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An International Review of OCC's Supervision of Large and Midsize Institutions

United States: Department of the Treasury: Office of the Comptroller of the Currency (OCC)

AN INTERNATIONAL REVIEW OF OCC'S SUPERVISION OF LARGE AND MIDSIZE INSTITUTIONS:

RECOMMENDATIONS TO IMPROVE SUPERVISORY EFFECTIVENESS

December 4, 2013

Executive Summary and Key Recommendations

The Office of the Comptroller of the Currency (OCC), as the primary supervisor of national banks and federal thrift institutions (together "institutions"), plays a critical role in the U.S. financial system. Institutions under its supervision hold the majority of deposits insured by the Federal Deposit Insurance Corporation (FDIC) and range from small community banks and thrift institutions to some of the largest and most complex financial institutions in the world.

In the aftermath of the financial crisis, the OCC, along with the Federal Reserve System, the FDIC, and the other federal and state financial supervisory agencies, has had to rethink its approaches to supervision and regulation. In addition, the OCC faces a number of additional challenges in the coming years. A high proportion of OCC examiners are at or near retirement age. A significant number of new rules and policies need to be put in place as a result of the Dodd–Frank Wall Street Reform and Consumer Protection Act (Dodd–Frank) and the output of international bodies such as the Basel Committee on Bank Supervision and the Financial Stability Board. The OCC also operates in a complicated environment of multiple federal and state regulatory agencies with overlapping responsibilities regarding the regulation and supervision of federally chartered depository institutions and with each agency having its own mandates and objectives.

Against this background the assessment team conducted a review of the OCC's approach to the supervision of large and mid-sized institutions. The assessment included briefings with senior OCC staff and meetings with bankers and non-OCC regulators, and was based on the team's understanding of successful supervisory practices in their respective countries. This report makes the following key recommendations:

1. Revise the **mission and vision statements and the strategic goals** to make safety and soundness of institutions the OCC's primary objective, consistent with compliance with applicable laws and regulations, including those regarding fair access and fair treatment of customers.
2. Enhance **risk identification** by expanding the role of Lead Experts (LEs) and ensuring that they have the capacity to provide meaningful input into the supervision of large institutions through review of examination papers and through the initiation of horizontal reviews.
3. Better integrate the **systems for assigning supervisory ratings to institutions** (CAMELS ratings) and the Risk Assessment System (RAS)), make examination ratings more forward-looking, and devise a more flexible approach to the consequences of certain ratings downgrades.
4. **Move examination teams and subject matter experts from individual bank locations to shared OCC offices in the field**, where practicable, to improve internal communications, sharing of information among examination teams, and workforce flexibility. This will facilitate horizontal supervisory reviews and help to address staffing shortfalls, particularly in specialized skill areas, by allowing specialists to work on several institutions over a shorter period of time.

5. **To further address staffing shortfalls** devise a program to use retirement-eligible staff as mentors and explore how to accelerate the integration of private sector experts into the examination force.
6. Enhance the **scope and consistency of supervisory planning, risk assessment and intervention** by enhancing the existing peer review process to involve all relevant Examiners-in-Charge (EICs) and Lead Experts, and by elevating key supervisory decisions such as material acquisitions to the Committee on Bank Supervision (CBS) and/or Major Matters Supervisory Review Committee (MMSRC).
7. Ensure that the **Enterprise Governance function** commences its proposed work on documentation of quality management practices as soon as possible and that the OCC utilizes this to determine the standard and consistency of practices it wishes to put in place across the agency.

The team notes that many good initiatives have begun at the OCC with the aim of improving supervisory effectiveness. The team urges the OCC to expedite full implementation of these projects. The team's recommendations in many cases reinforce the desired outcomes of the OCC's own process improvements.

Introduction

I. Background

The financial markets in the United States were at the epicenter of the global financial crisis that began in 2007. While the scope of the crisis encompassed a broad swath of the U.S. financial sector including the securities, insurance, thrift, and banking industries, the large commercial banks were particularly hard hit. Because the OCC is the supervisor of the largest U.S. commercial banks along with the Federal Reserve System (FRS), which supervises the parent bank holding companies, the performance of these agencies in the period leading up to the crisis has come under particular scrutiny.

At the request of the Comptroller of the Currency and his executive team, a small group of current and former senior supervisory personnel from Australia, Canada, and Singapore along with a former staff member of the International Monetary Fund were asked to participate in an independent review of the OCC's supervision of large and midsize institutions.[1] In choosing the national supervisory agencies to participate in the review, the selection criteria were countries with significant and mature financial markets, well-respected supervisory regimes, and large commercial banks that have been consistently rated among the safest in the world. While virtually all of the major financial sectors around the world were affected by the crisis, major banks in these three countries demonstrated strong resilience. While Australia and Singapore are distant from the United States and, therefore, might be expected to be somewhat insulated from the risky practices that arose in the U.S. financial sector, the large Canadian banks also avoided many of the problems encountered by U.S. banks, despite Canada's proximity to the United States and the significant retail presence of two major Canadian banks in the U.S. markets.

The exercise included a high level review of internal and external reports on the OCC's supervisory performance, speeches and testimony, supervisory policies and procedures, examination working papers and products, and documents prepared by the OCC for the on-site work of the team, which took place from October 28 to November 5, 2013.

The team focused on supervisory processes, risk identification and follow-up, and the supervisory culture of the OCC. Meetings were held with OCC senior management and a number of senior OCC supervisors, regulatory counterparts in one of the OCC's sister agencies, and members of the board and management teams of two large national banks.

