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FRB F-6 Task Force on Supervisory Staff Competencies Compensation and Coordination

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[1] John Mingo retired from the Federal Reserve System in June 1999 and, accordingly, did not participate in the preparation of this paper. The Task Force, however, wishes to recognize John for his invaluable contributions during the early stages of this project.

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EXECUTIVE SUMMARY

The F-6 Task Force on Staff Supervisory Competencies, Compensation, and Coordination (Task Force) has concluded that the most effective way for the Federal Reserve System (System) to address the challenges posed by the changes in the banking and financial services industry is to retain and refocus the System's decentralized approach to bank supervision. Consistency and efficiency must be improved, but not at the expense of effectiveness. Further, large complex banking organizations (LCBOs) pose a higher degree of systemic risk, and district supervision remains the best guarantor of safety and soundness. Although consolidation of LCBO supervision would address LCBO resource coordination and deployment issues, the System would lose the established relationships and the benefits resulting from those relationships, between Reserve Bank Presidents and the executive management of LCBOs headquartered in their districts. This has been a cornerstone of the System's supervisory program and has distinguished it from other federal agency supervisory programs. The status quo, however, will not be sufficient; important changes are necessary. In particular, the System must:

- achieve more consistent Systemwide implementation of the new LCBO supervision program (LCBO Program);[1]

- assess more effectively the risks posed by LCBOs individually, and collectively by lines of business;

[1] SR 99-15 provides System requirements for risk-focused supervision of LCBOs.

- improve its performance in attracting, retaining, and developing highly skilled supervisory staff required for LCBO supervision;

- better deploy supervisory staff resources; and

- overcome constraints presented by a lack of a critical mass of LCBOs in most Reserve Bank districts.

To achieve these goals, the Task Force recommends:

Program Enhancements

1. Developing Competency Centers.
2. Reviewing and coordinating existing and proposed horizontal structures.[2]
3. Establishing a continuing professional development program.
4. Developing job rotation and Systemwide posting programs.

Use of Outside Resources

5. Using internal consultants.
6. Broadening collaboration with external auditors.
7. Hiring external consultants.

Modified Performance Evaluation System

8. Enhancing feedback processes and aligning incentives.

[2] The term "horizontal structures" refers to a variety of exercises or processes where the goal is to broaden knowledge and/or facilitate resource allocation, while reviewing a specialty area or issue across several key institutions. Examples of horizontal structures include Coordinated Supervisory Exercises (CSEs), the Committee on Nonbank Financial Institutions (CONFI), and examiner pooling programs. Appendix G contains a list and description of the existing horizontal structures.

Enhanced Coordination

9. Enhancing the role of the Strategic Plan Steering Committee (Steering Committee).
10. Hiring an LCBO Resource Coordinator for those Reserve Banks without a critical mass of LCBOs.

MISSION AND METHODOLOGY

The Task Force was formed to address three issues related to bank supervision.[3] The Task Force was asked to:

- assess the kinds of supervisory skills needed to keep pace with ongoing and projected changes in the structure of banking and financial services,
- determine whether, and to what extent, the System's compensation system requires modifications to reflect changing needs, and
- review the best way to carry out the System's supervisory programs, focusing specifically on how the System might deploy, coordinate, organize, and allocate its examiner resources given its corporate structure.[4]

[3] The Task Force focused on the supervision of the LCBOs because they pose the greatest degree of systemic risk inherent in the U.S. banking system. Further, the Task Force limited its review to safety and soundness supervision. It did not review the supervisory resources required by the consumer affairs examination program because the consumer affairs function reports to a different oversight committee of the Board of Governors. The Task Force recognizes, however, that many of its recommendations may be applicable both to the consumer affairs program and to the safety and soundness community bank supervision program.

[4] The Task Force recommendations propose the development of a process that will identify and deploy existing resources more effectively across the System, and will identify and develop strategies to close gaps in skills on an ongoing basis. The recommendations do not include hiring a specific number of specialists at this time because the Task Force believes the System cannot accurately identify resource needs until it

The Task Force took several steps to understand and address these issues. First, the Task Force gathered information from and solicited the views of examiners, management, and the industry to understand better the challenges the System faces as a result of changes in the banking system.

