Remarks on Bank Supervision by FDIC Vice Chairman Thomas M. Hoenig, presented to the Federal Reserve Bank of New York, Conference on Supervising Large Complex Financial Institutions – March 18, 2016

Introduction

I want to thank Jamie McAndrew and the Federal Reserve Bank of New York for this opportunity to speak on the subject of bank supervision. I approach the topic from the perspective of nearly four decades in various roles in bank supervision inside the Federal Reserve System and now at the FDIC. I have had the dubious opportunity to respond to a host of financial crises, recessions, and problems at banks. While I cannot say that my experience is a silver bullet in the quest for financial stability, it has given me a perspective on the role of bank supervision in that pursuit. It also affords me an appreciation of the damage that can be done when supervisory policy is inadequate.

Good supervision is a process. It involves setting financial standards, collecting and analyzing information, and ultimately applying judgment and demonstrating courage in conveying that information to financial firms and other market participants.

With that in mind, today I will share with you my views on three elements in assuring success with this supervisory process.

First, commercial banking firms of all sizes, including the largest, should be subject to full-scope examinations. Second, because banks—especially the largest banks—have an outsized effect on the economy, they should be required to disclose important supervisory findings that serve to better inform the public regarding their financial condition. Third, supervisors must recognize their limits and insist that banking firms hold sufficient capital to backstop management mistakes and simply bad luck.

Full-Scope Exams

A long-held and useful principle in bank supervision is that commercial banks should receive full-scope examinations on a periodic basis. While smaller banks are examined in this systematic manner, this is not the case for the largest banks. Instead, regulators rely upon continual on-site examiner presence and limited, rotating targeted reviews to validate findings. Supervisors of these firms have become overly reliant on bank models, model validation reviews, stress tests, and updates from bank management as a substitute for records review and hard questioning to draw conclusions regarding a firm's condition.

Full-scope examinations delve into the quality of portfolios and their implications for long-term resilience. A full-scope exam is a point-in-time analysis of a bank's full balance-sheet quality and management competence. It includes the models and material provided by the banks that currently are used in exams, but a full-scope exam also involves reviewing and testing asset quality using accepted examination standards. In such an exam, examiners pull ledgers, review loans, and systematically review a cross-section of bank portfolios. These examinations focus on identifying a firm's risk profile and lapses in risk management practices. They include point-in-time analysis across the entire balance sheet of assets, earnings, liquidity, and sensitivity to market risk.

The full-scope exam process aggregates and analyzes bank data, thereby providing a thorough supervisory picture of individual institutions, in addition to enabling supervisors to better identify emerging risks and trends in the banking industry.

Full-scope examinations better use on-site staff as they are subsumed within the greater examination process, helping provide a deeper understanding of bank conditions, leadership, and performance.

Over time, as economists have come to play a greater role in the supervision of large firms, they have revealed a preference for relying on models—either their own or the firm's—to judge a bank's condition. Such reviews can be enormously helpful, but they would be most effective if used in conjunction with a full-scope exam and the systematic evaluation of exam results.

Focusing almost exclusively on models handicaps regulators to information and signals outside the model. Crises inevitably are instigated by events generated outside the assumptions and variables wrapped within these carefully constructed models; by unpredictable factors that by definition are impossible to include in models.

Effective supervision requires an objective review, which is difficult to maintain for embedded analysts who are practiced in reviewing management-presented material and reports. This too often becomes a self-assessment exercise that provides limited independent insight into the workings and risk profile of the largest firms.

Commissioned examiners who rotate among banks and pull different bank ledgers and review loans develop a fuller understanding of the portfolio. Combined with the results of stress tests, this systematic approach allows supervisors to develop a comprehensive basis for judging bank soundness. The knowledge and skills of a commissioned examiner are distinct from those of an economist or a statistician. On-site staff, without broader information sources, develop a more insular perspective of a bank that makes it harder to identify excessive risks and poor risk management processes that are firm specific.

