

OPERATIONS REVIEW REPORT



Federal Reserve Bank of New York

Bank Supervision Group

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INTRODUCTION AND SCOPE

A review of the operations of the Bank Supervision Group (the Group) of the Federal Reserve Bank of New York (the Reserve Bank) was completed during the weeks of November 30 and December 7, 2009. The review team consisted of officers and senior staff from the Board of Governors and eight Federal Reserve Banks; a list of the individual team members appears at the end of this report. The previous operations review occurred in May 2005.

The primary objective of the operations review was to evaluate whether the Reserve Bank's policies, processes, and products for its supervision and regulation programs adequately support performance of its delegated responsibilities and meet requisite standards and objectives of the System supervision function.

The scope of the review addressed the core safety-and-soundness and consumer compliance business lines, including large, regional, community and foreign bank supervision programs, market and liquidity risk, consumer compliance and consumer complaints. In addition, we reviewed the Applications function, which resides in the Legal Group, having been moved from the Bank Supervision Group in 2007. To assess the Reserve Bank's supervision function, we relied on existing supervisory guidance, such as SR and CA letters, the Reserve Bank's internal policies and procedures, and accepted sound practices.

On Thursday, December 10, 2009, we presented our findings to the officers responsible for each program area reviewed, and summarized those findings for Executive Vice President William Rutledge, and Senior Vice Presidents Zahra El-Mekkawy, Brian Peters, and Marc Saidenberg. On Wednesday December 23, 2009, Bill Spaniel and Paul Robin summarized the material findings for President William Dudley, General Auditor Edward Smith, and Executive Vice President Rutledge.

EXECUTIVE SUMMARY

Since the emergence of the financial crisis in the first half of 2007, the Reserve Bank and the Bank Supervision Group have operated in an extraordinarily challenging and stressful environment. Despite the strains on personnel, the Reserve Bank's officers and staff have responded to the financial market

turmoil, banking crisis, and consequences of severe economic recession with outstanding commitment and teamwork. The Group's contributions to System initiatives, crisis management, and the supervisory response to the deterioration in banking conditions, have been exceptional. When market issues unfold, the Group is highly effective at gathering pertinent information quickly and comprehensively from across firms on specific topics, such as liquidity and funding, counterparty exposure, and other risk areas. Throughout the crisis, management and staff both led and supported numerous System initiatives that were critical to the success of the Federal Reserve's broader mission and objectives, while also taking steps to adapt the Reserve Bank's supervision program to address the urgent, large-scale problems faced by the banking sector. By playing a major role in System initiatives, focusing on external vulnerabilities, and reallocating supervisory resources to where they were most needed, the Bank Supervision Group made large contributions to stabilizing the individual major institutions in the Second District. These actions were accomplished despite the reality of having to work in an unprecedentedly difficult financial and economic environment throughout the crisis period.

The financial market turmoil and reassignment of personnel to crisis management activities have made it difficult during 2008 and 2009 for some large bank teams to fulfill some supervisory program objectives. These factors have also contributed to staffing shortages in regional, community, and foreign banking supervision programs, and in the risk specialty areas. The Group accelerated hiring in 2008 and 2009, and will finish 2010 with a personnel increase of nearly 24 percent over staffing levels at year-end 2007, when the dimensions of the future financial crisis were still unknown. A large portion of the increase in personnel helped to offset the transfer of experienced staff to new bank holding company dedicated teams, and filled the need for technical skills and industry experience in the risk units. Notwithstanding the personnel increases, resource allocation remained a challenge for the Group at the time of the review due to the critical priority of resolving the financial crisis.

The operations review team's major finding is that the superb crisis management efforts of the past two years were of necessity accomplished by deferring important aspects of the institution-specific supervision program. Although the Reserve Bank generally met its supervisory responsibilities, the team identified a number of improvement opportunities that are described in this report. The demands of System initiatives such as the Supervisory Capital Assessment, Troubled Asset Restructuring, and

Financial Sector Assessment Programs in 2009, required senior management to reprioritize staff assignments and objectives, with the result that components of the supervisory process were not performed. Specifically, our team found that due to necessary priority adjustments, some institution-specific supervision was unable to consistently meet System standards with regard to the following:

- quality, and consistency of supervisory documents and processes;
- rigor of analysis and support for some supervisory conclusions;
- timeliness of some supervisory communications and products; and
- clarity of communications with supervised institutions.

As the economy and the banking system recover, and the demands of crisis management work subside, senior management of the Bank Supervision Group will continue to address how they should modify the Reserve Bank's supervisory program and resource allocation in the context of "lessons learned." Central to this question is how the Group will allocate staff resources between different but complementary supervisory objectives as outlined recently by Chairman Bernanke – improve our ability to identify and correct problems in individual financial institutions, and move to a supervisory approach that considers the stability of the financial system as a whole.¹ The Bank Supervision Group has long been the System leader in developing horizontal perspectives on financial industry risk management practices, and much of the Group's work during the crisis has moved the Reserve Bank's supervision program in the direction outlined by the Chairman.

The review identified improvement opportunities primarily in the performance of safety-and-soundness supervision, including the Applications function which is part of the Reserve Bank's Legal Group but reliant on the Bank Supervision Group for analysis and input. The review also identified improvement opportunities in the consumer compliance supervision program and in the administration of consumer complaints.

