Transcript
FedTalk: Assessing the Safety and Soundness of Banks: How the Cleveland Fed Supervises Financial Institutions
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Presentation

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Anulekha Mohanty:

Good afternoon and thank you for joining us and welcome to today's *FedTalk*. My name is Anulekha Mohanty, Senior Vice President of Supervision, Credit Risk, and Statistics here at the Federal Reserve Bank of Cleveland. It is my sincere pleasure to kick off today's *FedTalk* session titled Assessing the Safety and Soundness of Banks: How the Cleveland Fed Supervises Financial Institutions. *FedTalk* is the Cleveland Fed's speaker series in which we share research that is relevant to our community. Past events have covered topics such as the racial wealth gap, access to labor market, and financial literacy. All of our events can be found on our website clevelandfed.org or on our YouTube channel.

A few housekeeping items before we begin today. During this event, your microphone and camera will be disabled. However, if you have questions, please feel free to type and submit your questions to our panelists in the chat box. We will aim to address questions after the presentation during the moderated Q&A panel segment. And of course, in the event your Zoom meeting drops, please use the dial-in information provided in the invitation to join the call.

Moving on to slide two. Before we begin our programming today, I would like to state that the views shared today by myself and the panelists are our own and not necessarily those of the Federal Reserve banks or the Federal Reserve system. Additionally, we will not be able to comment on any rule proposals. Now I would like to introduce my esteemed colleagues and speakers who will get us started. Nadine Wallman is the Vice President of our Supervision Department here at the Cleveland Fed. Nadine has responsibility for supervision of our community and regional bank. Joining her today is Brian Sahnd, who is an Assistant Vice President in our supervision area. Brian has responsibility for supervision of banks to ensure compliance with consumer laws and regulations. I'll now turn it over to Brian to get us started.

Brian Sahnd:

Thanks, Anulekha. Moving to slide three. So as you can see, the Cleveland Fed is one of 12 reserve banks that are part of the Federal Reserve system. Today we'll focus on how the Cleveland Fed promotes a safe, sound, and stable banking and financial system that supports the growth and stability of the US economy, as well as fair and transparent consumer financial services market. We'll talk about how this work... And the context is on the fourth district. Geographically, this is an area consisting of Ohio, Eastern Kentucky, Western Pennsylvania, and the Panhandle of West Virginia. This work aligns with three of the key functions of the Fed, which are start on the slide.

The first key function is helping maintain the stability of the financial system. One of the primary ways that we perform this function is through the supervision of financial institutions. We're going to talk more about that later. There are other tools the Fed utilizes to promote financial stability, including the discount window and emergency lending facilities. The discount window is one program that enables the Fed to lend to depository institutions. It allows eligible institutions to borrow money, usually on a short-term basis to meet temporary liquidity needs. In return, the borrowing institution [inaudible 00:03:43] collateral. At one time, it used to be a physical window, hence the name discount window. There are a few money programs available within the discount window that are based on the conditions of the borrowing bank. These are called primary, secondary, and seasonal credit programs.

So now moving to the emergency lending facilities. During times of crisis, the FED also creates emergency lending facilities under Section 13(3) of the Federal Reserve Act. One such program may have heard of was the Paycheck Protection Program Lending Facility, your PPPLF, which was established during the pandemic. The Small Business Administration introduced the Paycheck Protection Program to get up to $660 billion in the hands of small businesses quickly so those businesses could keep paying their employees during the shutdown. Lenders need a source of cash to meet the business's demands for these loans, and thus the PPPLF or PPPLF was established.

More recently, the Bank Term Funding Program was established in the spring of 2023. This was in response to difficult banking conditions. This program offered loans of up to one-year length banks, savings associations, and credit unions, and other eligible depository institutions by pledging qualifying assets collateral. The program served as additional source of liquidity against [inaudible 00:05:00] securities eliminating the institution's need to quickly sell those off in times of stress. Both PPPLF and BTFP have since closed to new loans, but demonstrate the tools used by the Fed to promote financial stability in times of stress strain. Going back to the slide, key functions number two and three, supervising financial institutions and promoting consumer protection is where we're going to spend the rest of our time today. We'll more closely look at what we mean by financial institution supervision. Examinations, the type of risks examiners look for. How supervision is tailored and the ways in which supervision is evolving. So I'm going to go to the next slide.

