



OFFICE OF INSPECTOR GENERAL

Evaluation Report

2017-SR-B-005

The Board Can Improve the Effectiveness of Continuous Monitoring as a Supervisory Tool

March 29, 2017

BOARD OF GOVERNORS OF THE FEDERAL RESERVE SYSTEM
CONSUMER FINANCIAL PROTECTION BUREAU

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Abbreviations

Board	Board of Governors of the Federal Reserve System
FRB Cleveland	Federal Reserve Bank of Cleveland
FRB New York	Federal Reserve Bank of New York
FRB Richmond	Federal Reserve Bank of Richmond
FRB San Francisco	Federal Reserve Bank of San Francisco
LBO	large banking organization
LISCC	Large Institution Supervision Coordinating Committee
LISCC OC	LISCC Operating Committee
MIS	Management Information System
OIG	Office of Inspector General
S&R	Division of Supervision and Regulation



Executive Summary:

The Board Can Improve the Effectiveness of Continuous Monitoring as a Supervisory Tool

2017-SR-B-005

March 29, 2017

Purpose

We assessed the effectiveness of continuous monitoring as a supervisory activity for large, complex financial institutions, including Large Institution Supervision Coordinating Committee (LISCC) firms and large banking organizations (LBOs).

Background

The Federal Reserve System plays a major role in regulating the U.S. financial system. Specifically, the Board of Governors of the Federal Reserve System (Board) supervises systemically important financial institutions, including large bank holding companies, the U.S. operations of certain foreign banking organizations, and nonbank financial companies that are designated by the Financial Stability Oversight Council for Board supervision.

The Board has delegated the authority to supervise these institutions to the Federal Reserve Banks, which assign teams of examiners and risk specialists to supervise the institutions' day-to-day operations. The supervision teams use continuous monitoring—an activity less formal than an examination—to develop and maintain an understanding of an institution and keep apprised of recent developments that may affect its risk profile.

Findings

Although the Board and the Reserve Banks have multiple documents that address the expectations for certain aspects of continuous monitoring, the Board has not issued guidance that harmonizes these expectations across its supervisory portfolios and the Reserve Banks. Such guidance could outline the preferred analytical approach and documentation practices for this activity across the LISCC and LBO supervisory portfolios and minimize the variability that we noted for continuous monitoring activities across the Reserve Banks we visited. Although we noted certain best practices for executing continuous monitoring during our evaluation, those practices have not been broadly implemented across the System. As a result, supervisory guidance issued by the Board could help to foster more consistent execution of this supervisory activity throughout the System and maximize its effectiveness.

Recommendations

Our report provides recommendations to improve the effectiveness of continuous monitoring. In the response to our draft report, the Director of the Board's Division of Supervision and Regulation concurs with our recommendations and outlines progress that has been made to address specific recommendations. We will follow up to ensure that the recommendations are fully addressed.

Summary of Recommendations, OIG Report 2017-SR-B-005

Recommendation number	Page	Recommendation	Responsible office
1	8	Develop guidance and training on how to conduct continuous monitoring that a. reinforces the importance of analyzing the materials received to determine possible implications associated with the analysis, including developing conclusions that may affect safety and soundness. b. requires Federal Reserve Banks to periodically rationalize continuous monitoring activities, including meetings and document reviews. c. clarifies expectations for how to document, label, and store the outputs of routine continuous monitoring activities. d. discusses and implements continuous monitoring best practices across the Federal Reserve System.	Division of Supervision and Regulation
2	8	Improve the storage and retrieval of continuous monitoring documentation by a. clarifying the use of existing systems so that users understand where to store and access continuous monitoring documentation. b. ensuring that the existing systems' areas of supervisory focus are flexible and system search terms meet the needs of individuals conducting continuous monitoring.	Division of Supervision and Regulation



OFFICE OF INSPECTOR GENERAL

BOARD OF GOVERNORS OF THE FEDERAL RESERVE SYSTEM
CONSUMER FINANCIAL PROTECTION BUREAU

March 29, 2017

MEMORANDUM

TO: Michael S. Gibson
Director, Division of Supervision and Regulation
Board of Governors of the Federal Reserve System

FROM: Melissa Heist *Melissa Heist*
Associate Inspector General for Audits and Evaluations

SUBJECT: OIG Report 2017-SR-B-005: *The Board Can Improve the Effectiveness of Continuous Monitoring as a Supervisory Tool*

The Office of Inspector General has completed its report on the subject evaluation. We initiated this evaluation and conducted our fieldwork as part of our divergent views evaluation (*Opportunities Exist to Increase Employees' Willingness to Share Their Views About Large Financial Institution Supervision Activities*, [OIG Report 2016-SR-B-014](#), November 14, 2016) to further assess the effectiveness of continuous monitoring as a supervisory tool.