The nature of the exercise did not permit an in-depth analysis of any particular areas. The report's recommendations are based primarily on an understanding of the current processes as

[1] This report was prepared by a team comprising members from Australia—Keith Chapman, Executive General Manager, Australian Prudential Regulatory Authority (APRA); Canada—Brigitte Phaneuf, Managing Director, Office of Superintendent of Financial Institutions (OSFI), Ted Price, Consultant (former Deputy Superintendent, OSFI); Singapore—Swee Lian TEO, Special Advisor (former Deputy Managing Director, Financial Supervision), Monetary Authority of Singapore (MAS); and was led by Jonathan Fiechter, Consultant (former Deputy Director, Monetary and Capital Markets Department, International Monetary Fund). This report reflects the personal views of these individuals and not that of their current or former agencies.

explained by the supervisory staff and the documents received. The team did not review the extensive set of OCC supervisory handbooks and supervisory guidance.

The team received a high level of cooperation from the OCC and had access to a number of EICs, subject experts, policy staff, and samples of examination reports and working papers. The team extends its thanks to all of the OCC staff it met, all of whom were candid in their assessments of their own performance and provided an excellent level of cooperation, and to those individuals outside of the OCC who met with the team to participate in this process.

II. Operating Environment

The approximately 1,800 institutions supervised by the OCC range from some of the biggest complex financial conglomerates in the world to small community banks and thrift institutions, trust companies, and federal branches of foreign banks.[2] The larger institutions may be part of a financial entity that includes one or more national banks or thrift institutions, a parent financial holding company, intermediate holding companies, and a number of other bank and non-bank subsidiaries, both in the United States and overseas.

The OCC has organized its supervision of these 1,800 institutions into three groups: a large bank supervision program with approximately 620 examiners, a midsize bank supervision program with approximately 130 examiners, and a community bank supervision program with 1,700 examiners. The Large Bank Supervision (LBS) program is under one Senior Deputy Comptroller and the Midsize and Community Bank Supervision (MCBS) programs report to another Senior Deputy Comptroller. A third Senior Deputy Comptroller, who is also designated as the Chief National Bank Examiner, is responsible for developing supervisory policy.

The U.S. financial supervisory system in which the OCC operates is complicated. Commercial banks in the United States, particularly the large complex institutions, may be subject to multiple supervisory agencies including the Federal Reserve Board and district Federal Reserve Banks, the FDIC, state supervisors, the Consumer Financial Protection Bureau (CFPB), the U.S. Securities and Exchange Commission (SEC), and the U.S. Commodities Futures Trading Commission (CFTC). The mandates, objectives, and supervisory approaches of these various agencies may differ from those of the OCC. Supervisory responsibility for a given business line or activity may include several different agencies.

Moreover, assignments of supervisory and regulatory responsibilities are still evolving as Dodd–Frank is implemented. Among other things, the supervisory authority of the Federal Reserve System (FRS), which has traditionally been responsible for the supervision of financial holding companies, has now been increased to include indirectly, some aspects of large national banks. The responsibility for supervision and regulation of consumer compliance is now predominantly

[2] One provision of Dodd–Frank was to abolish the Office of Thrift Supervision and to transfer responsibility for the supervision and regulation of federal thrift institutions to the OCC while shifting responsibility for thrift holding companies to the FRS and responsibility for state thrift institutions to the FDIC.

with the CFPB for institutions over $10 billion. The FDIC has also been given additional powers with respect to resolving troubled banks outside of a formal bank receivership.

Given the complexity and overlapping responsibilities of the different agencies, each agency needs to have a well-defined mandate and clear priorities with respect to its supervisory responsibilities. There must be effective information sharing among the agencies to prevent duplication of efforts and avoid inconsistent messages being conveyed to the institutions. Because multiple agencies have the authority to conduct examinations and to require reports from institutions, good coordination both at the examination level, as well as at the policy level, is essential to avoid imposing an unnecessary burden on institutions. A common and shared view across all of the involved agencies of the overall financial condition, risks, and the significance of any deficiencies in the operations of the institution (at both a solo and consolidated level) is also important so that management of the institution has a clear idea of its priorities and the expectations of its supervisors.

III. Changes in Supervisory Approaches in Response to the Crisis

The OCC has begun a number of supervisory initiatives to address lessons learned during and after the crisis. Many of these initiatives are still under development or in the early stages of implementation. The team believes that these initiatives are very important. Some of these initiatives may be resource intensive and may also require structural changes. This means that dedicated management involvement, at all levels, in supporting and helping guide these initiatives will be required to ensure successful execution.

Observations and Opportunities

The body of this report is divided into six topics, although the team notes that many items cross topic boundaries. The topics are:

1. Mandate and Priorities
2. Risk Identification and Reporting
3. Early Intervention
4. Supervision Staffing
5. Supervisory Methodology
6. Enterprise Governance

I. Mandate and Priorities

Objective

Having a clear and well understood mandate and set of priorities for the agency is essential for effective supervision. Analysis following the crisis undertaken by the Financial Stability Board (FSB) and the Basel Committee on Banking Supervision (BCBS) reemphasized the importance of supervisory agencies having a clear and focused mandate. Following recommendations in a

November 2010 FSB report,[3] the BCBS revised its standards and included these three essential criteria (emphasis added)[4]:

1. The responsibilities and objectives of each of the authorities involved in banking supervision are clearly defined in legislation and publicly disclosed. Where more than one authority is responsible for supervising the banking system, **a credible and publicly available framework is in place to avoid regulatory and supervisory gaps.**
2. **The primary objective of banking supervision is to promote the safety and soundness of banks and the banking system.** If the banking supervisor is assigned broader responsibilities, these are **subordinate to the primary objective** and do not conflict with it….
6. When, in a supervisor's judgment, a bank is not complying with laws or regulations, or it is or is **likely to be engaging in unsafe and unsound practices or actions that have the potential to jeopardise the bank or the banking system**, the supervisor has the power to:
   (a) **take (and/or require a bank to take) timely corrective action;**
   (b) impose a range of sanctions;
   (c) revoke the bank's license; and
   (d) cooperate and collaborate with relevant authorities to achieve an orderly resolution of the bank, including triggering resolution where appropriate.

