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Remarks Before the Joint European Banking Authority and

European Central Bank International Conference

"Evolving Bank Supervision"

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Thank you for the opportunity to speak at this EBA/ECB conference on supervisory cooperation.

Today I want to talk about bank supervision. More specifically, I want to talk about how supervision has evolved over the past several decades.

The confidential nature of supervision has meant that most of that evolution has not been visible to the public. As banks and the financial system have become larger and more complex, however, the stakes for banks and bank supervisors have risen.[1]

Thus, this seems like a good time to reflect and level set so that the public, banks, and other stakeholders better understand the nature of supervision, how and why it has evolved, and the steps necessary to remain effective.

The Nature of Supervision

To set the stage, we can start by contrasting bank supervision with bank regulation. Whereas regulation is about adopting and enforcing rules, supervision is about promoting safe

[1] For the purposes of this speech, I am using the term "supervisor" to refer to the employees of banking agencies with responsibility for supervising banks (as opposed to developing regulations and guidance for banks). In other contexts, they are referred to as "examiners" or "regulators." Greg Baer, *The Bank Examination Problem, and How to Fix It* (Bank Policy Institute, July 17, 2024); Margaret E. Tahyar, "Are Banking Regulators Special?" (Clearing House, Quarter 1, 2018).

and sound practices and behaviors.[2] I have always found useful the analogy contrasting speed limits (regulation) with safe driving (supervision).

Other analogies abound. Supervisors are like referees or umpires calling balls and strikes. Or we are like cops on the beat enforcing the law or like firefighters ready to save the neighborhood from financial conflagrations. Some see us as quasi-auditors, checking for adherence to internal procedures and processes.

In practice, supervisors do all these things and more; the trick for supervisors is knowing which role to play in a given situation. Two financial historians tallied nine epistemologies (or paradigms) of supervision and charted them along two axes: coercive to persuasive and retrospective to prospective.[3] As shown in figure 1, the range of roles is wide. To be effective, supervisors must be good at all of them.

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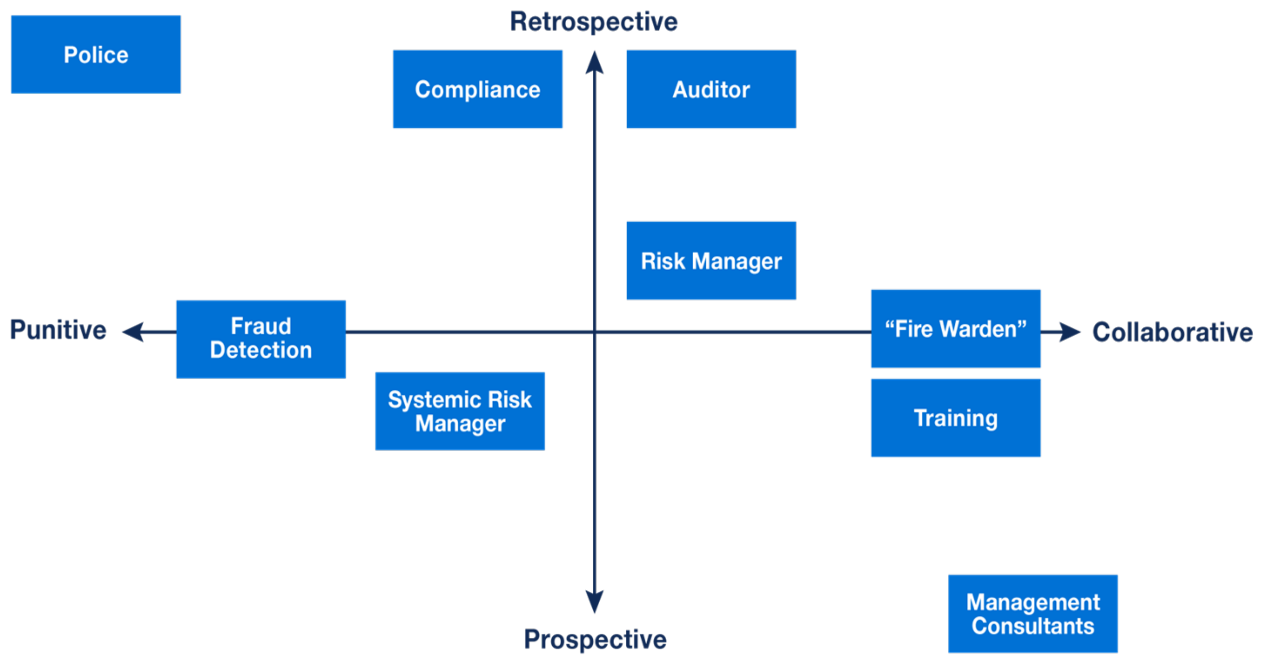
[2] As historians Peter Conti-Brown and Sean Vanatta noted, "If regulation sets the rules of the road, supervision is the process that ensures obedience to these rules (and sometimes to norms that exist outside these rules entirely). Regulation is the highly choreographed process of generating public engagement in the creation of rules. Supervision is the mostly secret process of managing the public and private responsibilities over the risks that the financial system generates." Peter Conti-Brown and Sean Vanatta, "Focus on Bank Supervision, Not Just Bank Regulation" (Brookings Institution, November 2, 2021).

