The Evolution of the “Bank Examiner”

Stephen Ong  
Vice President  
Supervision and Regulation

Back in those days, a bank examiner’s role was limited to performing reviews at a particular point in time such as close of business on a certain day. The job was also very entity-based; that is, the exam concentrated solely on the bank itself. At that time, banks primarily made plain vanilla loans to businesses and consumers. If they had enough cash on hand and their books showed no irregularities, they would probably pass the exam. Given the simplicity of banking activities at that time, this approach was sufficient and endured from the onset of examinations in the 1940s to the early 1980s.

Since then, the job of supervising banks has evolved and continues to do so. Where we once had basic bank examiners, we now have the much more complex role of “financial system supervisors.” While financial system supervisors are still responsible for supervising individual banks, this new and expanded role is meant to better guard the financial system, not just the banks, against future crises.

This is a brief history of that evolution, plus a glimpse into what the future might hold.

Here is a favorite old story among bank examiners:

There once was a banker who, faced with a “surprise” bank examination, didn’t seem surprised at all. He had all his bank’s records ready and in perfect order and seemed fully prepared for the pop exam. Asked if he knew of the examiners’ approaching visit, the banker smiled and confessed, “The manager of the hotel down the street told me.”

Of course, this tale comes from the times when bank examinations were conducted on a surprise basis, and a team of out-of-town examiners would arrive at a bank in the late afternoon, just before closing time. The team would count the cash in tellers’ drawers and assess the physical security of the bank premises. Enough cash? Check. Secure building? Check.
The traditional bank examiner becomes extinct
One might argue that the traditional bank examiner had become obsolete by the 1990s. By then, annual point-in-time examinations could no longer identify risks in a timely way. The pace of change in the banking industry had accelerated, largely because of technology.

Offsite monitoring techniques were developed to augment point-in-time examinations. This ongoing supervision required more frequent, sophisticated analysis of bank financial reports. At larger, more complex banks, teams of examiners were assigned to the ongoing supervision of specific firms. This ongoing supervision enabled more timely identification of changes in bank strategies and activities that could result in greater risk. The role of the bank examiner had evolved to that of a “bank supervisor,” who not only examined the banks but also monitored them continually.

The Gramm–Leach–Bliley Act of 1999 empowered banking organizations to engage in a wider array of financial activities. The line between banks and nonbank financial firms began to blur, and bank supervisors had to adapt accordingly. They were required to view these organizations differently and assess a broader range of potential risks. By necessity, the bank supervisor had evolved into a “financial institution supervisor,” still engaged in continuous supervision of a single firm but recognizing that the single firm was no longer a traditional bank.

Lessons learned from the financial crisis
Before the financial crisis of 2007–08, supervisors focused primarily on the safety and soundness of the individual entities they were responsible for. Risks that spilled over from a bank or were transferred to the rest of the financial system were not closely monitored. Unfortunately, as the financial crisis revealed, these risks often made their way back onto the books of the banks.

Subprime residential mortgage loans are a good example. Many of the supervised financial institutions that originated these loans used an “originate and sell” business model. In this model, the financial institution made the subprime loans, but instead of keeping them on their own books, they sold them to a third party. The third party then packaged the loans into asset-backed securities and sold them to investors in the financial markets. From the perspective of the originating institution, it had earned fee income from originating and selling the loans, but the risks had been transferred from their firm to somewhere in the marketplace. The supervisors, who likewise focused on the risks on the banks’ books, were satisfied that the risks associated with the subprime loans had been transferred out of the financial institutions they were supervising.

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Unfortunately, the risks did not disappear. Rather, they were transferred into another instrument—in this case, into an asset-backed security—and spread throughout the financial markets. Supervisors did not monitor the risks from the subprime mortgage loans closely once they were off the books of the firms they were supervising. These risks began to build, and remained collectively unmonitored in the financial system.

Further disguising these risks were the sophisticated methods used to package loans into complex financial instruments. The risks embedded in these instruments were often not easy to identify or fully understand. In many cases, financial institutions purchased securities collateralized by the same subprime loans that had been sold into the marketplace, thus bringing the risks back onto the bank’s books.

Following the crisis, it has become clear that a solely entity-based approach to supervision is not enough to ensure financial stability. In addition to identifying and monitoring risk within an individual firm, supervisors must also be alert to risks that exist more broadly in the financial system; these risks may ultimately find their way back onto the originating firm’s books, sometimes in very creative forms. In this way, financial institution supervisors evolved into “financial system supervisors,” who are engaged in the ongoing supervision of individual financial institutions and focused on the overall risks in the financial system.
Financial system supervisors: A new approach

Financial system supervision has two dimensions: scope and time.