So starting with the basics, bank supervision is government oversight of banks and examiners are the employees of the Fed who carry out this responsibility. So why is bank supervision necessary? Well, banks take deposits and put those deposits to work in the economy by offering financial services such as mortgage, loans, and credit cards. In providing these financial services, banks take on risks. Examiners work to understand the bank's operations major risks and how banks manage those risks, and whether the banks have sufficient financial managerial resources. Bank supervision at the federal level is carried out by three agencies with each agency supervising banks under different types of legal charters. You have the Federal Reserve, the Office of the Comptroller of the Currency or OCC, and the FDIC or the Federal Deposit Insurance Corporation.

In addition to the federal agencies, there are state agencies that also have supervisory responsibilities. In our region, the Cleveland Fed partners of agencies like the Ohio Department of Financial Institutions and the Kentucky Department of Financial Institutions. The Cleveland

Fed and staff have responsibility for supervising state member banks and holding companies in the fourth Federal Reserve district. This slide shows our overall supervisory footprint. You can see in the Cleveland Fed supervisory footprint box to the right that we supervise 33 state member banks, 162 small holding companies, 22 holding companies with assets greater than 3,000,000,004 of the largest banks with assets greater than 100 billion in total assets. Our district actually contains four of the 32 largest banks with total assets greater than a hundred billion. The largest of these banks is PNC, which is the sixth-largest bank nationally. These four institutions have branches in 37 states, and collectively over $1.1 trillion in total assets.

So why don't we move to slide five. So sometimes an analogy is helpful to better understand our role. In supervision, banks are more like the sports teams and supervisors in many way resemble the referees. Games have rules that all players are expected to follow to keep the game safe and fair. Supervisors, like referees, don't play the games. [inaudible 00:08:09] to monitor play to ensure that the games are played fairly and safely. Supervisors also help to establish the expectations to help ensure that banks do not violate the rules in the first place. Players that violate the rules receive warnings from the referee, and these warnings can then escalate based on the infraction. With bank supervisors, we take the same approach where we will provide any sort of issues and then escalate based on the infraction.

So moving to slide six, this slide helps to show our approach to supervising banks and then it's largely dependent on the size and complexity of the institution being supervised, and the frequency of the scope of the supervision is going to differ significantly for the smaller and simpler banks versus ones that are larger and more complex. The Fed categorizes banks into four different groups based on size and complexity. We have community banking organizations, regional banking organizations, large and foreign banking organizations, and Large Institution Supervising Coordinating Committee organizations or LISCC firms.

In this chart, you'll see that the approach to differs based on the category. The supervisory intensity is going to increase as we move from left to right within the table. Bank-specific examinations are as they sound. We focus on one bank at a time with the frequency of these exams increasing as the size of the institution increases as well. Horizontal examinations are reviews when multiple institutions are reviewed and assessed on a specific topic, so think liquidity or cybersecurity. We do this simultaneously, so examiners across the country can compare the range of practices used by these institutions. You can also see that meetings with management are as the phrase suggests, virtual, in person to better check in with bank management and check in how things are going.

So with that, I'll turn it over to Nadine Wallman who will continue the presentation.

Nadine Wallman:

Thank you, Brian. So turning to slide seven, please. As Brian just discussed, our supervision can include bank-specific exams and horizontal exams. However, this doesn't mean that supervision stops when an exam isn't occurring. Throughout the supervisory cycle. Examiners stay in contact with the banks they supervise and monitor to the bank's financial condition through various regulatory and financial reports. We also meet and speak with bank management and directors as needed or as market conditions change or bank-specific events occur. This monitoring is referred to as ongoing supervision. Ongoing supervision is a key component of our supervisory process because this is what enables us to be agile. Information attained through ongoing supervision helps us plan for the next exam or determine if we need to adjust our supervisory approach based upon certain risk factors. Ongoing supervision is also a helpful tool for the Fed to monitor changing regional economic conditions.

Another important component of our supervisory process is that we collaborate closely with our bank regulatory agencies throughout the supervisory cycle. We feel it's important to ensure we are leveraging their insights and perspectives and ensuring that, where appropriate, the regulatory agencies are delivering consistent messages to the banks we supervise. If we go back to the analogy of a sports team, think of an exam as a game or match. Sports teams play games, like exams, throughout the year, but the sports team doesn't stop playing when the game is over. There are continuously watching footage, training, assessing their next opponent, and then preparing for the next game. Examiners, like the players, are continuously assessing re-evaluating and preparing for the next exam.

