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### Draft Close Out Report

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**Draft Close-out report**  
Large Complex Banking Supervision

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Summary and Items of Particular Note

FRBNY's business model for Supervision is recognized within the Federal Reserve System as a best practice. The business model is focused on the interactions between relationship management staff and risk management staff. Relationship management staff is primarily responsible for continuous supervision activities. Risk management staff provides a horizontal risk perspective, directly conducts targeted examinations and also provides technical assistance on topical risk issues. The collaboration anticipated through execution of this model provides an excellent opportunity to advance both coverage of risk concerns within a particular firm as well as risk management practices of all institutions within the LCBO portfolio.

The operations review focused on assessing the ingredients within the business model that are necessary for balanced performance and execution. This would include the effectiveness and timeliness of the products produced, the adequacy of staffing to fulfill expectations, and the strategies used to advance quality and consistency that are promulgated through knowledge sharing and the vetting protocols on supervisory elements. The review also entailed the identification of some best practices that were evident within the above exercise. While a detailed list of best practice observations were left with senior management a few notable factors include:

- Balanced and Strong Senior Management Team
- Staffing strategy with defined backup roles at JPMC team
- Risk Coordinators Horizontal Meetings
- MRMG Meeting Program and Documentation
- Utilization of Quickplace software for information sharing
- CPC Strength
- High quality scope, product memos, transmittal letters
- Commitment of senior management to the vetting process
- Positive relationships with Board staff

The review also revealed several opportunities that need attention to ensure successful execution of the business model. Three recommendations were noted:

- Additional depth and/or staffing is needed on the relationship teams to fulfill continuous supervision objectives
- Documentation of ongoing supervision needs to be more timely and more consistently documented.
- Information sharing needs to be enhanced to provide greater accessibility of supervisory information to key stakeholders.

Lastly, there were two suggestions made related to new activities.

## High-level Organizational Processes

### ▪ **Organizational Structure**

The LCBO supervisory structure at FRBNY is managed by SVP Sarah Dahlgren with the assistance of two VPs (Marc Saidenberg and Una Neary). Together these three senior officers manage the LCBO portfolio of 12 institutions through dedicated relationship teams that are each headed by a central point of contact (CPC). Aside from Sarah's overall responsibility for the supervision of the whole portfolio, Sarah directly supervises the Citi, DTC, and CLS teams. Marc is responsible for the JPMC, Bank of New York, and CIBC teams, while Una is responsible for six FBOs (please refer to the attached organization chart for details). While not all of the institutions within the portfolio are LCBOs, the few complicated institutions that are not technically LCBOs are managed under the same program. Seven institutions within the portfolio are designated under the Federal Reserve System's new Large Financial Institution Program (LFI).

The LCBO CPCs and their teams are responsible for maintaining the vertical institutional relationship and continuous supervision program while on-site support from the Risk Management Function headed by Brian Peters provides the specialty resources to conduct targeted exams and technical assistance on topical risk specialty factors (i.e. Capital Markets, Credit, IT/Operational Risk, Compliance, BSA, Payment Systems, etc.).

The FRBNY's business model for supervision relies on the interdependencies between the institutional relationship staff and the risk specialists that provide support on a horizontal basis. The relationship team provides access for the risk specialists to information sources and institutional management that are needed to understand risk management activities and practices within the firm. The institutional knowledge gained by the relationship team through their continuous supervision activities provides the necessary background and collaboration for scope development for on-site target reviews, horizontal reviews, and discovery inquiries that are conducted by the Risk Group. The risk specialists in turn provide their horizontal perspectives and range of practice observations within the analysis they provide in their product memorandums. This collaboration enables the risk focused supervisory program to be executed in a value added manner that recognizes the benefits gained through advanced knowledge sharing.

### • **Status of Previous Operations Review Comments**

At the last Operations Review conducted in 2002, there were four **recommendations** and two **suggestions** for the LCBO Supervision area. Considerable development of the business model for supervision inclusive of closer coordination with the risk specialists and the execution of comprehensive vetting protocols have corrected or improved most of the observations from the previous operations review. Nonetheless, further effort is needed to address more effective updating of supervisory documents (risk assessments, and supervisory plans). Specifically, the monthly report was offered as the vehicle to provide an update on changes needed to adjust supervisory strategies/plans as a result of emerging issues that evolve from performance factors, target findings, or findings from continuous supervision activities. As detailed below, the monthly reports do not provide this insight on a consistent basis. While there is evidence that

there are some random references to satisfy the objective, a more formal conclusion needs to be made within each report to assure that consideration is given to this important objective.