Scope

Scope refers to the range of supervised entities, instruments, and practices. The evolution of the financial system, particularly the interconnectedness of financial institutions, requires a broader scope and a more collective assessment of risks across firms.

An important tool for making this assessment is the horizontal review, which supervisors use to assess risk across a population of firms. First, supervisors identify a specific activity or area of risk. Then, they conduct reviews simultaneously at all firms and aggregate the results to provide a “macroprudential” view of the activity or risk exposure. This collective view allows supervisors to determine how the activity or risk may broadly affect an entire population of firms and the stability of the financial system.

An example: In 2010, supervisors at the Federal Reserve looked at incentive compensation practices at the largest US banking organizations. The review assessed incentive or bonus programs and looked for those that encouraged employees to take risks that went beyond a firm’s risk tolerance or could result in substantial risk to the financial system.

The results of the review helped supervisors develop principles for incentive compensation practices at financial firms that promote a more appropriate consideration of risk and alignment with safe and sound practices. Horizontal reviews have also been conducted in capital planning and adequacy, mortgage servicing, and other operational areas. Each review resulted in an aggregate view of risks to the financial system from these practices and updated supervisory guidance for financial firms.

Beyond horizontal reviews, supervisors are looking closely at issues like the “shadow banking system,” which has introduced a host of instruments and activities that may pose risks to the financial system. Even though many of these activities originate or reside outside supervised banking organizations, shadow banking activities can introduce risks to the financial system that may ultimately affect banking organizations.
Time

Time is the other dimension in which approaches have evolved. Traditionally, supervisors judged the condition of a financial institution according to information gathered on a particular date. This is useful, but only to a point; at best, it provides a rearview mirror assessment. A better approach includes a forward-looking perspective to understand how well an institution might hold up in a variety of scenarios.

Toward that end, supervisors increasingly use simulation models to replicate the inter-relations among various balance-sheet and income-statement accounts of a financial institution. Assumptions related to risk exposure, earnings performance, expense levels, and other factors are used as bases for these models, and the outputs are factored into the assessment of a financial firm’s overall condition. The simulation models complement the historical trend and point-in-time perspectives of traditional supervisory approaches.

A high-profile use of simulation techniques was first deployed in 2009. Comprehensive capital assessment reviews have included various scenarios and assumptions related to macroeconomic factors that influence the performance of banking organizations. These simulation models give supervisors a better understanding of the potential losses that financial firms may experience in the future, should any of the assumed scenarios occur (including very high unemployment or a severe economic downturn). Given the potential loss exposure revealed by the scenarios, firms were required to maintain adequate levels of capital to absorb the potential losses. In this way, simulation models help the financial system prepare for the worst in ways that rearview assessments cannot.

Need for interdisciplinary collaboration

Today’s financial system supervisors require a specialized set of skills. As financial activities and transactions grow more complex and sophisticated, supervisors must also have — or have access to — more complex and sophisticated skills and techniques to assess these activities. As a result, conducting supervisory reviews effectively requires greater collaboration within the Federal Reserve System among supervisors, economists, quantitative analysts, and other specialists.

The big question, of course, is whether all these changes will offer better protection from future financial crises.

Capital planning exercises, for example, required collaboration by several specialty groups. Supervisors assessed the financial institution’s risk management practices. Quantitative analysts developed and assessed the various simulation models to determine adequate capital levels. Economists developed the economic scenarios on which the simulations were based and assessed the economic assumptions made by the financial institutions themselves. Finally, risk specialists quantified risk exposures and their effect on required capital cushions. This multidisciplinary approach was valuable, not only in terms of determining the horizontal review findings, but also in terms of reviewing the findings from multiple perspectives.

The big question, of course, is whether all these changes offer better protection from future financial crises. While that is a difficult question to answer with absolute certainty, we can say that a broad focus on financial stability was clearly missing in the run-up to the 2008 financial crisis. The tools financial system supervisors are now armed with are precisely the sort that could have helped mitigate the effects of that crisis. From detection of stress building in the financial system to enforcement of higher capital requirements, supervisors now possess important perspectives and tools they lacked last time. It should make a difference.

And next?

Gone are the days when bank examiners could limit their focus to the activities of a single bank. The examiner who famously showed up at Bailey’s Savings and Loan in the classic film It’s a Wonderful Life would feel wholly unequipped to do the modern-day job of supervising financial institutions and the financial system. Only a commitment to continuous evolution in the way we supervise will ensure that today’s supervisors don’t feel similarly ill-equipped. The safety and soundness of our financial system depends on it.

Speech

Watch video and read President Pianalto’s speech on financial stability regulation at www.clevelandfed.org/for_the_public/news_and_media/speeches