

BOARD OF GOVERNORS REVIEW
OF FEDERAL RESERVE BANKS'
LARGE INSTITUTION SUPERVISION COORDINATING COMMITTEE INFORMATION
FLOWS AND COMMUNICATION CHANNELS



November 2015

BACKGROUND

In the aftermath of the financial crisis, the Federal Reserve has improved its oversight of the largest, most systemically important financial institutions to mitigate risks to the financial system and to ensure that financial institutions are able to support lending to businesses and households.

Regulatory changes have been among the most important improvements:

- banks are now required to hold significantly more capital, with higher standards applied to the most systemically important firms;
- large institutions have also been required to substantially increase their liquidity;
- large firms are now required to show that they can continue to operate safely and serve their customers in stressful conditions similar to those that occurred during the crisis, an exercise known as “stress testing”; and
- the Federal Reserve and Federal Deposit Insurance Corporation (FDIC) now require large firms to submit resolution plans.

Alongside these regulatory changes, the Federal Reserve has also strengthened its supervision of large financial institutions. Important additions to supervision of large, systemically important firms include annual reviews to:

- stress test capital positions and evaluate the qualitative aspects of firms' capital planning, including risk management, governance, and internal controls;
- assess liquidity, including conducting an independent assessment of firms' liquidity and reviewing firms' own liquidity stress tests; and
- review firms' resolution strategies and operational ability to support recovery planning and their progress in removing impediments to orderly resolution.

In 2010, the Federal Reserve implemented these improvements to supervision through a new supervisory program and a new structure called the Large Institution Supervision Coordinating Committee (LISCC). The LISCC coordinates the Federal Reserve's supervision of domestic bank holding companies and foreign banking organizations that pose elevated risk to U.S. financial stability and nonbank financial institutions designated as systemically important by the Financial Stability Oversight Council (FSOC).¹

The LISCC supervisory program combines firm-specific, safety-and-soundness perspectives with a broader, horizontal view of the banking industry to anticipate and mitigate threats to financial stability. Key characteristics of the LISCC program include:

- micro- and macro-prudential perspectives;

¹ More information on the LISCC supervisory program, including a current list of firms in the LISCC portfolio, may be found on the Board's public website at <http://www.federalreserve.gov/bankinforeg/large-institution-supervision.htm>.

- multi-disciplinary and Federal Reserve System-wide input into the direction and execution of the supervisory program, including input from supervisors, research economists, payment system experts, and market analysts, from the Board of Governors (“Board”) and the Federal Reserve Banks;
- formal horizontal examinations, periodic stress-testing, and scenario analysis; and
- increased collection and use of consistently reported and timely firm-specific data.

The LISCC is comprised of senior staff and is a collaborative body providing Federal Reserve System-wide and cross-disciplinary perspectives on the supervision of firms in the LISCC portfolio. The LISCC draws on the rich diversity of financial services knowledge and the economic expertise that resides within the Federal Reserve System to provide advice on the strategic direction of LISCC portfolio supervision.

The LISCC Operating Committee (OC), in consultation with the LISCC, is responsible for setting supervisory priorities, overseeing the execution of supervisory activities, and vetting supervisory ratings and messages for the LISCC firms. The OC is a multi-disciplinary group comprised of senior officials from the Board and Reserve Banks. Responsible Reserve Banks, working under delegated authority from the Board, have dedicated supervisory teams for each LISCC firm. The OC provides direction to all LISCC firms’ dedicated supervisory teams, directly manages several subgroups, and oversees the LISCC program’s major horizontal initiatives. The OC subgroups, LISCC horizontal program oversight groups, and dedicated supervisory teams collectively execute the LISCC supervisory program in line with LISCC and OC priorities.²

REVIEW OBJECTIVES

On November 20, 2014, the Board announced a review to ensure that the examinations of the largest and most systemically important financial institutions in the United States are consistent, sound, and supported by all relevant information. Specifically, the review had two objectives: (1) determine whether LISCC decision-makers received the information needed to ensure consistent and sound supervisory decisions; and (2) determine whether adequate methods are in place for those decision-makers to be aware of material matters that required reconciliation of divergent views related to the supervision of those firms.³

The on-site portion of the review was conducted from December 2014 through April 2015 and included the Federal Reserve Banks of Boston, New York, Richmond, and San Francisco. The report takes into account observations from each Reserve Bank.