Second, the Task Force obtained benchmarking information from the United Kingdom Financial Services Authority, Office of the Comptroller of the Currency, Office of Thrift Supervision, and State of Minnesota. The Task Force reviewed how these agencies have used external resources to supplement their internal staff resources.

The Task Force additionally researched how other companies and industries (beyond other federal and state regulatory agencies) are addressing the need for additional highly skilled resources. An increasingly popular strategic move is to enhance a company's knowledge base by participation in strategic alliances.[5]

Finally, the Task Force reviewed prior System studies, papers, and SR and AD letters concerning staff skills, compensation, and coordination.[6]

TASK FORCE FINDINGS

Achieve More Consistent Systemwide Implementation of the LCBO Supervision Program

The System's new LCBO Program requires continuous supervision of LCBOs using dedicated supervisory teams, supplemented with specialists. The LCBO Program

develops this process. Moreover, the Task Force recognizes that, notwithstanding the significant strides many Reserve Banks have made in addressing compensation, it remains a significant issue. However, the strategies the System should take toward compensation will depend upon decisions made on other Task Force recommendations.

[5] A bibliography of the literature reviewed is at Appendix E.

emphasizes the analysis of peers and the evaluation of each LCBO in the context of a national portfolio of institutions.

Historically, Reserve Banks have implemented and managed supervisory programs independently and have generally used local supervisory staff for examinations. While this approach has worked well in the past, it will likely be ineffective in the future given the size, complexity, and geographic dispersion of LCBOs. Staffing on a national, versus district, basis is in line with the objectives of the LCBO Program and facilitates a consistent examination philosophy. A national approach provides a common understanding of sound practices and emerging risks as well as enabling institutions to be assessed relative to peers and as part of a national portfolio.

Assess More Effectively the Risks Posed by LCBOs Individually, and Collectively by Lines of Business

The portfolio approach envisioned in the LCBO Program involves integrating with the strong individual institution's risk-based supervisory program, evaluations of banking practices among LCBOs having similar business lines, characteristics, and risk profiles. To understand an LCBO's business and its risks better, an examiner needs to compare the LCBO with other organizations involved in similar business lines with similar risks. Moreover, examiners cannot effectively assess the condition of an LCBO in isolation from that of its peers. Information on the industry, current sound practices, and emerging supervisory issues will provide an important perspective, although examiners will have to exercise judgment in applying industry standards to any given institution and always recognize that consistency with prevailing industry standards may not be sufficient to ensure sound operations.

[6] A complete list of these materials is included at Appendix F.

Improve Its Performance in Attracting, Retaining, and Developing LCBO Supervisory Staff Required for LCBO Supervision

The System faces four challenges in attracting and retaining highly skilled supervisory staff. First, the System cannot compete with the salaries paid to experts by private industry. For example, data reviewed by the Task Force indicates that the industry pays an average of $160,000 total cash compensation for a credit risk management expert, while the System pays an average of $92,000 for its most senior examiners.[7] Second, the System does not generally have clearly defined career paths for professionals that include ongoing development opportunities in their areas of expertise. Third, some Reserve Banks may have difficulty providing highly skilled staff with challenging assignments. As noted below, most Reserve Banks have only a few LCBOs in their districts, limiting their ability to offer a broad range of examination assignments through which staff can apply and develop expertise in a national context. Fourth, the System cannot assume that career employees will continue to be available to carry out present and future supervision responsibilities. Some Reserve Banks have noted an increase in turnover among assistant and more junior commissioned examiners. It is not certain that the System can retain sufficient career staff to be available to develop into tomorrow's LCBO staff. Studies also indicate that employees today have less company loyalty than in the past.

The System's existing supervisory staff must continue to develop its depth of knowledge to keep pace with LCBOs' increasing level of sophistication and complexity. Examiners are constantly challenged to understand not only emerging issues, but also the innovative products and services produced by LCBOs. Further, technology advancements enable LCBOs to develop these new products and services quickly, thereby heightening the challenge for examiners.

[7] The $92,000 amount is the weighted mean average base salary for the System's most senior examiners and does not include benefits.