¹ "Monetary Policy and the Housing Bubble," speech by Chairman Bernanke at the Annual Meeting of the American Economic Association, Atlanta, Georgia, January 3, 2010.

FINDINGS

Safety-and-soundness Supervision

For safety-and-soundness supervision, the report groups findings into five **recommendations**, each of which is composed of related elements that we discuss in more detail below. The five recommendations are:

1. Fully implement the System's Consolidated Supervision and Compliance Risk Management guidance across all applicable portfolios;
2. Improve the timeliness of supervisory ratings, communications, products, and processes;
3. Improve the quality, content, and consistency of supervisory documents and processes;
4. For the Applications function, reinforce accountability, enhance processes, and strengthen analytical skills for both safety-and-soundness and Applications staff; and
5. Evaluate resource prioritization and allocation, with the goal of staffing to meet System standards for institution-specific supervision and our evolving macro-prudential efforts.

Fully implement Consolidated Supervision Guidance across all applicable portfolios

The Bank Supervision Group has not yet fully implemented the Consolidated Supervision or the Compliance Risk Management guidance.² We **recommend** that management fully implement the System's Consolidated Supervision and Compliance Risk Management guidance across all applicable portfolios. This recommendation has four related components:

- ensure that continuous monitoring efforts are sufficient to support the ongoing validation of supervisory and risk assessment ratings, and timely ratings changes;
 - update risk assessments and supervisory plans on an ongoing basis to reflect changes in the institutions' risk profile and financial performance;
 - make the coordination with primary and functional regulators more transparent and effective;
- and

² SR 08-09/CA 08-12 *Consolidated Supervision of Bank Holding Companies and the Combined U.S. Operations of Foreign Banking Organizations* and SR 08-8/CA 08-11 *Compliance Risk Management Programs and Oversight at Large Banking Organizations with Complex Compliance Profiles*.

- where needed, strengthen work regarding compliance with *SR 08-8 Compliance Risk Management Programs*.³

Ensure that continuous monitoring efforts are sufficient to support the ongoing validation of supervisory and risk assessment ratings, and timely ratings changes

There should be more explicit linkage between continuous monitoring efforts and staff perspectives on supervisory ratings and their subcomponents. Specifically, analysis and conclusions drawn from documents such as management meeting notes, target examination reports, monthly reports or quarterly analyses, and analytical products developed by the Risk staff, should significantly contribute to the updating of risk assessments and supervisory plans, as warranted. Supervisory issues raised by primary or functional regulators should inform this process as well. We observed that monthly reports and/or quarterly analyses were largely factual discussions of supervisory events, financial performance or institutional events, and that these documents lacked critical evaluations with respect to the relevant events' impact on supervisory ratings and risk assessments/supervisory plans. Management should ensure that continuous monitoring efforts are sufficient to support the ongoing validation of supervisory and risk assessment ratings, and the timeliness of ratings changes.

Update risk assessments and supervisory plans on an ongoing basis to reflect changes in the institutions' risk profile and financial performance

The team found that some risk assessment and supervisory plan documents were not being updated in response to changes in institutional risk profiles and/or in financial performance. At present, changes to these documents are generally annual events as opposed to ongoing evaluations based on current information about the risk profile or control framework as emerging risks are identified. An important goal of continuous monitoring is to apply information regarding emerging risks faced by the supervised institution to necessary changes in supervisory direction and strategy to address the

³ A fifth objective relates to Consumer Compliance supervision and is described below in the Consumer Compliance section of this report.

evolving concerns. Management should direct staff to update risk assessments and supervisory plans on an ongoing basis, to reflect changes in institutional risk profiles or in financial performance.

Make the coordination with primary and functional regulators more transparent and effective

Effective implementation of consolidated supervision recognizes the interdependencies of primary and functional regulators and their respective oversight responsibilities and actions. Particularly in the Large Complex Institutions and FBO portfolios, our team observed that Bank Supervision Group staff meet with domestic and foreign supervisors, participate in supervisory colleges, and share supervisory products under existing protocols and mechanisms. However, our team did not observe that these efforts were clearly connected or integrated into the risk assessments, supervisory plans, and other documents that support consolidated supervision.

- Specifically, these documents did not provide sufficient transparency that Bank Supervision Group staff were relying on the supervisory work of primary and functional regulators to inform Federal Reserve supervisory assessments or shape supervisory plans. Even in those cases where staff had gathered the supervisory plans of the primary or functional regulators, staff did not document the impact of those regulators' plans on the Federal Reserve's own risk assessments and supervisory plans. Management should direct staff to improve the transparency with which the staff document how they are leveraging the work and opinions of the other regulators to improve the effectiveness and efficiency of the Group's supervisory program.
- Also with respect to transparency, in a number of cases our team could not determine whether Reserve Bank staff evaluated the work of other supervisors in reaching judgments about whether that work met our standards as the consolidated supervisor. If the work of the functional regulators (or our access to that work) does not meet our standards as the consolidated supervisor, then Reserve Bank staff should document the gaps in supporting documents, explain the work that Reserve Bank staff will perform to fill the gap.

Where needed, strengthen work regarding compliance with *SR 08-8 Compliance Risk Management Programs*

We found examples where the examination teams need to perform more work to determine compliance with *SR 08-8 Compliance Risk Management Programs*.