Having a clear mandate and a set of priorities that is well understood by supervisory staff is particularly important in the case of an agency with the staff size and geographical dispersion of the OCC and where the institutions themselves vary dramatically in terms of size, range of business lines, and international activities.

Having a clear set of supervisory priorities underlying the mandate can be described in many ways—for example "risk culture," "risk appetite," and "hierarchy of risks." For the purposes of this report, the team has used the terms "risk appetite" and "risk appetite statement" to describe the values and choices the agency applies when setting supervisory priorities. Articulating the risk appetite helps establish safety and soundness as the primary objective of supervision.

The central elements of an effective risk appetite for a supervisory agency, which in many respects mirror what is expected of a bank, include the following:

- Business unit "ownership" of their risks.
- Horizontal information sharing across businesses and central functions.
- Rapid vertical escalation of vulnerabilities and emerging risks.
- Routine, open and informed discussion about risks at every level of the agency.
- Continuous and constructive challenging of the agency's actions and assumptions.

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[3] "Intensity and Effectiveness of SIFI Supervision, Recommendations for Enhanced Supervision," FSB, November 3, 2010 http://www.financialstabilityboard.org/publications/r_101101.htm

[4] "Core Principles for Effective Banking Supervision," BCBS, September 2012, http://www.bis.org/publ/bcbs129.htm

- Committed and consistent leadership at all levels.

What the OCC Is Doing

OCC staff demonstrated a strong commitment to rigorous supervision of institutions and a pride in the OCC as a supervisory agency.

There is an established mission statement for the OCC[5] and a medium-term strategic plan (2012-16) in place, which has operated as the foundation for the development of operating plans for the various OCC supervision departments. These operating plans are clearly tied to the strategic initiatives developed by the Comptroller and Executive Committee to make the OCC stronger and more effective.

Areas Identified for Improvement

Despite the establishment of a mission statement for the OCC, uncertainty regarding the priority of objectives can be created as the "mission" flows down into vision and then objectives.

- For example, the vision statement includes "maintain the ability [of national banks and federal savings associations] to compete effectively with other providers of financial services to meet the needs of their customers and communities for credit and financial services".
- Underlying one of the four strategic goals is "A flexible legal and regulatory framework that enables national banks and federal savings associations to provide a full, competitive array of financial services consistent with statutory and prudential safety and soundness constraints".

The team makes no judgment on whether maintaining the competitiveness of OCC-supervised institutions is a worthwhile secondary goal but notes that the current mission statement from which the vision statement and strategic goals flow does not include such a reference.

From the review of documentation and discussions with OCC staff, the team believes that across the agency there is a material degree of uncertainty as to the priority of outcomes the OCC is seeking.

Another observation of the team is that while there is a common view that increased collaboration among agencies is important, this objective has apparently led to delays in the issuance of policies. There does not appear to be an adequate mechanism (in effect, a time-bound decision tree) for ensuring that issues the OCC considers are important are identified and explicit decisions made regarding whether the OCC's appetite for interagency policy collaboration outweighs timely action.

[5] The current mission statement, which has been updated since the September 2011 OCC's Strategic Plan, is "To ensure that national banks and federal savings associations operate in a safe and sound manner, provide fair access to financial services, treat customers fairly, and comply with applicable laws and regulations."

International Practice

All agencies recognize the need, and challenge, to establish a robust Enterprise Risk Management (ERM) policy, which includes a risk appetite statement. An ERM policy supports long term and annual priority setting, planning, and performance measurement. Agencies find that their ERM helps clarify priorities for all staff throughout the agency.

While precise detail may vary, such ERMs should include risk appetite statements and/or risk tolerance statements that guide policy makers and supervisors. Risk tolerance statements can be used to help clarify judgments in the licensing approval process as well as to clarify the tolerance for delay of appropriate supervisory action. For instance, an agency might state that it will not tolerate the failure by responsible staff to act in a timely matter to avert or minimize the cost of an industry failure once relevant information has become available.

Recommendations

Revise the mission statement, vision statement, strategic plan, and goals to be better aligned to make safety and soundness of institutions the primary objective of the OCC.

Develop a "risk appetite statement" to provide all staff with a clear and consistent understanding of what the OCC is all about—what is most important to the agency.

In developing such a risk appetite statement the OCC should consider the following:

- The need for it to be simple, clear, and consistent.
- Its relevance to all operations of the OCC—not just supervision.
- The need for clear, risk-based supervisory and policy priorities.
- The establishment of a process to bring a strategic view to significant supervision matters (such as material acquisitions) or horizontal reviews arising from the forward-looking risk on the radar via the National Risk Committee processes.[6]
- Examples of risk taking that are, and are not, acceptable to the agency.