The type of knowledge and skills required for supervision also is evolving. With risk-focused supervision, examiners no longer can rely on completing standard procedures, but are required to conduct more unstructured analyses relying more heavily on a higher level of analytical skills and judgment. Additionally, the central points of contact (CPCs) who lead the LCBO supervisory teams need greater planning, multi-tasking, and project management skills in addition to strong technical skills. CPCs need to be able to manage a supervisory team and interact well with LCBO management and staff.

Better Deploy Supervisory Staff Resources

The System's existing resources are not always devoted to the right LCBO or issues at the right time. While the System has implemented some formal pooling arrangements (e.g., the Section 20 pooling program) and Reserve Banks have informally shared staff, these arrangements may not be adequate for the level of coordination required by the LCBO Program. Given the risks posed by LCBOs, the System has to deploy examination resources rationally so that the higher-risk institutions and issues receive the highest level of supervision, prioritized on a national versus district basis.

Overcome Constraints Presented by a Lack of a Critical Mass of LCBOs in Most Reserve Bank Districts

For Reserve Banks that have a relatively small number of LCBOs, the above challenges are even greater. It will be more difficult for these districts to assess their institutions relative to industry peers and sound practices. These Reserve Banks will also have fewer in-district development opportunities for staff. In addition, it will be more difficult for these Reserve Banks to hire needed expertise, particularly if the Reserve Bank does not have sufficient specialty work to justify hiring one full-time expert.

RECOMMENDATIONS

The Task Force is proposing enhancements to the LCBO Program, greater use of external resources, modifications to the performance evaluation system, and enhanced coordination mechanisms to address the challenges discussed above.

Program Enhancements

The System currently has a range of programs that provide opportunities for staff to receive and provide training, participate in System groups, and collaborate with others within the System. However, the Task Force believes that additional opportunities are needed to allow for more focus on specialty areas and to develop expert knowledge in topics not included in the existing programs. Four of the ten Task Force recommendations involve program enhancements.

1. Develop Competency Centers

In recent years, the System has had success in using "horizontal structures" to enhance supervision by providing reviews of specialty topics among organizations. The Task Force recommends that the System develop a new kind of horizontal structure, Competency Centers (CCs), to strengthen LCBO supervision and address skill needs in selected highly specialized areas (e.g., credit risk modeling) not being met by existing structures. CCs would consist of the System's best experts on a particular subject matter, including supervisory personnel who are responsible for supervising LCBOs, individuals from other functional areas in the System who do not necessarily have examination experience,[8] and industry and other experts from outside the System.[9] CCs would report to the appropriate subcommittee of the Steering Committee based on the nature of the

[8] See recommendation 1 and discussion at pages 35 through 41.
[9] See recommendations 5, 6, and 7, and discussion at pages 54 through 66.

CC. For example, a CC devoted to addressing an issue related solely to LCBOs would report to a reconstituted Global Complex Banking Subcommittee of the Steering Committee.[10] A Reserve Bank or Board staff would administer each CC, including distribution of information developed by the CC to all Reserve Banks and Board staff.

CCs would provide for greater consistency and quality of LCBO supervision in several ways. First, CCs would help attract and develop supervisory staff by providing them with opportunities to enhance and share their expert knowledge through participation in a System group devoted to a specialty area. Second, CCs would facilitate better deployment of resources by ensuring maximum and efficient use of specialty talent, including identification and development of required skills. Finally, CCs would coordinate assessments across LCBOs through the ongoing development, maintenance and dissemination of cutting edge practices (including "sound practices") of LCBOs, and the evolution of financial markets in a given specialty area.

There are several possible specialty areas and activities where a strengthened horizontal approach might benefit LCBO supervision efforts. Pages 39 and 40 of this report provide criteria that could be considered in selecting which specialty areas to cover. The Task Force members believe that the number of CCs should be limited to no more than two or three specialty areas. Further, the initial CCs should relate to specialty areas involving LCBOs. Once the System has gained experience with developing and implementing CCs, it can determine whether to invest in a greater number of these structures.

2. Review and Coordinate Existing and Proposed Horizontal Structures

[10] In August 1999, the Subcommittee Chairs began reviewing whether the existing subcommittees meet the needs of the supervision function. The Chairs determined that the following subcommittees would be required: large complex financial institutions, regional and community bank supervision, policy development, information technology, and staff development. The Steering Committee is scheduled to meet in October 1999 to consider the Subcommittee Chairs' recommendations.

