Improving Offsite Reporting and Analysis

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Federal Reserve Board
October 26, 2015

World Bank/International Monetary Fund/Federal Reserve System
Seminar for Senior Bank Supervisors from Emerging Economies

These views are solely the responsibility of the author and should not be interpreted as necessarily reflecting those of the Board of Governors of the Federal Reserve System.
The Surveillance Function

*Essential Elements*

- Distill risk signals
- Communicate risk signals
- Act on risk signals
- Measure success
Distilling Risk Signals

Key Steps

• Encompass all potentially relevant data
  • Continuously modernize
  • Aim toward granularity
  • Collect and purchase

• Create risk metrics and generate risk categorizations
  • Current conditions—detect embedded losses
  • Future problems—anticipate loss under stress
  • Modular—assess risk stripes separately

• Verify predictive capacity of metrics and categorizations
  • Expert judgment
  • Historical study
  • Deploy the best

• Provide backstop using models of overall financial condition
Distilling Risk Signals

*Issues in Risk Categorization*

Loss under stress (Absent offsetting action)
Distilling Risk Signals

Historical Study

• Identify historical stress periods for each risk
  • Interest rate risk: 2004-06 period of rising rates
  • Credit risk: 2007-12 period of high loan losses
  • Similarly for other risks, identify periods of manifestation

• Choose appropriate measures of bad outcomes
  • Interest rate risk: declines in net interest margin, securities losses
  • Credit risk: loan charge-off rates, bank failures
  • Similarly for other risks, identify forms of manifestation

• Measure ability of risk classification systems to predict bad outcomes
  • Assess accuracy of both low- and high-risk tiers
  • Allow alternative classification systems to compete
  • Deploy the best
Distilling Risk Signals

*Risk Tier Accuracy*

Stress period bad outcomes as a percentage of total observations in each risk tier

Pre-stress risk assessment

Winner
Distilling Risk Signals

*Risk Screens Need a Backstop*

Eventual loss under stress

- Critical level
- Models of overall financial condition track deterioration to support proactive resolution and contain losses

High risk detected/checked pre-stress

High risk undetected/unchecked pre-stress
Communicating Risk Signals

*Key Steps*

- Computer applications for deploying risk metrics and categorizations
  - Regular production
  - Secure maintenance
  - Directed distribution
- Trend analyses and reports using risk metrics and categorizations
  - Individual institutions
  - Supervisory portfolios
  - Financial industry
Acting on Risk Signals

*Key Steps*

- **Exams**
  - Work closely with field
  - Assess exam areas separately
  - Tailor scope and intensity of exam work to risk

- **Special initiatives**
  - Work closely with field
  - Mount supervisory actions
  - Monitor institution responses

- **Macroprudential policy**
  - Raise awareness of systemic risk trends
  - Inform and shape macroprudential decisions
  - Microview can spot macrofinancial troubles
Acting on Risk Signals

Illustrative Possibilities in Exam Scoping

Exam intensity

Exam scope

Assessed risk: L, M, or H
Acting on Risk Signals
Working Closely with Field

- Examiner overrides of risk tiers
  - Fewer is better
- Distribution of institutions across risk tiers
  - Widen low-risk tier while maintaining accuracy
- Distribution of exam hours across risk tiers
  - Time spent corresponds to risk
Measuring Success

• Accuracy—risk categorizations correspond to actual risk
• Efficiency—supervisory resources shift from low- to high-risk situations
• Effectiveness
  • Low-risk institutions avoid unnecessary burden
  • High-risk institutions face commensurate costs
  • Institution and systemic risk mitigated and contained