There was also a suggestion in the last operations review to address a more uniform format for supervisory documents. While the supervisory products are regarded as appropriate in their depth, coverage, and clarity, the timeliness standards are not being met which inhibits their effectiveness and comparison for timely horizontal review. Finally, there was also a suggestion related to capital markets supervision in the LCBO portfolio, namely that high turnover in the market and liquidity risk area had resulted in staff movement that were not well matched to the qualifications needed. The basis of the movement was linked to the Job Mobility Program and a suggestion was made to develop transition management guidelines to include a standard transition period and relevant standards for the overall transition process. While a transition policy was not developed, a set of principals was established for both knowledge transfer and the experience level factors needed to facilitate an orderly transition. Turnover in the LCBO relationship teams has resulted in limited transition time to effect the changes made. As a result, this factor places further emphasis on the importance of transitions stemming from either normal staff rotations or the Job Mobility Program.

- **Resource Adequacy and Allocation, and Staff Development**

The FRBNY Supervisory Business Model for LCBO supervision requires a balance of talent and resources between the relationship teams and the risk specialists to provide necessary ingredients for the successful coverage of the ongoing risk and relationship issues faced by the LCBO portfolio. A basic tenet of the above balance relates to the depth of staff, and the number of staff on the relationship teams to conduct ongoing continuous supervisory activities. (please refer to FRBNY's guidance for expectations for continuous supervision dated 1/12/03). If the team does not have the necessary talent and number of staff to conduct continuous supervisory activities, then there is the potential for a lapse in supervisory coverage and attention to emerging risk areas. The cycle of activities that the relationship team is involved in (Supervisory Products, Risk Assessment Process, Vetting of scopes, target results, horizontals, etc.) is also influenced by the depth of institutional knowledge that the team has in the organization under supervision. In a parallel **manner, the same variables are important in the staff support provided by the risk specialists.** The Risk Management Function must allocate its resources horizontally across the portfolios of institutions supervised by FRBNY based on the hierarchy of risk and the demand for the supply of specialists within a risk discipline. When there is more demand than supply, alternatives must be sought through the Department's Prioritization Committee. As a result, the depth of risk specialty talent as well as the level of institutional knowledge can have a positive or negative complement to the relationship team that is engaged in continuous supervisory activities.

In consideration of the above background, staffing at the LCBO relationship teams is under stress within the LCBO portfolio as it pertains to the Relationship teams' ability to conduct continuous supervisory activities. **This is of particular concern when evaluating the Citi team.** Turnover of staff and planned rotations have also left some of the teams with little tenure and short transitions for new staff. *It is **recommended** that LCBO supervisory management review the sufficiency of staff across the LCBO portfolio to address the teams' capacity to properly sustain continuous supervision objectives. **While it is recognized that management is actively***

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*engaged in adding staff to the Citi team, it is of paramount importance that the gaps in staffing that currently exist be addressed as soon as possible.*

The level of staff devoted to Corporate Compliance supervision on the Risk side of the business model needs to be expanded in view of the increased supervisory attention to compliance exceptions and the identified institutional governance gaps that pose legal and reputational risk exposure. It is **suggested** that an evaluation of the staff needed to execute the principles advocated in FRBNY's white paper on corporate compliance be completed to enable prioritization of the strategic hiring needed for this initiative.

#### Condition

Due to turnover and changes in the underlying risk issues at Citi, and to a lesser extent at other teams, there are insufficient resources to conduct continuous supervisory activities in a consistent manner. At Citi, much of the limited team's energy is absorbed by topical supervisory issues (Compliance, Governance, Information Requests, etc.) that detract from the team's continuous supervision objectives. Turnover has had a negative influence on the above, and the level of staffing within the Citi team has not kept pace with the magnitude of supervisory issues that the institution has realized.

