Financial Stability and Risk-Based Supervision: A View from the United States

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In the years leading up to the recent financial crisis and in the years since, lawmakers, legislators, and bankers have consistently reaffirmed their commitment to financial stability. Not coincidentally, the group created by the Dodd-Frank Act of 2010 to evaluate and respond to systemic risk was established as the Financial Stability Oversight Council. The international body that studies and makes recommendations for the global financial system was chartered as the Financial Stability Board. And the Basel Committee on Banking Supervision's mission statement expresses its goal of "enhancing financial stability."

Yet, despite many invocations, there are wide differences of opinion on what financial stability means and what policies it implies for financial institutions.[1]

That was not the case after the financial crisis that led to the Great Depression of the 1930s. Policy makers of that era were in very close agreement on what financial stability entailed and the steps that were necessary to achieve it. In the watershed legislation of 1933 (the Glass-Steagall Act) and 1935, they restricted entry into the banking system, suppressed bank competition, limited bank powers to the basics of deposit-taking and loan-making, made banking laws more prescriptive, and reduced regulatory discretion. Under this approach, the acceptable threshold for bank failures was effectively zero, reflecting a fear that the failure of a bank of any size would do unacceptable damage to still shaky public confidence.

This regulatory approach held for a full generation. As late as the 1960s and 1970s, the scars were still fresh enough that the failure of some quite minor U.S. banks triggered exaggerated public and congressional concerns that the Great Depression experience was about to repeat itself.[2]

Today we view financial stability in more nuanced terms. We recognize that banks must innovate and compete, not just with each other for business opportunities but also in the market for smart, talented people. We recognize that banks must take prudent risks in order to serve their public purpose. We further recognize that in serving their public purpose, bankers will take their share of chances that will not pan out, and that, especially in unfavorable economic conditions, too many errors of judgment could endanger the bank's viability. Although bank examiners identify and address many problems in banks, mostly unseen by the public, they cannot realistically catch them all. Nor is it clear that they would want to: a banking system that is safe and sound without exception or condition is probably one that is not doing its part to support customers and the communities in which they live and work.

In short, stable does not necessarily mean static nor risk free.

The goal of U.S. bank regulation today is, therefore, a banking system that is dynamic and safe and sound. For regulators, this requires careful balancing of our responsibilities. We must stay attuned both to the industry policies and behaviors that must be regulated, and then do so in a firm and measured way. But we must also take into consideration the burdens these regulations impose. We must constantly refine those regulations and act to revise or remove those found to be unnecessary or ineffective. Indeed, comprehensive periodic regulatory reviews are required under U.S. law, and we are in the process of conducting one of these reviews as I write.

Our approach to risk has also become more sophisticated. Some have suggested that, post crisis, bank regulators have embraced an uncompromising attitude toward risk, especially at the largest and most complex institutions. Some critics might view this as reminiscent of the regulatory response to the Great Depression, when overly cautious and constrained U.S. banks lost ground to foreign and non-bank domestic competitors, to the detriment of U.S. businesses and households.

But nothing could be further from the truth. At the Office of the Comptroller of the Currency (OCC), we recognize that banking is the business of informed risk-taking, and believe that banks, consistent with safety and soundness and consumer protection safeguards, should be free to exercise their own independent judgment when it comes to deciding which borrowers are creditworthy and which are not. Those are calls that bank managers—not regulators—are paid to make.

What we do insist upon is the proper management of the risks banks are empowered to take. This is an important distinction. OCC examiners require that the banks we supervise demonstrate a high level of risk awareness at all levels of the organization. We require them to have effective systems to identify, measure, monitor, and control risk-taking, and to ensure that boards of directors have sufficient information on the bank's risk profile and risk management practices to do their job, which is to provide oversight and guidance on strategy and risk appetite.

In other words, OCC supervision emphasizes that, subject to restrictions embodied in law, risk in and of itself is not what gets banks in trouble. Trouble happens when banks are unaware of and therefore unprepared for the possible consequences of the risk they take.

In my view, one fundamental reason for the recent instability in U.S. banking is that we periodically lost sight of the importance of strong bank supervision in an increasingly deregulated environment. In the several important pieces of legislation passed between 1980 and 1999 that dismantled the Great Depression-era rules and permitted U.S. banks to expand their activities and take on new risks, there was the expectation that these changes would be accompanied by less strict supervision. Indeed, some regulators embraced what they saw as the spirit of the times, examining and supervising with a lighter hand.

That proved to be a serious mistake. Recent history tells us that when the rules governing banking powers and activities are relaxed, banks should be subjected to intensified bank supervision to ensure that they are managing their affairs and activities in a responsible and legal manner.