The team believes that there will be many important benefits and outcomes gained by active engagement in the risk appetite process, beyond simply establishing a final agency risk appetite itself.

The following are examples of such benefits:

- Increased understanding of risks by all participants in the risk appetite process.
- Clearer understanding, and the boundaries, of acceptable risks throughout the OCC.

[6] This process might be achieved, for example, by expanding the responsibilities of the Major Matters Supervision Review Committee beyond its current limited scope of enforcement actions.

- Strengthening of risk management tools and systems.
- The dialogue-intensive nature of the risk appetite process, which strengthens the risk culture.
- A “decision tree” that makes it clear when actions are necessary.
- Increased ownership of risks and accountability for risk by business units.
- Strengthened internal communication channels and feedback mechanisms.

II. Risk Identification and Reporting

Objective

Early detection of risks within institutions and across the system as a whole is essential for effective supervision. Being able to identify areas where an institution’s internal risk management is ineffective and whether such control weaknesses are prevalent across the industry are important elements. In addition, supervisors must be able to understand and analyze how different risks might interact in ways that could compound the overall vulnerability of individual institutions and the system as a whole.

What the OCC Is Doing

The team found that the OCC is doing well in many aspects of risk identification, reporting, and analysis. Starting at the examiner and Lead Expert level, the team found that there seemed to be good early identification of emerging risks in significant areas of activity that might pose concerns. There was good engagement by examiners with institutions and these engagements seemed to be at all levels, including the boards and relevant board committee chairs.

The ability to focus in a more targeted manner on specific risk areas has also been enhanced by crystallizing the roles of the Lead Experts and grouping them together under a Chief Risk Officer at the Assistant Deputy Comptroller (ADC) level in the midsize bank supervision unit of MCBS. This has facilitated more horizontal reviews. There is also a clear process of including inputs from LEs into the supervisory plans for institutions. A similar initiative has begun in LBS with the LEs reporting to a single Deputy Comptroller (DC) along with the LBS Data Analytics team. We understand that risk experts have quarterly ‘Risk Network’ meetings to share information and develop risk assessments for submission to the National Risk Committee (NRC).

There are also discussions across experts and examination teams though perhaps more intensively within, rather than across, the MCBS and LBS areas; integration of this information may occur at the periodic meetings of the NRC. There are also many OCC committees at the management level where matters can be discussed. There seemed to be a good knowledge repository system, Examiner View, for the MCBS area, which examiners could access to learn how similar issues were dealt with in other examination teams. The review team noted that work is under way to incorporate Examiner View in LBS, which will create an agency-wide repository of examination information.

The information flow from examiners and experts into the policy and research areas of the OCC seemed robust, and the National Risk Committee (NRC) output, in the form of radar and early warning reports, was first rate. The team members were all impressed with the forward-looking and counter-cyclical nature of the early warning metrics, and the dashboard was a very good way of conveying the risk warnings in a clear, concise, and helpful way. In this area the team members felt that the OCC was likely ahead of many other countries, including their own.

Areas Identified for Improvement

While the OCC is doing a good job in the area of risk identification and reporting, the team feels that there is room for improvement in some areas:

First, the number of horizontal reviews needs to be increased. Institutions indicate that they would like to hear more about best practices (i.e., what are the other institutions doing to manage risk), and more comparative work, with feedback about the range of practices.

Second, information sharing among experts, examiners, and across the agency should be increased.

Third, within LBS, there does not seem to be a clear process for LEs to have input to supervisory plans and follow-up supervisory actions (e.g., supervisory letters, reports of examination) of institutions. Relatedly, there does not appear to be a clear internal process within LBS for the LEs to escalate disagreements with EICs on risk assessments.

Finally, it is also not clear to the team how the outputs of the NRC generated radar screen and early warning metrics dashboard are linked to concrete supervisory actions, either at the individual institution or system level.

International Practice

In contrast with the OCC, in the foreign agencies a greater proportion of specialist risk resources (e.g., capital markets, credit, operational risk, model risk) are centralized and not embedded in specific examination teams. These specialist teams work in close collaboration with supervisors. They have dual roles, conducting institution-specific examinations in their risk area of expertise, in conjunction with supervisors, and performing horizontal reviews on topical issues. The team believes that the constructive challenge to risk assessments provided by these specialists helps in risk identification and intervention consistency.

The amount of time spent on horizontal reviews varies by risk area and across countries. At one agency, for example, more than 30 percent of risk specialist review time in large banks is spent on horizontal or comparative reviews. In all countries, risk experts have input to supervisory planning, risk assessment, and intervention.

All agencies feel that these specialist teams provide valuable information on risks across the industry, whether current or emerging. Horizontal reviews serve as a benchmarking tool in identifying best risk management practices. Feedback from institutions in those jurisdictions, as well as the U.S. institutions interviewed as part of this review, indicates boards and senior management welcome peer benchmarking. Specialist teams also provide support and guidance to policy development.

Recommendations

> Empower the Lead Experts by moving more specialist resources to report directly to them.

This would facilitate horizontal reviews so that the LEs need not "borrow" resources from individual examination teams. In addition, LEs should have input into the performance appraisal of the Team Leads assigned to the individual institutions.

> Embed the LEs' inputs in the supervisory planning, risk assessment and intervention processes for large institutions. This would include having their views reflected in annual examination planning, on-site review scoping, issuance of supervisory letters and Matters Requiring Attention (MRA). Where disagreements between LEs and the EIC persist, a formal process, within LBS, should be established for escalation to more senior OCC management.

