Bank Supervision: Unfinished Business from the Financial Crisis

By Thomas H. Stanton[1]

Since the financial crisis policymakers have worked overtime to issue new rules requiring financial firms to adjust their behavior in many ways. One area of continuing concern relates to bank *supervision*, the process by which bank examiners and analysts check on actual performance and require corrective actions by financial companies as they conduct their business and accommodate to the post-crisis environment.

The Dodd-Frank Act eliminated the Office of Thrift Supervision (OTS), the hapless supervisor responsible for overseeing Countrywide, AIG, Washington Mutual, and several other failed institutions.[2] Other supervisory agencies, notably the Office of the Comptroller of the Currency (OCC),[3] which oversees national banks, and the Federal Reserve Bank of New York (FRBNY),[4] which oversees major Wall Street institutions among others, commissioned serious independent reviews of their own supervisory practices. The Financial Crisis Inquiry Commission (FCIC) interviewed numerous supervisors and obtained voluminous documents that shed light on supervisory shortcomings and the importance of addressing them.[5]

Although bank supervisors have taken many lessons of the financial crisis to heart,[6] serious issues remain. Structural shortcomings relate to split jurisdictions and organizational complexities among and within supervisory agencies and the ability of institutions to shop for more congenial regulators. These and other factors lead to an imbalance of strength between supervisors and banks, a supervisory context that leads to excessive caution by bank examiners, and at the Federal Reserve, the dominance of another function—monetary policy—that can diminish the relative status of supervision and especially on-site examination.

Since the crisis bank supervisors have sought to work around some of these infirmities. Workarounds include increased centralization of supervision at the OCC and Federal Reserve, stress-testing of banks for capital adequacy, improved forward-looking measures, and increased application of corrective remedies such as restrictions on the distribution of dividends for institutions found to be undercapitalized. Nonetheless, fundamental issues remain to be addressed, especially with respect to the supervision of large, complex financial institutions.

The bank examination process tends to be shrouded in secrecy, with stern legal prohibitions on the disclosure of information about communications between bank examiners and the banks they supervise. Outside observers tend to learn little about the practicalities of bank examination. Over the long term, protection from outside observation means that the organizations that conduct examinations can develop weaknesses. Secrecy means that needed feedback may be limited. Seldom do supervisory weaknesses become apparent to outside parties other than the banks subject to examination.

Although helpful in encouraging the flow of information between banks and examiners, the lack of transparency also means that some banks, at least, can exploit weaknesses in the supervisory process. A disturbing example came from JPMorgan Chase (JPM) in the course of the "London Whale" episode, involving risky trades that cost JPM $6 billion in investment losses in 2012. The US Senate Permanent Subcommittee on Investigations documented how in 2010, the OCC sent a supervisory letter to JPM including a call for corrective action by the bank to document investment

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policies and portfolio decisions. The JPM Chief Investment Officer, who later resigned once losses from the London-based Chief Investment Office (CIO) finally came to light, reacted "sternly" to the OCC findings and the way that the OCC's call for corrective action would require new limits, controls, and reports. As the subcommittee reported:

> When asked if the CIO's aggressive reaction to the 2010 examination of the CIO was unique, the OCC indicated that it was not. In fact, the OCC Examiner-In-Charge at JPMorgan Chase told the Subcommittee that it was "very common" for the bank to push back on examiner findings and recommendations. He recalled one instance in which bank executives even yelled at OCC examiners and called them "stupid."[7]

The subcommittee documented another case in which the heads of risk divisions from all the lines of business of the bank, and the JPM Chief Risk Officer, "ambushed" a junior OCC examiner and criticized the OCC findings and recommendations in a meeting that, as the examiner recounted, took on a loud and "combative" tone. The subcommittee also reported that JPM CEO Jamie Dimon personally denied access by the OCC to daily profit-and-loss figures from the investment bank.

The subcommittee reported that, even after the London losses came to light, "obtaining information from JPM was difficult, as the bank resisted and delayed responding to OCC information requests and sometimes even provided incorrect information." The subcommittee concluded, "The whale trades provide a striking case history of how a major bank, with 65 bank examiners on site, can keep a multi-billion-dollar derivatives portfolio off the radar screen of its regulator for [six] years, at least until it begins to lose money."[8] From the perspective of bank supervision, these revelations are especially disturbing because of the likelihood that, compared to many of its peer institutions, JPM is better managed and more risk averse.[9]

The Federal Reserve also had examiners on site at JPM to examine the holding company, and they too missed the serious problems at the London office.[10] An inspector general review indicated that resource constraints played a role. Even though FRBNY had identified risks related to trading at the CIO and planned two examinations of the CIO's governance framework and risk management, the supervisor failed to conduct these examinations, as well as a full-scope examination that another Fed team had recommended, "due to many supervisory demands and a lack of supervisory resources," among other reasons.[11]

Another investigation by the subcommittee related to money laundering by the global bank HSBC and its US affiliate, HSBC USA, N.A. (HBUS). Here the subcommittee found that OCC examiners had detected problems at HBUS, but that the problem lay with enforcement to ensure that the bank corrected them:

> For more than six years, from July 2004 until April 2010, despite compiling a litany of AML [Anti-Money Laundering] deficiencies, the OCC never cited HBUS for a violation of law, never took a formal or informal enforcement action, and turned down recommendations to issue Cease and Desist Orders targeting particularly egregious AML problems, even though the same problems surfaced again and again. The OCC's failure to compel HBUS to remedy the AML deficiencies repeatedly identified by its examiners over a six-year period indicates that systemic weaknesses in the OCC's AML oversight model require correction.[12]

From the perspective of the analysis presented here, one lesson is that, absent careful documentation such as became available through the work of the FCIC, the Senate Permanent Subcommittee on Investigations, and an inspector general, it can be difficult to pierce the fog of secrecy surrounding bank examinations to obtain specific case studies. The lessons of public administration concerning organization and management of public functions are directly relevant, however, especially when bolstered by available evidence. There have been improvements in the law and in management of supervision since the Financial Crisis, but these have not cured some of the fundamental factors that make bank supervision difficult.

