
The Changing Role of Supervision

Remarks by
William J. McDonough
President
Federal Reserve Bank of New York

Delivered before the
Institute of International Bankers
Waldorf-Astoria Hotel
New York, New York

Wednesday, September 10, 1997

THE CHANGING ROLE OF SUPERVISION

I am delighted to speak to you today on a topic that I believe is gaining more and more attention around the globe: the supervision of financial institutions. Let me make clear at the outset that I define supervision in the broadest sense, covering official supervision as well as supervision by the marketplace itself. At the Federal Reserve Bank of New York, we have spent a lot of time thinking about the future of financial institutions supervision, and today I would like to share with you some of these thoughts.

Effective supervision of financial institutions is a cornerstone of global financial stability, and it has been raised to the top of the agenda of the last three Group of Seven summits. While it is broadly recognized that the risk of a systemic crisis emanating from problems at a financial institution or a group of institutions is relatively low, the potential cost could be very high. It is a bet none of us wants to take. We have now experienced our fair share of shots across the bow: Herstatt, Continental Illinois, Drexel, BCCI, Daiwa, and Barings. And a growing number of countries—both industrialized and developing—have paid the high macroeconomic costs of an ailing financial services industry.

How should supervision be structured to meet the next set of challenges? To answer this question, I will first discuss some of the currents that are driving the rapid changes we

are witnessing in the financial services industry. Then I will review the basic objectives of supervision and present what I believe to be the most effective strategy for putting these supervisory objectives into practice.

While I will focus primarily on issues of supervision related to banks and financial conglomerates that carry out material banking activities, I believe that many of the issues are relevant for financial institutions more generally.

EVOLUTION OF THE FINANCIAL SERVICES INDUSTRY

An informed discussion of how to approach supervision as we enter the twenty-first century cannot occur without a clear understanding of the major trends that have been reshaping the financial services industry for some time now. I believe that many of the dramatic and rapid changes we have witnessed over just the past ten years or so are likely not only to continue, but also to accelerate in the future. Let me highlight five:

◆ *First, deregulation and globalization:*

The fall of the Berlin Wall has led to the opening of new markets in Eastern Europe. At the same time, countries in Asia and Latin America have lifted restrictions on capital movements and begun to deregulate their economies and financial services sectors. As a result, financial institutions from the

Effective supervision of financial institutions is a cornerstone of global financial stability.

Some financial institutions are sure to fall by the wayside, and it is up to official supervisors to create the appropriate framework to ensure that this process unfolds in an orderly fashion.

industrialized nations have expanded rapidly into these new markets while financial institutions from emerging market economies are entering our markets.

- ◆ Second, *growing competition*: Deregulation and globalization have created new opportunities for financial institutions, but they have also intensified competition. In the United States, banks clearly are in competition with securities firms, insurance companies, mutual funds, pension funds, and finance companies, as well as hedge funds. Investors, whether retail or wholesale, face a growing range of choices about where to place their funds, and the ongoing securitization of financial assets has altered banks' classical role in the intermediation process.
- ◆ Third, *consolidation within industry sectors*: It is not surprising that growing competition has resulted and will continue to result in industry consolidation. Some financial institutions are sure to fall by the wayside, and it is up to official supervisors to create the appropriate framework to ensure that this process unfolds in an orderly fashion.
- ◆ Fourth, *the rapid growth of financial conglomerates*: One form of industry consolidation is the growing trend toward financial conglomerates, which combine banking, securities, and insurance activities in a single group. In the United States, it is only a matter of time before the final vestiges of the

Glass-Steagall Act fall, and I also believe that banks' insurance activities will expand significantly in the future.

- ◆ And fifth, *innovation in products and risk management techniques*: In the past ten years, we have witnessed a revolution in financial innovation at banks and other financial services providers, both in terms of products and risk management techniques. Over the course of the 1990s, financial institutions have begun to apply modern portfolio theory to the management of their market risk, using techniques such as value at risk. The next frontier, toward which the pioneers are already en route, is to extend these techniques to the modeling of credit and operational risk—ultimately linking market, credit, and operational risk management in a single methodology. And increasingly, risks are managed on a global basis, cutting across products, countries, and legal entities.