[3] Ibid.



Source: Brookings Institute, Economic Studies.

For my purposes today, I think it may be most helpful to focus on the *nature* of supervision, with which the OCC has more than 160 years of experience. Three things in particular stand out.

Supervision is a ground game. Supervision consists of regular interactions between supervisors and banks through examinations, monitoring, and ongoing dialogue. These activities give supervisors opportunities to develop independent and informed views of a bank's strengths and weaknesses, its capabilities and vulnerabilities, and its financial condition. Ongoing supervisory interactions also reinforce good habits, discipline, and prudence at a bank.

In many ways, supervision is like exercise. Both require consistent effort and involve inch-by-inch progress. With exercise, it is hard to point to the impact of a particular day's

workout on the health of an individual. But the cumulative effect over time of exercising versus not exercising is indisputable. The same goes for supervision. The materiality of a particular examination or information request or meeting may be quite small, but the cumulative impact of those activities over time is significant in promoting safe and sound practices and strong risk management and controls.

Consider, for instance, the interactions supervisors have had with banks about cyber, operational, and IT risks leading up to the recent CrowdStrike incident. While airlines and other industries experienced significant disruptions due to CrowdStrike's faulty patch, bank operations were largely unaffected. This was not by accident. Like many agencies, OCC supervisors have been examining and pushing banks to improve their cyber, operational, and IT risk management capabilities for years because of the prevalence of legacy systems, deferred maintenance, and underinvestment.[4] Banks' relative resilience in the face of the CrowdStrike disruption was due in part to those supervisory efforts.

Supervision is a craft. In addition to being able to play a wide range of roles, effective supervision requires a special mix of skills, techniques, and experiences: curiosity, a nose for b.s., fluency with numbers (especially ratios), an ability to think critically, tolerance for tough conversations with bankers, situational awareness, good judgment, emotional intelligence, communications agility, and an unwavering commitment to public service.

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[4] The percentage of adversely IT-rated (3 or lower) OCC-supervised institutions is approximately 3.81 percent of all OCC-supervised institutions as of August 2024. This includes 33 percent of large banks, 7 percent of midsize and trust banks, 3 percent of community banks, and 13 percent of others. The trend for IT composite rating changes to adverse ratings in 2024 reflects downgrades for 17 institutions year over year from 2023, and upgrades for 13 institutions, for a net overall increase of four institutions as adversely rated. For example, see OCC *Semiannual Risk Perspective* (Spring 2024) and OCC News Release 2023-109, "OCC Releases Bank Supervision Operating Plan for Fiscal Year 2024" (September 28, 2023), which address cybersecurity, operational resilience, and IT risk management.