This would provide an industry-wide view to complement the EICs' views on risk identification. This would also improve consistency of regulatory responses to risks across the industry.

> Include in the NRC radar screen a list of the institutions most affected. This information would much better inform the EICs of the industry-wide risks that are relevant to their institutions.

III. Early Intervention

Objective

Once institution-specific risk, systemic risk or control weaknesses have been identified, early, consistent, and proportionate intervention is critical to effective supervision. This intervention may take place at the institution level or across the industry and could be a combination of direct examiner action and rule making.

What the OCC Is Doing

It was clear to the team that examiners on the ground are dedicated to monitoring and identifying risks and control weaknesses within the institutions under their charge. Supervisory letters appear to give important guidance to institution management on areas requiring attention in their institutions. One of the challenges facing the management and board of a large institution, however, may be the number of different areas identified by supervisors as requiring their attention. The quarterly letters, which summarize the examination work undertaken over the quarter and highlight the priority areas from the perspective of the OCC, take on added importance. These quarterly letters appeared to be sent out by EICs to each of the large and midsize institutions and were mentioned by the institutions themselves as being useful in highlighting priorities and much appreciated.

Areas Identified for Improvement

The team noted instances of a material lag between the identification of an emerging risk and the issuance of guidance or rules to address the risk. This puts the onus on examiners on the ground to try and contain the risks at the institution level. When acted upon at the level of an institution, this could lead to the perception if not the actual occurrence, of unevenness of treatment across institutions. Institutions interviewed in the course of this review raised concerns about inconsistent treatment.

If policy positions take too long to produce, particularly when undertaken on an interagency basis, it will be demoralizing for the front-line supervisors who may feel that their hard work on risk identification and warnings has not been acted on at higher levels of the agency. While this “policy paralysis” could be for good reasons (e.g., the wish to have a level playing field that does not inadvertently drive undesirable practices into non-OCC supervised institutions or into the shadow banking sector), it exposes the OCC to the risk of being perceived as not acting in a timely manner.

OCC staff raised concerns that legally-mandated consequences made some examiners hesitant to downgrade CAMELS ratings because such consequences were viewed as inappropriate in particular cases. In particular, there may be some hesitation in instances when an institution falls between a “2” and “3” (sometimes referred to as a “borderline” or “dirty 2”) to rate the institution a “3” because of automatic consequences for the institution of certain downgrades, such as a restriction on the institution’s operations. It is appropriate to pay attention to the proportionality of intervention with regard to deficiencies observed in an institution and the willingness and capacity of the institution to promptly remedy the problem. A fair and rigorous risk assessment and risk rating, however, should not be hampered by fear of pushback from the institution, or appeals, or litigation due to nondiscretionary actions triggered by a downgrade. Examiners should not feel constrained if they need to make tough calls and take timely actions, especially in cases where there are material risks.

International Practice

Unlike the OCC, intervention actions in the foreign jurisdictions are not “hard wired” to risk ratings. Intervention is proportionate and appropriate to the circumstance driving increased risk. While this provides flexibility to examiners’ recommendations, an accompanying peer review of supervisory actions ensures greater consistency across institutions. All of the foreign jurisdictions felt that having this additional supervisory flexibility associated with ratings downgrades was more effective in influencing institutional behavior.

Importantly, the review team believes that intervention should be proactive, rather than reactive to increased risk ratings. It is the more qualitative discussions and actions on a case-by-case basis that are key to improving the risk behavior and management of institutions.

Recommendations

> Create a formal policy development process (a "decision tree") with time lines, tracking, and accountability to address identified emerging risks to institutions when no policy exists. Importantly, this process should also clearly embed criteria and process for deciding when the OCC has to act unilaterally, even as it may continue discussions with other agencies on concerted actions.

> Consider ways to incorporate more flexibility into CAMELS ratings. One approach would be formally splitting the "2" rating into a "2" and "2+," which would allow for more directional guidance to an institution.

IV. Supervision Staffing

Objective

To assist the OCC meet its strategic goal of "*A competent, highly motivated, and diverse workforce that makes effective use of OCC resources.*"

The team has identified two major issues in this regard:

- A large proportion of senior examiners are eligible for retirement in the next five years. While industry hires are being brought on board to bolster capacity, these individuals are not, under current policies, able to easily substitute for departing examiners.
- A significant number of staff in examination teams is dedicated to single institutions for many years, primarily in LBS.

What the OCC Is Doing

The team views supervision staffing as an area of strength at the OCC. In particular:

- Staff members met by the team have a huge commitment and a great deal of pride in the agency and in the jobs they do.
- Staff members are well trained and have a significant supervisory and industry knowledge.
- Examiners have formal National Bank Examiner (NBE) and Federal Thrift Regulator (FTR) accreditation.
- Industry hires are being used to supplement formal NBE accredited staff and to build expertise and knowledge on new business lines and industry developments.
- EICs are rotated every five years and increasingly LEs are being rotated as well.

- Feedback from institutions is that examiners and subject matter experts are very knowledgeable.
- Institutions note that turnover of their examiners is structured and, while transition to a new EIC (for example) can be disruptive, they see value in the rotation process.
- Institutions appreciate the close, frequent contact with the examination team.

Areas Identified for Improvement

OCC management has previously identified many of the staffing issues the team has identified. The Strategic Plan (Strategic Goal IV) sets out seven strategies for this goal. The team considers all of these strategies appropriate.

