At the Federal Reserve, we disclose the capital stress-testing methodology and the results from our Comprehensive Capital Analysis and Review (CCAR) program. These CCAR disclosures are a work in progress, and we will have to continue to think about what stress scenarios will provide the best test of capital planning across all the major financial institutions and whether we should disclose more detailed information on individual institutions.

A strong reason for supervisors to consider a broader approach to transparency is that today's global institutions, with their systemic footprints, can easily turn the complexity of their operations into opaqueness. This, in turn, then hinders the ability of stockholders, large creditors and other parties to provide the appropriate level of market discipline. The annual reports of major institutions do not include simple disclosures, but contain a nearly unending stream of footnotes that attempt to describe their operations because of the legal liability of saying something that might prove to be misleading. As a result, annual reports contain few definitive statements and forecasts, or clear and specific statements about risk exposures. Unfortunately, this lack of transparency leaves many investors to rely on regulators to ensure sound conditions at banks—or in the extreme case, to protect these investors through "too-big-to-fail" policies and public assistance.

How can supervisors reverse this trend and return market discipline to the role it once played in financial markets? Transparency is something we must consider as we continue to work on our stress tests and as we implement new standards and limits in such areas as liquidity, counterparty risk, concentration of assets and risk exposures. We should work toward implementing standards that also provide useful and accurate information to stockholders and creditors. One way to accomplish this is to construct simple regulatory rules that can be easily understood by the public and readily enforced by examiners. Regulators may also be able to promote transparency and enhance market discipline by highlighting industry information in ways that inform the public, such as the Federal Deposit Insurance Corporation's Global Capital Index[*] or considering the disclosure of key or material findings from examinations.

Multiple regulatory agencies can be effective

A final issue is the growing chorus in many countries to reshape the regulatory structure, or to at least rationalize the structure we are creating through regulatory reforms. This has clearly become an important topic in Europe with the movement to a single supervisory mechanism and a single recovery and resolution framework. Structure and design are also important features in the European Systemic Risk Board and in individual countries as they participate in these consolidated systems while also deciding how to meet their domestic responsibilities in supervision.

In the United States, we face similar coordination issues with a new Financial Stability Oversight Council, the Consumer Financial Protection Bureau, and in meeting our mandate for enhanced supervision of systemically important financial institutions at both the bank and non-

[*] Hoenig, Thomas. "Capitalization Ratios for Global Systemically Important Banks," at http://www.fdic.gov/about/learn/board/hoenig/capitalizationratios.pdf.

bank level. This is in addition to our existing supervisory structure, which has been often criticized as structurally flawed, with both state and multiple federal banking regulators and other regulators for securities and insurance activities. Given the United States' record in structuring regulation, I am reluctant to offer anyone else advice on how to design a supervisory system. However, my own experience with multiple federal regulators and 50 state supervisors has shaped my perspective on how and why a complicated regulatory structure can work.

Where multiple interests exist—whether that might be bank or non-bank institutions, deposit insurance authorities, central banks, chartering or consumer protection agencies, or state or federal entities—it is important that the mandated responsibilities and the diversity of views be reflected in the supervisory process. This diversity of views helps to prevent one-sided approaches that might ignore important policy considerations. An essential ingredient in making this structure work and in achieving all the different objectives is cooperation among the appropriate agencies.

In the United States, and as a federal regulator, I have come to appreciate the value of each state's interest in banking industry outcomes as it closely relates to the state's economic success. To ensure that all stakeholders participate meaningfully in the supervisory process, this means sharing supervisory data, joint participation in examinations and cooperative rule-writing. A benefit of our structure is that state and federal chartering authorities can oversee their respective institutions, while the FDIC can use its supervisory experience to gain better insight into its deposit insurance responsibilities. The Federal Reserve's role in supervision provides important knowledge for carrying out its discount window responsibilities, monetary policy formulation and its macroprudential supervisory role.

Of course, the globalization of finance further complicates this picture, as we saw during the crisis with foreign funding exposures, cross-border lending and securities holdings, and resolutions that spanned several countries. Now we are all involved in international efforts to harmonize capital, liquidity and resolution rules—none of which can be viewed as a small challenge. It is crucial that we learn from the recent past and establish strong lines of cooperation ahead of the next crisis.

Conclusion

Lapses in our supervisory framework contributed to the tremendous and devastating costs to the global economy and demand that we look for new ways to oversee a complex financial system. Yet, even as we deploy new tools and methods, we must commit to strengthen microprudential supervision, market discipline and cooperation among regulators. Importantly, the courage and leadership to embrace and enforce whatever regime we adopt will in the end make all the difference to the outcomes we seek.