Turning to the next slide, please. Let's drill down into the specific parts of an examination. We always start an examination by identifying and communicating to the bank the scope of work that our examiners will be performing. I'll share on the next slide details on typical areas that can be scoped into an exam, but in general, an examination is a detailed review and evaluation of the bank's activities and generally includes a review of areas such as key risks, internal controls, the bank's financial condition and compliance with laws and regulations. The results of the examination are formally documented for bank management and its board of directors in a written report. This report outlines the results or conclusion of the work performed and provides details on any weaknesses and associated risks identified. The report will also specify, if necessary, required actions that the bank needs to take to address any identified weaknesses or risks.

Lastly, after an exam, examiners monitor how the institution responds to their findings and assesses the effectiveness of any corrective action taken by the bank. One important point I'd like to emphasize is that examiners do not run or manage the banks, our role is to evaluate a bank's material risks in light of its operations and to help make sure that the bank has efficient governance and controls and financial resiliency to continue to operate in both normal and stressful times. Additionally, when a bank does not manage its risk well or does not respond effectively to issues identified in an exam, the Fed has several tools that it can use to require the bank to take corrective action. The tools vary in severity and are applied in accordance to the degree of concerns or risks identified. Some of these additional tools include, one, downgrading the financial institution's supervisory rating. Banks that are rated in less than satisfactory condition are subject to more frequent examinations and heightened reporting and monitoring.

The Fed may also enter into an agreement called a Memorandum of understanding or MOU with a bank. An MOU is not released publicly nor is it legally binding. However, it is a formal written agreement in which bank management and its board of directors agree to take specific actions. If more pervasive weaknesses are present, the Fed has the ability to issue a public enforcement action. These actions are legally binding agreements that are disclosed publicly and often include provisions aimed at conserving capital at the institution. Similar to an MOU, this public enforcement action also specifies agreed upon actions that bank management and board of directors will take. Lastly, for the most severe violations or instances of misconduct, the FED also has the ability to issue civil money penalties or to remove and permanently prohibit any institution affiliated person or party from any future involvement with any bank.

Let's turn to the next slide please. As I previously mentioned, the scope of an exam can vary, but typically includes a review of the following areas. First, the bank's financial condition needs to be able to support its operations in both normal and stressful times. There are five main areas that examiners evaluate when assessing the bank's financial condition. The first is capital adequacy. Banks are required to retain capital levels in accordance with the risk of their assets. These levels are established in formal prompt corrective action guidelines. Capital is important because it serves as a cushion to ensure that the bank can absorb any unanticipated losses, which, if capital levels aren't sufficient, could threaten the bank's solvency. Next, the quality and level of bank earnings or net income are also important. Earnings are the first line of defense against losses and retained earnings augment capital over time.

Third, examiners evaluate asset quality or the level of credit risk in a bank. This would include evaluating the bank's underwriting standards for loans and likelihood that the bank will incur credit losses should borrowers fail to repay. Fourth, liquidity risk or the risk that a bank will not have enough cash to meet its expected and unexpected cashflow obligations is evaluated. This would include assessing things such as the current and projected liquidity levels and the effectiveness of contingency funding plans. Lastly, market risk is assessed. Market risk is the degree to which changes in interest rates or equity prices can adversely affect a bank's earnings and capital. To do this, examiners assess the bank's model risk management practices for interest rate risk. This would include assessing policies and procedures, governing their models, quality and effectiveness of model validation processes, and compliance with bank-established risk limits and tolerance levels.

A second key component of our examinations is risk management. Banks need to ensure that they adequately identify, measure, monitor, and control the risks of its operations. In addition, banks should ensure that their risk management programs evolve to align with new strategies, asset growth, and changing economic conditions. Importantly, risk management is most effective when it is strengthened prior to new products or initiatives being implemented or prior to the bank experiencing... Excuse me. Significant growth such as what might occur through a merger or acquisition. Risk management can be assessed in several areas. In addition to the risks I already discussed, like liquidity, market and credit, other risk areas assessed include legal, compliance, operational and reputational. When evaluating risk management, examiners will review the bank's policies and procedures, establish risk limits to determine their compliance and adequacy. Quality of the bank's information systems and any risks associated with its technology infrastructure including information security, cybersecurity risks, business continuity and incident response plans are also examples of areas reviewed.