² For more information on the operating structure of the LISCC, please see: <http://www.federalreserve.gov/newsevents/press/bcreg/20150417a.htm>.

³ Press Release, Federal Reserve Board announces two separate reviews are underway regarding examinations of large banking organizations, November 20, 2014: <http://www.federalreserve.gov/newsevents/press/bcreg/20141120a.htm>.

SCOPE AND METHODOLOGY

To address the objectives as comprehensively as possible, the review focused on the work performed by dedicated supervisory teams to support the 2013 annual assessment.⁴ The annual assessment determines supervisory ratings and identifies key supervisory issues for the LISCC firms. As the culmination of all supervisory work performed during the past year, the annual assessment is informed by examinations, continuous monitoring activities, stress testing of capital and liquidity, and other horizontal exercises.⁵

As part of the annual assessment process, the LISCC OC reviews materials prepared by each dedicated supervisory team, including recommendations for the supervisory ratings and the rationale behind the team's recommendations. The LISCC OC also considers information from LISCC horizontal reviews, including the Comprehensive Capital Assessment and Review (CCAR) and the Comprehensive Liquidity Assessment and Review (CLAR), as part of the annual assessment.

The review analyzed dedicated supervisory team processes for generating the recommended annual ratings proposed to and vetted with the LISCC OC, including the supervisory work completed through firm-specific examination activities, continuous monitoring, and other supervisory reviews. The review examined documentation for 29 targeted examinations and enhanced continuous monitoring events. The review also examined more than 350 separate work products supporting continuous monitoring and the 2013 annual assessment process, including any information that addressed how Reserve Bank staff and management considered and resolved differing supervisory opinions that arose during the supervisory process.

Additionally, 122 current and former members of the dedicated supervisory teams and 8 senior officers responsible for the Reserve Banks' execution of the LISCC program were interviewed. The review also examined how the hiring and initial training provided for new Reserve Bank dedicated supervisory team members affected the ability of team members to document relevant supervisory information and raise varying views of that information.

The review was conducted by officers and senior staff who were independent from the Reserve Banks within the scope of the LISCC review and had relevant knowledge of supervisory programs and practices for large complex financial institutions. At the Federal Reserve Bank of New York, the review was conducted by 16 senior staff and officers from the Board and Federal Reserve Banks of Cleveland, Atlanta, Chicago, and Minneapolis. At the remaining Reserve Banks, the review was conducted by seven senior staff and officers from the Board and the Federal Reserve Bank of Chicago.

While the annual assessment process represents the culmination of a year's worth of supervisory work, it is important to note that the scope of this review was limited to assessing the Reserve

⁴ The review concentrated on the 2013 annual assessment, as it was the most recent assessment that had been completed prior to the start of the review. Annual assessments are typically completed in the subsequent year (e.g. the 2015 annual assessment process will conclude in 2016).

⁵ For further context, please refer to the appendix on the annual assessment process.

Bank's *work products and processes* for generating the recommended annual ratings, rather than the overall effectiveness of the LISCC program itself.⁶ The focus of the review was to ensure that decision-makers in the LISCC program were receiving all necessary and relevant information needed to make informed supervisory decisions.

The selection of firms whose annual assessments were included in the review was based on the distribution of LISCC firms across the four Federal Reserve Banks within the LISCC portfolio.⁷ Specifically, the review evaluated the annual assessment process for six firms at the Federal Reserve Bank of New York and for one firm at each of the remaining Reserve Banks, for a total review sample of nine firms.

FINDINGS AND CONCLUSIONS

Objective One

In evaluating whether LISCC decision-makers received the information needed to ensure consistent and sound supervisory decisions, the review found that some dedicated supervisory teams employed sound practices, such as maintaining examination workpapers that were complete, accurate, and well organized. The review also identified continuous monitoring work that demonstrated detailed and thorough analysis of how firm-provided information and meetings with firm management affected the risk profile of the firm, planning for future supervisory work, and ratings.

However, the review also identified inconsistencies in the work produced by other dedicated supervisory teams, such as insufficient documented support for the disposition of supervisory issues and incomplete or missing supervisory workpapers for some examinations or continuous monitoring activities. As a result, for the dedicated supervisory teams where these inconsistencies were observed, it could not be determined whether all appropriate information was being brought forward for consideration by LISCC decision-makers to ensure consistent and sound supervisory decisions.