Additional observations from the team's review:

- The process for developing staff into "traditional" formally accredited examiners is an extended process that averages five years. While the agency has been able to take some industry hires and provide them with requisite examination experience and training that has enabled them to pass the commission test more quickly, the OCC should consider if there is a need for a different model in the future to enable more high quality industry hires to assume EIC positions.
- With a significant proportion of senior OCC staff eligible to retire in the next several years, it will be important to have a clear agency-wide culture that can be embedded and maintained as the nature of the workforce changes. If there is not a clear and consistent focus on this important area there is a danger of a significant 'upward' driven cultural change from the new hires that may be invisible from the agency-wide perspective until it has become embedded.
- Communication and collaboration among examiners across the two main supervision departments (large banks, and midsized and community banks) can be improved. While there appear to have been some moves to improve the level of communication there would be significant benefit from both greater communication and collaboration across the teams. Accomplishing this objective of improved communication and collaboration requires two changes to current practices:
    - First, teams assigned to large banks and some midsize banks may currently be located on the institution's premises. While this presence in the bank may facilitate good communications with the bank it has the undesirable effect of reducing communications among OCC examiners assigned to other banks.
    - Second, some staff below the EIC and LE level presently is assigned to the same institution for many years. Examiners may get stale and become too familiar with the mid-management of the institution, giving rise to perceptions of regulatory capture. Supervisory effectiveness may be hampered as a result of lack of comparative experience in other institutions—examiners, lacking good comparators, may simply assume an institution's controls are adequate.

- Institutions indicate that they would like to learn more from their examiners about best practices (e.g., what are other institutions doing to manage risk). They want more comparative work, with feedback about the range of practice. While the team does not consider it to be the role of the supervisor to set “absolute standards,” it is clearly good supervisory practice to provide comments on relative weaknesses and strengths and, by doing so, to promote higher standards in individual institutions. Over time, this will improve the entire system.
- With the regular (five year) rotation of both EICs and LEs, there should be consideration of appropriate “staggering” of the rotations to avoid coincident turnover of key staff who are supervising an individual institution.

International Practice

Like the OCC, foreign supervisors have found that as the financial sector has become more complex, there is tremendous benefit from having additional industry expertise on specific risk areas. Not only are risk specialists able to more readily identify risky practices in the institutions but they may also have more credibility because of their understanding of industry wide activities.

Foreign supervisors have found immense value from periodically rotating supervisors across institutions so that experiences gained supervising one institution can be applied to another. Such a rotation program needs to be designed carefully so that at any given time, there is always a core team of dedicated examiners that understand the institution.

The value of such rotation is both for individual institution supervision but also to promote more consistency across the industry, which can be an important component of gradually raising industry-wide standards.

Supervisory training and certification of examiners at the foreign agencies is not as formal as at the OCC. Examiner authority is geared to a combination of seniority and performance. None of the agencies represented on the team has a certification program similar to the NBE/FTR.

Rotation programs at all of the agencies include all supervisory staff. Supervisors are encouraged to move between safety and soundness examinations of individual institutions and risk areas (e.g., capital markets) and to have input into supervisory policy.

Recommendations

Ensure an ongoing focus on the staffing and Human Resource strategies set out in the Strategic Plan.

These strategies are essential to ensuring the OCC has suitable staff for its ongoing operations going forward.

Expand the use of employment programs to retain qualified retirement-eligible staff on a part-time basis as mentors for incoming staff and to supplement temporary shortages of staff.

This would assist in ensuring that the expertise and supervisory culture of the current staff is not lost over a short period and can be imparted to the next generation.

Relocate examiners that are resident in commercial banks to common OCC premises. While the “resident examiner program” facilitates access to institution management and information systems, it should be continued on a much smaller scale. In select instances, moving resident examiners to a common OCC premises may not be feasible because there is no critical mass of other OCC staff in the same geographical area.

Combining LBS staff in the field in common space along with MCBS staff will:

- strengthen a “one OCC culture,”
- ensure better communication among examination teams, across risk expert areas, and between LBS and MCBS,
- allow more flexible resource management, and
- strengthen the external perception of OCC independence from institutions.

Establish a formal rotation process for all examination staff.

This will provide examination staff with a richer and more diverse set of experiences. It will also provide them with a greater capacity for comparisons among institutions. Over time this will enhance the OCC’s capacity to increase the overall standards of supervised institutions and the industry as a whole. Where there are structural exceptions (e.g., small regional offices), appropriate alternatives should be examined.

Consider alternative career development and examination structures for a new work force environment in which the OCC may not have the benefit of lifetime career examiners because of changing demographics and a tendency of more recent college graduates to change employers more routinely.

The model of bringing college graduates into the OCC, training them to be examiners, and then having them spend their professional career at the OCC may not be reliable going forward. Newer generations may expect to have multiple jobs over their career. At the same time, mid-career industry hires, with significant experience, may not need the entire intensive examiner education program that is required of younger, less experienced staff.

Coordinate EIC turnover with that of LEs.

To the extent possible, sequence the rotation of senior examiners assigned to an institution to assist in providing appropriate continuity of knowledge of individual institutions.

V. Supervisory Methodology

Objective

In recent years, significant developments in the global financial services industry have changed the nature of the risks and risk management of financial institutions. For example, product sophistication has increased, globalization has caused risks to become more systemic and interconnected, and institutions have experienced multiple and severe stresses to their solvency and liquidity. In response, international standards and requirements for supervising institutions have been strengthened.

