Monetary Policy in the Classroom
Financial Regulation & Reform

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Agenda

- Why do we do Bank Supervision
- Supervisory & Regulatory Responsibilities
- Safety and Soundness Supervision
- Consumer Compliance/Consumer Protection
- Some Risk Management Lessons Learned from the Global Banking Crisis
- Supervisory – Capital Assessment Program
- Regulatory Reform – Dodd-Frank Act

Why Do We Do Bank Supervision?

- Federal Reserve Mission: Foster stability, integrity and efficiency of the nation's monetary, financial and payments system to promote economic performance.

- Bank Supervision Objectives: Supervising and regulating banking institutions to ensure the safety and soundness of financial institutions, stability of financial markets and to protect the credit rights of consumers (fair and unbiased access to credit).
- Delegated authority from the Board of Governors to carry out the objectives.

Supervisory & Regulatory Responsibilities

- The Fed has supervisory and regulatory authority over a wide range of financial institutions and activities
  - Bank holding companies, including diversified financial holding companies (formed under Gramm-Leach-Bliley Act) and foreign banks with U.S. operations (Umbrella Supervision)
  - State-chartered banks that are members of the Federal Reserve System (State Member Banks)
  - Edge and agreement corporations, through which U.S. banking organizations may conduct international banking activities
  - U.S. state-licensed branches, agencies and representative offices of foreign banks and their nonbanking activities

Supervisory & Regulatory Responsibilities

- The Federal Reserve shares supervisory and regulatory responsibilities with other Federal Banking Agencies & States
  - Office of the Comptroller of the Currency (OCC) – National Banks
  - Federal Deposit Insurance Corporation (FDIC) – State Nonmember Banks
  - Office of Thrift Supervision (OTS) – Federally Chartered Thrifts
  - State Banking Departments – State Member & Nonmember Banks

Safety & Soundness Supervision

- Main objective is to evaluate the overall safety and soundness of the banking organization
  - Includes an assessment of the organization's operations and risk management systems, financial condition / capital adequacy, and compliance with applicable banking laws and regulations
  - Entails both on-site inspections and examinations and off-site surveillance and monitoring
- Risk-focused supervision – more continuous vs. point-in-time
- Banking holding company rating system – RFI/C(D)
- Bank rating system – CAMELS
- Foreign bank branch rating system – ROCA
- Inspection / Examination Mandates
- Supervisory authority to take informal and formal actions

Consumer Compliance / Consumer Protection

- Federal Reserve's responsibilities include:
  - Writing and interpreting regulations to carry out many of the major consumer protection laws
  - Reviewing bank compliance with regulations
  - Investigating complaints from the public about state member banks' compliance with consumer protection laws
  - Addressing issues of state and federal jurisdictions
  - Conducting community development activities
- Most financial transactions involving consumers are covered by consumer protection laws
  - Credit, charge and debit cards
  - ATM transactions and other electronic fund transfers
  - Deposit transactions, mortgages & home equity loans, auto leases
- Community Reinvestment Act – agencies review a bank's attempt to meet the credit and development needs of its entire community

Some Risk Management Lessons Learned from the Global Banking Crisis

- Four firm-wide risk management practices differentiating better performance from worse were:
  - Effective firm-wide risk identification and analysis,
  - Consistent application of independent and rigorous valuation practices across the firm,
  - Effective management of funding liquidity, capital and the balance sheet, and
  - Informative and responsive risk measurement and management reporting.

Supervisory Capital Assessment Program (S-CAP)

- The SCAP was a milestone in both the financial crisis and in the practice of bank supervision.
- Helped to restore confidence in the banking system and was an important step toward quelling the crisis. Designed to reduce uncertainty and attract private capital.
- Not a solvency test, rather intended to determine whether the firms would have sufficient capital remaining (after absorbing losses) to continue lending.
- February – May 2009: Federal Reserve led interagency effort – over 150 examiners, analysts, economists, policy and legal staff.
- Conducted a capital assessment exam of the 19 largest domestic BHCs to determine if they had sufficient capital buffers to withstand the impact of an economic environment that is more challenging than was anticipated.
- Three macroeconomic assumptions: GDP, unemployment, home price appreciation (depreciation).
- Estimated two-year forward projection of losses, resources and capital under a baseline and a more adverse scenario.