- In one example, the supervisory plan did not always address activities to determine compliance with *SR 08-08*. The dedicated team is comfortable, based on information obtained through discovery reviews, that the firm's compliance risk management function complies with the guidance; however the team agreed going forward to document their evaluation in the risk assessment.
- In another example, the team was not able to complete its assessment of compliance with *SR 08-8*, and completion of the assessments did not appear to be planned until 2011. The team has completed considerable testing of compliance risk management at the firm; however, they have not always compared the firm's practices to the guidance.

Improve the timeliness of supervisory ratings, communications, products, and processes

Our team found opportunities to improve timeliness throughout the Group's supervisory program. Timeliness of supervisory products and processes, and of delivery of supervisory messages to the banking institutions, becomes even more important given current banking conditions. This is a repeat finding from the 2005 operations review, which recommended that the Bank Supervision Group improve timeliness of supervisory products and processes. The Bank Supervision Group took steps to improve timeliness following that review, but because our team found issues related to timeliness during this review, we conclude that additional efforts are necessary. Thus, we **recommend** that management continue progress to improve the timeliness of supervisory ratings, communications, products, and processes. The recommendation includes four components, which are described below:

- Make prompt adjustments to supervisory ratings when warranted;
- Deliver timely supervisory communications;

- Improve timeliness of examination products and processes; and
- Ensure timely and effective follow-up on supervisory issues.

Make prompt adjustments and interim changes to supervisory ratings when warranted

In the Large Complex Institutions supervision program, we found that supervisory ratings were not always updated on an ongoing basis to reflect the evolving risk profile and financial condition of the organization. Specifically the team found ratings updates tended to be calendar-driven events; ratings were usually assigned annually, and did not always reflect ongoing changes in the supervisory team's identification of evolving supervisory conditions or emerging risks. In some cases, there was evidence of a changing risk profile and deterioration at the supervised organization, but no intermediate change in supervisory ratings. System guidance⁴ requires that supervisory ratings reflect a current assessment of an institution's financial condition and risk profile; up-to-date ratings are important because ratings affect a range of statutory and regulatory requirements, including supervisory reporting and examination requirements.

Improve timeliness of examination products and processes in Community supervision

In Community supervision, our review found some instances where the distribution of examination reports and the documentation of workpapers was not timely. The timeline for the examination process was often quite extended, with six months or more elapsing from the on-site start date until the date the report was mailed. A protracted examination cycle delays the communication of the supervisory findings, which adversely affects the timeliness of correction on supervisory issues. We also found delays in documenting the resolution of supervisory issues in the Community supervision program. Posting of workpapers to the Electronic Workpapers (EWP) database was not timely in several instances.

Management and staff explained that extended timeframes for the examination process are chiefly the result of limited availability of staff. We acknowledge that shortage of staff in the Community

⁴ SR 99-17, *Supervisory Ratings for State Member Banks, Bank Holding Companies and Foreign Banking Organizations, and Related Requirements for the National Examination Data System.*

supervision program could be a reason for the extended timeframes, but our review team has also communicated to Reserve Bank staff where process improvements could contribute to a more timely examination cycle.

Perform timely and effective follow-up on supervisory issues

Our team found some opportunities for more timely and effective follow-up on supervisory issues, and examples where the staff were delayed in recording supervisory issues and follow-up actions in the Issues Tracking Database; our findings are consistent with the Bank Supervision Group's Quality Assurance report on LFI Issues Tracking performed in July 2009.

- Examples include a situation where staff did not take timely and appropriate action to validate that the organization had addressed supervisory findings. We concluded that the dedicated team should have developed a more disciplined (meaning periodic and structured) and proactive approach to assessing and validating actions taken by the firm to address supervisory issues, and thus improve how it monitored the firm's compliance with the Memorandum of Understanding (MOU).
- At another large institution, we believe that the dedicated team will need to perform analytically rigorous and timely tracking to evaluate the firm's progress to successfully implement the large number of projects underway to improve credit, market, and operational risk management systems.
- In Regional supervision, our team did not find consistent written evidence that formal and informal supervisory actions are being analyzed and assessed on a regular basis. Our review also found that staff were at times relying on verbal rather than written communications with bank or holding company management to provide supervisory feedback on the status of the institution's progress to address those supervisory actions; such communications are sufficiently important that they should be in writing. In addition, supervisory databases did not show how the status of identified supervisory concerns is being regularly monitored and updated.

Improve the quality, content and consistency of supervisory documents and processes

Our review found some examples where supervisory products are not fully completed, and supervisory processes were not fully performed, relative to System standards. We **recommend** that management take steps to improve the quality and content of supervisory documents, and the consistency of the performance of supervisory processes. This recommendation includes five components, which are described below:

- improve the quality and content of supervisory documents;
- improve the consistency of supervisory processes;
- enhance review of risk areas and communicate broader risk management themes in Regional supervision;
- strengthen oversight of Market and Liquidity Risk supervision across the LFI institutions; and
- improve supervisory processes in Community bank supervision.

Large Complex Institutions supervision: Improve the quality and content of supervisory documents

In the Large Complex Institutions supervision program, we found that weaknesses were greatest in the large FBO institutions, but we also found opportunities to improve transparency with respect to the quality, content, and consistency of supervisory documents and processes in the domestic LFIs. In this discussion, supervisory documents include the risk assessment, supervisory plan, and all documents supporting continuous monitoring.