One point I'd like to emphasize is that sound risk management practices also apply to any third-party relationships or relationships with vendors or service providers. Just because a service may be outsourced does not eliminate the bank's responsibility for managing or overseeing this service or third party, they should be overseeing this activity just as if it was being conducted in-house or within their bank. Examiners will ensure that banks are also complying with all relevant laws and regulations. This includes consumer compliance requirements for fair lending, preventing unfair and deceptive acts and practices, and ensuring the bank is meeting the credit needs of the communities in which they do business. Lastly, bank governance processes and internal control environment is also examined. This would include evaluating the adequacy of internal and external audit, the strength of and adherence to internal controls, the quality of management and the board of directors, and corporate governance structure and its effectiveness.

Let's turn to the last slide please. Lastly, it's important to note that supervision is always evolving. The Fed actively monitors for emerging risks so that we can adapt our practices accordingly. Also, recognizing that each financial crisis or economic cycle is unique, the Fed makes it an important priority to always reflect on the lessons we learn so that we can identify opportunities to strengthen supervision. One way we continue to evolve is our ability to risk focus our examinations. As the type and amount of data and modeling capabilities continues to improve, we're better able to tailor the scope of our examinations. This not only ensures our limited resources are focused on the right risk areas, but also helps to manage the amount of regulatory burden placed on the banks we supervise. It also improves information available to use during ongoing supervision, which ultimately improves our ability to detect trends and remain agile.

One example of how data and modeling is used to support supervision is the Fed's BETR program or the Bank Examinations Tailored to Risk program. BETR is essentially a suite of data-driven, forward-looking surveillance metrics used to our community and regional banking examinations. These models help us identify areas which may require more focus or attention or areas that may require less attention. Secondly, the Fed has also found horizontal reviews to be an effective tool for supervising the largest banks in the country. This type of review, as Brian mentioned, occurs when multiple institutions are examined at the same time in a specific area.

One good example of this is the Comprehensive Capital Analysis and Review or CCAR. This is the annual capital stress test that the Fed implemented as a result of the 2008 financial crisis. Today, CCAR is conducted for the LISCC firms. And a large foreign banking organizations undergo a similar capital stress test called a Horizontal Capital Review. Horizontal reviews such as these not only enables us to see the range of practices across firms, but also enables us to better assess systemic risk, which supports the Fed's important role in financial stability. For CCAR, the Federal Reserve's Board of Governors uses the results of this review to set to the capital requirements for the largest, most complex banks in the nation.

Lastly, as a result of the bank failures last year, we are currently looking at ways to improve the speed, force, and agility of supervision. In August of last year, the Federal Reserve Board of Governors established a new novel activity supervision program. This program is aimed at enhancing supervision for banks engaged in innovative activities such as cryptocurrencies, distributed ledger technology and technology-driven partnerships with non-banks, which is also referred to as banking as a service. This new supervisory program fosters greater awareness and oversight of the use of these emerging technologies by the banks supervised by the Fed, and thereby enhances the Fed's ability to identify emerging risks and trends including broader financial stability risks.

We're also looking at ways to better ensure that supervision intensifies at the right pace as banks grow in size and complexity. Based on the bank failures Last year, the Fed is working on strengthening the coordination between our large and regional bank supervision programs to better ensure that their transition for fast-growing banks is more of a gradual slope. For example, as regional banks grow in size and complexity, the firm's risk management capability should grow commensurately with the firm's risk firms. Making investments along the way should make this more of a gradual transition as they breach the $100 billion dollars asset threshold. Firms with more than $100 billion in assets, as Brian discussed earlier, fall on our large bank portfolio and are subject to heightened standards since these larger firms can pose a greater potential for systemic risk to the US economy. That concludes our formal remarks, so I'll turn the program over to Anulekha now to moderate our Q&A. Thank you.

Anulekha Mohanty:

Nadine and Brian, thank you so much for setting the stage and providing a baseline of what bank supervision is all about. And as Nadine mentioned, we'll now move into our moderated Q&A panel segment where we'll address questions. Not only that came in advance, but any live questions as they come through the chat. To start off, while our participants think about their questions, let's take a question that came in advance on a hot topic of artificial intelligence or AI. So the question really centers on how we as supervisors evaluate risks posed by AI or generative AI on our banks and their customers, and then also what do we look at as we go into evaluate our institutions when they are using such technology. Brian, would you like to take a stab at responding to this question?