Fundamental Factors Diminishing Ability of Supervisors to Carry Out Their Responsibilities

Bank supervisors must cope with structural infirmities that limit their ability to supervise more effectively.

A major difficulty relates to the ability of many supervised institutions to shop for the most congenial supervisor. This directly affects the OCC because the law permits national banks, supervised by the OCC, to change and become state-chartered banks, supervised by a state bank regulator.

The OCC is funded by assessments on the institutions it supervises. Although superior to dependence on funding through appropriations, such as occurs with the chronically underfunded Securities and Exchange Commission and Commodity Futures Trading Commission (CFTC), funding through assessments has its own weaknesses. The most important of these relates to regulatory arbitrage and the ability of financial firms to select a favored regulator from among those with jurisdiction. The Fed and Federal Deposit Insurance Corporation (FDIC) face similar arbitrage possibilities, when depository institutions (usually smaller ones) decide whether to be members of the Federal Reserve System, with Fed supervision, or to accept FDIC supervision as a state nonmember bank.

For the regulator that gains authority to supervise a large institution, the change means a substantial increase in budget and staff resources; for the regulator that loses responsibility for supervision of an institution, the loss means diminution of budget resources and perhaps a commensurate reduction in staff size. An agency may also feel that its prestige correlates with the number of large institutions or the total number of institutions it supervises, and the total volume of assets held by institutions that it supervises. Little wonder that an agency that ended up with a weak regulatory culture, the OTS, referred to supervised institutions as the agency's "constituents" and sought to curry favor with them.[13] A classic example of regulatory arbitrage concerned Countrywide, the nation's largest mortgage bank, which encountered problems and was allowed to shift from the OCC (for the bank) and the Federal Reserve (for the holding company) to the more congenial OTS to supervise both the bank and holding company shortly before it failed in the financial crisis.

The Dodd-Frank Act eliminated the OTS, which has the major advantage of leaving the Federal Reserve as the single supervisor of bank and thrift holding companies. However, regulatory arbitrage remains an option for depository institutions, which, among other options, still may shift from a federal charter to a state charter, or vice versa, as they choose.

Senator Dodd had sought to go farther. He proposed an amendment to eliminate competition among regulators by consolidating jurisdictions so that a single regulator (the Fed) would supervise bank holding companies and a different single consolidated regulator would supervise depository institutions. His amendment to the Dodd-Frank Act failed by a vote of 91-to-8. Community banks, state-chartered banks and the Fed (which didn't want to lose its jurisdiction over depository institutions) strongly opposed the idea of supervisory consolidation.[14] One consequence of the Senate vote against consolidation, Senator Dodd pointed out, was to give large national banks an incentive to move from OCC regulation to less expensive, and less onerous, state regulation:

> Since the OCC depends on assessments from the banks it regulates to fund its operations, the agency may go to great lengths to keep its banks from converting to State charters. We have seen what happens when depository institutions exploit these weaknesses in our bank regulatory system and when agencies compromise their supervisory integrity to maintain companies within their domain. If this happens, we could have another race to the bottom—just like the competition and regulatory arbitrage that led to the financial crisis.[15]

The failure of Senator Dodd's amendment reflected both the political power of the financial sector on issues such as supervision and the advantages that firms believe that they derive from the ability to shop for the most advantageous regulator.

One other complexity deserves mention here. That is the possibility that a regulated bank or bank holding company might simply give up its bank status and become an unsupervised financial company completely beyond the jurisdiction of any bank regulatory agency.[16] This concern means that a bank regulator could decide to pull its punches, for fear that a company may simply shift its operations to an unsupervised financial firm. Susan Bies, a member of the Federal Reserve Board before the financial crisis broke, raised this issue in an interview with the FCIC:

> Based on the data that I saw back then, I think it was—and this is off of memory; I could be off—but I want to say two-thirds of the more troublesome forms of mortgages were being originated by non-commercial bank lenders. Now, some of those were subsidiaries of bank holding companies. And there was some real concern about if the Fed tightened down on non-bank subs of bank holding companies, whether that would create an unlevel playing field between bank holding company mortgage lenders and stand-alone mortgage lenders, who the Fed did not regulate. [17]

In other words, fear of creating an "unlevel playing field" creates resistance among regulators to impose prudential requirements that they otherwise might find appropriate. As with regulatory arbitrage by institutions seeking the most congenial regulator, this again raises the specter of Stanton's Law, the precept that "Risk will migrate to the place where government is least equipped to deal with it."[18]

The Federal Reserve faces a special difficulty because of organizational complexities within the system itself. For a variety of historical reasons, the Federal Reserve System is structured to be a government agency—the Board of Governors—perched on top of 12 private instrumentalities, the 12 Federal Reserve Banks. The Federal Reserve Banks are "private corporations whose stock is owned by the member commercial banks within their districts. The board of directors of each Reserve Bank consists of six members elected by the member commercial banks and three members appointed by the Board of Governors of the Federal Reserve System."[19]