SCAP (continued)

- In-depth reviews of lending portfolios, securities activities, and revenue opportunities.
- Appling consistent models and analysis across these firms, SCAP was able to distinguish those BHCs best positioned to withstand a more stressed environment from those likely to need additional capital support.
- The 19 BHCs faced aggregate potential credit-related and trading losses of $600 Billion. Projected resources to absorb losses of $360 Billion.
- Aggregate results – net capital need of $185 billion.
- After capital actions (assets sales, conversions from preferred to common, strong 1Q 2009 revenues) 10 BHCs identified as needing additional capital - $75 Billion in total.
- Post SCAP – within 5 weeks the 10 BHCs increased common equity by $60 Billion and the other 9 BHCs $21 Billion.
- The public release of detailed information enhanced the credibility of the exercise by giving outside analysts the ability to assess the findings, which helped restore investor confidence in the banking system.

Lessons for Future Supervision & Regulation

- We are toughening capital and liquidity rules in cooperation with other regulators here and around the world.
- Issuing proposed guidance to help ensure the compensation structures at banking organization do not encourage excessive risk taking.
- Leading cooperative efforts by market participants and regulators to strengthen the infrastructure of key markets, including the markets for credit derivatives and OTC derivative instruments.
- Supervisors must adopt a macroprudential, ore systemically oriented, approach that addresses safety and soundness risks at individual firms and risks to the stability of the financial system.
- Leveraging the success of the SCAP, the Federal Reserve is bringing together the skills of economists, financial market specialists, payment systems experts, and others, with those of bank examiners to get the widest possible perspective on financial developments and help assess the largest firms we supervise.
- Again leveraging SCAP success, the Federal Reserve is increasing it use of cross-firm, horizontal examinations. Moreover, we will be looking at all activities within a consolidated organization that can create risk to the firm and financial system.

Regulatory Reform – The Dodd-Frank Act

- Establishes a Financial Stability Oversight Council to monitor systemic risk. Is charged with identifying developments that pose systemic risk as well as addressing emerging risks.
- Charges the Federal Reserve with establishing prudential standards for all BHCs with $50 Billion or more in assets and supervising certain systemically risky, nonbank financial companies designated by the Council.
  - Risk-based capital requirements
  - Liquidity requirements
  - Resolution plans/living wills (jointly with FDIC)
  - Annual stress tests conducted by supervisors
- Makes a number of changes to the regulatory and supervisory framework for banking organizations. Terminates the existence of the OTS (absorbed by the OCC) and subjects thrift holding companies to Fed supervision.
- Establishes new regulation of advisors to hedge funds and places new scrutiny on the activities of credit rating agencies.
- Brings greater transparency to, and regulation of, the over-the-counter derivatives market. The bill provides the Commodity Futures Trading Commission and SEC with new broad oversight and regulatory powers over previously unregulated OTC markets.

Regulatory Reform – The Dodd-Frank Act

- Gives the Federal Reserve an enhanced role in setting standards for systemically important financial market utilities and payment, settlement and clearing activities.
- Creates a new Federal Bureau of Consumer Financial Protection housed in, but functionally independent of the Federal Reserve, charged with writing all consumer financial protection rules.
- Places new restrictions on emergency lending by the Federal Reserve.
- The Volcker Rule - Requires the Federal banking agencies, the SEC, and the CFTC to issue regulations to prohibit insured depository institutions and their affiliates from engaging in "proprietary trading" and investing in, sponsoring or having certain relationships with hedge fund or private equity fund.
- Establishes new insolvency rules and functions that are designed to mitigate the problems faced by systemically important firms confronting collapse. The bill gives regulators the authority to seize and dismantle financial firms posing systemic risk and it creates a certain resolution process to be run by the FDIC.

Questions & Answers