THE CHANGING ROLE OF SUPERVISION

These developments present serious questions about how supervision should be structured in the twenty-first century. However, to begin answering these questions, we must first identify the basic objectives of supervision in this rapidly changing environment.

I believe that the reasons for official supervisory intervention in the banking system, and in the financial system more generally, can be summed up as promoting financial market stability and minimizing systemic risk. This is a

broad mandate and one that encompasses the responsibility to ensure that markets operate in a fair, transparent, and efficient manner and that participants comply with the rules of the game, in a context in which small, unsophisticated depositors and investors are protected.

While important, protecting the deposit insurance fund will not be the primary objective of supervision in the future. I believe this for two reasons: First, there is a growing realization that our approach to deposit insurance needs to be reconsidered so as to minimize the potential for moral hazard and to focus on only those small depositors that truly require protection. And second, the share of household savings in the banking system has declined dramatically.

Supervision increasingly will be about promoting financial market stability. The dramatic transformations in the financial services industry require us to be particularly vigilant to ensure that these changes proceed in an orderly fashion. We have seen numerous examples of the potential damage to the financial system, and to the real economy more generally, when deregulation and innovation are not accompanied by sufficient oversight by official supervisors and the market. In the United States, the most notable example was the savings and loan crisis.

I believe that central banks have a particularly important role to play in this regard, because ultimately they must provide liquidity and perform crisis management to ensure that problems at financial institutions (banks or nonbanks) do not take on systemic proportions and spill over into the real economy. My experience tells me that to carry out this role

effectively in the United States, the Federal Reserve must have hands-on responsibility for the supervision of banks and conglomerates with material banking activities. Day-to-day involvement in supervision is the only way to detect problems early on and to prevent them from spreading to other financial institutions or to the payments system.

So what, specifically, can we do to foster this objective of financial stability? Let me state up front that I do not believe there is a quick-fix, cookie-cutter answer. The financial marketplace is too dynamic and complex, and we must work within political realities. Instead, what I would envision is a multipronged strategy that emphasizes prevention, goes with the grain of the market, and fosters cooperation between the private and public sectors.

The key elements of this strategy are

- ◆ sound capital adequacy standards,
- ◆ effective management oversight,
- ◆ market discipline, and
- ◆ a dynamic, risk-focused approach to official supervision.

Let me discuss each of these in turn, noting that each should reinforce the others to maintain a safe and sound financial system.

Capital Adequacy

Capital has played, and continues to play, an important role in the supervisory tool kit. An adequate capital cushion helps ensure that shareholders monitor the risk of financial institutions and that they put in place appropriate oversight mechanisms to help prevent problems from surfacing in the first place.

What I would envision is a multipronged strategy that emphasizes prevention, goes with the grain of the market, and fosters cooperation between the private and public sectors.

We need to begin thinking now about a comprehensive framework for the next generation of capital rules—particularly given the long lead times involved.

Should an institution experience difficulties, capital will serve as a buffer to absorb losses and reduce the risk of spillover from a problem institution to other financial institutions.

Bank supervisors' thinking on capital is evolving with the changes we are seeing in how banks manage their risk exposures. The Basle Capital Accord's market risk amendment, which will go into effect at year-end 1997, is a case in point. It represents a significant shift in capital supervision, moving away for the first time from the prevailing approach of a mandated and rigid regulatory formula or ratio. It also represents a major step toward a more market-based approach to supervision that draws on banks' internal methodologies for risk measurement, places greater emphasis on promoting sound risk management and control processes, and encourages further innovation and improvement in the banks' internal models.