Although the Federal Reserve Board possesses legal authority to supervise financial institutions within the system's jurisdiction, it has delegated this authority to the 12 Federal Reserve Banks. The large bulk of supervisory staff of the Federal Reserve System is located in the Federal Reserve Banks rather than at the Board of Governors. The theory of the delegation was that the Federal Reserve Board would set policy for the 12 Reserve Banks, but rely largely on the supervisory staff of the Reserve Banks to be, as Sabeth Siddique, formerly Assistant Director and head of Credit Risk Supervision at the Federal Reserve Board, told FCIC staff, the "eyes and ears" of the Federal Reserve Board's supervisory staff.[20]

Interviews with the FCIC revealed that the delegation has created a bureaucratic fault line between the Federal Reserve Banks and the Board. At times the split has had negative consequences, such as when the Federal Reserve Banks may decline to provide information to the board with respect to supervised institutions. Mr. Siddique explained:

> … [T]here are strong cultures that are in place in the Reserve Bank system that were hard to overcome, and that culture includes not giving Washington the information that they're looking for. So it's always been very, very difficult to get information out of the Reserve Banks throughout the years. And the responsibility for supervision has been delegated to the Reserve Banks, so invariably when we would ask questions for information or data, they would say, "everything's fine, don't worry about it." We would get tremendous pushback when I would try to get data.[21]

The fault line between the Federal Reserve Banks and the Fed Board splits the supervisory function itself in a potentially disruptive way. While the Federal Reserve Banks examine the financial condition of financial firms, the Board of Governors possesses legal authority to take enforcement actions. Several years after the crisis the Fed was embarrassed by revelations that the FRBNY was more lenient with Citigroup, one of its supervised institutions, than the Board of Governors wanted to be. Although the New York Fed had given Citigroup a 2015 deadline to address shortcomings in the company's 2013 capital adequacy stress test, the Federal Reserve Board in Washington unanimously decided to reject Citigroup's capital plan and determined that the company hadn't made enough progress to remedy those shortcomings. The shock of the change in signals and the board's rejection of its capital plan sent the company's stock price reeling.[22]

Imbalance of Strength between Supervisors and Banks

Other factors contribute to the imbalance of strength between supervisors and institutions that they supervise. Especially when dealing with a large complex financial institution a supervisor's job is not easy. There can be a significant disparity in skills and knowledge between a bank examiner and the people he or she deals with at the bank. This is reflected in the large gap in compensation and in perceived status between a bank examiner and a senior bank official. Lloyd Blankfein, CEO of Goldman Sachs, which became a bank holding company only in the course of the financial crisis, once joked that examiners were people who "get their coffee, sit in their offices, and ... don't work for us."[23]

Another problem relates to the outsized profits that an institution may enjoy in the period before excessive risks materialize. This happened in the years before the financial crisis when rising asset prices and an apparently benign economy allowed financial firms to reap profits without regard to the risks that they were accruing. It is difficult at best for a bank examiner to tell a CEO who is making substantial returns for the company that the institution must impose limits and controls that will have the effect of reducing the institution's short-term revenues, profits, and market share to protect against risks that may or may not materialize.

Supervisors may also find themselves short staffed compared to the work they are supposed to do. Thus, as the Senate Subcommittee reported, the OCC and Fed together deployed somewhat more than 100 examiners on site at JPM around the time of the London Whale, to supervise a $2.3 trillion institution with 260,000 employees. The Federal Reserve Board's Inspector General report cited previously notes how resource constraints discouraged FRBNY from conducting a timely examination of JPM's CIO; another factor was a multiplicity of supervisors and lack of cooperation, in this case between FRBNY and the OCC, that led to a gap between the two that might have helped to overcome some of these resource issues.[24]

Supervision is further complicated by the organizational complexity of many large financial institutions, to the point at which their own managements have difficulty understanding interactions among their multiple lines of business and especially their major risks and vulnerabilities. Sometimes these institutions fail to get their numbers right. In 2014 Bank of America, for example, suspended its capital plan after discovering a $4 billion shortfall in its calculations.[25] This affects supervisors as well as institutions; if a large complex institution fails to understand its financial condition, supervisors are more likely to be in the dark as well.

In 2009 the FRBNY commissioned an independent review by Professor David Beim of the Columbia Business School. His review found that the imbalance of strength led supervisory staff to be deferential to the banks they supervised:

> Regulators were reluctant to be prescriptive in exam findings. Beyond not wanting to impose their judgment on an outwardly successful business model, supervisors were concerned that their recommendations might be wrong and would be faced with ongoing criticism from the bank.[26]

JPM's treatment of OCC examiners during the London Whale fiasco seems to be part of a process that could generate such a response.

Fear Leads to Excessive Caution

Structural infirmities, difficulties of the supervisory task, and disrespect by supervised institutions together have led to a culture of caution among examiners. Professor Beim's review included interviews with FRBNY bank examiners. He found that supervisory staff often feared to speak up. His report lists the following responses in interviews:

"No one feels individually accountable for financial crisis mistakes because management is through consensus."

"Grow up in this culture and you learn that small mistakes are not tolerated."

"Don't want to be too far outside from where the management is thinking."

"No opportunity to earn enough merit from ten right policy decisions to compensate for one wrong decision."

"The organization does not encourage thinking outside the box."

"After you get shot down a couple of times you tend not to 'go there' any more."

"Until I know what my boss thinks I don't want to tell you."