As noted above, the System already has a number of horizontal structures in place. Accordingly, before adding CCs, the Task Force recommends that the System review the responsibilities of the various structures to determine whether any of these initiatives should be combined, eliminated, or modified.[11] The goal of this review is to avoid redundancies, address any gaps, and ensure that the most effective approach is being used in any given situation.

3. Establish a Continuing Professional Development Program

The Task Force recommends that the supervision function establish a continuing professional development (CPD) program[12] for LCBO supervisory staff.[13] Such a program would provide LCBO staff with diverse training and development opportunities to maintain, broaden, and deepen supervisory skills. Development opportunities might consist of classroom training, seminars, conferences, work assignments, teaching assignments, or mentoring opportunities.

The Task Force recognizes that an effective CPD program will need to be developed and administered on a local basis by each Reserve Bank as part of each Reserve Bank's overall human resources management program. Further, development plans must be

[11] In August 1999, System personnel responsible for many of the existing horizontal structures began such a review at the request of the Director of the Division of Banking Supervision and Regulation.

[12] The Core Curriculum Review Group's *Draft Continuing Professional Development Proposal* (CPD Proposal), July 1999, provides additional information concerning CPD programs.

[13] The Task Force Report focuses on hiring and staffing for critical specialized skills. Task Force members noted, however, that bank supervision departments of Reserve Banks traditionally have hired and trained almost all professional and managerial staff to be commissioned examiners. Using this single filter may not be necessary or efficient if, for example, some of the process of examination and supervision relies on information gathering and analysis requiring specialty skills rather than the broad skills of commissioned examiners. Accordingly, specialist career paths could be established. In addition, the System should recognize that many college graduates joining bank supervision departments do so with the expectation of leaving to pursue graduate degrees. The System may realize additional flexibility in hiring and staffing practices, as well as some personnel cost savings, by creating a limited track in Reserve Banks for the equivalent of research assistants as used in Reserve Bank Research Departments. For example, these jobs might be designed to have no intended long-run career path and involve lower training expenditures by recognizing the expected duration of their time with the System.

created and tailored to each examiner's needs.[14] Thus, no one CPD opportunity will meet every LCBO staff's development needs. However, the Task Force believes that development opportunities that expose examiners to industry developments and practices would be particularly effective and appropriate for LCBO supervisory staff. LCBO staff would benefit from opportunities to attend industry conferences and to participate in industry immersion programs. Under immersion programs, an individual is given an opportunity to work side-by-side with industry experts to learn about the industry, specific products, and activities. For example, staff assigned to Section 20 companies could benefit from working with traders at a broker/dealer firm.

The Task Force also recommends that one particular CPD opportunity—rotation—be implemented and offered nationally. For LCBO supervisory staff development, in-district rotation or other job assignments will not always suffice. As emphasized above, the System needs to provide LCBO staff with opportunities that expose them to organizations outside their district so they can develop a sense for overall industry risks and sound practices. The System would also benefit from a national rotation program because such a program could be used to fill key positions across the System.

4. Develop Job Rotation and Systemwide Posting Programs

The Task Force recommends that the supervision function establish a national job rotation program supported by a Systemwide posting program.

Job Rotation Program

A job rotation program would facilitate more frequent sharing of resources among Reserve Banks and Board staff, help build perspective, and develop depth of expertise. Participation in a rotation program would be an important factor to consider when

[14] See the CPD Proposal for more information on development plans.

appointing staff to senior supervisory positions at Reserve Banks and Board staff. The program could cover a range of work arrangements, including:

- **Short-term rotations**. An annual program of short-term rotations among Reserve Banks and Board staff could be used to broaden the perspective of high-potential staff, to develop a better horizontal view of LCBO risk management practices, and to strengthen relationships.

- **Rotations for ad hoc projects**. Short-term rotations among Reserve Banks and Board staff could be used for ad hoc projects, such as reviewing and evaluating a particular market development or event.

- **Long-term rotations**. Longer-term (two to three year) rotations could be established to upgrade the breadth and depth of staff's experience and to fill a critical need at a Reserve Bank or Board staff (e.g., CPC position where permanent placement is not possible or desirable).

