3-17-2010

UA37/29 Gary Ransdell - Federal Reserve Board - Federal Reserve's Role in Bank Supervision

St. Louis Federal Reserve Board

From: Mary.H.Karr@stls.frb.org [mailto:Mary.H.Karr@stls.frb.org]
Sent: Wednesday, March 17, 2010 1:11 PM
Subject: Fw: FedDigest March 17, 2010: Chairman Bernanke's Testimony on The Federal Reserve's Role in Bank Supervision

Before the House Committee on Financial Services.
This document is not an official transcript. The text below is selectively drawn from the original testimony and summarized. Full text: http://www.federalreserve.gov/newsevents/testimony/bernanke20100317a.htm

The Federal Reserve's Role in Supervision

Like many central banks around the world, the Federal Reserve cooperates with other agencies in regulating and supervising the banking system. Our specific responsibilities include the oversight of about 5,000 bank holding companies, including the umbrella supervision of large, complex financial firms; the supervision of about 850 state member banks; and the oversight of foreign banking organizations operating in the United States.

The Federal Reserve's involvement in regulation and supervision confers two broad sets of benefits to the country. First, because of its wide range of expertise, the Federal Reserve is uniquely suited to supervise large, complex financial organizations and to address both safety and soundness risks and risks to the stability of the financial system as a whole. Second, the Federal Reserve's participation in the oversight of banks of all sizes significantly improves its ability to carry out its central banking functions, including making monetary policy, lending through the discount window, and fostering financial stability.

The financial crisis has made clear that all financial institutions that are so large and interconnected that their failure could threaten the stability of the financial system and the economy must be subject to strong consolidated supervision. Promoting the safety and soundness of individual banking organizations requires the traditional skills of bank supervisors; the Federal Reserve has developed such expertise in its long experience supervising banks of all sizes. But the supervision of large, complex financial institutions and the analysis of potential risks to the financial system as a whole (also) requires other forms of expertise, including macroeconomic analysis and forecasting; insight into sectoral, regional, and global economic developments; knowledge of a range of domestic and international financial markets; and a close working knowledge of the financial infrastructure.

In the course of carrying out its central banking duties, the Federal Reserve has developed extensive knowledge and experience in each of these areas critical for effective consolidated supervision. For example, Federal Reserve staff members have expertise in macroeconomic forecasting for the making of monetary policy, which is important for helping to identify economic risks to institutions and markets. In addition, they acquire in-depth market knowledge through daily participation in financial markets to implement monetary policy and to execute financial transactions on behalf of the U.S. Treasury. Similarly, the Federal Reserve's extensive knowledge of payment and settlement systems has been developed through its operation of some of the world's largest such systems, its supervision of key providers of payment and settlement services, and its long-standing leadership in the international Committee on Payment and Settlement Systems. No other agency can, or is likely to be able to, replicate the breadth and depth of relevant expertise that the Federal Reserve brings to the supervision of large, complex banking organizations and the identification and analysis of systemic risks.

Even as the Federal Reserve's central banking functions enhance its supervisory expertise, its involvement in supervising banks of all sizes significantly improves the Federal Reserve's ability to effectively carry out its central-bank responsibilities. Perhaps most important, as this crisis has once again demonstrated, the Federal Reserve's ability to identify and address diverse and hard-to-predict threats to financial stability depends critically on the information, expertise, and powers that it has as both a bank supervisor and a central bank. Not only in this crisis, but also in (other) episodes...the Federal Reserve's supervisory role was essential for it to contain threats to financial stability.

The Federal Reserve's making of monetary policy and its management of the discount window also benefit from its supervisory experience. Notably, the Federal Reserve's role as a supervisor of state member banks of all sizes offers insights about conditions and prospects across the full range of financial institutions, not just the very largest, and provides useful information about the economy and financial conditions throughout the nation. Such information greatly assists in the making of monetary policy. The legislation passed by the House last December would preserve the supervisory authority that the Federal Reserve needs to carry out its central banking functions effectively.

Improving the Federal Reserve's Supervision of Banking Organizations

The Federal Reserve strongly supports ongoing efforts in the Congress to reform financial regulation and close existing gaps in the regulatory framework. While we await passage of comprehensive reform legislation, we have been conducting an intensive self-examination of our regulatory and supervisory performance and have been actively implementing improvements.

On the regulatory side, we have played a key role in international efforts to ensure that systemically critical financial institutions hold more and higher-quality capital, have enough liquidity to survive highly stressed conditions, and meet demanding standards for company-wide risk management. We have also been taking the lead in addressing flawed compensation practices by issuing proposed guidance to help ensure that compensation structures at banking organizations provide appropriate incentives without encouraging excessive risk-taking. Less formally, but equally important, since 2005 the Federal Reserve has been leading cooperative efforts by market participants and regulators to strengthen the infrastructure of a number of key markets, including the market for securities repurchase agreements and the markets for credit derivatives.

To improve both our consolidated supervision and our ability to identify potential risks to the financial system, we have made substantial changes to our supervisory framework. So that we can better understand linkages among firms and markets that have the potential to undermine the stability of the financial system, we have adopted a more explicitly multidisciplinary approach, making use of the Federal Reserve's broad expertise in economics, financial markets, payment systems, and bank supervision….We are also augmenting our traditional supervisory approach that focuses on firm-by-firm examinations with greater use of horizontal reviews that look across a group of firms to identify common sources of risks and best practices for managing those risks. To supplement information from examiners in the field, we are developing an off-site, enhanced quantitative surveillance program for large bank holding companies that will use data analysis and formal modeling to help identify vulnerabilities at both the firm level and for the financial sector as a whole. This analysis will be supported by the collection of more timely, detailed, and consistent data from regulated firms.

Many of these changes draw on the successful experience of the Supervisory Capital Assessment Program (SCAP), also known as the banking stress test, which the Federal Reserve led last year. Improvements in the supervisory framework will lead to better outcomes only if day-to-day supervision is well executed, with risks identified early and promptly remediated. In the future, to facilitate swifter, more-effective supervisory responses, the oversight and control of our supervisory function will be more centralized….Supervisory concerns will be communicated to firms promptly and at a high level….Greater involvement of senior Federal Reserve officials and strong, systematic follow-through will facilitate more vigorous remediation by firms. Where necessary, we will increase the use of formal and informal enforcement actions to ensure prompt and effective remediation of serious issues.

In summary, the Federal Reserve's wide range of expertise makes it uniquely suited to supervise large, complex financial institutions and to help identify risks to the financial system as a whole. Moreover, the insights provided by our role in supervising a range of banks, including community banks, significantly increases our effectiveness in making monetary policy and fostering financial stability. We are strengthening regulation and overhauling our supervisory framework to improve consolidated supervision as well as our ability to identify potential threats to the stability of the financial system. And we are taking steps to strengthen the oversight and effectiveness of our supervisory activities.