We found that risk assessment documents did not always provide full support for risk ratings assigned. A comprehensive risk assessment is important if weaknesses within the firm are to be fully identified so that they can be addressed in the supervisory program via planned and appropriately scoped supervisory activities. We also found that risk assessments/institutional overviews were sometimes incomplete and did not always present a consolidated view of the risk of U.S. operations of the organizations.

In addition, we found that supervisory documents were not always posted to BOND in a consistent and timely manner. Scope memos for discovery reviews were not always prepared consistent with System

guidance. In addition, examination reports issued by other regulators have not consistently been posted to BOND.

Improve the consistency of supervisory processes

We found that supervisory issues and supervisory actions were not consistently tracked, followed-up on, or closed out. We also found instances where supervisory issues were closed based on responses from the supervised institution's management; however, follow-up documentation did not always evidence validation or testing by the supervisory team. In some cases, there was not documentation that control functions had been sufficiently evaluated.

- Examples include a situation where the supervisory program lacked the appropriate level of focus on risk management and internal audit functions. The team had not conducted a review of the firm's corporate risk management function in a number of years. As a result, significant work remains to be done to fully evaluate the adequacy of the corporate risk management function and associated risk assessment and control processes. Additionally, the team recently assigned a satisfactory rating to internal audit without addressing how the audit function should have performed relative to identifying outsized risk taking and poor risk management in certain business lines.
- In another situation, we concluded the 2009 and 2010 supervision plans for the firm did not include enough transaction testing across the credit, market, and liquidity risk areas.
- Our team found several examples where the process for documenting the results of continuous monitoring work in the teamroom, BOND, Issues Tracking Database, or monthly reports needs improvement. In one situation, it is difficult to track the status of some of the supervisory issues, and thus it is difficult to understand how any identified risk management and control issues roll up into the overall assessment of risk management and controls at the firm. Asset quality deterioration, and the scale and complexity of the over-the-counter (OTC) trading, sales and hedging business, were emerging issues at the institution during 2009. Although these

issues have been mentioned in the monthly reports, the possible significance of the issues to the firm's financial rating and risk management assessments is not clearly documented.

Certain formal communications to management do not consistently meet System guidance for addressing Matters Requiring Attention (MRAs) in communication of examination findings.⁵ We found that examination reports and annual roll-up letters did not consistently identify the MRAs identified during discovery and target reviews conducted throughout the supervisory cycle, and did not always include specific timeframes for corrective action on MRA issues.

Regional supervision: Enhance review of risk areas and communicate broader risk management themes

In Regional supervision, we found that risk factors at the some of the regional holding companies were not always evaluated at a critical level of depth or detail. For example, some risk assessments and supervisory plans were prepared using dated financial information, and lacked critical analysis of the key control functions and processes at the institution.

With respect to the state member banks, the analysis in supervisory documents was more consistently thorough and better documented. We found, however, that state member bank examination reports did not always effectively communicate the broader supervisory concerns that the board of directors needs to hear. In some cases, the reports would deliver a more effective message if they presented the supervisory concerns framed in risk management themes as opposed to individual findings. Specifically, the reports and work products should focus more on forward-looking observations and broader risk management themes.

Strengthen oversight of Market and Liquidity Risk supervision across the LFI institutions

In Market and Liquidity Risk, we found that the allocation of resources and rigor of analysis and documentation that supports this supervision program are not consistent across the portfolio of LFI institutions. Management should strengthen its oversight of this program across the LFI portfolio. Current management and staff are experienced, knowledgeable, and committed to delivering a strong oversight program; the program has been considerably deepened and strengthened in the past two

⁵ SR 08-1, *Communication of Examination/Inspection Findings*.

years. Acknowledging this significant progress, management also agrees with our assessment that additional work is needed to deliver an appropriate level of supervisory activities (continuous monitoring, control validation reviews and discovery reviews) to support timely risk management and control assessments across the portfolio of LFI institutions.

Our review of the liquidity risk-related supervisory activities and assessments at one foreign LCBO indicated that the supervisory approach for the company is not at a comparable rigor and depth when compared to supervisory guidance and to similar companies of a like size, risk profile and complexity. The firm has a very complex structure and risk profile with significant market positions in several key areas (e.g., domestic and international clearing and settlement, derivatives, etc.). The complex structure and activity, let alone the volatile nature of recent and current market conditions, supports the need for more intensive supervisory coverage.

With regard to the market and liquidity risk program overall, management should review staffing needs to determine the adequacy of coverage in terms of staffing numbers and skill sets. The assessment should include the market, liquidity, and models/methodologies teams, and span examination activities, continuous monitoring, related supervisory activities (such as follow-up and issue resolution), special projects, and evolving macro-prudential commitments. Management should adjust staff levels based on the review results.

All three teams -- market, liquidity, and models/ methodologies -- have played key roles throughout the market disruption, and going forward demand for the teams' skills clearly exceeds supply. In 2010, we see the Reserve Bank has planned supervisory activities across multiple areas such as commodities and derivatives reviews, price/valuation methodologies, Basel II models support, enhanced market risk monitoring, the pending incentive compensation horizontal review, and evolving macro-prudential commitments. With the range of future supervisory assignments for the staff seemingly open-ended, there is a risk that conflicts regarding resource prioritization could remain and, in an attempt to fill all requested assignments, service levels for core supervisory activities could fall below minimum effectiveness.