In a sense, supervision is like investigative journalism or intelligence gathering. While quantitative analysis looms large in any supervisor's tool kit, the ability to ask probing questions and draw out new, insightful information from stakeholders is what differentiates good from great supervisors.

In another sense, supervision is like diplomacy, where the objective is to influence and correct behaviors deftly, and, when necessary, backed by the authority to escalate as warranted. This requires being able to read people well and knowing when to be nuanced versus blunt.

At the OCC, we commit significant resources to train examiners in the craft of supervision. For instance, to become a commissioned National Bank Examiner (NBE), one must spend upwards of five years mastering a wide range of content to pass a series of tests, including live simulated interactions with agency leaders role-playing bankers and directors ("mocks"). In addition, they must accumulate on-the-job experience participating in exams and observe senior staff working through supervisory challenges and delivering tough messages to bankers when necessary. OCC large bank examiners-in-charge, for instance, have an average of 29 years of OCC experience, and midsize and community bank commissioned examiners have an average tenure of 17 years.[5]

Supervision is asymmetric. Supervision usually enters the public consciousness only when something has gone wrong. For instance, the failures of Silicon Valley Bank and Signature Bank sparked intense public scrutiny of supervisors at various banking agencies.

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[5] The OCC applies rotational requirements and term limits to many examiner positions in order to strengthen supervisory processes and examiner expertise, provide staff with a richer and more diverse set of experiences, promote cross-training, enhance professional and leadership development, and support agency succession planning.

Effective supervision, by contrast, is largely invisible to the public. When the banking system weathers notable events well, few give supervision a thought. In 2022, for instance, as the crypto market imploded with $2 trillion of market value lost and multiple crypto platforms filing for bankruptcy, the banking system was largely unaffected. That was not luck. That was the result of a long ground game of supervision seeking to ensure that crypto activities banks engaged in were safe, sound, and fair.[6]

This asymmetry can have real impacts on how supervisors do their work. When there is a headline-grabbing negative incident—such as a bank failure, compliance or operational breakdown, or violation of law—supervisors understand they may be subject to intense criticism. This can cause them to become unnecessarily cautious, defensive, or to second-guess themselves. (I have experienced this personally, having supervised investment banks at the Securities and Exchange Commission in the lead-up to the 2008 financial crisis.) This can result in supervisors seeking safety in closely adhering to preapproved checklists and processes rather than exercising judgment and discretion. As I will discuss later, this can create significant obstacles to implementing risk-based supervision.

The sheer breadth of issues and risks that a supervisor *could* cover at any bank—big or small—is immense. Supervisors must prioritize. Unfortunately, they are too often thought to be omniscient or all-powerful over the day-to-day operations of a bank. These expectations are unrealistic, unfair, and counterproductive because they can pressure supervisors to spread

[6] See OCC Interpretive Letter 1179, "Chief Counsel's Interpretation Clarifying: (1) Authority of a Bank to Engage in Certain Cryptocurrency Activities; and (2) Authority of the OCC to Charter a National Trust Bank" (November 18, 2021); OCC News Release 2023-1, "Agencies Issue Joint Statement on Crypto-Asset Risks to Banking Organizations" (January 3, 2023).