Recent history also demonstrates the importance of the timely dissolution of financial institutions when their problems are so acute that recovery is no longer a realistic possibility. During the U.S. savings and loan crisis of the late 1980s and early 1990s, many insolvent institutions were allowed to continue operations in hopes they could grow their way back to health. More often than not, "regulatory forbearance" produced so-called "zombie banks" that eventually failed anyway, but at higher cost to the government-backed deposit insurance funds than if they had been closed earlier. In response, Congress in 1991 passed the FDIC Improvement Act (FDICIA), which established a new regime of "prompt corrective action" requiring regulators to respond in graduated ways to declines in a bank's capital. When it reached a point deemed to be "critically undercapitalized," FDICIA required regulators to close the bank and liquidate it. In this respect, FDICIA was a turning point, affirming that the failure of a bank was not necessarily a failure of public policy.

Similarly, the Dodd-Frank Act of 2010 was based on a new concept: that henceforward, no U.S. bank would be viewed as inherently too big to fail and that the implicit public commitment to rescue such a bank—a commitment believed to have contributed to excessive and mismanaged risk-taking and, ultimately, to the multi-billion dollar public bailout—was no longer on the table. To that end, Dodd-Frank provided the FDIC with "orderly resolution authority" to liquidate insolvent institutions, which includes the ability to fire bank management and board members, and to "claw back" previous compensation. It prohibited the Federal Reserve from using its lending authority to prop up failing companies. And, among other things, it required the largest banking companies to develop plans, subject to regulatory approval, for their own rapid and orderly resolution in the event of severe financial distress—so-called "living wills."

More importantly, Dodd-Frank raised prudential standards so that regulators have the tools they need to ensure a banking system that is both dynamic and safe and sound. The Dodd-Frank mandate for enhanced prudential standards complemented parallel work undertaken internationally by the Basel Committee to strengthen capital and liquidity standards for global financial institutions. The OCC has implemented these various new provisions through the U.S. federal banking agencies' rules that impose higher standards for capital and liquidity, the so-called Volcker Rule that sharply limits bank involvement in proprietary trading and speculating in derivative instruments, and the OCC's enforceable safety and soundness guidelines for heightened standards for bank management and board oversight.

As I have said, the thrust of the OCC's supervisory policy has been to ensure that banks properly understand, manage, and monitor the risks they assume. That

approach is embodied in what we call "supervision by risk." This is an approach to bank supervision that the OCC introduced more than 20 years ago, and one that we have been refining ever since.

Supervision by risk as practiced by the OCC is built on three pillars: regulations that carry the force of law; guidance that instructs bankers on how to meet their legal and prudential obligations; and supervision, which focuses on evaluating the risks banks face, identifying material and emerging problems, and ensuring that banks take action to resolve problems before those problems compromise their safety and soundness. This is a dynamic approach that is responsive to changing risks at individual institutions and sensitive to evolving market conditions and regulatory changes. It is based on the premise that no two banks are alike, and that their unique characteristics of size, location, corporate structure, risk profile, systemic importance, and many other variables require customized supervision.

For supervisory purposes, the OCC designates each national bank as a large, mid-size, or community bank. This designation is based on the bank's asset size and the presence or absence of other factors that affect its risk profile and complexity. Among those factors are the bank's relationship to any corporate partners, its share of the market in which it competes, and its product mix. For example, banks with extensive international operations, or sophisticated capital market activities, or customer menus that offer riskier products and services are more likely to qualify for a designation that provides a more intensive level of supervisory oversight than banks of similar asset size that do not share those characteristics.

The OCC's organization is designed to support the large, mid-size, and community bank designations. Large bank supervision is coordinated through the Senior Deputy Comptroller for Large Bank Supervision in the agency's Washington, D.C. headquarters. Mid-size and community banks receive a decentralized brand of supervision. Community banks, which constitute the overwhelming majority of OCC-supervised institutions, are supervised by local examiners, who often bring first-hand familiarity with the bank's market and business model to their work. We periodically rotate the assignments of lead examiners for large, mid-size, and community banks.

The OCC's supervision concentrates on systemic risk and institutions that pose the greatest risk to the banking system. Under this approach, the OCC allocates greater resources to areas of higher risk. It does this by identifying risk using common definitions. The OCC has defined eight categories of risk for the purposes of its supervisory activities: credit, interest rate, liquidity, price, operational, compliance, strategic, and reputation. These categories are not mutually exclusive; any product or service may expose a bank to multiple risks. For example, mortgage loans that are not properly underwritten or do not comply with the applicable law may expose banks to multiple categories of risk. Poorly underwritten mortgages may entail a loss that diminishes the bank's capital and liquidity, while seizing collateral that is a debtor's family home may tarnish its reputation with present and future customers. And, if in

making or servicing such loans the bank runs afoul of the complex rules governing these activities, it may be exposed to substantial penalties that can interfere with its ability to operate.