Brian Sahnd:

I'd love to. Thanks, Anulekha. Thanks for the question. And again, just to level set, when we use the term artificial intelligence or AI, the Financial Stability Board is referring to the application of computational tools to address tasks traditionally requiring human sophistication. And I'm using this definition just to level set because I know that with AI there can be some different interpretations around it. Also, share as far as machine learning, we're talking about a method of designing a sequence of actions to solve a problem known as algorithms which optimize automatically through experience with limited or no human intervention. And again, just level setting from the terminology standpoint.

So banks can use slightly different definitions of these terms. But one area, to go back to Anulekha's question, where we're specifically seeing risks that these models pose to consumers is with fair lending. So on the consumer compliance side, we're seeing risks when banks use these technologies or are using these technologies more, but there's potential for risks of violating fair lending laws and potentially perpetuating disparities as they're being evolved and being used. So AI or ML, artificial intelligence or machine learning may perpetuate biases or potentially inaccuracies inherent with the data that they're taking in. And because of that, they're then making incorrect predictions to the dataset, which is incomplete or non-representative.

You may also have redlining which occurs, where they're using these different tools or models and advertising or advertisers are selecting audiences based on characteristics that are more tied to protected classes. There's also potential with these tools that reverse redlining could occur where steering of advertisements of maybe more expensive or inferior products is focused around minority communities. Another risk that we're seeing with AI or generative AI could be with unfair deceptive acts and practices. It's a bigger area, but in addition to fair lending, we're seeing potential concerns to consumers that bubble up in unfair deceptive acts or practices.

Anulekha also mentioned what we're doing from a regulatory standpoint. So from a regulatory standpoint, Nadine and her comments mentioned third-party risk management. Oftentimes, when banks are leveraging some of this new technology, they're not creating this technology on their own, but instead leveraging a third party to do so. So as supervisors, what we try to make sure to do is follow through and assess their third-party risk management practices. So Nadine said it well that just because an institution leverages a third party, that doesn't remove the institution and bank management's responsibilities in terms of making sure that the bank conducts their practices in a safe and sound manner.

So things that we're assessing are the due diligence on the front end, what's being done to establish the arrangement, what sort of ongoing monitoring they're doing throughout the contract. And some of this too, just as we talked about earlier, is adjusted based on the level of risk. So if it's a critical vendor, we're making sure that we look at these practices a little bit more closely based on the criticality to the firm. We're also monitoring the financial condition of the third party, how the bank is assessing information security, safeguarding customer information, compliance with appropriate laws and regulations, as well as any third-party audit reports.

There's more inter-agency guidance that we leverage related to this, such as SR234 and SR242, to really outline expectations for third party-risk management, as well as third-party risk management for the smaller firms, community banks, less than 10 billion in consolidated assets. Lastly, I'll just note we also have more specific guidance around model risk management. So we look at it from a third-party standpoint, but we're also going to look at how banks maintain their models and maintain their models that are leveraging artificial intelligence.

So we're doing that and one of the primary guidance SR Letters that we leverage is 11-7, and this is really making sure that we and banks follow through on governance around development, implementation, and approved use of any models, clear documentation of limitations around models, making sure that there's the right staff in place to oversee the models as well as development, and the validation and testing to make sure that these are conceptually sound, ongoing monitoring on what the model's putting out, as well as testing and validation.

Again, with both of these, these are expectations that we are making sure that bank management and boards of directors oversee and conduct and they're following best practices in risk management guidance. So whoever submitted that question, hopefully that answers it. And if there's anything more, please feel free to add something to the chat.

Anulekha Mohanty:

Brian, thank you so much for the comprehensive overview and response. Nadine, is there anything else that you would want to add to the AI topic?

Nadine Wallman:

No, I think Brian said it well, he... Very thorough response, Brian, thank you. Good job.

Anulekha Mohanty:

Great. I don't see any questions coming in through chat quite yet. Please feel free to put in any questions that you may have on the topics so far, but we'll move forward with a second question that came in around credit conditions, which I know everybody's interested in. So Nadine, if you wouldn't mind addressing this question around what are we seeing as our top credit concerns in the environment currently?

Nadine Wallman:

Yes, absolutely, and thank you for whoever submitted this question. So yes, so while in general, asset quality still remains favorable across the industry given weaker economic and labor conditions, credit risk continues to be a supervisory priority. The Fed is seeing delinquency and charge-off rates increase in some consumer loan segments, particularly credit card and auto. And in these segments, delinquency levels have started to exceed what they were prior to the pandemic. So I think the question specifically was around what are those top three credit concerns besides CRE? So credit card and auto would be part of that. And then the other area I would say would be more individualized for banks and what we do as supervisors is that we continue to focus on portfolios where banks have credit concentrations. And for these portfolios, examiners are conducting in-depth assessments of the firm's credit risk management. I'll leave it at that.