We conclude that management can more fully articulate expectations for the Market, and Funding and Liquidity Risk supervisory activities at the LFI institutions. These expectations should be consistent with System standards and should provide a foundation or floor of coverage to ensure sufficient resources across the portfolio. Expectations should similarly be set to guide the target objectives expected for offline monitoring, special projects, and evolving macro-prudential activities. After the minimum expectations are defined, the resource assessment described above can be conducted to evaluate the adequacy of staffing and skills against the target commitments.

Improve supervisory processes in Community bank supervision

The team found opportunities to bring greater consistency and transparency to examination and supervision processes and thus improve administration of the Community bank supervision program. Management should reinforce expectations regarding continuous monitoring activities, issues tracking processes, and vetting processes to achieve greater consistency. Staff should more clearly document decisions to either not carry issues from workpapers to examination reports, or to change the issues' significance.

The staff's process to review state examination reports, to assess the state's findings and the appropriateness of state-assigned ratings, is informal. Although staff reported that they review the state reports, there was no documentation of their review or the results of their assessment of the examination findings and ratings. Management told our team that staff were recently informed of the need to document these reviews, and to document whether there is Federal Reserve concurrence with the assigned ratings. Management also stated that more formal procedures would be incorporated into the unit's processes regarding continuous monitoring. We encourage management to develop and implement procedures as soon as possible to ensure that the Community bank supervision program complies with System guidance.⁶

⁶ SR 99-17, cited earlier, and AD 09-12, *Rating Differences between the Federal Reserve and the State Supervisory Agencies*, issued August 13, 2009. AD 09-12 states that if there is a disagreement with the CAMELS composite or component ratings assigned by the state supervisory agency, the Reserve Bank should assign a separate rating and communicate both the rating and the reason for assigning that rating in writing to the board of directors of the banking organization, the appropriate state supervisory agency, and the Board of Governors.

Applications: Reinforce accountability, clarify responsibilities, and strengthen skills

With respect to applications, especially domestic applications, the review found that the current structure and process to review safety-and-soundness issues in the Applications function are not satisfactory; the resulting supervisory products and decisions do not meet System expectations and standards. We **recommend** that management reinforce accountability for the Applications function, clarify roles and responsibilities between the Bank Supervision Group and the Applications department, strengthen applications analysis skills for both groups, and ensure that key processes are performed. Specifically, we found that:

- The safety-and-soundness review of Applications proposals should be performed by staff who are accountable for this aspect of the review, and who feel a sense of ownership for the results. Staff should have the skills to perform financial and managerial analysis, identify issues requiring further review, and ensure resolution of issues prior to taking approval action, as well as sufficient training in the Applications function to understand how to apply the skills in context.
- Analysis of novel, expansionary proposals, and membership applications, should be expanded to ensure that staff perform a comprehensive assessment of the overall risk profile of the organization that will result from the proposed transaction, and a determination of whether that risk profile is acceptable from a safety-and-soundness perspective.
- Management should ensure that staff perform, or participate in, a pre-membership examination before approving any membership application regarding a bank that has key red flags or a dated safety-and-soundness report.
- Applications and safety-and-soundness staff should work collaboratively to monitor bank compliance with commitments related to approval of specific applications. The Applications function should produce and distribute to the safety-and-soundness, consumer, and legal sections a quarterly report on outstanding commitments.

- Management should direct staff to evaluate whether the proposed bank's investment in premises will conform to the requirements of Regulation H and generally accepted occupancy requirements.

Reinforce accountability for analysis that supports the Applications function, and clarify roles and responsibilities

Despite efforts by the Applications staff to gain input from the Group's safety-and-soundness staff, safety-and-soundness staff members reported in our interviews that they do not have sufficient time to review the proposals closely; as a result, safety-and-soundness staff rely on the Applications staff to identify issues that need further consideration. Roles and responsibilities between the safety-and-soundness staff and the Applications staff are either not fully understood by staff or not enforced by management. Applications staff believe that issue identification is being performed by safety-and-soundness staff, while safety-and-soundness staff believe that issue identification is being performed by Applications staff; as a result, our team found that there is a significant deficiency with respect to the overall accountability and ownership for the safety-and-soundness review of proposals.

Improve training and strengthen skills for both groups of staff

The situation regarding issue identification described above is made worse because Applications staff members have limited backgrounds and training with respect to finance, accounting, or other supervision matters. For this reason, and by the Reserve Bank's internal guidance⁷, Applications staff are expected to rely heavily on safety-and-soundness relationship managers to review the proposals and perform issue identification. However, this protocol is not followed; Applications staff develop the requests for additional information, and write the financial and managerial analysis of the proposal, despite their limited background and experience to perform these tasks; as a result, the analyses are narrowly focused. Meanwhile, staffing constraints in safety-and-soundness make it difficult for those staff to devote the requisite time needed to comprehensively evaluate proposals, much less develop the requests for additional information, and perform the financial and managerial write-ups. Our review also found that safety-and-soundness relationship managers have received limited training in the

⁷ Bank Supervision Group *Instruction Bulletin 832, Responsibilities and Procedures for Reviewing Bank Applications*, issued March 13, 2008.

applications area, and this lack of training further hampers their ability to identify applications-specific concerns.