Finally, it's important to mention that the role of the examiner should be limited. The examiner is not there to judge, approve, or identify with management decisions, as sometimes can happen with on-site examiners.[1]

Sampling and Bank Examination

It is somewhat misleading to assume that it would take an army of examiners to review the largest banks in a manner equivalent to that of a community bank. Sampling across a bank's

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[1] An International Review of OCC's Supervision of Large and Midsize Institutions: Recommendations to Improve Supervisory Effectiveness: http://www.occ.treas.gov/news-issuances/news-releases/2013/nr-occ-2013-184a.pdf

portfolio can provide a sound means to judge balance sheet quality. Statisticians have long-standing sampling methodologies for determining the soundness of assets, at an affordable cost.

Sampling is used, for example, during narrowly defined bank reviews, such as the Shared National Credit (SNC) program. Under the SNC program, examiners pull a series of significant credits held among the largest banks and rate the credits based on performance, quality of underwriting, and risk profile of the borrower. The exams provide important insight into the quality of the asset portfolio, the overall credit culture of the bank, and the quality of its management. Both supervisors and management gain useful perspective on where future problems for this category of assets might arise in a downturn. In instances where underwriting is weak, remedial actions are required to strengthen the portfolio and perhaps avoid future losses.

Using statistical sampling, a broad portfolio of loans and other assets from across the firm would be pulled. The equivalent of a full-scope review for the largest firms could be accomplished using techniques comparable to those used in the SNC program. Within this framework, the Comprehensive Capital Analysis and Review (CCAR) and other complementary analyses also would be incorporated, providing a unique insight into the risk profile of these systemically important firms.

The banking agencies devote enormous resources to reviewing models, developing models, and stress testing the largest firms. Some of these resources might more productive if they were devoted to examining firms in a systematic, full-scope manner. Once developed, such exams would provide a much-needed assessment of a bank's asset quality, liquidity, operations, and controls. Only then can we accurately judge the bank's risk profile, balance-sheet strength, and management.

Disclosure and Transparency

The largest banking firms have a disproportional effect on the economy and receive public support. Therefore, it is appropriate that they be highly transparent. Early disclosure of findings about the condition of a bank is an essential prerequisite for effective market discipline. This need increases as banks and financial products become more complex and, in many ways, more opaque.

Regulators can help improve bank transparency by assuring that valid information is brought forward, not only to bank management but also to the market. Regulators also should consider requiring banks to disclose significant or material findings, which could include examiner concerns about weak control systems or credit review programs. The disclosure of examination findings represents a natural outgrowth of the examination process that would help provide greater consistency to the balance-sheet, income statement, and related information publicly traded banks already disclose under SEC regulations. Such disclosure could be made by bank management with their explanations and plans to address such findings, after the examining agency reviewed the disclosure for accuracy.

Such disclosures would impose market discipline at an earlier stage, which would likely make banks more accountable for their risk choices and help limit the severity of problems identified by examiners. Additionally, enhanced disclosures would hold supervisors accountable and inhibit their being captured by firms.

I recognize that there is concern that disclosing supervisory information would be destabilizing for banks experiencing difficultly. I would agree that bank ratings should not be disclosed, as this would make supervisors rating agencies, which they are not. Beyond this, however, I believe the fear of disclosing findings is misplaced. Disclosure, especially early disclosure, is the best cure for unanticipated crises. It seems that the market already recognizes the absence of full disclosure by the largest firms, as evidenced by the fact that many are trading below their book values.

Capital Matters

Finally, an integral part of the supervisory process is insisting on strong capital. The purpose of bank supervision is to verify that banks are operating soundly and to assure that noted weaknesses are addressed. No supervision program can, should, or is intended to shield firms from the consequences of failed business decisions, even those that appeared reasonable at the time. That is the role of ownership capital.

The question, then, is: What level of ownership capital is sufficient? The largest banking firms insist that they are well capitalized, but data and evidence suggest that this is not the case. In an apples-to-apples comparison, it is striking that the largest firms are the least well capitalized of any group of banks operating in the United States.[2]

Capital adequacy is judged using a number of risk-based measures. One, using internal models, adjusts capital of the largest banks to 13 percent of assets or higher. But this is capital against risk-weighted assets, which are only about 40 percent of total assets. No other industry is allowed to remove 60 percent of its assets when its financial condition is assessed. I do not believe it's an accident that these risk-based standards have increased in importance and complexity as supervisors have moved away from full-scope exams. Instead of relying on strong examinations to address risk concentrations, regulators have relied on risk-based capital rules.