Anulekha Mohanty:

Thank you, Nadine. Brian, is there anything else that you would want to cover regarding this topic of credit condition?

Brian Sahnd:

Nothing else. Thanks Anulekha.

Anulekha Mohanty:

Great. A third question that has come in advance has to do with metrics, and in particular how do you identify gauge how the institution is doing through various risk metrics? So Brian, if you would take a shot at addressing that particular question.

Brian Sahnd:

No problem. So thanks for the question. As Nadine mentioned earlier on in the presentation, examiners are consistently assessing the financial condition as well as resiliency of the institution. So areas that examiners are looking into involve capital, asset quality, earnings, liquidity sensitivity, and market risk. So an example of some key metrics that we might be looking into would be return on average assets or loans 30 to 89 days past due compared to total loans. However, these are just examples.

I think as far as the metrics go, what's really important is making sure that bank leadership reviews these metrics based on the risk profile of the firm. So for example, if your firm is moving into a new strategy, a new product or service, you might want to be pulling in certain metrics that are different from standardized ones. So the other thing too that I would say is from a metrics standpoint, it's important not just to look at the metrics on a static level, but ensure that you're comparing these based to whatever your risk tolerance is, trends over a certain period of time, as well as measuring them against a certain peer group. So again, that's unique to your specific institution. A peer group might be appropriate for a bank that's concentrating agricultural loans versus one that's concentrated in CRE. So more than anything else is making sure that the metrics align with the strategies that your firm has and the risk tolerance of your officers.

Nadine Wallman:

Oh, you're on mute on Anulekha, but I have two points I would like to add.

Anulekha Mohanty:

Absolutely, please go ahead. Thanks so much, Brian. Go ahead, Nadine.

Nadine Wallman:

So I would say too, some things that keep in mind if you're in the institution, certainly you're going to want to monitor the responsiveness of management to audit findings, regulatory findings, how are they receiving those findings? Are they acting on them in an effective manner? Are they acting on them in a timely manner? Another aspect I would offer up from a corporate governance standpoint is just openness and transparency of dialogues in board of director meetings. Are there dominant executive officers within the organization or dominant personalities that might not necessarily be fostering open dialogue or greater transparency on risks or activities at the bank? So those are just some of the corporate governance matters that I would just offer as potential red flags.

Anulekha Mohanty:

Thanks, Nadine. One question that I know often comes up during these types of conversations is around the role of the discount window and how that has evolved over time. So I thought I would share a few comments and then engage my colleagues with any additional perspectives that you might want to offer on this particular topic. Over the decades, the role of the discount window has shifted from being a lender of last resort to that of a liquidity provider. As you heard Brian speak, the discount window is a valuable tool, liquidity tool for our depository institutions. It assists our institutions in maintaining resilient liquidity and contingent funding plans, as well as really diversifying contingent funding resources. Primary credit that Brian spoke to just a little bit ago is absolutely available for healthy institutions. It does not indicate any sign of weaknesses and certainly can be used for any short-term funding needs and not just as a backup for contingent purposes.

To ensure that discount window readiness is intact for our institutions, it's very important for our institutions to not only have the appropriate legal documentations in place and the appropriate collateral pledge, but really to make sure that testing is performed on a periodic-based. That periodic testing is critically important to understand how the borrowing and the settlement mechanics operate and making sure to understand what it takes and how long it takes to perhaps move collateral from one secured financing facility to the discount window. And making sure that all the parties who are part of that process are kept up to date and it's operating as intended.

Similar to how you heard a little bit from Nadine in terms of work that we're doing to modernize our supervision, similarly, we're also looking at avenues of how do we continue to modernize the discount window. And in that phase, I would say in 2024, there was a soft launch of a new tool called Discount Window Direct, which is an online portal that provides self-service options for discount window borrowing. And currently, that Discount Window Direct offers borrowing capabilities for the primary credit program with its intention to be expanded for the other credit risk program and functionalities over time.

Anything, Brian or Nadine, that you would want to add relative to the topic of Discount window and credit risk management?