#### Criteria

The evolving nature of corporate compliance issues within the LCBO portfolio has changed the steady state of supervisory risk from a traditional perspective. This shift in focus has resulted in a significant increase in specialty support in some topical areas such as BSA\AML supervision. Boarder corporate compliance issues are also a driver of substantial exposures related to legal and reputational risks. The shifting of staff to address these issues and the scarcity of available talent in the marketplace has left gaps in both the relationship and risk areas, while staff turnover has further hindered progress on the above. The gaps in staffing and depth need constant attention to address the above conflicts. It is admittedly difficult to stay ahead of the above events, but the highest attention should be placed on the risks within the LCBO portfolio, with highest attention to institutions designated as LFI's.

#### Cause

Staff turnover and changing risk profiles within the LCBO portfolio are the principal causes of the staffing challenges. It is also noted that exposure also occurs as a result of transition pressures on staff related to normal job rotations and the job mobility program.

#### Effect

As stipulated earlier, the effect of not having sufficient staff to sustain continuous supervision activities on the LCBO relationship teams may result in late reaction to address emerging risk areas within the LCBO portfolio.

#### ▪ **Knowledge and Expertise of Management and Staff**

Management demonstrates a deep knowledge and expertise regarding their supervised institutions. The management team is highly engaged and has a strong understanding of each institution's operations, strategies and evolving risk profile. This understanding is gained through regular

meetings with CPCs and risk coordinators, and active involvement in vetting sessions and other initiatives such as the awards program for scopes and written communications.

The Central Points of Contact are similarly strong and sufficient depth of talent appears to exist within the department to fill these positions as rotations or other openings occur. Within the risk coordinator ranks, knowledge and expertise of tenured staff is good, evidencing a thorough understanding of business lines, strategies, inherent risks and risk control structures. However, in a number of cases, tenure for both CPCs and risk coordinators is low. In more than one instance, the average tenure of an entire team is less than 15 months. The lack of documentation of ongoing supervision and a lack of timely updates to Supervisory Strategies and Risk Assessments (see "*Surveillance and Monitoring*" comment below) presents an additional challenge to new team members striving to develop institutional understanding of these large and complex institutions.

The risk specialists bring an additional level of expertise to bear on the examinations in terms of both technical knowledge and horizontal perspective. In addition, some risk specialists participate in the regularly scheduled meetings with the institution's business line management. On the whole, LCBO teams have adequate access to risk specialist resources, although overall resource constraints were noted in several key areas such as BSA and Corporate Compliance. In order to reduce the burden on the institution and advance the understanding of risk management processes from one review to the next, it is important to have appropriate continuity on the risk team. This is particularly critical at present given recent turnover and lack of tenure on some of the Relationship teams.

▪ **Work Flows, Use of Information Systems, and Communication**

The Department's size and business model make communication challenging as evidenced in the results of the recent employee climate survey. Senior management, however, is taking steps to improve communication namely by establishing focus groups to talk about issues that are of concern. Also, management is hosting other informal venues in which to interact with employees in the department. Within the Relationship unit, communication is enhanced through regular meetings between senior management and the CPC's.

One of the primary communication vehicles in this District is the vetting process, whereby the rationale for and scope of target examinations and horizontals, the key issues resulting from examination work, and the communication to institutional management are thoroughly discussed. Representatives from both Risk and Relationship participate in these sessions. Although employees have mixed reactions to this process, we recognize management's commitment to the continuous improvement of this key business process and to the quality of the supervisory products that have been subject to the vetting process.

An observation that we have concerning the vetting process is that efficiencies could be gained by offering more flexibility. Vetting sessions to discuss supervisory products are mandatory irrespective of the complexity of the institution. This places high demands on management's and staff's time, which is amplified during this time of high turnover. The vetting process could be more useful if it was limited to those supervisory activities and products where there are new or complex supervisory issues, where there is disagreement on resolution between the Risk and Relationship units, and where there are policy implications.

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While it is apparent that good dialogue and information sharing takes place verbally in the aforementioned forums, it is **recommended** that the use of information sharing tools be improved.