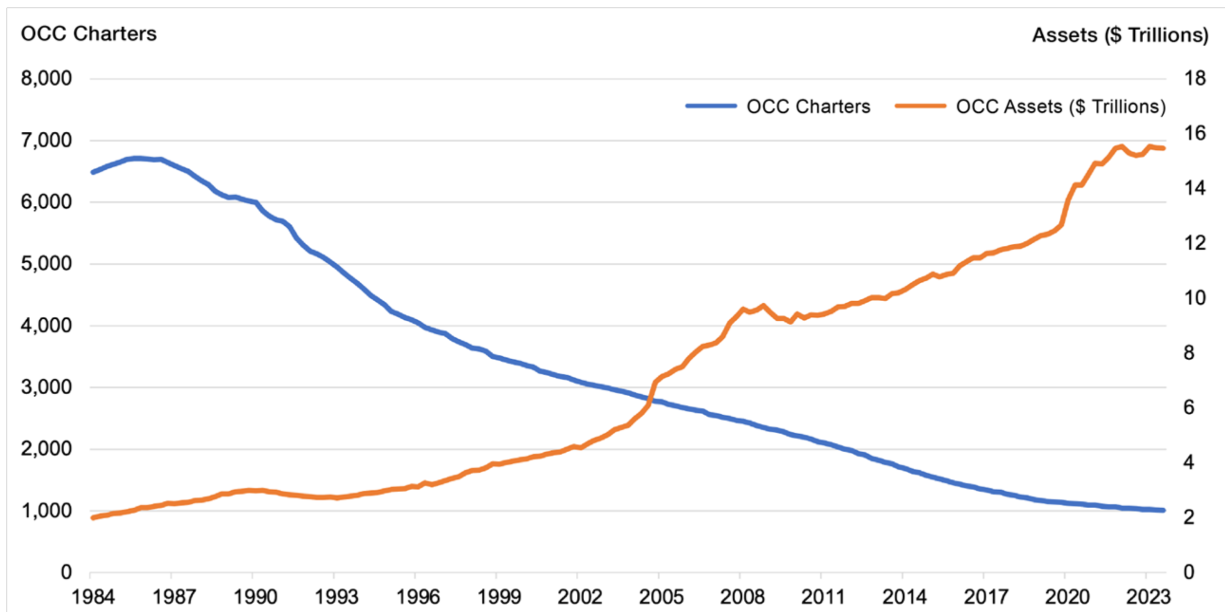
themselves out to ensure broad coverage (quantity) rather than to focus on what matters most (quality).

These three attributes of supervision—ground game, craft, and asymmetry—have not changed much over the years. In other ways, however, supervision has had to adapt to an evolving banking system.

An Evolving Banking System

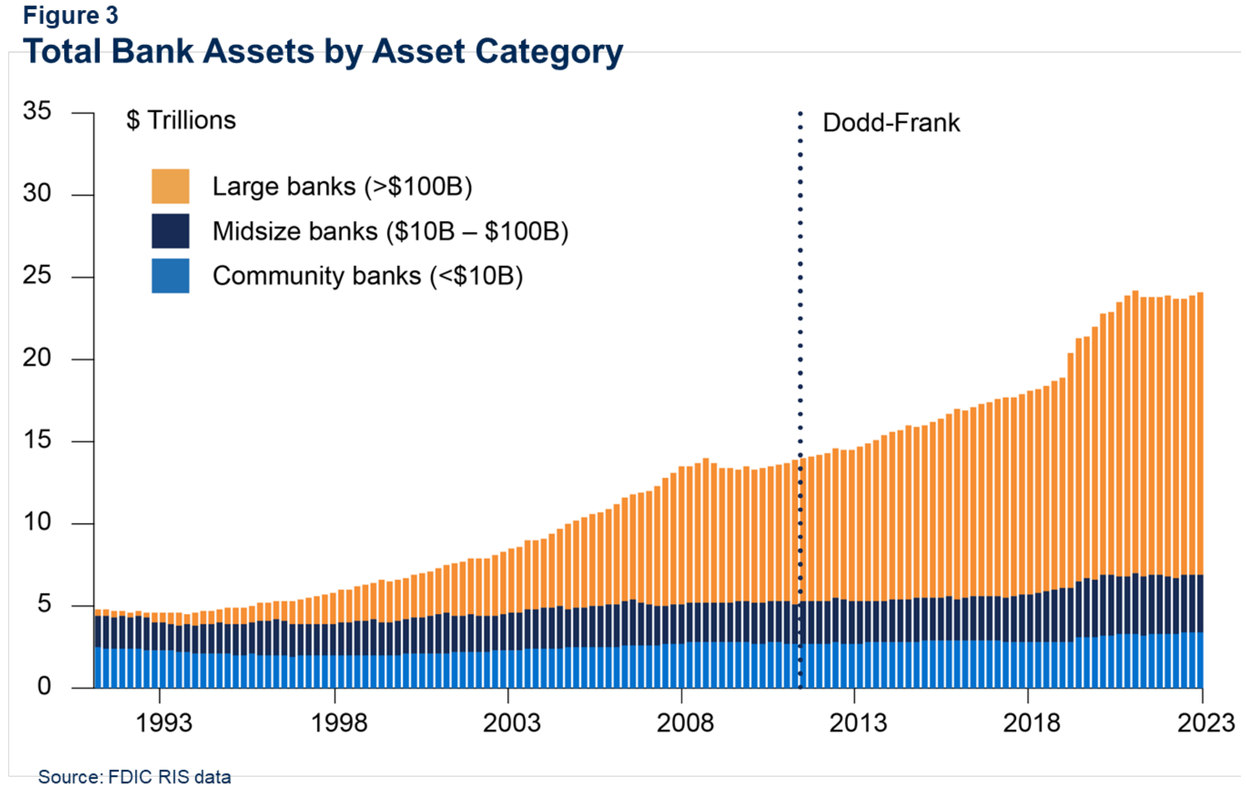
Big picture: banks and the banking system have grown significantly in size and complexity over the past 30 years.