Brian Sahnd:

So Anulekha, you noted it, but just to re-emphasize, as far as the discount window goes, one of the items that we noticed with community banks specifically is oftentimes different funding plans or strategies, the policies at the institutions would note reliance on the discount window or leveraging the Discount window. But from an examination standpoint, when we would ask the questions of, "When's the last time you've tested this, how prepared are you?" To Anulekha's point, it may not have been tested frequently, if ever. And so just to again highlight that if you are planning utilizing the discount window as Anulekha outlined, please make sure that you take the next steps to go through that operational standpoint of is it ready? Are we ready? Do we have a plan in place with the appropriate collateral setup?

Anulekha Mohanty:

The next question that I'd like to ask our panelists today is around your views of the banking environment and conditions. So I'll open it up to either Nadine or Brian who want to take that [inaudible 00:40:33].

Nadine Wallman:

I can start with that, Anulekha. So overall, the banking system is sound and resilient. For the most part, bank capital and liquidity levels are above regulatory requirements across the country for all sized banks. Liquidity conditions have stabilized with deposit levels increasing in the first three months of this year. Loan growth has slowed in sectors, but this is in comparison to the rapid pace of growth last year in 2023. And we are seeing though higher growth in credit card balances due to the strong consumer spending environment. Overall, as I think I mentioned earlier, asset quality does remain sound, but we are seeing some uptick in delinquencies, particularly in the auto and credit card sector. The Fed also issues a senior loan officer opinion survey, which that came out in April, and that reflected... This is from the survey respondents indicated there that credit standards are slightly tighter, and demand is slightly weaker.

The only other thing I would offer up is just from an earnings standpoint, earnings levels have declined some, but some of this is attributed to non-re-occurring expenses. One of those is the FDIC special assessment for the Insurance Fund, is impacting earnings levels at banks over $5 billion in assets. And also banks are being responsive to potential credit concerns and they are allocating additional money for higher provision expenses just to guard against any losses in their credit portfolios. And lastly, while liquidity levels have stabilized, interest expenses are still outpacing in general interest income. So all those factors together are impacting earnings levels. So for that, I will open up to any other comments or thoughts folks might have.

Anulekha Mohanty:

Brian, any additional thoughts from your end?

Brian Sahnd:

No, I think Nadine covered that well, thank you.

Anulekha Mohanty:

And I'll just add that, as Nadine and Brian have already articulated through our various responses from the Federal Reserve perspective, we really do continue to monitor the evolving risks of the banking sector, and that's inclusive of credit, interest rate, risk, liquidity. We haven't talked a lot about cyber quite yet, but that is... Cyber risk preparedness is very much an important element that we continue to focus on as well.

Another question that has come in, panelists, really centers on how our work at the Fed is similar or different to our regulatory counterparts of the FDIC, OCC and also how we look to work alongside and/or leverage their results and their insights. So if I could open it up to either of you to take that question.

Brian Sahnd:

Yeah, so I'll start before I pass it over to Nadine, but I share that as far as working with our supervisory counterparts, we try to work together and rely on each other's work as much as possible to limit the burden on financial institutions. So ultimately, there's some regulatory partners that we work a little bit more closely hand in hand, for example. As I mentioned earlier, when it comes to the Ohio Division of financial institutions or the Kentucky division of financial institutions, we will conduct examinations jointly for our state member banks or rotate our examination cycles with them. When it comes to relying on the OCC or CFPB, particularly for our larger institutions, where we have supervisory authority of the holding companies, as opposed to the underlying depository institutions, we'll rely on their supervisory conclusions and work at the depository level to then help with our supervisory planning process and what we'll do at the holding company level.

As mentioned earlier, the horizontal reviews and some of the other work that we do, again, at that holding company standpoint, it's done really leveraging again those work of the primary regulator, and any of those functions that are unique to the holding company that aren't already being covered at the depository institution by the OCC or other regulatory agency. From a coordination standpoint, the other thing that I would note is a lot of our supervisory guidance is joint guidance. It's guidance that as agencies we have come together to make sure that we are on the same page and moving forward with a consistent message. And so the SR letters that I referenced earlier, those are ones that are noted to be from FDIC, OCC, as well as the Federal Reserve. So not only from an examination standpoint, do we work collaboratively, do we communicate together as well as our responses, we're also going to make sure that our guidance is aligned so that our supervisory message is one.