In order to meet the increasing challenges of keeping pace with the changes in the environment, supervisors must not only maintain but also continually adapt their risk-based supervisory methodologies to be as dynamic and forward-looking as possible. This is necessary to ensure supervisors maintain their ability to respond effectively and in a timely manner to changes in their domestic and international financial sectors, now and in the future.

What the OCC Is Doing

The OCC uses a dual approach in assessing the risk profiles of its institutions: CAMELS and RAS. RAS is used in conjunction with CAMELS to identify current and prospective risks. While CAMELS provides a point in time assessment of risks, RAS provides a much more forward-looking assessment of risks.

The internal guidance on supervisory expectations is well documented in the *Comptroller's Handbook*. While the approach for supervising midsize and community banks seems to be more prescriptive, the framework for supervising large banks introduced in recent years is principles-based and non-prescriptive, which allows more flexibility to exercise judgment.

MCBS has implemented a robust process of quality assurance throughout the supervisory cycle, which promotes consistency of application.

Areas Identified for Improvement

RAS: This system, which has tremendous potential in terms of providing a more forward-looking view of risk, is focused on categories of risk across the institution rather than according to business lines, which is the focus of management. The fact that the assessment is segmented by risk category limits the ability of the examiner to really understand the nature of the risk by business activity. In addition, such segmentation may make it difficult to determine who in the institution is accountable for the remediation of the issues.

CAMELS is not forward looking: While the OCC communicates its views on risk using both CAMELS and RAS, CAMELS remains the primary means to communicate the OCC's risk ratings to institutions. Although the OCC has tried, it remains a challenge to incorporate more-forward-looking elements into CAMELS. In part this is because an interagency process defines CAMELS. The assessment objectives of RAS and CAMELS differ and this may result in conflicting assessments.

Inconsistent intervention in LBS: The non-prescriptive principles-based approach adopted for LBS provides more latitude to exercise judgment, but it also creates a challenge in terms of ensuring an appropriate level of consistency. There is no minimum set of prescribed procedures to guide large bank examiners. In addition, the formal internal quality control process and the quality assurance process in LBS are after the fact. In its conversations with institutions, the review team was informed that supervisory intervention was inconsistent between examination teams. While such complaints are heard in many jurisdictions, it is important to have processes in place that minimize actual occurrences of such inconsistencies.

One approach to fostering greater consistency is through a formal review process. Such a process does not appear to be routinely followed in LBS whereby all of the LBS EICs present and defend their large institution supervisory strategies and supervisory ratings on an annual basis.

Senior management engagement: The process of when and whether to engage senior OCC management in the decision process of strategic and material supervisory issues, such as major acquisitions by institutions, is not clearly defined. Developing guidelines and a process so it is clear when it is appropriate for strategic OCC senior management input into material supervisory issues would be an advantage.

MRA follow-up: The level of MRAs outstanding in LBS has shown a constant and significant increase since 2005. The identification of weaknesses is important, but the follow-up and resolution of such findings is equally if not more important. In addition to monitoring MRAs that are outstanding, there needs to be a focus on the quality and robustness of the follow-ups in order to ensure timely and effective remediation.

International Practice

The team noted that there are a variety of supervisory approaches taken by regulators, each with its own merits. Over time each of the agencies has initiated global benchmarking exercises of their methodology.

The supervisory frameworks used by supervisors in Canada and Singapore are based on the assessment of risk by significant activity. A significant activity is a line of business, unit, or process that is fundamental to the regulated financial institution's business model and its ability to meet its overall business objectives. This approach facilitates a close alignment between the assessment of the bank and the bank's management of its risks, and it facilitates the use of the bank's information and risk analysis. This approach also allows flexibility in the peer review process for ratings such that banks can be grouped by size or complexity or by significant business lines.

In Australia, the supervisor adopts a rather different approach, similar (in principle) to that of the OCC. The overall risk assessment is by risk type, rather than by significant activity. However, APRA does undertake business line (or sub-business line) supervisory assessments where assessed as appropriate on a risk basis and provides specific feedback on weaknesses identified at each level of the business line.

Recommendations

> The OCC should conduct a benchmarking review of its supervisory framework in comparison to international peers.

Many developed countries have moved away from CAMELS ratings and adopted more forward-looking supervisory approaches.

> The OCC should consider the feasibility of either developing alternatives to CAMELS or, if this is not a feasible option under the statutes, the OCC should work with the other agencies to prioritize the incorporation of more forward-looking elements into the CAMELS rating system to closely align it with the RAS.

> LBS should implement a robust review process that includes both LBS EICs as well as LEs (referenced earlier) to scrutinize supervisory strategies and supervisory ratings of large banks.

Such a process would provide greater consistency in the supervisory approach and supervisory assessments across institutions. In addition, it would be helpful in assessing the individual EICs' level of overall understanding of the risk profile and activities of the institution for which they are responsible.

> Develop a process to clarify when strategic supervisory issues (e.g., mergers and acquisitions, intervention actions) need to be escalated to senior management (e.g., MMSRC). The protocol should include examples of situations and also suggest what strategic outcomes are sought.

> OCC should undertake an analysis of the effectiveness of the MRA process and consider developing controls to better manage the MRA follow-up process to promote more timely and consistent resolution of identified deficiencies by the institutions.

Systems to track the aging and progress to resolution of MRAs would provide greater consistency and more timely closure. Ensuring that MRAs continue to be an effective tool should be a high priority.