- **Permanent relocations**. Permanent relocations could facilitate the deployment of supervisory staff to different Reserve Banks or Board staff in line with System priorities.

Systemwide Posting Program

The Task Force recommends that the System adopt Systemwide posting to facilitate permanent relocations and long-term rotational assignments. A posting program would make it easier for staff to find out about and apply for these assignments. The types of positions that should be considered for posting should include at least CPC positions and

CC technical staff. Further, the System should consider using a web site to post these positions.

<u>**Considerations for Implementing Job Rotation and Systemwide Posting Programs**</u>

The Task Force recommends the review of current reimbursement policies associated with relocations and rotations to provide management greater flexibility in structuring assignments and to reduce where possible the perceived impediments for individuals accepting such assignments. The proposed job rotation and posting programs will also require a commitment by senior management to promote the programs' advantages and to make appropriate use of their features. Senior management will need to instill confidence in these programs by supporting their value as a career enhancement tool and by encouraging staff to apply for postings.

Use of Outside Resources

The supervision function historically has met its resource requirements by hiring full-time staff. Relying totally on internal resources, however, will not be sufficient going forward. The rising cost and scarcity of certain expertise, coupled with the indirect costs of not having resources available, require that the supervision function consider using more outside resources. Three of the Task Force recommendations include greater use of outside resources to obtain expert knowledge.

5. Use Internal Consultants

The Task Force recommends that the supervision function use System experts (outside of banking supervision and regulation), where appropriate, to enhance existing knowledge and to address specialized or highly technical matters.[15] Technical expertise that might be used in the bank supervision process is available within the System in such diverse areas as research, priced services such as check and ACH, legal, and various support areas such as credit and payments system risk. These internal groups have knowledge of developing trends or issues in particular business lines or risk areas and may have ready access to information on the extent of the activities or exposures of individual institutions in various product lines.

Internal consultants currently are not used extensively within the System because of actual and perceived cultural differences, budget concerns, and confidentiality issues. The Task Force believes that these obstacles can and should be reduced and makes the following recommendations:

- **Recognize value provided by internal consultants**. The Governors and Presidents should recognize explicitly the valuable contributions that research and other policy units could make to enhance supervision. This should be done in ways that make clear that internal collaborative efforts are just as valuable as, and can provide a basis for, publishable research and other projects focused on specific objectives of the policy area.

- **Identify projects for collaboration**. Each Reserve Bank and Board staff should develop mechanisms or structures that would cut across departmental lines to bring together differing areas to work on specific projects of mutual benefit to participating departments.

[15] This recommendation is consistent with the supervision function's goal of maximizing the value of the System's multiple functions as outlined in the Board of Governors' Strategic Plan for Supervision and Regulation dated 1998-2002.

- **Include internal consultants in horizontal structures**. Each CSE team, CC,[16] or other unit engaged in the review of specialized activities should be expected to determine the value of input from designated representatives from other functional areas assigned to the specialized unit and make appropriate arrangements to secure their participation.

- **Inventory information concerning institutions**. Each Reserve Bank and Board staff should make an inventory of information available on individual institutions and the markets in which banks operate and share that inventory among its various departments, including bank supervision. Channels for sharing institution-specific information should then be established as appropriate.

6. Broaden Communication with External Auditors

The Task Force recommends that the System broaden its communication with outside auditors as a means to supplement existing resources and obtain expert knowledge. In many other countries, regulators are increasing their reliance on external auditors to meet their supervisory responsibilities. The Basle Committee has endorsed greater cooperation between external auditors and supervisors, and the American Institute of Certified Public Accountants continues to encourage regular communication between external auditors and bank examiners. Revisions in U.S. banking law have also drawn external auditors closer to the supervisory process. Supervisors are placing more reliance on internal risk management systems, including sophisticated risk measurement systems used by banks, to manage their businesses. External auditors have developed growing specialized

[16] See discussion beginning at page 35.

expertise in the review and assessment of management systems to identify, measure, and assess risk exposures. Accordingly, external auditors could provide valuable assistance in ensuring the quality of an institution's risk management system.