We provided you with a draft of our report for review and comment. In your response, you outlined actions that the Division of Supervision and Regulation has taken and will take to address our recommendations. We have included your response as appendix B to our report.

We appreciate the cooperation that we received from Board and Reserve Bank employees and officers during this evaluation. Please contact me if you would like to discuss this report or any related issues.

cc: Maryann Hunter
Tim Clark
Jack Jennings
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Introduction

Objective

The Federal Reserve System plays a major role in regulating the U.S. financial system. Specifically, the Board of Governors of the Federal Reserve System (Board) supervises systemically important financial institutions, including large bank holding companies, the U.S. operations of certain foreign banking organizations, and nonbank financial companies that are designated by the Financial Stability Oversight Council for Board supervision.

The Director of the Board's Division of Supervision and Regulation (S&R) chairs the Large Institution Supervision Coordinating Committee (LISCC). LISCC members include senior officers representing various functions at the Board and the heads of the supervision departments from the four Federal Reserve Banks with responsibility for LISCC firms. The LISCC provides an interdisciplinary and cross-firm perspective that advises on the strategic direction of and priorities for LISCC portfolio supervision and the intended response to supervisory issues raised by the LISCC Operating Committee (LISCC OC).

The LISCC OC, in consultation with the LISCC, is responsible for setting priorities for and overseeing the execution of the LISCC supervisory program. Members of the LISCC OC include senior Board officers and officers from the Reserve Banks. The LISCC OC is chaired by a senior Board officer who reports to the Director of S&R. The LISCC OC provides direction to the LISCC firm supervisory teams and directly oversees various subgroups, such as the LISCC OC Vetting Committee and the Risk Secretariat. The LISCC OC oversees the committees charged with executing the Comprehensive Capital Analysis and Review, the Comprehensive Liquidity Analysis and Review, and the Supervisory Assessment of Recovery and Resolution Preparedness. The LISCC OC also discusses firm-specific supervisory plans and annual assessments and ratings prepared by the responsible Reserve Banks and approves the assessments and ratings to be issued to supervised institutions.

We initiated this evaluation to further assess an aspect of the Board's supervisory program, continuous monitoring, that we addressed in a 2014 evaluation.¹ In that evaluation, we recommend that the Board improve the effectiveness of continuous monitoring by issuing guidance that details expectations for documenting the results of continuous monitoring activities. We also recommend that the Board enhance its knowledge management capabilities for supervisory information, so that supervisory materials can be easily accessed.² As a result of our narrow focus during the prior evaluation on one supervisory team's continuous monitoring activities at the Federal Reserve Bank of New York (FRB New York), we decided to assess the

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1. Office of Inspector General, *The Board Should Enhance Its Supervisory Processes as a Result of Lessons Learned From the Federal Reserve's Supervision of JPMorgan Chase & Company's Chief Investment Office*, [OIG Report 2014-SR-B-017](#), October 17, 2014.
 2. We reviewed ongoing work performed by the Board to address our recommendations. One recommendation remains open because the Board is still in the process of implementing action plans to address it.

effectiveness of continuous monitoring as a supervisory tool across multiple Reserve Banks and supervisory teams.

During our fieldwork for this evaluation, we visited four Reserve Banks—the Federal Reserve Bank of Cleveland (FRB Cleveland), FRB New York, the Federal Reserve Bank of Richmond (FRB Richmond), and the Federal Reserve Bank of San Francisco (FRB San Francisco). We selected these Reserve Banks to reflect the regional and geographic dispersion of firms within the LISCC and large banking organization (LBO) portfolios.³ During our visits, we interviewed Reserve Bank personnel throughout the chain of command for large financial institution supervision activities for a sample of LISCC firms and LBOs. We also interviewed Reserve Bank and Board staff who perform, assess, and rely on the conclusions from continuous monitoring activities to evaluate the effectiveness of continuous monitoring as a supervisory tool. Our document reviews included the Board’s and Reserve Banks’ continuous monitoring policies, procedures, and guidance. We also reviewed specific supervisory teams’ document repositories containing continuous monitoring work products. We conducted this evaluation in conjunction with another evaluation, which we concluded in November 2016.⁴