"Members of the vetting committee fight their way through a giant document rather than risk prioritizing and being wrong. People are risk averse, so they include everything."[27]

He concluded that the supervisory culture was one that caused examiners to become passive even when they detected problems at a supervised institution:

> The New York Fed had some terrific people. I really came to admire them greatly. They are intelligent, they're well-meaning, and they're hard working and really good people. But what they told me was that time and again they would see a problem and they wouldn't do anything about it. So they would say, "Oh, subprime is getting a little out of hand here." There was some wringing of hands but nobody said, "And therefore here's what we're going to do about it." I think they needed more of that spirit. They needed a spirit that said, "Let's take some action and do something to change the world and change the institution."[28]

In 2014, five years after submitting his report, Professor Beim opined that, although FRBNY had made some improvements in staffing and its supervisory process, "the culture remains much as it was, or appears to."[29] Professor Beim based his 2014 opinion on news coverage of the termination of a FRBNY examiner after she had disagreements with her supervisor. The examiner contended that her FRBNY superiors pressured her to change findings that were adverse to Goldman Sachs, the company she was examining at the time.[30]

Progress since the Financial Crisis

The financial crisis revealed that the traditional bank examination scorecard, CAMELS (Capital adequacy, Asset quality, Earnings, Management capability, Liquidity adequacy, and Sensitivity to market risk), was unsuited to testing safety and soundness of large institutions when an asset price bubble was inflating. At a time of rising asset prices (most notoriously house values as they affected the mortgage market), defaults were low; the borrower could always sell the asset (again, such as a house) backing the loan and pay off the lender in full. That meant that capital levels, earnings, liquidity, and perhaps even market sensitivity all looked good, at least on the surface. Management tended to be a secondary criterion that examiners derived from the other factors and thus also looked good in the years before the asset bubble burst. Another problem was that capital is a lagging indicator; capital levels can look good until an institution finally recognizes its losses.

Since the crisis, financial regulators have taken to heart the need to address more forward-looking issues:

- Does an institution have enough liquidity to stay in business even if the markets freeze for a period of time?
- Does it have enough capital to withstand another crisis?
- If an institution were to fail, does management have a plan in place to reduce the complexities of trying to wind up its affairs?
- What other issues relate to the ability of an institution to withstand serious financial turmoil or at least to fail without contributing to a financial crisis?

Federal bank regulators also are increasingly focused on the quality of governance of financial institutions and especially the quality of feedback that the institution's board of directors provides to the CEO and senior management. Risk management, a traditional but limited examination focus, has been enhanced to look at the actual quality of input from the risk management function into a firm's decisions.

Some of these initiatives help to buttress the examination process itself. To help address the problem of examiners being absorbed by the culture and environment of the large complex institutions they supervise (the phenomenon some supervisors call "going native"), both the Federal Reserve and the OCC have centralized parts of the examination process. The Federal Reserve has created the Large Institution Supervision Coordinating Committee (LISCC) to oversee supervision of large, systemically important U.S. financial institutions.[31] In contrast to an earlier effort to centralize oversight of supervision of large complex institutions, the Fed Board has successfully assumed chairmanship of LISCC.

LISCC's value is threefold:

(1) It brings together senior officers with an interdisciplinary focus, thereby enabling supervisors to

learn lessons from each institution and, by extension, to share best practices across large complex institutions.

(2) LISCC provides a forum that helps to integrate information about macroeconomic developments with supervisory insights about the condition of large complex institutions so that systemically important events can be anticipated and perhaps addressed in advance.

(3) LISCC helps to centralize oversight of the supervisory process across the Federal Reserve Banks and potentially provides a counterweight to Federal Reserve Bank examination teams that might be inclined to undergo what economist Willem Buiter calls "cognitive regulatory capture."[32]

The OCC responded to recommendations of an international peer review of OCC supervisory practices by stating, among other changes, that the OCC would create a "Large Bank Risk and Steering Committee structure" to guide supervisory strategies and promote consistent responses across large bank examination teams. The OCC also stated that it would significantly expand its staff of "lead experts" available to provide support to on-site examiners in key substantive areas.

The OCC and Fed are also trying to address larger issues. Both organizations are working to encourage complex financial institutions to simplify their structures.[33] The Fed Board and FRBNY also have been challenging the cultures of large complex financial institutions.[34] FRBNY President and CEO William C. Dudley made the case that improving bank cultures was "imperative":

> In recent years, there have been ongoing occurrences of serious professional misbehavior, ethical lapses and compliance failures at financial institutions. This has resulted in a long list of large fines and penalties, and, to a lesser degree than I would have desired employee dismissals and punishment. Since 2008, fines imposed on the nation's largest banks have far exceeded $100 billion.[35]

At the same conference Federal Reserve Governor Daniel Tarullo observed that improved culture depends on improved incentive structures, adding that, "My expectation is that if banks do not take more effective steps to control the behavior of those who work for them, there will be both increased pressure and propensity on the part of regulators and law enforcers to impose more requirements, constraints, and punishments."[36]

Although important, these and other large bank initiatives are largely conducted outside the traditional examination process. Regulators now require large institutions to hold enough capital to withstand a range of difficult financial scenarios, and the Fed and FDIC require large complex institutions to submit resolution plans, called "Living Wills" in the trade, which it hopes would permit an orderly wind-down if one of them fails. Regulators also are deliberating how much of a liquidity cushion an institution should have to withstand a possible financial shock, and they are implementing a variety of new legal requirements, such as restrictions on when institutions trade derivatives for their own accounts.[37]

Daniel Tarullo, the Federal Reserve governor with responsibility for financial supervision, has spoken of a shift in supervisory emphasis along these lines: "Prudential regulators certainly need to maintain a presence at the largest bank-holding companies. But I think we may need to devote more of our supervisory resources to data-driven, comparative assessments of capital, liquidity and other conditions in these firms."[38] In other words, there would be more off-site, quantitative, economic analysis of bank data and less reliance on information from on-site supervision.