Condition

There is currently no standardized information sharing tool(s) being used in the LCBO program. Posting of supervisory documents, meeting minutes, and institutional MIS to sites like BOND and shared drives is inconsistent. There is a reluctance to post to BOND on a timely basis due to the conflicting parity of information available. Specifically, the OCC has access to the Federal Reserve's documents through BOND but does not post its own documents here. To house information, many of the LCBO teams are using individual shared drives that have access that is restricted primarily to those individual teams. The JPMC team recently started using Quickplace, a web-based tool to house meeting notes, supervisory products, and institutional MIS. Access outside the team is granted to senior management, certain Risk professionals and the Board of Governors analyst. While in its infancy stage, this appears to be a best practice within the LCBO program. Anecdotally, it has been noted that since the implementation of Quickplace, external requests for information have significantly declined.

The vetting process, which is extensively used in the NY District, is considered a good forum in which to share ideas and information. While this serves as a primary conduit for knowledge transfer in the department, there is no documentation of the vetting sessions. Thus, the aforementioned ideas and information that are shared during these meetings are limited to the vetting participants unless the people involved in the vetting take the time to pass along this information to their co-workers.

Criteria

LCBO management desires a collaborative relationship between its unit and the Risk unit. Counterparts in the Risk unit are expected to have input into the LCBO team supervisory products and strategic planning process.

Cause

Management acknowledges that FRB New York has historically had a culture that strongly promulgated the idea that knowledge is power and information should only be shared on a limited "need to know" basis. While it clearly desires a more collaborative environment, it is unrealistic to expect that the culture will be changed overnight. On a broader basis, knowledge management is negatively impacted by short to no transition periods for most positions, a lack of a common information sharing tool, a recent period of high turnover, and a large department that has people working in multiple locations.

Effect

Efficiencies are lost by not making information sharing a priority. Several of the LCBO team members routinely deal with a multitude of ad hoc information requests. As noted above, it is expected that at least a portion of the time spent on responding to these types of requests could be reduced if there were a common information sharing tool easily accessible to the Risk teams, management, and counterparts at the Board of Governors. Furthermore, information sharing at the LCBO level becomes even more critical under the new LFI framework that has just been put in place. It is expected that the LCBO teams falling under the LFI umbrella will routinely share information with their counterparts from the other LFI Reserve Banks so as to achieve a more consistent supervisory process for the largest financial institutions in the System.

▪ **Quality and Adequacy of Work Products**

Written work products are generally considered to be of high quality. A sampling of relevant written documents was reviewed and evaluated for clarity, thoroughness, and appropriateness. Documents reviewed include Supervisory Plans, Scope Memorandums, Product Memorandums, Institutional Profiles, Risk Assessment Documents, Monthly Reports, and communication with financial institutions including Roll-up reports, transmittal letters, and target review letters.

The written Supervisory Plans follow a consistent format, adjusted to reflect the individual differences in corporate structure and activities, emerging risks, and supervisory concerns. The plans follow a similar template as each document includes sections for risk assessments, key supervisory questions to be answered, an overview of the supervisory strategy as well as the tactics to be used to execute the strategy.

Scope Memorandums generally provide an appropriate amount of background information and include clearly stated objectives. The questions to be answered, examination procedures to be followed, and description of deliverables provide a good framework to understand why the proposed activities are being undertaken and what supervisory purpose is being served by conducting the proposed activity.

Product Memorandums reviewed were clearly written and included a concise executive summary. In addition, there were thorough descriptions of conditions, an assessment of the inherent risk, an evaluation of the risk control environment, recommendations regarding supervisory activities, and a connection back to the Supervisory Plan.

Roll-up reports, transmittal letters, and target examination letters sent to supervised financial institutions were clear, readable, and effectively conveyed issues of supervisory concern. In addition, these communications with financial institutions made clear what the institution was expected to do and provided timeframes for responding.

Documents associated with continuous supervision and the LCBO program are in process of transitioning to the new Risk Assessment Process. As a result, the quality of these new documents was not evaluated during this review. However, current documents (Institutional Overviews and Risk Assessments) associated with the existing LCBO program as initially described in SR 97-24, and updated in an April 2003 document titled LCBO/FBO Program Product Guidance have not been produced or updated on a consistent basis. While the Monthly Reports are excellent briefing documents, and are prepared on a consistent basis<sup>1</sup>; however, these documents still do not fully link changes in the supervisory strategy resulting from changes in the LCBO risk profile. It is **suggested** that documentation standards with respect to format, content, and timeliness be incorporated into the new RAP to ensure that risk assessment documents are current and effectively link to the Supervisory Plan.