For instance, at the OCC, the number of banks we regulate and supervise has declined significantly while their total assets have grown, as seen in figure 2.



Source: FDIC Research Information System (RIS) data

Large banks in particular have gotten much bigger and are much more complex. Thirty years ago, there were only five U.S. banks with more than $100 billion in assets ("large banks").[7] Together, they had $800 billion in combined assets.[8] Today, there are 32 large banks in the United States with aggregate assets exceeding $17 trillion, as seen in figure 3. The trend is clear.



Harder to quantify, but just as importantly, a range of nonfinancial risks has steadily risen in importance for banks and the banking system. Cyber risk, for instance, began to feature heavily in bankers' lists of top risks starting around 2012. That coincided with the rapid growth of online and mobile banking, associated digitalization, and significant increases in banks'

[7] Integrated Banking Information System (IBIS) data. Counts are based on highest holders, not individual charters. Assets are rolled up by highest holder.

[8] FDIC RIS data, as of December 31, 1993.

technology budgets. Around the same time, high-profile compliance breakdowns, market manipulation incidents (e.g., LIBOR and FX), and challenges combatting illicit finance (e.g., Bank Secrecy Act enforcement actions) became topics of public discussion, significantly affecting trust in banks, especially large banks.[9]

In the meantime, the dynamic nature of interactions between banks and nonbank financial institutions and technology firms (fintechs), which compete, support, and rely on banks to varying degrees, has led to an increasingly complex nexus between banking and commerce.[10] From the rise and fall of crypto to concerns about the growth of private credit and nonbank mortgage servicing to the recent bankruptcy of fintech middleware firm Synapse, lurking behind these developments have been proliferating questions about the roles, interdependencies, and exposure of banks to nonbanks.

Evolving Supervision

These changes in banks and banking have compelled bank supervisors to adapt to remain effective. Three changes in particular are worth highlighting:

Effective supervision requires a more nimble "team-of-teams" approach. In general, supervision has long consisted of bank-specific teams led by an examiner-in-charge or equivalent. These teams are sometimes referred to as on-site teams, vertical teams, or supervisory teams.

[9] U.S. House of Representatives, Committee on Financial Services, *Holding Megabanks Accountable: An Update on Banking Practices, Programs, and Policies* (May 27, 2021) and *Holding Megabanks Accountable: A Review of Global Systemically Important Banks 10 Years After the Financial Crisis* (April 10, 2019).

[10] Acting Comptroller Michael J. Hsu, "Preventing the Next Great Blurring," Vanderbilt University (February 21, 2024).