While the market risk amendment represents an important step in the right direction, we need to begin thinking now about a comprehensive framework for the next generation of capital rules—particularly given the long lead times involved. As an example, the original Basle Capital Accord took about five years to develop, and almost seven more years were required to reach agreement on the market risk amendment. I believe that a review of the current capital framework needs to address at least the following questions:

- ◆ How do we reconcile the sophistication of the internal models approach used to measure market risk with the relatively simple methodology of the original Capital Accord for measuring credit risk?
- ◆ How do we explicitly incorporate into the capital framework other critical risk areas, such as portfolio concentrations and operational, liquidity, legal, and information systems risks?
- ◆ How do we ensure that the capital framework is consistent with the direction of the industry, in which financial institutions are moving toward a more integrated approach to the measurement and management of their various risk exposures—in particular, credit and market risk?
- ◆ How do we ensure that the capital framework is sufficiently broad to reflect the growing tendency of financial institutions to take on and manage banking, securities, and insurance risks by using derivatives and investment products? And is there value in studying not only volatility-based models of risk, such as value at risk, but also the models used by insurance firms to manage catastrophic risk?
- ◆ How do we address the problem of divergent accounting standards, which continue to impede comparisons of earnings, asset valuations, reserves, and capital across borders?
- ◆ And finally, how do we assess the consolidated capital position of the growing number of internationally active financial conglomerates that combine banking, securities, and insurance activities in a single group?

As you may know, the Federal Reserve System is also giving thought to the issue of capital. Not too long ago, the Federal Reserve Board put out for public comment a so-called precommitment approach.

Under the precommitment approach, regulators would no longer specify any capital adequacy ratios or other analytical measures of capital for market risk. Rather, banks would be permitted to commit capital consistent with their own estimate of their maximum trading loss exposure. However, if a bank suffered cumulative losses larger than its committed capital at any point during a particular commitment period, it would face a penalty, which could take the form of public disclosure, a higher capital requirement going forward, or even monetary fines.

The challenge of the precommitment approach is to put in place incentives that align, as much as possible, supervisors' safety and soundness concerns with an institution's incentives to measure, monitor, and dynamically manage its market risk exposures. Bank management—and not supervisors—would set the quantitative parameters of the model.

The precommitment approach does raise a number of complex issues, including, for example, the questions of how to select the desired capital levels, how those desired levels of capital relate to precommitment amounts, and how to define the penalty function. The New York Clearing House is currently conducting a pilot study with a number of major banking institutions to improve our understanding of these issues.

We at the New York Fed have also been doing some thinking about the next generation of capital requirements. Not too long ago, we published an article by Arturo Estrella, one of our senior research officers, arguing that the efforts of supervisors should focus on assessing the reasonableness of a firm's approach to setting its internal capital requirement without attempting to specify the methodology or assumptions to be used. However, the supervisor would define a minimum capital requirement that is simple, objective, and comparable across institutions and that is roughly representative of a firm's overall economic risk. It is expected that a firm's internal capital requirement would generally lie well above the supervisory minimum.

The New York Fed also plans to host a conference in February 1998 on the theme "Financial Services at the Crossroad: Capital Regulation in the Twenty-First Century." With international participation by industry members, supervisors, and academics, the conference should afford an excellent opportunity to explore innovative ideas on how we might improve the international capital framework for the twenty-first century. And I hope that such a framework would be broad enough to cover not only banks, but also financial conglomerates that may also contain securities firms and insurance companies.

Of course, all the capital in the universe will not be enough if a rogue trader or loan officer is able to operate recklessly or fraudulently in an environment lacking sound internal controls and proper risk management systems. Thus, while a sound capital adequacy

While a sound capital adequacy framework is essential to financial market stability, it must be complemented by effective management at the firm level, by market discipline, and by meaningful official supervision.

I continue to be surprised by the persistence of significant losses at major global institutions that can be traced to basic, avoidable breakdowns in management controls.

framework is essential to financial market stability, it must be complemented by effective management at the firm level, by market discipline, and by meaningful official supervision.