Expand analysis of novel, expansionary proposals, and membership applications

Our review also found a significant deficiency with respect to the analysis of novel, expansionary and membership proposals. The record for these types of proposals generally reflects insufficient documented analysis of the overall risk exposure and the acceptability of the risk exposure. Further, branch proposals do not take into consideration certain statutory and safety-and-soundness aspects. Examples of factors that do not appear to be consistently considered or were not mentioned in the record include: why the novel activity was considered to be a safe and sound practice; what would be the resulting asset quality of the pro forma organization; why the future prospects of the resulting organization are consistent with approval; and why membership applications for prospective membership banks with declining asset quality and other negative indicators should be approved.

Perform or participate in a pre-membership examination before approving applications for banks with red flags or dated safety-and-soundness information

We conclude that the Reserve Bank should have performed pre-membership examinations of two applicant institutions that showed signs of financial weakness when their applications were evaluated. Board guidance⁸ requires that pre-membership examinations of state nonmember banks, national banks, and savings associations seeking to convert to state membership status will not be required if the bank or savings association seeking membership meets the criteria for "eligible bank." However, in the case of two recently processed membership conversions, the applications were approved without benefit of pre-membership examinations despite the fact that both institutions showed grounds for supervisory concern. The Reserve Bank should have conducted and/or participated in pre-membership examinations. As of this operations review, both banks were considered to be in less-than-satisfactory condition and one may possibly fail.

⁸ SR 98-28, *Examinations of Insured Depository Institutions Prior to Membership or Mergers into State Member Banks*.

Management should ensure that safety-and-soundness staff conduct or have significant participation in a pre-membership examination prior to approving any membership application regarding a bank that is in deteriorating financial condition or has not received a recent safety-and-soundness examination.

Monitor bank compliance with commitments related to approval of specific applications

Our review found that the Reserve Bank had not fully implemented a system for monitoring the status of outstanding commitments related to approval of specific applications. This finding is consistent with the Bank Supervision Group's Quality Assurance review of commitment monitoring, which concluded that there is no formal process to track and review compliance with commitments. Although the Reserve Bank now has internal guidance⁹ that outlines procedures that both Applications and Bank Supervision Group staff must follow to monitor compliance with applications-related commitments from financial institutions, neither the Applications function nor the Bank Supervision Group complies with that guidance.

We found that some safety-and-soundness relationship staff are relying on the financial institution to attest that it complies with all outstanding commitments, rather than reviewing and evaluating the institution's actions to address the commitments. This situation depends on the effectiveness of the supervised institution's internal controls rather than on the Reserve Bank's independent review.

Applications management has committed to take corrective steps to implement *Bulletin 833* and perform its obligations, including production and distribution of a quarterly *Outstanding Commitment Report* to the appropriate safety-and-soundness, consumer, and legal staff. BSG Quality Assurance will validate performance in 2010.

⁹ Bank Supervision Group *Instruction Bulletin 833, Commitments Monitoring, and Commitments Monitoring FAQs*, issued July 9, 2008. Specifically, the Bulletin states that the Applications unit will distribute an "Outstanding Commitments Report" to selected safety-and-soundness staff on a quarterly basis, and those staff will be responsible for tracking and assessing, at least annually, whether the institution is complying with the commitments. Safety-and-soundness staff must document their review in a "Commitments Compliance Review Memo" that is forwarded to the Applications unit. This process has not yet been fully implemented.

Evaluate whether proposed investment in premises conforms to the requirements of Regulation H and occupancy requirements

Our review of branch proposals indicated that the Reserve Bank does not evaluate limitations on investment in premises as defined in Regulation H section 208.21, as well as the generally accepted requirement that a bank must initially occupy 25 percent of newly acquired premises and 50 percent of the premises within a reasonable time period. This issue was self-identified by the Applications function, and management plans to incorporate review of this regulation, and generally accepted occupancy requirements, into the review process.

Improve quality and accuracy in Consumer Affairs analysis

The team concluded that, in a few cases, analysis of consumer affairs issues in the applications process did not cover the issues in sufficient depth, were poorly organized, or placed too much reliance on the applicant's representations rather than the analysis and opinion of consumer affairs staff. More recent consumer affairs memoranda are more concise and better organized. Further training of consumer affairs analysts, and closer review of their memoranda, should result in more consistently achieving products with high quality content.

In a number of files reviewed, the team found inaccuracies or discrepancies in the CRA or consumer compliance rating dates presented in the safety-and-soundness applications memoranda or the consumer affairs memoranda. Staff reviewing applications memoranda should more thoroughly check the CRA and consumer compliance rating dates to ensure they are accurate.

Evaluate resource prioritization and allocation

Because our review found examples where supervisory products and processes were not consistently meeting System standards, and interviews revealed that many staff members have felt and continue to feel stress from the operating environment, it would be easy to conclude that the Bank Supervision Group is understaffed. This explanation, however, is likely too simplistic, because it does not recognize the Group's recent challenges to allocate scarce resources in the face of the recent financial

crisis. Nor would such an explanation recognize the significant staffing initiatives the Group has accomplished for the 2009 and 2010 budget years.¹⁰ The Reserve Bank's supervision function faces a dynamic situation caused by the interplay of different factors: the demands of crisis management work may be subsiding in some respects while those of macro-prudential supervision are expanding, and the large number of recently hired staff are being progressively integrated into the supervision programs. This places the Bank Supervision Group at a strategic juncture, where it is timely to assess how its significant resources should be best allocated to meet all of the Group's important responsibilities.