These inconsistencies can be attributed to two underlying reasons: (1) a lack of consistent expectations from Reserve Bank senior management for dedicated supervisory teams to comply with System guidance and documentation standards, and (2) ineffective Reserve Bank training programs for new members of the dedicated supervisory teams who possessed technical knowledge but limited supervisory experience.

The review observed several instances where individual supervisory teams were responsible for establishing their own expectations for complying with System guidance and documentation

⁶ This review did not assess the overall effectiveness of the LISCC program, as important elements, such as stress testing and horizontal reviews, were not within the scope of the review.

⁷ At the time of the review, there were 2 LISCC firms at the Federal Reserve Bank of Boston, 11 LISCC firms at the Federal Reserve Bank of New York, 1 LISCC firm at the Federal Reserve Bank of Richmond, and 1 LISCC firm at the Federal Reserve Bank of San Francisco. The nonbank financial institutions designated by the FSOC (of which there were three) were not included in the scope of the review.

standards. While it is appropriate for each supervisory team to have a degree of autonomy in setting forth expectations, the review found that these expectations were not always in compliance with System guidance and documentation standards. Further, the review also noted that the senior oversight structure at some Reserve Banks did not always hold management and staff accountable for complying with System guidance or expectations for documentation.

For example, the review noted instances where the continuous monitoring was inconsistently performed and documented by supervisory teams, documentation and support for changes to supervisory assessments was insufficient, and documentation of key changes to ratings and findings that occurred as supervisory issues were discussed by Reserve Bank staff was not always evident. In addition, some dedicated supervisory teams did not routinely maintain supervisory databases in compliance with System expectations. Moreover, at times, supervisory messages were communicated verbally, rather than in writing, which constrained the development of an appropriate audit trail, limited firms' accountability for addressing issues, and limited the ability of decision-makers to evaluate, monitor, and have confidence in some of the supervisory teams' assessments.

Further, some training programs for new members of the dedicated supervisory teams were limited in scope and did not always ensure that these staff members, who possessed strong technical skills but limited supervisory experience, had the training necessary to function effectively within a supervisory environment. During many of the interviews conducted, it was apparent that this lack of training was a contributing factor in the deficiencies observed.

For example, the review found instances where staff did not document sufficient analysis of firm-provided financial information and did not consistently link continuous monitoring activities to the ongoing assessments of these firms. Improved training and greater staff participation in training would have provided team members with an appropriate understanding of the importance of the documentation and the processes necessary to establish a clear audit trail for following supervisory issues from identification to disposition.

Objective Two

To evaluate whether adequate methods are in place for decision-makers to be aware of material matters that required reconciliation of divergent views related to the supervision of those firms, interviews were conducted with 122 current and former members of the dedicated supervisory teams. The review found that more than ninety-five percent of interviewees felt empowered to raise supervisory concerns and express divergent views. While staff expressed satisfaction in being able to raise divergent views, the review team noted differences among the dedicated supervisory teams in how staff were able to raise such views and to whom they could raise them to.

Further, the review team found that neither the Reserve Banks nor the LISCC OC had established a formalized process for staff to raise dissenting or divergent views in instances when a senior member of a dedicated team disagreed with the staff member's supervisory assessments. As such, documentation of relevant information, decisions taken, and disputes resolved, and the

degree to which divergent views were encouraged, vetted, and resolved varied among supervisory teams. However, even without a formalized process, the review did find evidence of the consideration of dissenting or divergent views as part of the decision-making processes at the Reserve Banks and the LISCC OC.

RECOMMENDATIONS

To address the findings noted above, two recommendations were made to the Reserve Banks to strengthen their execution of the LISCC supervisory program. These recommendations were directed to the Federal Reserve Banks of New York and Richmond. The review has also made one recommendation to the LISCC OC to ensure that more formalized channels exist for supervisory staff to raise divergent views.

Reserve Bank Recommendations

1. Strengthen documentation methods in order to comply with System requirements for supervisory assessments, the resolution of divergent views, the communication of supervisory assessments to the LISCC OC, and the communication of supervisory decisions to firms.
2. Enhance internal training programs for new members of the dedicated supervisory teams to ensure the new members receive the knowledge and experience necessary to be aware of all supervisory responsibilities.