Supervisory staff as a whole is increasingly challenged to build the competency levels required to supervise LCBOs and assess their sophisticated systems. Given ongoing compensation constraints, the System will continually be hindered in effectively competing in the marketplace for high-end individuals who possess these competencies. The System needs to find ways to bring additional resources (beyond its own) to the supervisory process. Accordingly, the Task Force recommends that the System increase its communication with and reliance on external auditors as follows:

- **Greater Reliance on External Auditors' Reviews**. The System should consider placing increased obligations on banking organizations to ensure the integrity of their underlying models and systems and to obtain external validation of the processes used to review their risk management systems. External auditors could play a key role in validating the integrity of an institution's systems.

- **Increase Communication with External Auditors**. The System should broaden its communication with outside auditors by encouraging and identifying cross-training opportunities, such as exchange programs and interactive training sessions, for external auditors and examiners to improve each other's understanding of their respective objectives and procedures. The System should also develop guidance that encourages examiners and auditors to share auditing and supervisory plans for the purpose of coordinating activities.

7. Hire External Consultants

In addition to relying more heavily on resources from other areas of the System and on external auditors, the supervision function should expand its reliance on experts outside the System. The System may want to consider hiring experts from consulting, law, and accounting firms or academia to conduct research, work on ad-hoc projects, and participate in examinations as appropriate.

When hiring such outside expertise, the System will need to review conflict of interest issues and address concerns about external consultants' access to confidential supervisory information. In addition, hiring outside expertise can be costly. However, with respect to certain issues and projects, it might be more cost effective to hire the expertise than to attempt to maintain it internally. Moreover, the System might not be able to obtain this expertise in any other manner.

Modified Performance Evaluation System

8. Enhance Feedback Processes and Align Incentives

The recommendations discussed above are intended to facilitate implementation of a national program for the supervision of LCBOs, using resources from across the System. In order for many of the recommendations to be effective, Reserve Banks and Board staff will need to achieve a common understanding of the overall LCBO Program goals, will need to monitor progress towards reaching those goals, and will need to increase ongoing communication among Reserve Banks and Board staff. Accordingly, the Task Force recommends two changes to the current performance evaluation system.

Enhance Feedback

The Task Force recommends that the existing programs that provide performance feedback to Reserve Banks be enhanced and supplemented. These existing feedback mechanisms should facilitate peer reviews and sharing of sound practices. Separately, the Task Force recommends that mechanisms be developed to allow for two-way discussions between Reserve Bank and Board staff. In all instances, feedback and two-way discussions should be timely and candid. The Task Force is specifically recommending that periodic meetings be held between each Reserve Bank's Senior Officer in Charge of Supervision (Senior Officer) and the Board's Director of the Division of Banking Supervision and Regulation (Division Director).[17] The Task Force additionally recommends that the System conduct peer reviews of the LCBO Program across the System.

Align Incentives

The Task Force recommends that the System align the Reserve Bank performance measurement process to support the LCBO Program by having Board staff, in consultation with members of the Steering Committee,[18] develop performance measurement and evaluation standards, including a description of clear expectations for Reserve Banks. Currently, Reserve Banks are evaluated primarily on how effectively they are supervising entities in their own districts. If the supervision function is going to change its focus to a national perspective, the incentives must also change to encourage Reserve Banks to give a higher priority, at times, to organizations and issues outside their own districts.

[17] On July 28, 1999, the Division Director announced plans to hold face-to-face meetings with each Senior Officer (and one or two senior Reserve Bank supervision staff) and Board officials to discuss the Reserve Bank's performance including supervisory responsibilities, staffing, and resource utilization.

[18] The Steering Committee consists of 16 individuals including the 12 Senior Officers, the Director and Deputy Division Director of the Board's Division of Banking Supervision and Regulation, and the Director and Deputy Division Director of the Board's Division of Consumer and Community Affairs.

Enhanced Coordination

The program recommendations discussed above should enhance staff knowledge and skills, lead to a better assessment of the risks posed by LCBOs, and bring more expert resources to bear on the supervision of LCBOs. The modified performance evaluation system should lead to a more common understanding of the overall LCBO Program goals and help promote consistent implementation of a nationally focused program. These changes alone, however, will not necessarily ensure consistent Systemwide implementation of the LCBO supervision program, guarantee rational deployment of scarce supervisory resources, or fully address the "critical mass" issue. The Task Force believes that the program changes need to be supported by enhancing the mechanisms used by the supervision function to coordinate their activities at the System level.