A more dependable measure of capital is the tangible leverage ratio, based on International Financial Reporting Standards (IFRS). This measure, which market investors rely on, shows that U.S. G-SIBs have a tangible capital ratio of only 5.73 percent and foreign G-SIBs have 5.13 percent.

To appreciate the significance of these percentages, compare them to the conservative estimates of bank losses in the 2008 crisis which show the industry lost approximately 7 percent of assets. Leverage ratios currently around 5 percent might boost ROE to individual firms and facilitate growth of economies during boom times, but they provide virtually no sustainability during downturns nor enough margin for inevitable errors by even the best bank managers or simply from bad luck.

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[2] Global Capital Index: https://www.fdic.gov/about/learn/board/hoenig/capitalizationratio2015-2.pdf

It has been suggested that using the more strict leverage ratio as the principal measure of capital adequacy would cause loan and economic growth to slow. Incongruously, it is also argued that demanding capital would cause bankers to take on greater risks to boost returns. Research on these topics, however, suggests otherwise. Going into the crisis of 2008, banks holding an average 12 percent capital saw more modest declines in loans and a quicker recovery. In contrast, banks with capital below 8 percent, including the largest banks, experienced more dramatic declines in lending. Strong capital levels support growth over the business cycle and are good for the economy.

From a supervision program perspective, moving away from risk-based capital measures toward an assessment of adequacy based on tangible equity would generate more reliable information from which to make supervisory judgments and would free up billions of dollars from supervision budgets currently spent waiting for, understanding, and implementing risk-based measures. Risk-based capital models do have an appropriate role as a component of the supervision process for stress testing different scenarios, but the extension of their use to judge bank health is misleading. The leverage ratio—which the market uses to access banks, as seen by the price-to-book ratios of the largest firms—in combination with strong examinations is the only real way to ensure firms have sufficient capital and to enhance stability.

Final Thoughts

The process of bank supervision is demanding. Extensive data collection and analysis are required. Asset and liability portfolios must be tested. Operations and related controls must be understood and tested, and the quality of management must be judged. Supervision requires an appreciation of the best balance of transparency and confidentiality, especially as it might involve disclosure of some examination findings. Finally, capital standards —so necessary to the resiliency of individual firms and the industry—must be determined and enforced.

The keystone on which the usefulness of these principles rests is the willingness of supervisors to do their job, which includes operating with healthy skepticism and asking tough questions. Importantly, it also includes the responsibility and courage to convey their findings to bank management – even in an environment of growth, when it is often easier to accept the prevailing view. But within reasonable bounds, it is the supervisors' responsibility to swim against the tide of enthusiasm. In 2006 and 2007 there were clear signs that problems were surfacing, and yet supervisors were slow to act. Even when guidance was issued about commercial real estate, the agencies quickly backed down after the industry raised objections. In hindsight, the regulators were correct in their projections, and the only mistake was in backing down.

More serious perhaps was that the agencies appeared to have actually joined the chorus of "this time it's different," judging from the absence of any supervisory actions against some of the world's largest and most complex firms and the decision to cut back on systematic examinations in the years leading up to 2008. All the exam findings in the world and all the model warning signals are of little use if leaders of the regulatory bodies fail to carry the message forward.

I will close by referring to the book that is in each of your packets. "Integrity, Fairness and Resolve" is a biography of one examiner, Bill Taylor, who headed up the Fed's Division of Bank

Supervision and then was chairman of the FDIC. Bill taught that good supervision requires information gathering and validation, experience, and true courage. He exemplifies that one leader can make a difference; that one bank examiner with these characteristics can make an industry and an economy more resilient.

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The views expressed are those of the author and not necessarily those of the FDIC.

Thomas M. Hoenig is the Vice Chairman of the FDIC and the former President of the Federal Reserve Bank of Kansas City. His research and other material can be found at [http://www.fdic.gov/about/learn/board/hoenig/.](http://www.fdic.gov/about/learn/board/hoenig/)