The 2008 financial crisis highlighted deficiencies in relying primarily on the on-site team model to supervise global systemically important banks (GSIB). Their size, complexity, and geographic span made clear that a single team, no matter how well resourced or empowered, would not be enough. A mix of teams working together—i.e., a "team of teams" approach[11]—is necessary. For instance, so-called horizontal teams, with expertise in particular areas such as liquidity or market or cyber risk, might monitor, benchmark, and assess a cohort of banks. While such teams are not new, after the 2008 financial crisis their stature and influence were elevated to better balance and complement the vertical teams. Ensuring that the multiple teams that cover a bank work together productively and in a manner that generates credible, consistent assessments and outcomes is one of the top responsibilities of a supervision banking agency's leadership.

As community banks evolve and the number of smaller banks in the United States shrinks, the organization of those vertical teams can also be rethought. At the OCC, we realigned our midsize and community bank supervision (MCBS) function away from four fairly autonomous districts toward "one MCBS" with teams managed on a cohort or subregional basis supported by nationwide horizontal risk teams and a centralized resource function. For instance, we now have one portfolio of trust bank teams, another portfolio of novel bank teams, and yet another portfolio of technology service provider (TSP) teams, all reporting to the same deputy comptroller. Previously, each district had a smattering of trust banks, novel banks, and TSPs, with resources, expertise, and decision-making scattered accordingly.

Smartly cohorting institutions and enabling a team-of-teams approach to supervision improve consistency, efficiency, and preventing blind spots. More importantly, they allow a

[11] Stanley McChrystal, Tantum Collins, Chris Fussell, and Dave Silverman, *Team of Teams: New Rules of Engagement for a Complex World* (New York: Penguin/Portfolio, 2015).

flatter organizational structure to flourish in practice, which helps with agility in the face of change and evolving interdependencies with nonbanks.

Supervision must be as adept at covering nonfinancial risks as financial risks. Trust and confidence in banks and banking are not just about ensuring financial resilience. Cyberattacks must be repelled, critical operations must be maintained, consumers must be protected, and laws and regulations, such as anti-money laundering and fair lending requirements, must be complied with.

What's different now is that the stakes for each of these are higher, bank-nonbank interdependencies have increased, and the pace of change has accelerated significantly.

Digitalization, for instance, has brought great benefits, but has also increased the risk surface for cyberattacks. At the same time, hackers, money launderers, and fraudsters have become much more sophisticated. Controls and systems that were effective a couple of years ago may not be effective today.

Particularly challenging is the proliferation of bank partnerships and arrangements with nonbank third parties, who in turn often partner and rely on fourth parties, and so on. The provision of banking services increasingly resembles global manufacturing supply chains, with their efficiencies and vulnerabilities. Earlier this year a nonbank technology firm called Synapse filed for bankruptcy. Synapse served as an intermediary between roughly 100 consumer-facing fintechs and four banks. When it failed, over $100 million in end-user deposits sourced by those fintechs were frozen by Synapse's bankruptcy.[12] As millions of consumers are now learning the

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[12] Mary Ann Azevedo, "Synapse's Collapse Has Frozen Nearly $160M From Fintech Users — Here's How It Happened," *TechCrunch*, August 22, 2024.

hard way, banking is no longer done by just banks. And the nonfinancial risk aspects of these arrangements are as prominent, complex, and important as the financial risks.

Supervision must contend with more large banks. As highlighted in figure 3 earlier, 10 years ago large banks in the United States had roughly $10 trillion in aggregate assets, while today the 32 large banks have over $17 trillion in combined assets. Ten years from now, combined assets in U.S. large banks may be $26 trillion.[13]

There must be a commensurate evolution and strengthening of supervision and regulation. For GSIBs, we must maintain high regulatory and supervisory standards and update them when necessary. While the post-2008 financial crisis reforms have significantly improved large bank resilience, resolvability, and manageability, the risks of backsliding and stasis are increasing as memories of the financial crisis fade.

In addition, we must ensure that our supervision and regulation of *non-GSIB* large banks are not under-calibrated. Given last spring's banking turmoil and the projected growth of large banks, the time may be ripe for the U.S. banking agencies to consider a framework for formally identifying *domestic* systemically important banks (DSIB). Doing so could provide helpful transparency and rigor for those banks that need it as it would clarify the stakes involved of weakly supervising and regulating such institutions.