Current Oversight Structure and Coordinating Mechanisms

By statute, supervisory and regulatory responsibilities and authority are vested with the Board of Governors. The Board has delegated responsibility for supervision of individual institutions to the Reserve Banks. The Senior Officers at each Reserve Bank report to their respective Presidents. These officers report findings related to each LCBO to their Presidents and to the Division Director. The Division Director reports to the Board's oversight Committee on Supervisory and Regulatory Affairs, which reports to the full Board of Governors.[19]

Over the past few years, the Senior Officers have coordinated their activities, particularly the implementation of the function's strategic plan and objectives, through the Steering Committee, chaired by the Division Director. Consistent with the function's strategic plan, seven committees currently report to the Steering Committee. These committees are co-chaired by various senior Reserve Bank and Board staff.

Program enhancements such as job rotations and CCs will promote a portfolio approach to the supervision of LCBOs and will help to improve the System's deployment of scarce supervisory resources. These proposed changes, however, could be made even more effective by strengthening the supervision function's coordinating mechanisms.

9. Enhance the Role of the Strategic Plan Steering Committee

The Task Force recommends that the various supervision committees and, in particular, the Steering Committee act as coordinating bodies for the supervision function, including the LCBO Program. Given the increasing need to coordinate supervisory efforts, particularly with respect to LCBOs that span several districts, the Task Force recommends that the Steering Committee take a more active role. The Task Force believes that the Steering Committee should operate more like a board of directors in establishing priorities, coordinating efforts, and overseeing the program enhancements recommended by this report. The Steering Committee, like other boards of directors, would form subcommittees to conduct its business. To operate in this manner, the Steering Committee will need to consider whether the existing subcommittees continue to meet the needs of the function, whether certain of their responsibilities should be modified consistent with the changing role of the Steering Committee, and whether these committees should operate in a more formal fashion.[20] The Steering Committee will also need to consider strengthening the ongoing planning and budgeting process for the supervision function. Finally, the Steering Committee should determine what staff support, including a secretariat, will be needed to assist with the Steering Committee's expanded responsibilities and the Steering Committee Chair's increased duties.

10. Hire an LCBO Resource Coordinator

[19] Appendix K provides a diagram of the current oversight structure.
[20] In August 1999, the subcommittee chairs began such a review at the request of the Division Director.

The Task Force generated and discussed a variety of structures that could be used to improve the deployment of resources. These options, or models, ranged from maintaining the current decentralized resource coordination structure (Option 1) to a fully centralized structure (Option 4B).

Option 1. Continue Current Resource Coordination

Option 2. Have One Reserve Bank Assume Responsibility for LCBO Resource Coordination for those Reserve Banks without a Critical Mass of LCBOs

Option 3. Establish a Separate LCBO Resource Coordination Office/Position for those Reserve Banks without a Critical Mass of LCBOs to either:

A. Facilitate Assignment of Supervisory Staff Resources, or
B. Control Assignment of Supervisory Staff Resources

Option 4. Centralize LCBO Supervision Responsibility and Control of Supervisory Staff Resources into:

A. Two or More Centers, or
B. One Reserve Bank or Board Staff

The elements, strengths, and weaknesses of each of these options are discussed at pages 71 through 83 of this report. The Task Force recommends Option 3A. Under this option and Option 3B, the Steering Committee would establish a separate LCBO Resource Coordination office/position to facilitate assignment of staff resources for the seven Reserve Banks that have a relatively small number of LCBOs in their district. The LCBO Resource Coordinator would be responsible for identifying the resource needs Systemwide and making recommendations to rationally deploy scarce resources among the seven Reserve Banks, working closely with resource coordinators at the Federal Reserve Bank of New York (FRBNY) and Board staff. The LCBO Resource Coordinator would report to the reconstituted Global Complex Banking Subcommittee of the Steering Committee. Specific responsibilities would include:

- developing a detailed roster of System personnel available for LCBO supervision;
- ascertaining each LCBO's staffing requirements relying on bottom-up assessments from Reserve Banks and in consultation with Board LCBO supervision management;
- matching needs of each LCBO with best resources; and
- identifying and developing budget requirements to feed into the overall supervision budget.[21]

The LCBO Resource Coordinator would work with CCs, as well as with the resource coordinators at the FRBNY and Board staff to determine the specific System critical skill needs, the number of staff necessary to fill those needs, and the cost to acquire those individuals.