A process should be established to bring an OCC strategic view to material supervision matters, such as major acquisitions or horizontal reviews arising from emerging risk identified via the NRC processes.[7]

VI. Enterprise Governance

Objective

In order to ensure an effective and consistent application of their supervisory framework, regulatory agencies must develop and implement a robust quality assurance framework.

What the OCC Is Doing

Enhancements to enterprise governance: The OCC has recently elevated the stature of the enterprise governance function and created an independent quality assurance process to review the processes and practices of the supervision divisions.

Quality assurance in MCBS: All business units are required to implement an internal, ongoing quality assurance process. This process has already been implemented in MCBS and seems very effective. For example, MCBS has implemented a Lead Experts' review process. As part of this process, the LEs review all supervisory strategies, supervisory letters, and supervisory documentation.

LBS Lean Six Sigma initiative: LBS has recently commenced a Lean Six Sigma project in order to enhance the efficiency of its internal processes. The review team notes that this initiative, which is currently at the "development" stage, is very worthwhile and should be pursued.

Areas Identified for Improvement

LBS' quality assurance program is not as effective as it could be. It is essentially an after-the-fact process. Moreover, it has not historically been given a high profile, and in the past, it has not influenced supervisory planning or examination outputs. The program in LBS is less developed and less robust than the corresponding process in the MCBS unit. Incorporating the positive features of the MCBS approach would be a relatively easy way to enhance the LBS program.

LBS devotes large teams of dedicated examiners to the major large banks. The Supervisory Intensity and Effectiveness (SIE) working group under the FSB has grappled with the issue of the optimal number of dedicated examiners for large complex institutions. Among the G-20 countries, current practice ranges from a low of less than 10 dedicated examiners to over 100 dedicated examiners (from the OCC, Fed, and FDIC in combination) in some U.S. banks. There is no evidence from the International Monetary Fund's Financial Sector Assessment program or

[7] This process might be achieved, for example, by expanding the brief of the Major Matters Supervision Review Committee beyond its current limited scope for enforcement actions.

the work of the SIE that demonstrates that above some minimal staffing level, supervisory effectiveness increases in direct proportion to the number of examiners assigned to a bank. The review, therefore, of the effectiveness of the current configuration of dedicated examiners within the LBS program has much merit. In a resource-constrained environment, it is important to understand how resources are being utilized.

The recent enhancement of the OCC wide Enterprise Governance (EG) unit is another positive step to improving the effectiveness of the OCC. It will be important that the unit is staffed appropriately and that there is continued agency support at the senior management level for building a robust system. The team notes that the brief for the unit, as set out in the OCC's 2012-16 Strategic Plan, directs that for each OCC department, the EG unit:

- document the department's goals and objectives and related measures;
- document the processes and systems the department uses to measure and monitor achievement of the goals and objectives;
- verify that structured and unstructured quality management activities are completed; and
- document the department's assessment as to whether each goal and objective was effectively achieved.

The team considers it important that the EG unit commence its work on documenting departmental goals, objectives, and related measures, etc., as soon as possible and not wait until departments develop their approaches further. Having an initial assessment of current practices will enable strong and robust practices to be identified and allow the OCC as a whole to decide what practices it wishes to have in place consistently across all departments (i.e., "top down") and whether there are other areas of practice that should be department specific (i.e., "bottom up").

International Practice

Supervisors in Australia, Canada and Singapore introduce quality assurance at various levels. Accountability for file and supervisory reviews would normally be formalized by delegation of authority and performed by the examination chain of command. In addition, an institutionalized quality assurance process allows work to be conducted on all areas of supervision and is a powerful aid in ensuring a level of uniformity in the application of the supervisory framework.

All three of the foreign agencies also have independent internal audit functions. In all cases the internal audit function has a dual reporting line: an administrative report to the head or deputy head of the agency and a reporting line to an audit committee. The audit committees are comprised of a majority of independent members.

A further good practice is to implement an internal panel (or "peer") review process by which supervisors can present various cases to obtain peer supervisor feedback. Such a process may be either binding or non-binding and is a good mechanism to obtain feedback from peers and provide a learning experience for attendees of the panel. A wide range of topics can be discussed during the panels, such as intervention, application of the supervisory framework, matrix ratings, and specific risks.

At one of the agencies there is a regular process of presenting supervisory action plans to senior (non-supervision) staff. This is not aimed at ‘second guessing’ the decisions made or future supervision plans but is a key communication process across all levels of the agency. It serves to increase the understanding of the non-supervision staff of the direct supervisory challenges and allows an opportunity for supervision staff to have a dialogue with senior non-supervision staff about broader strategic imperatives facing the agency.

Recommendations

Complete LBS’ Lean Six Sigma process. Findings from this exercise should be shared with MCBS.

Commence work by the EG unit on documentation as soon as possible to identify current practices and allow the OCC to determine the standard and consistency of practices it wishes to put in place across the agency.

Conclusions

The OCC is one of the oldest supervisory agencies in the world and has a well-deserved reputation for having a high quality and professional supervisory staff. The team appreciated the opportunity to undertake a review of the supervisory effectiveness of the OCC’s supervision of midsize and large banks and thrift associations. The team found OCC staff members to be open, candid, and cooperative.

A number of initiatives were presented to the team that are currently under way or planned at the OCC. It is the team’s view that if these initiatives are implemented effectively across the agency, they will be of long-term benefit. Based on their experience, the team has recommended additional steps the OCC take to improve the quality of OCC supervision and believes that many of these steps could be taken as part of the initiatives already planned or underway.