Management Oversight

This leads me to my next point: The primary responsibility for the safe and sound operation of an institution lies with its board of directors and senior management. Effective management supervision is the first and most important line of defense against potential problems, and this will increasingly be the case as the activities of financial services institutions become more global and complex.

Overall, I believe the industry has made significant progress in recent years in strengthening risk management capabilities and practices. And the supervisory community remains committed to working with the industry to do even more to improve those risk management practices over the period ahead.

That being said, I continue to be surprised by the persistence of significant losses at major global institutions that can be traced to basic, avoidable breakdowns in management controls. It is even more surprising considering that the principles of sound risk management and controls have been promulgated and published globally, by the Basle Committee on Banking Supervision and the Group of Thirty among others, and, in principle, have been fully embraced by the industry.

How can this phenomenon be explained? Although part of the answer may just be bad luck, I believe that a more important explanation lies in what I would term “culture issues.”

While on paper it may appear that an institution has put in place a risk management and control structure, this structure may not be accompanied by the institutional management culture needed to ensure that written policies and procedures are actually translated into practice, with buy-in at all staff levels. They all need to be in sync.

Ultimately, an institution’s culture is set by the board of directors and the quality of senior management it chooses to install. If the board of directors and senior management are interested excessively in profits and choose to pretend that profits do not involve risk, the institution is in grave peril. Senior management, assuming it has its own values straight, must ensure that the right tone filters down the line of the organization. However, culture has to do with the most basic values that individuals and groups embrace, so it is fairly inertial and slow to change. This inertia is a big advantage if you have the right culture, and it is a big risk to your business if you do not. Symptoms of a culture that is not conducive to prudent business practices include the following:

- ◆ Poor communication, including the failure to encourage individuals to deal promptly with problems and to alert management early on. This may also include poor communication of material events to supervisors, an issue we have raised with our supervised institutions over the past year or so.
- ◆ Rewarding officers for business profitability through promotion or compensation when there are many control

deficiencies in that business that remain outstanding for long periods of time.

- ◆ An inappropriate balance in the importance of business lines, audit, and control functions. This lack of balance may manifest itself through reporting lines and compensation policies.
- ◆ Hiring practices that do not adequately screen potential employees for a track record of integrity. I believe that this is one of the best, but least acknowledged, ways to nip fraud in the bud—namely, right at the entrance door.
- ◆ Aggressive recruiting that entails offering salaries far above the market norm (with the resultant pressure to take on excessive risks).
- ◆ Aggressive performance-based compensation packages that do not account for risks at the inception of a deal.
- ◆ A failure to question the source and sustainability of profits that are excessive in relation to the riskiness of a given activity.

A concrete and timely example of the importance of senior management's proactive stance in the risk management and control process is the year 2000 issue. The Federal Reserve has emphasized that responsibility for preparing for this event rests squarely with the senior management of banks—and we expect them to be on top of the issue. I anticipate that variations in how institutions deal with this issue will be highly correlated with the quality

of their management, the quality of their controls, and the strength of their corporate culture.

Market Discipline

After effective management supervision, the second line of defense against financial instability takes the form of market discipline. As financial institutions and their activities become more complex, diversified, and global in nature, I believe that market discipline will become an even more important ally of the supervisor than it is now.

Effective market discipline is not possible without meaningful public disclosures. Unfortunately, disclosure practices have not kept pace with the rapid changes in banks' business activities and risk exposures, and with how these exposures are measured and managed. Recent initiatives by the industry, the Group of Thirty, the Group of Ten central banks, and the Basle Committee on Banking Supervision have focused on improving disclosure of trading and derivatives exposures of both banks and securities firms, and I note that the industry has made significant progress in this area. But more work can and should be done.

For example, many countries still need to improve the quality of their disclosures for traditional lending activities. Time and again experience has shown that in periods of stress, insufficient information about asset quality can lead to rumors and overreactions in the marketplace, creating the potential for problems to spread to institutions that may otherwise be in relatively good health.

Effective market discipline is not possible without meaningful public disclosures.

While management oversight and market discipline are crucial elements of a strategy to promote financial stability, neither can substitute for the critical role played by official supervision.

