Regulatory Alert

Financial Services Regulatory Insight Center

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Federal Reserve publishes inaugural Supervision and Regulation Report

Key points

- The Federal Reserve Supervision and Regulation Report outlines supervisory findings as of June 2018 and highlights identified supervisory priorities for 2019.
- Examiners will continue to conduct horizontal examinations across multiple firms within supervisory portfolios; for LISCC firms this will include some areas identified as supervisory priorities (spanning capital, liquidity, governance and controls, and recovery and resolution planning).
- Among the key findings: 40 percent of large financial institutions are rated "less-than-satisfactory;" 70 percent of the supervisory findings for LFBOs are related to governance and controls; and less than 6 percent of RBOs and CBOs are rated "less-than-satisfactory."

Federal Reserve Supervision and Regulation Report - November 2018

The Federal Reserve issued its inaugural Supervision and Regulation report, which summarizes current banking system conditions and regulatory and supervisory developments. The Federal Reserve reports that the U.S. banking system is generally strong with high levels of quality capital and improved liquidity, but also reports that some areas need improvement. This alert covers the supervisory developments and 2019 supervisory priorities highlighted by the Federal Reserve for large financial institutions, including LISCC firms (firms subject to the agency's Large Institution Supervision Coordinating Committee supervisory program) and large and foreign banking organizations (LFBOs), as well as regional and community banking organizations.

Supervisory developments and 2019 priorities

Large Financial Institutions (LFIs): The Federal Reserve finds that LFIs, including LISCC firms and LFBOs, are generally stable with higher capital levels than before the financial crisis. However, 40 percent of LFIs have a less-than-satisfactory ratings due to risk management weaknesses in one or more of the following areas: compliance, internal controls, model risk management, operational risk management, IT infrastructure, and BSA/AML.

For LISCC firms in particular, more than half of examiners' findings in the past five years were related to weaknesses in governance and control; sixty percent of the currently outstanding supervisory finding relate to these weaknesses, including BSA/AML, internal audit function, IT risk management (cybersecurity), and model risk management. In 2019, supervisors will continue to focus on horizontal examinations within the LISCC portfolio including in some of the following priority areas:

— Capital: Capital planning; regulatory reporting; counterparty risk; collateral management; and wholesale credit underwriting

— Liquidity: Internal liquidity stress test assumptions, liquidity positions, governance over liquidity data, contingency plans, and currency risk management; compliance with liquidity regulations

— Governance and controls: IT and cyber risks; internal audit; compliance and business conduct; vendor risk management; and risk committee practices

— Recovery and resolution planning: Recovery planning and LISCC foreign bank intermediate holding company resolution plans.

For LFBOs, the Federal Reserve states that they also are stable and meeting expectations for capital and liquidity. However, improvements are needed in certain areas related to higher-risk loans and internal reviews of capital planning processes. Almost 70 percent of supervisory findings relate to governance and controls; a majority of these pertain to BSA/AML/OFAC compliance (higher risk products/services; lack of sufficiently strong systems) or IT risk management. FBOs continue to be challenged with deficiencies in their IHCs' risk management and reporting systems.

For the LFBOs as a whole, the 2019 supervisory priorities will include:

— Capital: Loss estimation methodology; capital policies; and scenario design

— Liquidity: The independent review function and liquidity limits risk management; and security dealer internal stress testing assumptions

— Governance and controls: Cyber-related risks; internal audit; compliance and business conduct; and BSA/AML and OFAC compliance program control

— Recovery and resolution planning: Resolution plans, including IHC resolution plans.

Regional and Community Banking Organizations (RBOs and CBOs): The Federal Reserve states that most RBOs and CBOs have satisfactory conditions, with 99 percent of banking organizations in this group considered to be "well-capitalized" and less than 6 percent rated "less-than-satisfactory."

For RBOs, the Federal Reserve notes that there has been a 40 percent increase in the number of institutions in the RBO portfolio in the past five years. Further, all institutions in this category are considered to be "well-capitalized." However, opportunities for improvement in risk management have been identified and examiners have observed some deterioration in RBO liquidity positions. Common risk factors across the RBO portfolio that will be considered as a part of the 2019 supervisory cycle include:

— Credit risk: Concentrations of credit; commercial real estate and construction and land development; and underwriting practices

— Operational risk: merger and acquisition risks; and information technology and cybersecurity

— Other: sales practices and incentive compensation; BSA/AML

For CBOs, similar to RBOs, more than 99 percent of CBOs are considered to be "well-capitalized." Areas of emerging risk include the management of concentrations of credit, rising interest rates, and increased liquidity risk. Supervisory priorities in 2019 will focus on the same issues identified for RBOs and also operational risks from IT and cyber-security, and BSA/AML.

For additional information please contact Deborah Bailey or Amy Matsuo.

Amy Matsuo
Principal and National Lead
Regulatory Insights
T: 919-664-7302
E: amatsuo@kpmg.com

Contributing authors:
Amy Matsuo, Principal and National Lead, Regulatory Insights

Karen Staines, Director, Financial Services Regulatory Insight Center

Phil MacFarlane, Associate Director, Financial Services Regulatory Insight Center

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