Supervision by risk requires examiners to determine how certain existing or emerging issues for a bank, its related organizations, or the banking industry as a whole affect the nature and extent of risks in that institution. It guides examiners in the risk evaluation process by providing consistent definitions of risk, a four-dimensional system for assessing those risks, and integration of risk assessment in the supervisory process. After performing risk evaluations, OCC examiners tailor supervisory activities to the risks identified. Examiners also include periodic testing in their supervisory activities to validate risk assessments.

National banks and Federal savings associations are required to undergo a full-scope, on-site examination at least once during each 12-month period. This may be extended to 18 months if the bank has total assets of less than $500 million, qualifies as "well capitalized" under the FDICIA definitions, is not under a formal enforcement action, and has received at least a satisfactory rating at its last examination. The OCC also has the latitude to schedule examinations more frequently if a bank's deterioration requires immediate attention.

But as important as what goes on during examinations—and what distinguishes the OCC's supervisory approach from others—is what goes on between examinations. The OCC practices what it calls "continuous supervision." This is most apparent in our large bank program, where resident examiners constantly monitor the bank's condition and evaluate its risk profile, drawing on their communications with bank management and with OCC headquarters experts on broader economic and market trends. But we also provide continuous supervision for our mid-size banks and continuous monitoring of our community banks: OCC managers who have responsibility for a "portfolio" of community banks stay abreast of their condition through various tracking mechanisms, as do officials in our four district offices, which are located in Chicago, Dallas, Denver, and New York.

The flexibility built into the OCC's supervisory system enables the agency to respond to day-to-day, week-to-week changes in a bank's condition. It also enables us to spot and take action in response to new and evolving risks. Consider, as a case in point, our growing attention to operational risk. A decade ago, operational risk was rarely referred to by name; and although regulators and bank managers were well familiar with what that species of risk entailed, coping with it was not usually an enterprise-wide or supervisory priority. But especially as credit risk has temporarily receded in the years following the financial crisis, operational risk has taken its place in importance and prominence, to the point where, today, the risk of inadequate or compromised bank systems and weaknesses in the bank's risk culture constitute one of the foremost threats to safety and soundness. To describe all the steps that the OCC has taken to address such risk, especially those associated with, for example,

cybersecurity, would take a paper several times the length of this one. I would refer you instead to the OCC Web site, OCC.Gov, where, under the "news and issuances" and "publications" tabs, you can familiarize yourself with the many papers, speeches, and regulatory issuances that we have produced to focus the industry's attention and help mobilize the regulatory community.

As I said at the outset, there is plenty of room for national regulators and central bankers to disagree about their understanding of the concept of financial stability and even the best methods to preserve it. Whatever your national inclinations, the techniques of risk-based supervision may be useful in supporting them. I offer these thoughts in the spirit of international collaboration and information sharing that brings us together through this forum and others around the world.

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Thomas J. Curry was sworn in as the 30th Comptroller of the Currency on April 9, 2012. On April 1, 2013, Mr. Curry was named Chairman of the Federal Financial Institutions Examination Council (FFIEC) for a two-year term. Comptroller Curry is the 21st FFIEC Chairman, marking the fifth time the OCC has led the Council. Prior to becoming Comptroller of the Currency, Mr. Curry served as a Director of the FDIC since January 2004, and as the Chairman of the NeighborWorks® America Board of Directors.

Prior to joining the FDIC's Board of Directors, Mr. Curry served five Massachusetts Governors as the Commonwealth's Commissioner of Banks from 1990 to 1991 and from 1995 to 2003. He served as Acting Commissioner from February 1994 to June 1995. He previously served as First Deputy Commissioner and Assistant General Counsel within the Massachusetts Division of Banks. He entered state government in 1982 as an attorney with the Massachusetts' Secretary of State's Office. Mr. Curry served as the Chairman of the Conference of State Bank Supervisors from 2000 to 2001, and served two terms on the State Liaison Committee of the FFIEC, including a term as Committee chairman.

He is a graduate of Manhattan College (summa cum laude), where he was elected to Phi Beta Kappa. He received his law degree from the New England School of Law.

Endnotes

1. On this point, see Garry J. Schinasi, (2004), "Defining Financial Stability," *World Bank Working Paper,* WP/04/187, October, and Abayomi A. Alawode, (2008), "What is Financial Stability?," *Central Bank of Bahrain Financial Stability Paper,* Series No. 1, March.

2. The San Francisco National Bank, whose failure was the subject of hearings in 1965, would not have ranked in the top 1000 U.S. banks by assets at the time. The U.S. National Bank of San Diego, California, ranked 86th when it failed and was investigated by Congress in 1973.