LISCC OC Recommendation

3. Establish a requirement that Reserve Banks develop formal channels for supervisory staff to raise divergent views outside their immediate chain of command and implement a defined method for all Reserve Bank supervisory staff to raise supervisory concerns directly to Board staff.

Progress in Meeting the Recommendations

In response to the review's recommendations, each Reserve Bank and the LISCC OC have supplied an action plan identifying corrective actions already taken, as well as those planned, to remediate the recommendations identified. The Board will periodically perform follow-up work to validate that the Reserve Banks have taken corrective actions to address the recommendations within a reasonable timeframe. To date, the LISCC OC and the Reserve Banks have taken the following actions:

Recommendation One

- The LISCC OC is drafting a Program Manual that will describe all elements of the LISCC Program, including minimum operating and documentation standards for supervisory activities to ensure consistency across the dedicated supervisory teams.
- The Federal Reserve Banks of New York and Richmond have added additional resources to each dedicated supervisory team to improve quality and ensure consistency in supervisory approaches.

Recommendation Two

- The Federal Reserve is in the process of strengthening its examiner commissioning and training program to develop a curriculum specifically tailored to the supervision of large financial institutions.
- The LISCC OC is establishing additional expectations for both procedural and substantive elements of the LISCC supervisory program and is overseeing the development of new training material for members of the dedicated supervisory teams to improve the consistency of implementation.

Recommendation Three

- The Federal Reserve has adopted a 2016 high priority initiative focusing on the development and implementation of policies and practices encouraging the exchange of, and response to, divergent views on all supervisory matters.

Appendix Annual Assessment Process

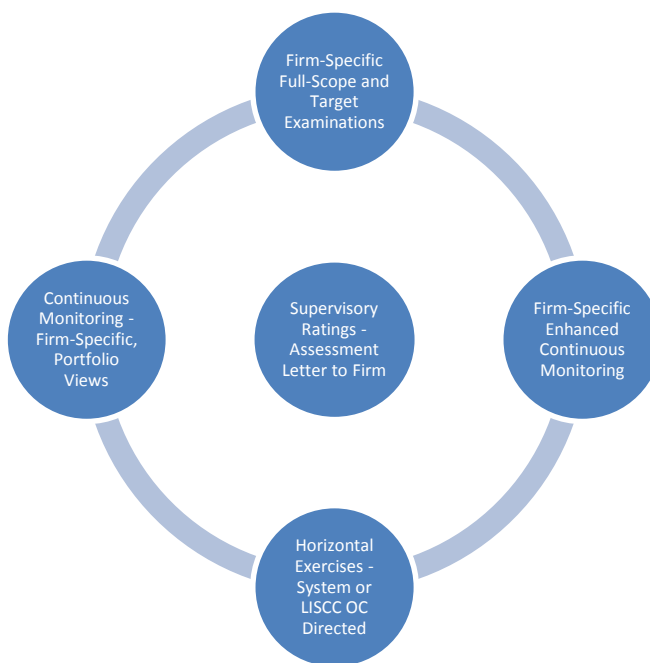
The annual assessment conveys supervisory ratings and key issues and risks and is the culmination of all supervisory work performed during the past year (supervisory cycle). The annual assessment fulfills the mandate of conducting an annual inspection or examination.

Firm-Specific Full Scope and Target Examinations –

Full scope examinations are planned events that assess the safety and soundness and assign supervisory ratings to state member bank subsidiaries. Target reviews are more limited in scope and assess the quality and effectiveness of a firm’s control function (i.e. audit), line of business, or business process (i.e. credit origination process). Includes transaction testing (i.e. loan review).

Continuous Monitoring –

The cornerstone of firm-specific supervision and a key component of portfolio supervision efforts. These activities provide information that is used to assess inherent risks; stay abreast of risk management and internal control processes; and assist in the assessment of management, corporate governance practices, and the firm’s financial condition. Continuous monitoring also assists in the identification of emerging risks. Examples include ongoing meetings with management, review of firm management information system reports, and meeting with other supervisors.



Enhanced Continuous Monitoring --

A planned event that requires a “deeper dive” than routine continuous monitoring in order to learn more about a particular area, business strategy, risk level, and/or risk management practices and control. These events have fewer documentation requirements, are typically less formal than a target review, and are meant to fill a knowledge gap or determine if more formal supervisory work is needed.

Horizontal Exercises-- A planned event that is directed at the System level (i.e. CCAR) or by the LISCC OC.