Continuous monitoring is one type of supervision activity; others include horizontal reviews⁵ and target examinations.⁶ Continuous monitoring can be helpful in identifying knowledge gaps for the supervision teams that may require further supervisory focus and allows the supervision teams to remain apprised of potential strategic and operational changes at an institution that may affect its risk profile. In this respect, we understand that continuous monitoring can serve an important risk discovery function. Reserve Bank supervisory teams allocate time to conduct continuous monitoring activities for specific purposes in their supervisory plans. Because we did not compare continuous monitoring with other supervisory activities, our report should not be viewed as rendering any opinion on the appropriate balance or distribution of time spent by supervisory employees between various supervisory activities.

For more information on our scope and methodology, see appendix A.

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3. The LISCC is a Federal Reserve System committee that coordinates the supervision activities of the largest, most systemically important financial institutions in the United States. LISCC firms are domestic bank holding companies, foreign banking organizations, and nonbank financial institutions designated by the Financial Stability Oversight Council as systematically important. There are 14 LISCC firms. In general, the System considers banking organizations with more than \$50 billion in total assets that are not LISCC firms to be LBOs.
 4. In November 2014, the Board requested that we (1) assess the methods for System decisionmakers to obtain material information resulting from supervisory activities performed at LISCC firms and LBOs and (2) determine whether there are adequate channels for System decisionmakers to be aware of supervision staff divergent views on supervisory activities related to the supervision of LISCC firms and LBOs. Office of Inspector General, *Opportunities Exist to Increase Employees’ Willingness to Share Their Views About Large Financial Institution Supervision Activities*, [OIG Report 2016-SR-B-014](#), November 14, 2016.
 5. A *horizontal review* is a coordinated examination of several institutions simultaneously. It encompasses firm-specific supervision and the development of cross-firm perspectives.
 6. A *target examination* assesses the quality and effectiveness of an area of supervisory focus. It typically involves transaction testing and may be performed to assess a firm’s remediation efforts and assess risk management within business lines or processes.

Background

The Board's *Bank Holding Company Supervision Manual* defines *continuous monitoring* as nonexamination activities to develop and maintain an understanding of a regulated entity's risk profile, policies, and practices. These activities can include meeting with banking organization management, analyzing data in Management Information System (MIS) reports, reviewing internal and external audit findings, and using work performed by other regulatory agencies. We understand that supervision staff generally perceive continuous monitoring to be a useful supervisory tool that allows examination teams to remain nimble and to provide broader coverage of a firm's activities. It also helps examiners remain apprised of recent developments—such as strategy changes, new product initiatives, internal audit results, and instances of a firm exceeding its risk appetite—at large, complex financial institutions. Awareness of these recent developments allows supervisors to constantly assess emerging risks in a dynamic environment.

Continuous monitoring activities fall into two categories: (1) routine and (2) enhanced. Routine continuous monitoring activities occur periodically, or ad hoc, throughout the supervisory cycle and include meeting with a supervised entity's management, reviewing reports from the firm or other regulators, and monitoring market events and emerging risks. Through routine continuous monitoring activities, supervisory teams assess whether developments or emerging issues warrant additional supervisory activities, such as enhanced continuous monitoring or target examinations.

Enhanced continuous monitoring is a planned point-in-time supervisory event similar to a target examination, but less formal.⁷ Examiners use enhanced continuous monitoring activities (1) to increase their understanding of a firm's activities; (2) to address potential knowledge gaps; and (3) to assess a supervised institution's response to corrective actions required by a matter requiring attention, a matter requiring immediate attention, or an enforcement action.⁸

According to data provided to us by S&R, during 2015 Reserve Bank examiners for LISCC firms and LBOs spent 56 percent of their time on continuous monitoring.⁹ During 2015, LISCC firm examiners spent a higher percentage of their time than LBO examiners on continuous monitoring activities: 53 percent versus 30 percent for routine continuous monitoring and 14 percent versus 9 percent for enhanced continuous monitoring.¹⁰ Given the considerable time dedicated to continuous monitoring, maximizing its effectiveness should enhance the overall effectiveness of the supervisory program.