A more difficult and fundamental issue is how far management discussions in financial statements can go toward revealing the true quality of internal controls and global risk management systems of large, complex financial institutions. Currently, there are no common criteria for measuring and disclosing such information. Market participants are left to rely on regulators or diverse opinions of external auditors to ascertain the quality of management controls. In this context, the Group of Thirty recently issued an interesting proposal that, among other things, calls for the development of an international industry framework for comprehensive and effective management controls. This framework would be validated through a groupwide global audit, and the results would be disclosed to the public. The G-30 initiative represents an important step in the right direction. But, as the G-30 itself points out, such an initiative can only bear fruit if the private sector and the supervisory community collaborate closely.

Progress on the disclosure front will be limited if accounting standards are not enhanced to reflect innovations over the past ten years, both in terms of new products and modern risk management techniques. And there is a need for greater harmonization of accounting standards across countries. An important first step would be to improve our understanding of the major differences that exist in national accounting conventions. We simply must get to the point where supervisors and market participants alike can compare all global financial institutions on a consistent basis. And it will not be possible to have uniform capital standards until we have achieved

a minimum degree of consistency in accounting standards across countries.

Official Supervision

While management oversight and market discipline are crucial elements of a strategy to promote financial stability, neither can substitute for the critical role played by official supervision. Official supervisors have a number of comparative advantages that they can bring to the table:

- ◆ First, supervisors have clear incentives to monitor risks to the financial system as a whole. While each financial institution is best positioned to monitor its own risk exposure, it does not have the incentives to internalize the costs it may impose on other financial institutions should it experience difficulties.
- ◆ Second, supervisors are able to obtain and monitor proprietary information about an institution's risk exposures, its management information systems, and its internal controls when such information does not lend itself to public disclosures.
- ◆ Third, supervisors are in a unique position to observe trends across groups of financial institutions and, on the basis of these insights, to provide the industry with a perspective on what constitutes sound practice.

For example, the New York Fed conducted a comprehensive review of private banking activities at about forty domestic and foreign banking

organizations in the Second District. Using New York's findings, the Federal Reserve recently released a sound practices paper that contains guidance on basic controls to minimize reputational and legal risk and to deter illicit activities such as money laundering.

- ◆ Fourth, official supervision is needed to enforce compliance with applicable laws and regulations. We have observed that poor compliance, in addition to simply being wrong, can result in serious reputational risk. In certain cases, a problem in this area could threaten the well-being of a financial institution.
- ◆ Finally, supervisors are able to ensure that prompt corrective actions are taken when serious financial or other problems are identified, particularly if the problems are not known to the market. The critical role that can be played by the supervisor in problem cases, both through public enforcement actions and through other, less visible means, cannot be overstated.

Changes in the financial services industry present new challenges for how official supervision is to be carried out most effectively. Let me just mention a few:

- ◆ The scope of supervision needs to evolve in line with the way financial institutions manage their activities, which increasingly is on a global portfolio basis and no longer along legal entity lines.
- ◆ We need to continue our efforts to develop a more dynamic, process-oriented, and risk-focused supervisory framework, reflecting the reality that financial institutions are able to alter their risk profile at will. By "process-oriented," I mean that examiners and/or auditors should ascertain whether the risk management process and the risk control environment of the organization as a whole are adequate given the nature of its business. By "risk-focused," I mean that resources should be directed at the most material risks to which the institution is exposed. Institutions that demonstrate a sound risk management and control structure and environment should be subject to less intrusive supervision than institutions that do not have this essential infrastructure in place.
- ◆ We, the supervisors, need to sustain our efforts to ensure that we have in place state-of-the-art information technologies and that we train our staff to keep pace with the growing complexity of financial institutions' operations. In this regard, it is often said that supervisors cannot attract and retain staff with the technical expertise necessary to understand the high-tech instruments and models at financial institutions. I believe this view is wrong. For example, at the New York Fed we have always been able to hire and retain a critical mass of top-level individuals by focusing challenges and new responsibilities on

We need to continue our efforts to develop a more dynamic, process-oriented, and risk-focused supervisory framework, reflecting the reality that financial institutions are able to alter their risk profile at will.