Governor Tarullo's position is consistent with the long-standing proclivities of the Federal Reserve. There is a principle of public administration that, when an organization has two specific missions, the higher priority mission tends to crowd out the lower one. In the case of the Fed, the highest priority mission of the central bank has been monetary policy. This emphasis has fostered a culture at the Fed that depends heavily on high-quality economists. Supervisors, by contrast indicated to the FCIC that they often felt themselves to be second-class citizens.

This had perceptible consequences before the crisis broke when the Fed was still deciding how to respond to a troubled mortgage market. In May 2007, Federal Reserve Chairman Ben Bernanke spoke at a conference at the Chicago Federal Reserve Bank and stated that the crisis would largely spare the banking system.[39] However, the FCIC spoke with Fed supervisors who contended that they had actively warned that the crisis could be catastrophic because of the way that troubled assets had come to rest on the books of highly leveraged institutions. The supervisors said that they based their views more on what they learned from reviews of major institutions than on quantitative data. Culturally, supervisors did not speak the quantitative language that the Fed's leadership could hear, which meant that the supervisors' views were disregarded in the chairman's speech.

Signs continue that supervisors at the Fed remain in a secondary position. The board has located its supervisory staff in a building far from the elegant offices of the Federal Reserve Board itself. And the position of Fed Vice Chairman for Supervision, created by the Dodd-Frank Act, continues to go unfilled, without a name even being submitted for the position. Instead of bringing supervisors closer to the center of influence at the Fed, it appears that the Fed is relying more heavily on economists than before for the quantitative analysis that is an important complement, but by no means a substitute for direct supervision.

Adding Value Through Bank Supervision

Although current supervisory improvements have been significant, they continue to represent workarounds that can ameliorate but not overcome three fundamental weaknesses: the ability of large banks to switch (or at least threaten to switch) charters and obtain a more congenial supervisor, the organizational weakness of the Federal Reserve Board *vis-à-vis* the Federal Reserve Banks to whom it has delegated supervisory authority, and the need to build an examiner corps with the necessary skills and *esprit de corps* to provide useful feedback to management of large, complex institutions. More effective supervision of large institutions will require realignment of several traditional elements of organizational strategy: goals, resources for achieving those goals, and the external environment.

Goals

The purpose of bank supervision is to enhance market efficiency by creating confidence that an institution is well-managed, law abiding, and capable of sustaining its operations in a safe and sound manner. Since the crisis, the micro-prudential focus has changed to be more forward-looking:

- What is the institution's business model and strategy?
- How and where is the institution earning its revenues and profits?
- Is the strategy sustainable in the longer term?
- Does management have integrity and the expertise needed to implement the strategy?

One area of special importance concerns the quality of governance and decision-making. Working at the FCIC, the author had the opportunity to interview CEOs, bankers, traders, risk officers, regulators, and policymakers. A review of a dozen large complex financial institutions, four that navigated the crisis and eight that failed, in the sense that they required substantial government assistance or went out of business, revealed that the quality of decision-making was a key variable in determining whether an institution succeeded or failed.[40]

At successful institutions CEOs created cultures that encouraged feedback, from their boards, from risk officers, and from others more generally. Managers at the successful firms solicited feedback continually. Although they didn't act on all, or perhaps most, such feedback, they developed a robust understanding of their firm and its environment that otherwise might not have been possible. By contrast, at unsuccessful firms the CEO and heads of major business units resisted feedback. They dominated their boards, disregarded warnings from risk officers, and generally failed to have processes in place to challenge their views before a decision became final.

This means that supervisors need to focus in a sophisticated way on the way firms make major decisions. When CEOs and powerful business unit heads resist feedback, supervisors will need to insist that more voices are properly heard and considered. They also need to back up the review of decision-making with a review of the flow of information to decision-makers, especially including risk-related information that often was inadequate or neglected by unsuccessful firms in making their decisions. It is a sign of dysfunction either when top management lacks important information that is known farther down in the organization or when organizational "silos" prevent important information from flowing across different parts of the organization. Supervisors need to interview across the organization and up and down the organizational hierarchy to pick up these trouble signs. Resistance to feedback from supervisors can be another trouble sign, as it was in the case of JPM and the London Whale.

In other words, as bank supervisors increasingly have come to understand, good supervision must be intrusive: "Supervisors in the financial sector should not be viewed as hands-off or distant observers, but rather a presence that is felt continuously…"[41]

Resources

The supervisory corps needs to be strengthened in several dimensions. Examiners need to be trained so that they become strong not only in specific technical areas of finance, operations, and law, but also in interpersonal skills. Supervisors do not have an easy task:

> [They] must not only be capable of rapidly understanding new and complex financial issues and identifying risks, but also be able to evaluate how such issues interact with one another and have the acumen to cut to the quick. They should be able to engage in dialogue with financial institutions as evenly matched and critical discussion partners, and be willing and able to ask difficult questions and not be too easily satisfied. While they must be familiar with the problems facing the institutions under their supervision, they also need to keep their distance and be able to switch from dialogue to forceful intervention.[42]

This task is especially difficult when supervising a large complex financial institution. The FCIC heard from supervisors that, although the leadership of smaller and medium-sized institutions felt they might learn from supervisors about good management lessons from other supervised institutions, that was not the case at large complex institutions, where top management generally felt that they had little to learn from supervisors. On the other hand, seasoned supervisors stated that they did believe that they could provide valuable feedback to leaders of larger institutions and that—if they had strong interpersonal skills—they could make the feedback heard.