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[13] See Acting Comptroller Michael J. Hsu, "Size, Complexity, and Polarization in Banking," remarks before the Exchequer Club (July 17, 2024).

Imperatives for Supervision Going Forward

In addition to the adaptations just discussed, I see two imperatives that are at the boundaries of supervision agencies' capabilities or comfort zones, but which we must embrace if we are to remain effective in the future.

Supervisors must operationalize and sustain robust risk-based supervision. Supervisors are fond of process and have a by-the-book orientation. Process, however, can morph from being a tool to being a cage. Supervisors sometimes criticize banks for taking a "check the box" approach to remediation or change. We supervisors are just as prone to falling into that trap, especially after facing public criticism, when fear of making mistakes is highest.

The problem with check-the-box supervision is that there are a lot of boxes to check, and each box is given equal weight. This ensures comprehensiveness, but artificially limits our ability to focus supervisory attention where it is needed most. Risk-based supervision takes a different approach by de-emphasizing the checklist. At the OCC, our commitment to risk-based supervision is summarized by the mantra "The right work, with the right people, at the right time."[14]

We know that implementing and sustaining risk-based supervision isn't easy. The first challenge is prioritizing supervisory work simultaneously and consistently at the bank level, the portfolio level, and the banking system level. Unless there is a highly collaborative team-of-teams process for doing this, the risk of conflicting priorities and discord within an agency is high.

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[14] For example, see Comptroller of the Currency Thomas J. Curry, "The 2016 Robert Glauber Lecture," Harvard Kennedy School (September 15, 2016).

The second challenge is sustainability. Old habits and constraints tend to reassert themselves over time, making new priorities just as sticky as previous ones. The key to overcoming this is to develop habits for constantly reprioritizing.

In many ways, the greatest challenge for risk-based supervision lies with what is *not* prioritized. In theory, supervisory teams should not be responsible for incidents or bank weaknesses in deprioritized areas. In practice, however, supervisors are often expected to know everything about every bank. This expectation rewards check-the-box supervision over risk-based supervision. The asymmetry noted earlier rears its ugly head here. Maintaining perspective and proportionality can help ensure that misses in deprioritized areas are treated differently than misses in prioritized areas.

Risk-based supervision shifts accountability for outcomes from individual on-site supervisory teams and their managers to the agency's most senior executives responsible for prioritization, collaboration, resource allocation, and quality control. In my opinion, this is critical and will become increasingly important as large banks increase in size, complexity, and number.

Supervisors must prioritize agility and credibility. In general, consistency and subject matter expertise are hallmarks of strong supervision. The OCC, for instance, is well-known for its robust training and deep experience with traditional risks such as credit risk and operational risk, which have served OCC-supervised banks well over the past years.

In environments of change, however, agility and the ability to learn are more critical to supervisors' credibility than consistency and experience.

At the OCC, we are addressing this head on. Our 2027 Strategic Plan identifies "agility and learning" and "credibility and trust" as key objectives.[15] We have made organizational changes, such as establishing an Office of Financial Technology, removing internal barriers to information access, deepening collaboration with our domestic and international counterparts through rotations and secondments, and encouraging agency-wide initiatives, such as one focused on generative AI pilots.

Conclusion

Supervisors are the guardians of trust in banking. This makes bank supervision one of the most important, rewarding, and under-appreciated jobs in finance. From the outside, this can be hard to see.

My hope is that by sharing my perspective on the nature of supervision, changes to the banking system, and what the future demands, I have been able to provide some visibility into what supervision is and how it is evolving.

As an agency focused exclusively on bank supervision and regulation, the OCC has been able to lead on these matters over its long history. Prioritizing agility and credibility will help ensure that we can continue that well into the future.

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[15] OCC News Release 2022-105, "OCC Releases Strategic Plan for Fiscal Years 2023–2027" (September 6, 2022).