Nadine Wallman:

Thanks, Brian. The one thing I would add, Brian covered that very well, though the one thing I would add, I would equate it to my remarks earlier on ongoing supervision. So as regulatory agencies, there's a lot of us out there, we realize that, but outside of the specific exams or developing guidance, as Brian said, we make it a point to interact and collaborate throughout the year. We have a number of forums that we have with the Cleveland Fed, with our peer regulatory agencies to talk about emerging risks, talk about our own strategies and approaches, and talk about trends. That makes us be more effective together and it helps us in our planning for our supervisory areas of focus and for future examinations. So we are engaged even with national agencies such as the Conference of State Banking Supervisors, not just our state parts, the Ohio Department of Financial Institutions and Kentucky and Pennsylvania Department of Supervision we also engage at the national level and have deep relationships and constant coordination.

Anulekha Mohanty:

Thank you, Nadine and Brian for addressing that question. The next question I know it was already touched on just a bit, but just to maybe expand on the question really relates to how has the Fed changed its approach to supervision since the pandemic and its interactions with institutions. I know we touched on that just a bit, but if you could expand on that [inaudible 00:47:39].

Brian Sahnd:

Anulekha, just to clarify it's how have you changed our approaches since the pandemic? Okay. So since the pandemic, obviously it was an adjustment for all of us as we had to move to more of a remote working relationship and remote working approach. Since the pandemic, we've tried the best right-size in terms of what this looks like, balancing both working remotely as well as the supervisory needs of our work and the institutions. So since the pandemic, we have still continued to do work offsite. We still, as Nadine mentioned earlier, continue to leverage more and more data to do continuous monitoring to better focus on our highest priority risks and supervisory concerns. And we are now also moving back into institutions because from a supervisory standpoint, we recognize that a lot of work can be done offsite. However, there's a lot of value in terms of having that in-person presence as well as the relationship between our exam staff, as well as bank management and boards of directors.

So since the pandemic, we have moved to more of a hybrid model, and we are also trying to better leverage technology, whether that be Teams or Zoom, to have as much face-to-face interaction as we can if we're not physically present at the institution. There are some other uses of innovative technologies that we're starting to better leverage, but I'll pass that over to Nadine to maybe further explain how we're considering these and evolving our supervisory approaches.

Nadine Wallman:

Yeah, thank you, Brian. No, I think you covered that well. On the supervisory side, that's exactly what we're doing. I would just emphasize even more so since it... Because of the pandemic, we are offsite, outside not going to the institution. So we are making a point to be physically present at the institutions meeting with senior management, meeting with boards of directors, re-establishing that relationship and the ongoing dialogues. It's critically important to that partnership in the supervision process. But specific to AI, and are we as the Fed using innovative technologies in our supervision? We talked about, Brian did a good job earlier talking about how we supervise banks using that technology, but what about us?

So right now, so for the Cleveland Fed, we're not using AI in any implemented supervisory process, but we are considering what some potential use cases might be. But relative to technology in general, we do recognize that there are opportunities to leverage technology to reduce very manually-intensive processes that we have in supervision, and we have quite a few of those. One good example I'd offer up, which is something that we are piloting, is the use of natural language processing to assist examiners with reviewing very large files or large documents. So we're doing that locally relative to earnings releases, the public earnings releases that financial institutions will issue, or even for the largest, most complex banks their capital plans. Some of these documents are hundreds and hundreds of pages in blank, so we recognize that some type of technology could help us streamline the review of that information.

The other thing that we're actively looking at is how we might automate some of our manually-intensive data verification processes, particularly in the consumer compliance space. There definitely are opportunities to better use the examiner's skillset for that judgment and analyses and reduce that manual processes that in several instances like datafication we have to go through in order to get the data before we analyze it. So I'd stop there and see if anybody else wants to offer any other comments.

Anulekha Mohanty:

Brian and Nadine, thank you for those comments and for the comments around how we're thinking about AI use ourselves. Very similar to the industry, we are taking a measured approach in how we go about it, recognizing that it's very important to evaluate the risks and controls and the unintended consequences before any sort of implementation takes place. So thank you again for all of your comments.

I think our time as quickly as it has is coming to a close. So thank you all for such an informative discussion today. And for our participants online, please note that there are a variety of resources that were just dropped into the chat today for your reference. Information about today's program will also be sent via a follow-up email, and the recording of the event will be available to you on clevelandfed.org. And a plug for our future *FedTalk*. Please join us for the next *FedTalk* on healthcare on June 26 at 3:00 P.M. Thank you everybody for joining today and have a great day.