Executive Summary:

Opportunities Exist to Increase Employees' Willingness to Share Their Views About Large Financial Institution Supervision Activities

2016-SR-B-014 **November 14, 2016**

Purpose and Approach

We initiated our evaluation in response to a written request from the Director of the Board of Governors of the Federal Reserve System's (Board) Division of Banking Supervision and Regulation and the Board's General Counsel. The request suggested that we

- assess the methods for Federal Reserve System (System) decisionmakers[1] to obtain material information necessary to ensure that decisions and conclusions resulting from supervisory activities at Large Institution Supervision Coordinating Committee (LISCC) firms and large banking organizations (LBOs) are appropriate, supported by the record, and consistent with applicable policies[2]

- determine whether there are adequate channels for System decisionmakers to be aware of supervision employees' divergent views about material issues regarding LISCC firms and LBOs

For our first objective, we assessed key aspects of the supervisory decisionmaking process that are common to the LISCC and LBO portfolios by focusing on the annual supervisory plan and the annual rating and assessment processes.[3] For our second objective, our team focused on assessing the cultural aspects of the supervision process, including the supervision team dynamics at various Reserve Banks and employee comfort levels in sharing their views. To achieve our objectives, we conducted a survey of more than 700 employees at the 10 Reserve Banks that supervise LISCC firms and LBOs, interviewed more than 240 Board and Reserve Bank employees, and reviewed relevant academic research.[4]

Background

The Board plays a major role in supervising and regulating the U.S. financial system. The Board's supervisory responsibilities include the supervision of LISCC firms and LBOs. The LISCC and the LISCC Operating

1. For the purposes of our evaluation, the term *System decisionmakers* refers to System officials at the Board and Federal Reserve Banks who have decisionmaking authority for the supervision of large financial institutions.

2. The LISCC is a Systemwide committee that coordinates the System's supervision of domestic bank holding companies and foreign banking organizations that pose elevated risk to U.S. financial stability and other nonbank financial institutions designated as systemically important by the Financial Stability Oversight Council. In general, the System considers banking organizations with more than $50 billion in total assets that are not LISCC firms to be large banking organizations, or LBOs.

3. The LISCC and LBO portfolios have other supervisory decisionmaking processes that were not the focus of this evaluation.

4. Our team issued its survey to employees at the Federal Reserve Banks of Atlanta, Boston, Chicago, Cleveland, Dallas, Minneapolis, New York, Philadelphia, Richmond, and San Francisco.

Committee establish supervisory priorities for LISCC firms.[5] Under delegated authority from the Board, the Reserve Banks conduct supervisory activities, including executing the supervisory priorities. The Reserve Banks assign dedicated teams of examiners, which may include risk specialists, to supervise LISCC firms and LBOs on a continuous basis under the Board's oversight. The members of those teams are responsible for identifying, discussing, and escalating potential issues to decisionmakers at the Reserve Banks and the Board. In their request letter, senior Board officials highlighted the importance of this escalation process by stating that "[supervisory] decision-makers must have access to complete information and to the informed views of members of the examination team in order to reach appropriate decisions and supervisory conclusions regarding the examination of large banking organizations." We agree and acknowledge the importance of an effective information flow to decisionmakers.

Leadership and Management Approaches Influence Reserve Bank Employees' Comfort Level Sharing Views

While 71.8 percent of large financial institution supervision employees responded favorably to a question on our survey inquiring whether it is safe to speak at their Reserve Bank,[6] other questions that focused on employee comfort level sharing views with Reserve Bank management and System decisionmakers yielded less favorable results.

Among the 10 Reserve Banks included in the scope of our evaluation—those that supervise LISCC firms and LBOs—we noted that significant variability exists in employees' comfort levels sharing views. Our survey results and interviews revealed that differences in leadership and management approaches among supervisory leaders at the Reserve Banks contribute to this variability. We identified five root causes for employees' reticence to speak: (1) the need for management to solicit employee views more frequently; (2) the need for improved relationships between Reserve Bank employees and System decisionmakers; (3) the fear of retaliation during the performance management process; (4) the futility perception—the belief that no action would be taken; and (5) the expectation that employees must have complete confidence in their viewpoint before speaking. Addressing these root causes of employees' reticence to share their views will likely improve the flow of information to decisionmakers.

Reserve Bank Leaders Use Several Techniques to Encourage Employees to Share Views but Do Not Have a Forum to Share Best Practices

During our evaluation, we identified several leadership behaviors and processes currently employed by Reserve Bank leadership that appear particularly effective in helping to convince Reserve Bank supervision employees that it is both safe and worthwhile to share their views. In general, those activities have not been shared or widely implemented among the Reserve Banks. We believe that establishing a forum to share and perpetuate best practices among the Reserve Banks will likely increase supervision employees' willingness to share their views.

Hiring, Developing, and Retaining Effective Managers Is a Challenge

We noted that hiring, developing, and retaining effective managers is a challenge for all the Reserve Banks that supervise large financial institutions; this challenge is particularly acute for the Federal Reserve Bank of New York (FRB New York) for several reasons, including the geographic concentration of LISCC firms in New York, the multiple layers of financial institution supervision hierarchy at FRB New York, and the fluid composition of its supervisory teams. These challenges and the potential effect of leaders who do not foster positive team dynamics magnify the importance of FRB New York's talent acquisition and development efforts for the

5. The LBO Management Group is an advisory body that guides supervision of LBOs, but it does not establish supervisory priorities like the LISCC Operating Committee.

6. We distributed the survey to 1,029 employees and officers responsible for supervising large financial institutions at the 10 Reserve Banks that have at least one LISCC firm or LBO in their jurisdiction. Of those 1,029 recipients, 737 (approximately 72 percent) completed the survey.

System's supervision program. Although we focused on the factors that make these challenges more acute for FRB New York, we believe that all Reserve Banks will likely benefit from considering the appropriate balance between leadership, management, and team-building skills and technical proficiency when filling supervisory leadership positions.

Employees Need a Channel to Report Divergent Views to System Decisionmakers

Generally, we found that employees and System decisionmakers feel that decisionmakers receive the necessary information to reach appropriate decisions and supervisory conclusions regarding the examination of LISCC firms and LBOs. However, we found that there is no formal mechanism for reporting a divergent view to decisionmakers and that there is a lack of clarity about whether decisionmakers would like to be informed of close calls during the annual rating and assessment process, such as ratings decisions when a case for multiple outcomes exists. Highlighting close calls and instances in which there was disagreement among team members will allow decisionmakers to focus attention on these issues and determine whether they warrant further consideration and debate.

Recommendations

Our report contains recommendations designed to increase employees' willingness to share their views and to improve the flow of information to decisionmakers regarding the supervision of large financial institutions. Some of the recommendations focus on topics related to leadership, management, and the performance management process. The Director of the Board's Division of Banking Supervision and Regulation and the relevant heads of supervision at the Reserve Banks do not have exclusive authority for these human resources topics. Therefore, we encourage those leaders to coordinate with the appropriate Board and Reserve Bank divisions to address these recommendations.

In the response to our draft report, the Director of the Board's Division of Banking Supervision and Regulation agreed with all of the report's recommendations and highlighted instances in which progress has been made to address specific recommendations. We will follow up to ensure that the recommendations are fully addressed.