Most important, supervisors need to come up with a contemporary model for overseeing the activities of financial conglomerates.

those people with a strong interest in shaping public policy.

- ◆ But the qualifications and training of our examiners should reflect the reality that the global financial business today is an information technology business, based on financial theory of increasing rigor and precision and on sophisticated operational analysis. This means that we must not only train specialists with well-developed expertise, and in the right areas, but also attain synergies among the different specialists through, for example, the use of multidisciplinary teams that can review whole business lines.

Most important, supervisors need to come up with a contemporary model for overseeing the activities of financial conglomerates. It has become increasingly difficult for supervisors and the industry to distinguish the business of banks from the business of securities firms. As the Barings incident and other major financial problems have shown, the linkages among global banks and securities firms are far greater and more extensive than just their direct, measured credit exposures. Additional exposures include funding relationships, membership in clearinghouses and exchanges, securities clearing operations, and fiduciary businesses. Given these linkages, the failure of either a major bank or a securities firm could have broad systemic effects on the financial system. This leads me to conclude that all global financial conglomerates large enough to pose a potential threat to the stability of the financial system should, at minimum, be subject to some form

of consolidated supervisory oversight that has market stability as its guiding principle. Such a limited supervisory framework might include the following key elements:

- ◆ Designation of an “umbrella” supervisor to provide consolidated oversight and to facilitate the sharing of information across the group’s various national and functional supervisors. It is also time to determine definitively what legal impediments to information flows actually exist and to set them aside fully.
- ◆ Agreed-upon channels of communication among home- and host-country supervisors, and the willingness to raise supervisory concerns and to hear them.
- ◆ Adequate direct reporting of information to the umbrella supervisor by the conglomerate itself, to the extent that existing information flows must be supplemented for a representative view of the enterprise.
- ◆ Some framework for assessing capital adequacy on a consolidated basis. Such a framework needs to be sufficiently flexible to cover not only exposures related to the banking and securities businesses, but also insurance underwriting risks. I believe that we should look to a framework that draws on the best practices developed by all three of these industry sectors and their functional supervisors.

- ◆ Qualitative standards for the management of interaffiliate exposures, perhaps supplemented by quantitative limits.
- ◆ Periodic coordinated reviews of the conglomerate's risk management and internal control systems, including efforts to ensure compliance with applicable laws and regulations and to ensure the identification of concentrations.

In the current debate on the appropriate supervisory framework for financial conglomerates, a distinction is made between those conglomerates with a significant proportion of business concentrated in banking activities and those that engage primarily in nonbank financial activities. The former group requires a higher degree of supervisory oversight to protect banks from activities conducted in nonbank affiliates. However, as the activities of "banks" change—with assets becoming more and more liquid and reliance on insured deposits decreasing—it becomes necessary for supervisors to consider a more uniform approach to all large financial conglomerates. This brings me back to where I started, namely that the future of supervision will be about ensuring the stability of all financial institu-

tions—whether they belong to a single industry or are conglomerates—that have the potential to destabilize the financial system.

CONCLUSION

I recognize that I have outlined an ambitious agenda for the supervision of financial institutions that will carry us into the twenty-first century. In implementing this agenda, we must recognize that the public and private sectors each have an important role to play. Indeed, only if the two work together and reinforce each other do I believe that we will be able to supervise effectively the rapidly evolving financial services industry going forward. We have seen a growing number of examples in which this collaboration has worked well, including the area of public disclosure, efforts to develop capital requirements for market risk, and the initiatives of the Bank for International Settlements' Committee on Payment and Settlement Systems to promote private sector solutions that will result in the elimination of foreign exchange settlement risk. If such cooperation is done right, it can make a significant contribution to achieving a safer and sounder financial system.

Thank you.