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<sup>1</sup>In addition to serving as effective briefing updates to senior Bank Supervision officers and the President of the bank, the Monthly Reports are an effective knowledge sharing tool that facilitates discussion of supervisory issues amongst CPCs and other Bank Supervision management.



### **Compliance with Key Programs and Policies**

Overall Compliance (OC), Notable Departures (ND), Critical Noncompliance (CN)

| OC | ND | CN | <i>Note: The following five documents were considered as a whole as they are closely related and represent a progression in related guidance..</i>  |
|----|----|----|---|
|    | X  |    | SR 97-24 Risk-Focused Supervision of Large Complex Banking Organizations<br>SR 99-15 Risk-Focused Framework for Supervision of Large Complex Institutions<br>SR 00-14 Enhancements to the Interagency Program for Supervising the U.S. Operations of Foreign Banking Organizations<br>SR 00-13 Framework for Financial Holding Company Supervision<br>LCBO/FBO Program Product Guidance dated 4/21/03 |
| X  |    |    | SR 03-22/CA 03-15 Framework for Assessing Consumer Compliance Risk at Bank Holding Companies  |
| X  |    |    | SR 95-51 Rating the Adequacy of Risk Management Processes and Internal Controls at State Member Banks and Bank Holding Companies  |
| X  |    |    | SR 04-18 Bank Holding Company Rating System   |

#### **LCBO/FBO Program Product Guidance dated 4/21/03**

See recommendation in Surveillance and Monitoring below.

#### **SR 03-22/CA 03-15**

With respect to the preparation of risk assessments for LCBOs, we understand that Reserve Bank management intends to incorporate the results of the consumer compliance risk assessment into the Legal/Compliance portion of the LCBO RAP. Reserve Bank management should not lose sight of the fact that the SR/CA Letter requires separate consumer compliance risk assessment for LCBOs and RBOs under continuous supervision prepared by an examiner with consumer compliance expertise. This risk assessment is in addition to the requirements of the LCBO RAP.

### **Efficiency and Effectiveness of Supervisory Processes**

#### **▪ Surveillance and Monitoring**

Continuous supervision is conducted through the team's onsite presence, target examinations, discovery and horizontal reviews as well as regular interaction with institution management. These activities generate a flow of meaningful information that results in a comprehensive and current understanding of the institutions, their business strategies, risk profiles and the quality and effectiveness of their risk management systems. This depth of knowledge is evidenced by the quality of supervisory judgments and communications to the supervised institutions.

The products which are the output of these activities, most notably Supervisory Plans, Risk Assessments, and Risk Matrices are satisfactory; however, they are not completed in a regular or timely manner. In several cases, comprehensive risk assessments and risk matrices have not been updated in over twelve months. Similarly, documentation of ongoing supervision, such as notes from meetings with institution management, assessments of risk reports from institutions and correspondence with the organization or other parties are not maintained nor posted to a central repository. In addition, updates to the Supervisory Plan are not documented in any of the products

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although it is clear through discussion that appropriate changes are made to the Plan on an ongoing basis which reflect the organizations' changing risk profile. It is **recommended** that LCBO supervisory management ensure regular and timely documentation of ongoing supervision and monitoring.

This lack of consistency in documentation appears to have several root causes, but most notably reflects time constraints and a need to prioritize other tasks such as responding to frequent information requests, following-up on "headline" news events, and coordinating targets, discovery reviews and other supervisory events with both risk specialists as well as other regulators.

Since the previous Operations Review, emphasis has been placed on improving the quality and timeliness of the Monthly Reports. A report template has been developed which is used consistently by the teams. Since mid-2004, these reports are being completed in a timely manner and posted to BOND within ten business days of the end of the month. These reports provide a good high-level briefing of key developments, including organizational changes, significant financial or operational events and the status of ongoing supervisory reviews. While not a substitute for regular Risk Assessments, these documents provide useful information regarding the ongoing activities of the organizations and are a good vehicle for communicating with the multiple stakeholder groups to which the teams are accountable.

It is also apparent that since the previous Operations Review, resources have been directed toward reviewing risk control functions through both individual targets as well as horizontal reviews. Topics that have been covered include: audit, regulatory reporting, accounting controls, corporate compliance, and AML/Correspondent Banking. These reviews contribute to the overall understanding of the organization's risk profile and improve the confidence with which the work of internal control systems can be relied.