During the financial crisis, senior management had to make numerous decisions to shift staff to address the highest priorities, and focus its primary attention on major problem situations within the Large Complex Institutions portfolio. Management also selected experienced and very senior individuals when it organized the new teams to supervise the investment banks and other major firms that converted to bank holding companies. To immediately address the challenges of having lesser experienced staff on some LFI teams, management assigned "senior relationship managers" with significant supervisory experience over such CPC teams. The goal of this structure was to enable these senior relationship managers to better understand and assess risks and breakdowns in controls across like institutions, as well as to provide additional senior oversight to these teams.

Recognizing the value of these changes, it remains the case that resource allocation questions arose in each of the safety-and-soundness areas that our team reviewed. In Consolidated supervision, the team

¹⁰ The Bank Supervision Group (Service Line 4000) added 79 ANP in 2009 and 42 ANP for 2010. Most of the 2010 increase represents the full-year effect of personnel already hired in 2009. The increases bring the total ANP to nearly 696 for budget year 2010, an increase of 21 percent relative to 2008 ANP of 575. Subsequent to the review, the Group announced plans to propose additional supervision resources in the 2011 budget.

According to BSG management, of the new staff members hired in 2009, approximately 70 percent were experienced industry professionals. These hires were largely devoted to the new supervisory responsibilities, and to addressing the Group's highest priorities. In addition to a proactive hiring program, the Group also implemented an accelerated onboarding process, as well as a new System training course to orient experienced industry professionals to the perspective and role of bank supervision. As of April 2010, the Group's management plans to continue recruiting staff with critically needed skills through the next eighteen months to bring the Group to a level of resources needed to address all portfolios.

concluded that a 2005 Operations Review recommendation¹¹ should be noted as a repeat finding because staffing seems “insufficient across the Large Complex Institutions portfolio to properly sustain continuous supervision objectives.” In addition, the team reviewing other aspects of Large Complex Institutions supervision concluded that management should “critically evaluate resource allocation and experience to ensure that an effective supervisory program is carried out.” In FBO supervision, the team concluded that management should “review the staffing model and overall staffing allocation currently in place for the business line.” In Market and Liquidity Risk supervision, the team concluded that management should “conduct a staff resource review to determine the adequacy of coverage” relative to expected obligations, and “adjust staff levels or management priorities based on the review results.” In Regional bank supervision, the team concluded management should “evaluate the resource needs and staffing model.” In Community bank supervision, the team concluded that management should “thoroughly assess resource allocation” in the context of achieving “consistent performance that meets System expectations.” Accordingly, we **recommend** that management evaluate the Group’s resource prioritization and allocation with the goal of staffing to meet System standards for institution-specific supervision and our evolving macro-prudential efforts.¹²

Quality Assurance

The Quality Assurance (QA) section was not explicitly scoped for this review. The team, however, evaluated and leveraged the selected QA reports as part of its work. The Quality Assurance reports are generally thorough, identify relevant issues and present their findings clearly, and promote the objective of quality management for the business lines reviewed. The reports often identified many of the same issues described in this report. For many of the issues identified, management and staff had initiated steps to address the issues prior to the opening date of this operations review; management and Quality Assurance staff also acknowledged that additional work remains to fully resolve the issues identified.

¹¹ Specifically, there were two closely-related recommendations related to resource allocation and prioritization: (i) that management review the sufficiency of staff across the LCBO portfolio to address the teams’ capacity to properly sustain continuous supervision objectives; and (ii) that management dedicate adequate priority to provide regular and timely documentation of ongoing supervision and monitoring.

¹² The Consumer Compliance review team also concluded with a resource-related recommendation that is described later in this report.

Consumer Compliance and Consumer Complaints Supervision

Overall, the Reserve Bank's consumer compliance supervision and consumer complaint programs are effective. Consumer compliance examination reports and CRA performance evaluations are generally well written and conclusions are adequately supported. Matters raised in consumer complaints are appropriately investigated and response letters accurately address concerns raised by consumers. Our review, however, did identify some concerns regarding consumer complaint processing and consumer compliance risk assessments.

The overall concern with consumer complaint processing involves the number of experienced analysts (one) dedicated to investigating complaints, particularly given the increase in the volume and complexity of complaints received in 2009 and the anticipated continued growth in both volume and complexity. In the area of consolidated supervision of bank holding companies, consumer compliance risk assessments (separate from the general risk assessments prepared by the CPC for each institution) have not been completed for nine of the twelve bank holding companies in the Reserve Bank's LFI/LBO portfolio.

Consumer Complaints Processing and Documentation

The operations review included an evaluation of the Reserve Bank's adherence to applicable Board policies and the quality of analyses and written responses for consumer complaints. Overall, adherence to policy and the quality of analyses and responses were found to be satisfactory. However, in 2009, the Reserve Bank saw significant increases in the volume and complexity of consumer complaints, leading to the concern that one analyst dedicated to the consumer complaints function may not be sufficient.