The relationship between a supervisor and the supervised institution requires the type of balance that has been worked out in other similar kinds of relationships. Madelyn Antoncic, a well-regarded Chief Risk Officer at Lehman before CEO Richard Fuld sidelined her to a lesser position, told the FCIC about the relations between her risk officers and the business units they were interacting with:

> There shouldn't be conflict, but they shouldn't be too cozy. There has to be an intellectually independent, intellectually honest person who's mature enough not to drink the Kool Aid and become part of the trading desk. He knows where he's getting paid from—he's getting paid from me. The whole concept of his job is to steer the business out of trouble, but at the same time, do the risk reporting and analytics and ensure that the business didn't blow up."[43]

The approach articulated by Dr. Antoncic for risk officers is similar to the idea of "principled intimacy" that allows police officers engaged in community policing to undertake frequent and effective communication without diminution of their responsibilities to carry out the law.[44] It is also an apt description of the relationship that supervisors should establish with the management of banks for which they are responsible.

Although bank examiners often have felt themselves constrained to flag only easily documentable violations, the change in focus to provide feedback regarding a bank's business strategy, governance, and quality of leadership means that bank examiners will need to be much more sophisticated and knowledgeable than ever before. This will require training and clear support from the top so that supervisors feel confident when providing feedback to a bank's officers and directors. For the Fed, given the governance structure of Federal Reserve Banks, credible support from the top is likely to require revision of the terms of the delegation of supervisory responsibility from the board to the Federal Reserve Banks.

Even with increased training and skills, bank supervisors cannot expect to know as much about a large complex financial institution as do the institution's managers. Rather, the goal should be to provide supervisors with enough knowledge that they can pose useful questions and pursue the answers. An operative question for JPM with respect to the excessive profits reported by its London investment office before 2012, for example, would be: "You are thriving in a highly competitive market. Are you making all that money because you are smarter than everyone else or are you simply taking greater risks than others are willing to take?" In the case of the London Whale, the answer was excessive risk-taking; in other cases an institution might have figured out a successful investment strategy that kept risk-taking within reasonable bounds.

Other industries have similar issues with respect to the quality of their supervisors. In testimony presented after the disastrous Gulf oil spill, ExxonMobil Chairman and CEO Rex Tillerson told the National Commission on the BP Deepwater Horizon Oil Spill that the industry should educate its supervisors on technological developments so that supervisors can ask the right questions:

> As to the regulator, it is a significant challenge for the regulator to have people at competency levels commensurate with where the industry is technologically.... They may not be capable of formulating the precise response, and that may not be necessary. But they need to be capable enough to say, I see a risk, it's not clear how it's being managed, and say to us, how are you addressing that? And that's enormously important to us as an industry. In my view, we want a competent regulator. They are part of the risk management system.[45]

Unpalatable as it may be for the political process, it probably will be necessary to increase the compensation of bank supervisors. It is in the interests of supervised institutions, and not just bank regulatory agencies, to reshape the culture of supervisors so that they can carry out the balancing act needed to do their jobs well, to be firm without becoming overbearing, to earn the trust of the managers of supervised institutions without being "captured," and to ask good questions even if they don't know the answers. To gain the status needed to attract strong people, supervisors don't need to attain the sometimes stratospheric levels of remuneration of senior management of large complex institutions; but compensation must be high enough at least to ensure that supervisors can send their children to college and that they do not need to stretch to do so. Bank supervision needs to be a prestigious calling without losing so many of the most experienced supervisors to the private sector at a time when they have finely honed their skills.

External Environment

As with any change in strategy, the changed goals of bank supervision also require a change in the external environment. Some factors are within the control of today's supervisory agencies. The sometimes troubled relationship of disrespect and distrust between supervisors and supervised banks can be improved in part by upgrading the skills and job descriptions of bank examiners so that more of them have the authority and ability to ask the right questions and respectfully insist on answers. This requires that bank examiners have the support and the backing from the top that is needed to revitalize the culture that Professor Beim warns about.

These are important steps. However, for supervision to be effective, fundamental structural issues need to be addressed as well. Within the Federal Reserve System, it is hard to see how long-standing cultural and bureaucratic differences between the board and the Federal Reserve Banks can be overcome so that the board remains in control of communications of important decisions to institutions that are member banks of the Federal Reserve Banks and—most importantly—so that information flows more freely to the board, except through a concerted effort that includes amending the terms of the Federal Reserve Board's delegation of supervisory authority to the Federal Reserve Banks. Complexity and rapid change in the financial world require that feedback from the supervisory process be promptly available to inform decision-makers at the board about new developments in financial practices and the condition of financial institutions.

Removing the option of banks to shop for their favored supervisor is even more fundamentally important because of the continuing check it provides on the ability of an agency to provide honest feedback when an institution's practices or condition warrant. This will become especially salient as the passage of time again engenders complacency. Given political realities, progress again may need to be incremental, preferably without another crisis to spur reforms.

Removing the ability to shop for a regulator can help to create a more constructive balance in the relationship of regulated institutions to their supervisors. Even without the ability to shop, the many advantages of a bank *vis-à-vis* its supervisor, in terms of available resources, the skills of its personnel, information asymmetries, and the ability to appeal to the political process, all can ensure that large complex financial institutions can be treated fairly and respectfully in the supervisory process. Feedback is a valuable gift, not only for supervised institutions, but also for their supervisors.