It is **recommended** that LCBO supervisory management ensure regular and timely documentation of ongoing supervision and monitoring.

Condition

Regular Risk Assessments and documentation of ongoing supervision activities such as minutes of meetings with bank management, summary memos of reviews of MIS or risk management reports, or significant briefing materials are not being completed in a consistent and timely manner.

Criteria

The LCBO/FBO Program Product Guidance (PPG) from 2003 indicates that "the primary objectives of the LCBO and FBO programs are to maintain an accurate and current assessment of each banking organization's financial and managerial strength, and to respond in a timely manner to emerging issues." The guidance further indicates that "it is necessary that documents related to each phase of the supervisory process be posted to BOND in a timely manner to provide a comprehensive understanding of the institution and related supervisory activities." The frequency of supervisory product updates is left up to the individual supervisory teams, however, it should be noted that FRB NY LCBO management has established internal guidelines that require the completion of semiannual risk assessments (as of 3/31 and 9/30), annual supervisory plans and institutional overviews, and monthly reports.

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As noted in the “*Work Flows, Use of Information Systems, and Communication*” section above, in general, Risk Assessments and the documentation of ongoing monitoring are not posted to BOND or another central repository, or when posted, are not posted in a timely manner.

The Operations Review team did note that target exam scope memos, product memos, and the annual roll-up documents are particularly strong products that are consistently well-written, thorough, and have well-supported analysis. These products go through an extensive vetting process that clearly contributes to their robustness.

#### Cause

The lack of consistency in documentation appears to have several root causes, but most notably reflects time constraints and a need to prioritize other tasks such as responding to frequent information requests, following-up on “headline” news events, and coordinating targets, discovery reviews and other supervisory events with FRBNY examiners and other regulators.

#### Effect

The lack of documentation regarding the Reserve Bank’s current view of the organization’s condition, governance and risk management practices may result in a failure to identify significant risks or supervisory issues or to justify particular actions if the institution were to suffer from an adverse event. It also limits the ability of the System as a whole to provide for the assessment and evaluation of banking practices across organizations. LCBO Program Product Guidance Memo issued 4/21/2003 provides guidance on the specific expectations for each product.

#### • **Examination Planning and Scheduling**

Supervisory Plans are thorough; clearly identify key risks and articulate detailed and appropriate processes to address these risks. As noted above, LCBO teams are generally accorded a priority claim on risk specialists to conduct these reviews. As a further control, the Prioritization Committee serves as an arbitration body by which resources are allocated and management – deemed priorities are accomplished.

#### ▪ **Risk Assessment**

As described in the section titled **Quality and Adequacy of Work Products** Risk Assessment Documents are not prepared on a consistent basis. While LCBO team use alternative documents to update information, there is inconsistent documentation to reflect current information across the range of products and risk dimensions.

#### ▪ **Report Review and Workpapers**

The vetting process, as described in the **Work Flows, Use of Information Systems, and Communication** section, is in effect the Report Review function. Other than a review of selected scope and product memorandums, as described in the section titled **Quality and Adequacy of Work Products**, a Workpaper Review was scoped out of this review.

▪ **Problem Identification and Resolution**

Problem identification, resolution and supervisory follow-up are adequately addressed by the LCBO supervisory teams. This is especially evident on the JPMC and Citigroup teams, which have had to monitor several formal supervisory agreements related to compliance-related issues. Ongoing supervision and target exams related to these formal agreements are detailed in the most recent roll-up letters, supervisory plans, and monthly reports. Also, the JPMC team has created an Access-based issues tracking database.

▪ **Supervisory Follow-Up**

See comment above on “*Problem Identification and Resolution*”

▪ **Quality Control**

The Operations Review team noted that workproducts, including Supervisory Plans, Institutional Overviews, scope memos, product memos and transmittal letters are thorough and well-supported. The organization’s business model which pairs technically competent risk specialists with broad industry perspective and relationship coordinators with institutional knowledge and context creates an environment in which these high-quality products can be developed. The extensive vetting process is a further control to ensure that final assessments are accurate and consistent. However, these products are not always issued in a timely manner and as discussed above, exceptions to LCBO program standards with respect to the completion of Risk Assessments and the documentation of ongoing monitoring were noted.

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