With this option, quality is improved. First, by having individuals be responsible for identifying the System's resource needs and coordinating resources, the supervision function would have a mechanism to help ensure that the right resources are being devoted to the right institutions at the right time. Second, the Resource Coordinator would encourage the rotation of resources across the System, thereby promoting consistent Systemwide implementation of the LCBO Program, staff development, and better risk assessment across LCBOs. The Resource Coordinator would also help identify critical resource gaps and provide recommendations to the Steering Committee on specific resources that need to be hired for the LCBO Program.

The Task Force recognizes that many of these same goals might be achieved with the other options. The Task Force believes, however, that this option strikes the appropriate balance between the need to improve coordination (and thereby improve the quality, efficiency, and consistency of supervision) and the need to retain the benefits of local supervision (which promotes quality and efficiency). In other words, placing too high a value on consistency can be costly, both in terms of lost quality and efficiency.

Taking the options one by one, the Task Force believes Option 3A (its preferred option) compares favorably to each. Option 1 (no resource coordination beyond that offered by enhancing the role of the Steering Committee) is the simplest to implement but does not go far enough in promoting consistency, given the need to implement the LCBO Program as a national program. Option 2, which would place resource coordination responsibilities with one of the seven Reserve Banks, would address the primary weakness of Option 1. However, Option 2 would likely be as costly as Option 3A but perhaps not as effective. The Task Force believes that it would be difficult for one of the seven to be viewed as an "honest broker" in the allocation of resources. Option 3B, which consists of hiring a resource coordinator and giving that individual control of resources, may be required if experience with Option 3A shows that the Resource Coordinator needs more authority to properly deploy resources Systemwide. However, under this option, Reserve Banks would have responsibility for local institutions but would have no control over the resources required to fulfill this responsibility.

Options 4A and 4B would centralize LCBO supervision responsibility, not only in terms of resource allocation but in terms of substance of supervisory decision making. Option

[21] The LCBO Resource Coordinator's duties are described in greater detail on pages 77 through 79 of this

4A would centralize this responsibility at two or more centers (which would have many similarities to product offices). This option would take responsibility for certain institutions away from local Reserve Banks and require a costly infrastructure, but it would result in greater coordination and consistency. Similarly, Option 4B, which centralizes LCBO supervision at one Reserve Bank or Board staff, would result in greater coordination and consistency, but at a lower cost than Option 4A. The Task Force rejected these options due to the loss of local Reserve Bank responsibility for the institutions in its district. Further, if one believes that vetting issues with multiple Reserve Banks (which often have diverse views) increases knowledge, innovation, and creativity, Options 4A and 4B would enhance consistency to the detriment of quality.

COST CONSIDERATIONS

The Task Force estimates the cost to the System of implementing these ten recommendations is approximately $3.5 million or 1.3 percent of the 1998 System direct expenses for supervision functions.[22] Approximately $579,000 of the costs will fund staff development, job rotations, and a Systemwide posting program; $720,000 will pay for outside experts; about $1,400,000 will be used to establish CCs (which includes $160,000 for outside expertise); and $776,440 is needed to fund the LCBO Resource Coordinator, provide staff to the Steering Committee, and enhance feedback and incentive mechanisms. The Task Force recognizes that a significant percentage of the cost is to fund programs and administrative oversight mechanisms (versus developing and hiring additional expertise). The Task Force, however, believes that these costs are justified. These programs and mechanisms must be put in place in order for the System to determine, on an ongoing basis, what staff to hire and where to deploy them. The System's supervisory resource needs are not static but will change as the industry consolidates and expands into new products and services. Therefore, the Task Force

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report. A proposed job description is included in Appendix M.

[22] Refer to Appendix N for a detailed budget analysis of each recommendation. Additionally, some of the recommendations could result in increased cost to the LCBOs.

recommendations are intended to address immediate resource and deployment needs, while retaining the benefits of the System's decentralized structure and being sufficiently flexible to adapt to future industry changes.