In the end, the relationship of the financial sector, and large complex institutions in particular, to financial supervision needs to change. Edmund Clark, CEO of TD Bank, a bank that successfully navigated the crisis, articulates a goal of win-win relations: there must be "productive working partnerships between the industry and its regulators, enabling both parties to agree in principle on what needs to be done, and on the least intrusive way in making it happen."[46] Bank supervision is an important part of this equation; both responsible bank leaders and supervisors have a stake in increasing the ability of supervisors to become respected parts of the process of soliciting and weighing feedback that can make the difference between success and failure for their institutions and, as the crisis has shown, for the financial system itself.

Notes

1. The author is grateful to three knowledgeable reviewers for their valuable comments on an earlier draft. The author is solely responsible for this article and its contents.
2. *See, e.g.,* Senate Permanent Subcommittee on Investigations, *Exhibits: Hearing on Wall Street and the Financial Crisis: The Role of Bank Regulators*, April 16, 2010.
3. "An International Review of OCC's Supervision of Large and Midsize Institutions: Recommendations to Improve Supervisory Effectiveness," December 4, 2013; and "Summary of OCC's Responses to the Supervision Peer Review Recommendations," May 28, 2014.
4. Federal Reserve Bank of New York, "Report on Systemic Risk and Supervision," Discussion Draft, August 18, 2009, available on the permanent FCIC Web site, *http://fcic.law.stanford.edu/resource*, last accessed Nov. 26, 2014.
5. Many of these issues are summarized in Thomas H. Stanton, *Why Some Firms Thrive While Others Fail: Governance and Management Lessons from the Crisis*, New York: Oxford University Press, 2012, chapter 7.
6. *See, e.g.*, A.J. Kellermann *et al.* (eds), *Financial Supervision in the 21st Century*, Berlin: Springer Verlag, 2013.
7. Senate Permanent Subcommittee on Investigations, *JPMorgan Chase Whale Trades: A Case History of Derivatives Risks and Abuses*, March 15, 2013, p. 224.
8. *Id.*, pp. 223–225 and 217.
9. Stanton, *supra* n.5, Chapter 3.
10. On demoralization among FRBNY examiners responsible for overseeing JPM, *see* 'Secret Tapes Hint at Turmoil in New York Fed Team Monitoring JPMorgan: examiners are reportedly blocked from doing their job as 'London Whales' trades blow up," *ProPublica*, November 17, 2014.
11. Office of Inspector General, Board of Governors of the Federal Reserve System and Consumer Financial Protection Bureau, "Summary Report: The Board Should Enhance Its Supervisory Processes As A Result Of Lessons Learned From The Federal Reserve's Supervision Of JPMorgan Chase & Company's Chief Investment Office," 2014-SR-B-017, October 17, 2014, p. 2.
12. Senate Permanent Subcommittee on Investigations, *U.S. Vulnerabilities to Money Laundering, Drugs, and Terrorist Financing: HSBC Case History*, July 17, 2012, p. 316.
13. Senate Permanent Subcommittee on Investigations, *Wall Street and the Financial Crisis: Anatomy of a Financial Collapse*, Majority and Minority Staff Report, April 13, 2011, p. 4.
14. Stephen Labaton, "Leading Senator Pushes New Plan to Oversee Banks," *New York Times*, September 20, 2009.
15. *Congressional Record*, May 12, 2010, p. S3573 (daily edition).
16. Dodd-Frank addressed this issue for the largest non-bank institutions that are subject to Federal Reserve jurisdiction if the Financial Stability Oversight Council designates them as "Systemically Important Financial Institutions," or SIFIs. Criteria for designating an institution as a SIFI are codified at 12 U.S. Code § 5323, "Authority to require supervision and regulation of certain nonbank financial companies." Implementing regulations of the Financial Stability Oversight Council, "Authority to Require Supervision and Regulation of Certain Nonbank Financial Companies," are found in 77 *Federal Register* 21637, codified at 12 CFR Part 1310.
17. FCIC interview with Former Federal Reserve Governor Susan Bies, October 11, 2010, available on the permanent FCIC Web site, *http://fcic.law.stanford.edu/resource*, last accessed Nov. 26, 2014.
18. This dynamic was first presented in the author's testimony before the Senate Banking Committee in a hearing on *The Safety and Soundness of Government Sponsored Enterprises*, October 31, 1989, p. 41, pointing out that increases in the stringency of capital requirements and government supervision for thrift institutions after the savings and loan debacle would drive many billions of dollars of mortgages from the portfolios of savings and loan associations to Fannie Mae and Freddie Mac where capital standards and government oversight were much weaker.
19. *Melcher v. Federal Open Market Committee*, 644 F.Supp. 510 (D.D.C. 1986). The decision also provides a useful synopsis of

the antecedents and history of the Federal Reserve System as the nation's central bank. *See also*, U.S. Government Accountability Office, *Federal Reserve Bank Governance: Opportunities Exist to Broaden Director Recruitment Efforts and Increase Transparency*, GAO-12-18, October 2011.