The Reserve Bank's volume of consumer complaints increased significantly from 354 in 2008 to 624 (a 76 percent increase) in 2009. Over the same time period, an increase occurred in the volume of consumer complaints received from Congressional offices. Specifically, Congressional complaints increased from 14 to 61 (a 336 percent increase). Many of the 2009 complaints involved complex issues, including foreclosure and loan modifications. The number of complaints closed outside the

Board standard of 60 days increased from 12 complaints in 2008 to 30 complaints (an 150 percent increase) in 2009. In 2009, in approximately 40 percent of the cases, the Federal Reserve supervised entity responded to the complaint more than 7 days after the due date of the response.

Until the fourth quarter of 2009, the Reserve Bank had only one full-time complaint analyst who analyzed and responded to all consumer complaints, including Congressional complaints.

In the fourth quarter, given the increased volume of complaints, the Reserve Bank temporarily assigned an additional analyst, who has consumer complaint processing experience, to work on complaints. Complaint volume has increased throughout the System and the increase is expected to continue, in part due to the current economic conditions that have resulted in increased complaints related to foreclosures and loan modifications. In addition, on September 14, 2009, the Board announced a new policy that includes the investigation of complaints against nonbank subsidiaries of bank holding companies and FBOs engaged in activities covered by the consumer protection laws and regulations that the Federal Reserve enforces.¹³ The Reserve Bank, in conjunction with Board staff, has tentatively identified a number of nonbank subsidiaries in the New York District that are likely to draw complaints due to their engagement in consumer credit-related activity. Prior to the new Board policy, in mid-2008 the Reserve Bank began reviewing complaints against a particular nonbank subsidiary. The number of complaints against this entity increased from 47 for 2008 to 121 for 2009 (29 of the 2009 complaints were Congressional complaints).

Given the continued increase in the number and complexity of complaints, including Congressional complaints, we **recommend** that management assess the number of experienced staff dedicated to consumer complaint processing to ensure that the Board's required processing times are met and that responses are maintained at the highest quality.

Large Bank and Consolidated Supervision

Consumer compliance risk assessments, separate from the general risk assessment, were not prepared for nine of the twelve the bank holding companies in the Reserve Bank's large bank portfolio. We

¹³ CA 09-8, *Consumer Compliance Supervision Policy for Nonbank Subsidiaries of Bank Holding Companies and Foreign Banking Organizations*.

recommend that by June 2010 separate consumer compliance risk assessments be prepared pursuant to the Board policy for the applicable bank holding companies in the large bank portfolio.¹⁴

¹⁴ CA 03-51/SR 03-22, *Framework for Assessing Consumer Compliance Risk at Bank Holding Companies*, and CA 06-8, *Pilot of Additional Revisions to the Draft Risk-Focused Consumer Compliance Supervision Program*.

REFERENCE LIST OF RECOMMENDATIONS

Safety-and-Soundness Supervision

We **recommend** that the Bank Supervision Group fully implement the System's Consolidated Supervision and Compliance Risk Management guidance across all applicable portfolios. This recommendation has four related components:

- ensure that continuous monitoring efforts are sufficient to support the ongoing validation of supervisory and risk assessment ratings, and timely ratings changes;
- update risk assessments and supervisory plans on an ongoing basis to reflect changes in the institutions' risk profile and financial performance;
- make the coordination with primary and functional regulators more transparent and effective; and
- where needed, strengthen work regarding compliance with *SR 08-8 Compliance Risk Management Programs*.

We **recommend** that management continue progress to improve the timeliness of supervisory ratings, communications, products, and processes. The recommendation includes four components:

- Make prompt adjustments to supervisory ratings when warranted; use interim ratings changes.
- Deliver timely supervisory communications and messages in Regional supervision.
- Improve timeliness of examination products and processes in Community supervision.
- Perform timely and effective follow-up on supervisory issues.

We **recommend** that management take steps to improve the quality and content of supervisory documents, and the consistency of the performance of supervisory processes. This recommendation includes five components:

- Improve the quality of supervisory documents in Large Complex Institutions supervision.
- Improve the consistency of supervisory processes.
- Enhance review of risk areas and communicate broader risk management themes in Regional supervision.
- Strengthen oversight of Market and Liquidity Risk supervision across the LFI institutions.
- Improve supervisory processes in Community bank supervision.

We **recommend** that management reinforce accountability for the Applications function, clarify roles and responsibilities between the Bank Supervision Group and the Applications department, strengthen applications analysis skills for both groups, and ensure that key processes are performed. This recommendation includes seven components:

- Reinforce accountability for analysis that supports the Applications function, and clarify roles and responsibilities.
- Improve training and strengthen skills for both groups of staff.
- Expand analysis of novel, expansionary proposals, and membership applications.
- Perform or participate in a pre-membership examination before approval for a bank with red flags or dated safety-and-soundness information.
- Monitor bank compliance with commitments related to approval of specific applications.
- Evaluate whether proposed investment in premises conforms to the requirements of Regulation H and occupancy requirements.
- Improve quality and accuracy in Consumer Affairs analysis.

We **recommend** that management evaluate the Group's resource prioritization and allocation with the goal of more consistently meeting System standards for institution-specific supervision as well as our evolving macro-prudential efforts.

Consumer Compliance and Consumer Complaints Supervision

We **recommend** that management assess the number of experienced staff dedicated to consumer complaint processing to ensure that the Board's required processing times are met and that responses are maintained at the highest quality.

We **recommend** that by June 2010 separate consumer compliance risk assessments be prepared pursuant to the Board policy for the applicable bank holding companies in the large bank portfolio.