PROMONTORY

Remarks by

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# Supervision in a Time of Change

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I am truly honored by the opportunity to take part in today's event. After several years of interacting with C-LEAF and Professor Wilmarth, I have come to expect some remarkable, even humbling gatherings in this auditorium. I was last here in May for the announcement of the Volcker Scholar Awards, and saw Don Kohn interview Chairman Volcker on the direction of monetary policy and financial reform. Today, with Chairman Gensler and Vice-Chairman Hoenig on the agenda, I think it's fair to say Art is batting a thousand. The involvement of such senior policymakers and respected thinkers is a testament to GW's primary commitment: to foster dialogue and learning on the most pressing issues of the public good. I am very grateful for the opportunity to take part.

The road to recovery since 2008 has been long, not only economically, but institutionally. Financial institutions have been adjusting to new and evolving rules and regulatory expectations, and doing so in an uncertain financial landscape. The scale of the reform movement is vast. As with every major social and regulatory reform process of the last century, the early steps are some of the hardest to take, and they often require corrections.

Our learning curve since the financial crisis has been steep, but not because the lessons of the crisis are hard to identify. Unregulated institutions can do great harm to regulated ones. Dark markets are dangerous markets, especially when they give rise to misaligned incentives. Regulatory arbitrage is the enemy of stability.

What has been harder to achieve is balanced implementation—turning the negatives of the financial crisis into affirmative steps that institutions and the public sector alike can follow. This is a much harder task than the public understands, and regulators are wise to take time and care to get the rules right. Financial activity is as important as it is complex; it is the circulatory system of an economy, and it can bring vibrancy and prosperity to the country's most neglected communities. To work well, it needs balanced regulation, which fosters the extension of safe financial services while protecting those who use them.

The process of creating those regulations is meticulous and lengthy. But the length of the process itself creates uncertainty. Business does not stop in the midst of this uncertainty, and a gap often forms between evolving practice and the formal regulatory rulebook.

There is one tool that helps fill this gap between rules and reality. It is one that my old agency, the Office of the Comptroller of the Currency, has put at the center of its work for 150 years: supervision.

Supervision is vital to financial oversight during the best of times. It fills the gap between regulation and enforcement, by giving a close, candid view of the health of financial institutions. It bridges the theoretical with the practical, and at its best, it can add the balance and nuance that prolix rulemakings often lack. It is possible to practice it poorly, but done right, it can be the ultimate early warning signal for systemic risk.

Supervision also plays a special role when markets shift and expectations begin to change. That is due to its greatest value: nimbleness. Supervision can respond to changing circumstances faster than Congress, and faster than it takes to draft and approve a new rule. It can convert the facts on the ground into actionable counsel, steering banks to safe waters before the storm arrives, and providing an early view of trends across the regulated sector. When the rulebook is in flux—as it is today—supervision is the system's last best line of defense.

The burden on supervision may be greater today than it has ever been.

- In many areas, the formal requirements of Dodd-Frank have become expected practice for financial institutions. Take, for example, the Volcker Rule, which is not yet finalized, but has led banks to shutter proprietary trading desks and scale back market-making activity.

- Supervisors are also responsible for a wider and wider set of risks, including, of course, market risk, credit risk, enterprise risk, and operations risk, but also areas that arguably encompass all of these and more, like systemic and reputation risk.

But most importantly, supervision received far less attention in financial reform than did other areas of financial oversight. Supervisors do have new tools to look at an institution from a greater distance, like regulatory stress testing and a more robust set of capital and liquidity ratios. But these are indicators which are only as good as the information that feeds into them. That information relies on robust systems and competent management—something that only supervisors can verify through the exam process and other ground-level work.

In short, supervision faces a difficult landscape, with heightened public scrutiny, a still-unsettled rulebook, and a growing set of risks to address. And meanwhile, another crisis is waiting—as it always does—just around the bend.

The question, then, is how supervisors and the regulatory agencies can handle this rugged terrain.

The first answer, I believe, is a renewed focus on quality at all levels, from examiners to agency directors. A concern for quality led me to introduce the government's first regulatory ombudsman program at the OCC, which offered an appeals mechanism for anyone who thought a mistake had been made. "Escape valves" like these are vital when demands are high and rules are unsettled. To this end, the OCC's recent decision to apply examination techniques to its own operations shows bold leadership, and Comptroller Curry should be applauded for making it.

The second answer is consistency. Good regulatory systems foster and reward good behavior, while identifying, deterring, and correcting bad behavior. But an institution can only hit the targets it sees and understands. When the rulemaking process is delayed, yet standards are being raised and expectations being set, it is more important than ever to provide clear, detailed, and achievable expectations for every player on the field. This is particularly true for community banks, which often feel the costs of shifting compliance requirements more heavily than their larger peers.

This, of course, means clear coordination and communication between supervisory teams, as well as with the public. But it also means coordination between different parts of the regulatory agencies. Again, research has an important role to play here. For too long, agency economists were kept away from the supervisory process, and valuable insight went unheeded. The academic talent at these agencies is astounding, and their work can be a guidepost to the areas of greatest concern for bank safety and the health of the sector.

Importantly, regulators should recognize that the new tools at their disposal are merely a means to an end. Regulation can only reach its full potential with the first-hand look and careful guidance that supervision and examination offer. The new focus on systemic risk does demand new instruments and indicators. But we ignore prudential supervision at our own peril.

History—and not distant history—shows that institutional and systemic risks go side-by-side. They are not as separate as they seem; either one can precipitate the other. We first see system-wide problems at individual banks, and even a trend at small- and mid-size institutions can create havoc. As I said, this is one lesson that has been inadequately reflected in financial reform, as supervision is still neither fully appreciated nor fully understood.

That lack of appreciation is deeply unfortunate, but it does not diminish supervisors' importance. American banking supervision has a legacy of unsung victories and crises averted, and a strong track record of institutional stability. The challenges of the moment are great, and they are almost certain to grow. But supervision, guided by strong leadership and an equally strong supervisory corps, has a vital role in addressing them.

Thank you for your time. I will be happy to answer any questions you have.

**About Gene Ludwig**

*As CEO of a premier strategy, risk management, regulatory, and compliance consulting firm, Gene Ludwig is a trusted adviser to the world's leading financial companies. He is recognized as a farsighted thinker on the most pressing issues confronting financial services. Before founding Promontory, Gene served under President Clinton as Comptroller of the Currency, head of the agency responsible for supervising the preponderance of U.S. banking assets. He later became Vice Chairman and Senior Control Officer of Bankers Trust/Deutsche Bank. A former partner in the law firm Covington & Burling, Gene earned degrees from Haverford College, Oxford University, and Yale Law School.*

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Promontory Financial Group helps companies and governments around the world manage complex risks and meet their greatest regulatory challenges with integrity and quality. We are the world's foremost experts in financial risk, regulation, and compliance. Our work makes our clients stronger and the financial system safer for consumers.

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