20. FCIC interview with Sabeth Siddique, October 25, 2010, available on the permanent FCIC Web site, *http://fcic.law.stanford.edu/resource,* last accessed Nov. 26, 2014.
21. *Id*.
22. Dan Fitzpatrick, Ryan Tracy, and Christina Rexrode, "Citigroup Received Mixed Signals On 'Stress Test': The Bank Thought It Had More Time to Fix Problems, but Fed Failed It Anyway," *Wall Street Journal*, April 16, 2014.
23. Francesco Guerrera, "Too Many Cops on the Bank Beat," *Wall Street Journal*, July 23, 2012.
24. Office of Inspector General, Board of Governors of the Federal Reserve System and Consumer Financial Protection Bureau, "Summary Report: The Board Should Enhance Its Supervisory Processes As A Result Of Lessons Learned From The Federal Reserve's Supervision Of JPMorgan Chase & Company's Chief Investment Office," 2014-SR-B-017, October 17, 2014, p. 2.
25. Peter Eavis and Michael Corkery, "Bank of America Finds a Mistake: $4 Billion Less Capital," *New York Times*, April 28, 2014. Bank of America explained that, "the company discovered an incorrect adjustment being applied in the determination of regulatory capital related to the application of the fair value option to certain legacy Merrill Lynch structured notes resulting in an overstatement of its regulatory capital amounts and ratios," Bank of America, "Bank of America Announces Adjustment to Estimated Regulatory Capital Ratios," press release, April 28, 2014.
26. Federal Reserve Bank of New York, "Report on Systemic Risk and Bank Supervision," discussion draft, August 18, 2009, p. 6, available on the permanent FCIC Web site, *http://fcic.law.stanford.edu/resource*, last accessed Nov. 26, 2014.
27. Federal Reserve Bank of New York, *supra* n.4 at. 6, available on the permanent FCIC Web site, *http://fcic.law.stanford.edu/resource*.
28. Jon Hilsenrath, "New York Fed Needed a Culture Change, Columbia Professor Says," *Wall Street Journal*, October 8, 2014.
29. *Id*.
30. "Inside the New York Fed: Secret Recordings and a Culture Clash: A Confidential Report and a Fired Examiner's Hidden Recorder Penetrate the Cloistered World of Wall Street's Top Regulator—and its History of Deference to Banks," *ProPublica*, Sep. 26, 2014.
31. *See, e.g.,* Federal Reserve Board, "Large Institution Supervision Coordinating Committee," available at *http://www.federalreserve.gov/bankinforeg/large-institution-supervision.htm*, last accessed Nov. 26, 2014.
32. Willem Buiter, "Lessons from the North Atlantic Financial Crisis," revised May 28, 2008. For Buiter cognitive capture is not a product of corruption, but rather a process by which regulators, and by extension other parts of the control function such as risk officers, may internalize "as if by osmosis, the objectives, interests, and perception of reality of the vested interests they are meant to regulate and supervise … "
33. *See, e.g.*, Charles Taylor, Deputy Comptroller for Capital and Regulatory Policy, OCC, Remarks to the Institute of International Bankers, March 3, 2014; and Sarah Dahlgren, Executive Vice President, Remarks at the Securities Industry and Financial Markets Association Conference, April 29, 2014.
34. It is interesting to note historical parallels with this effort. *See*, J.F.T. O'Connor, Comptroller of the Currency, "Recommendations for Code of Ethics for Banks by J.F.T. O'Connor, Comptroller of the Currency," in J.F.T. O'Connor, *The Banking Crisis and Recovery Under the Roosevelt Administration*, 1938, pp. 134–136. For a similar approach after the banking crisis of 1893, *see*, O.M.W. Sprague, *History of Crises Under the National Banking System*, Note D, "Banking Reform Proposals in New York in 1894," National Monetary Commission, 1910.
35. William C. Dudley, "Enhancing Financial Stability by Improving Culture in the Financial Services Industry," remarks to the FRBNY Conference, "Reforming Culture and Behavior in the Financial Services Industry," October 20, 2014.
36. Daniel K. Tarullo, "Good Compliance, Not Mere Compliance," remarks to the FRBNY Conference, "Reforming Culture and Behavior in the Financial Services Industry," October 20, 2014.
37. One useful complement between quantitative analysis and the examination process concerns the Fed's Comprehensive Capital Analysis and Review (CCAR), which is designed "to strengthen both supervisory assessments of capital adequacy and the processes through which large complex [bank holding companies] internally assess capital needs." Tim P. Clark and Lisa H. Ryu, Federal Reserve Board, "CCAR and Stress Testing as Complementary Supervisory Tools," December 20, 2013, available at *http://www.federalreserve.gov/bankinforeg/ccar-and-stress-testing-as-complementary-supervisory-tools.htm,* last accessed Nov. 26, 2014.
38. Quoted in Guerrera, *supra.*, n. 23.
39. "As the problems in the subprime mortgage market have become manifest, we have seen some signs of self-correction in the market.… Importantly, we *see* no serious broader spillover to banks or thrift institutions from the problems in the subprime market; the troubled lenders, for the most part, have not been institutions with federally insured deposits." Federal Reserve Chairman Ben S. Bernanke, "The Subprime Mortgage Market," speech to the Federal Reserve Bank of Chicago's 43rd Annual Conference on Bank Structure and Competition, Chicago, Illinois, May 17, 2007.
40. This is the conclusion of research presented in Stanton, *supra* n.5.
41. Jose Viñals and Jonathan Fiechter, "The Making of Good Supervision: Learning to Say 'No'," International Monetary Fund, May 18, 2010, p. 12; *see also* Kellermann, *supra* n.6, chapter 1.
42. Kellermann, *supra* n.6. at 9.

43. FCIC interview with Madelyn Antoncic, July 14, 2010, available on the permanent FCIC Web site, *http://fcic.law.stanford.edu/resource*, last accessed Nov. 26, 2014.
44. Sparrow, Malcolm K. *The Regulatory Craft: Controlling Risks, Solving Problems, and Managing Compliance*, Washington, DC: Brookings Institution Press, 2000, p. 177.
45. National Commission on the BP Deepwater Horizon Oil Spill and Offshore Drilling. Fifth Meeting, Day Two, *Transcript of Proceedings*, November 9, 2010.
46. Edmund Clark, Group President and CEO, TD Bank Group, "Building a Better Banking System For America," remarks to the Chief Executives' Club of Boston, April 26, 2012.