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7. Board guidance requires that examiners issue a conclusion letter to the firm following the completion of a target examination. However, this requirement only applies to enhanced continuous monitoring if examiners plan to issue a matter requiring attention or a matter requiring immediate attention.
 8. *Matters requiring attention* constitute matters that are important and that the Federal Reserve expects a banking organization to address over a reasonable period of time. *Matters requiring immediate attention* are similar, but banking organizations are expected to address the identified issue immediately.
 9. LISCC firm and LBO examiners spent 44 percent of their time on routine continuous monitoring and 12 percent on enhanced continuous monitoring. These figures are based on time examiners spent on institution-specific supervisory activities.
 10. We used continuous monitoring time data only for 2015 and not for previous calendar years because the Federal Reserve System converted to a new time-tracking system for 2015. The prior time-tracking system did not capture routine continuous monitoring specifically. We understand that given the recent implementation of the new time-tracking system, S&R expects the precision of the Resource Optimization Activity Manager (ROAM) tracking data to improve over time.

Finding: The Board Should Issue Guidance That Establishes Consistent Expectations for Continuous Monitoring

S&R and the Reserve Banks have issued guidance on some aspects of continuous monitoring, such as establishing the supervisory focus on key meetings and management reports and describing the expected outputs. Nevertheless, S&R has not issued guidance that harmonizes its expectations for supervisory portfolios and the Reserve Banks. Such guidance could help to maximize the benefits associated with continuous monitoring by defining a consistent framework or approach to analyzing materials or information and defining how those learnings should be documented across the LISCC and LBO portfolios. We learned that examiners use varying approaches to conduct particular aspects of continuous monitoring. We also noted certain best practices for executing continuous monitoring during our evaluation at the Reserve Banks we visited. Those practices have not been broadly implemented across the System. Given the considerable amount of examiner time devoted to performing continuous monitoring activities across the System and the risk discovery function that continuous monitoring can serve, supervisory guidance issued by the Board that establishes more consistent expectations for conducting continuous monitoring could help to standardize this activity and maximize its effectiveness.

The Board Has Not Established Comprehensive Guidance That Harmonizes Its Expectations for Continuous Monitoring

The Board's *Bank Holding Company Supervision Manual* describes continuous monitoring and lists associated activities, but it does not address the differences between routine and enhanced continuous monitoring activities or outline how to approach them. The LISCC OC and LBO Management Group have each issued a guidance document on continuous monitoring specifically applicable to their respective portfolios. These documents define routine and enhanced continuous monitoring as well as other supervisory activities and outline expected documentation for each activity. We noted that the LISCC OC guidance provides expectations for what constitutes key meetings. The guidance requires dedicated teams to assess and identify key meetings and MIS reports and document key takeaways from those activities on a quarterly basis. The LBO Management Group guidance provides an illustrative list of key MIS reports and key meetings but does not address expectations for documenting key takeaways from those activities. Given the discretion afforded examiners to perform these activities as well as the amount of time spent on routine continuous monitoring, a guidance document that establishes a common analytical framework may help to provide supervision staff with more clarity on the Board's expectations for maximizing the value and insights to be derived from this activity.

Each Reserve Bank we visited had its own guidance for continuous monitoring. We noted that these documents address the differences between routine and enhanced continuous monitoring and explain how those supervisory tools should be used. The Reserve Banks' guidance documents also describe expected outputs from routine and enhanced continuous monitoring. However, the level of detail included in Reserve Bank policies regarding specific expectations and the purpose of routine continuous monitoring varies.

We noted that supervisory teams at the same Reserve Bank and even examiners on the same teams performed routine continuous monitoring differently. The lack of Board guidance on this topic and the current multiple portfolio-level and Reserve Bank guidance documents for this activity may contribute to this inconsistency. Because LISCC and LBO supervisory teams devote a considerable amount of time to routine continuous monitoring and because this activity helps to identify emerging risks, the Board should create a guidance document that establishes baseline expectations for this supervisory activity. This approach should help maximize the benefits of continuous monitoring.

Certain Factors Limit the Effectiveness of Continuous Monitoring

During our interviews, we learned that approaches to continuous monitoring vary. Also, examiners and risk specialists we interviewed described challenges that indicate a need for Board guidance as a means to address these challenges and mitigate these inconsistencies.

Large Amounts of Information and Many Meetings

We learned that institutions provide Reserve Banks with voluminous documentation for continuous monitoring on an ongoing basis. Some of the documents include board committee reporting packages, MIS reports used to track various business lines, and other reports prepared on a periodic basis. During our interviews, we heard that examiners do not have sufficient time to review all this information and that the teams may not have analyzed all of the information prior to it being uploaded into the various repositories.

The collection of a voluminous amount of information was necessary during the financial crisis. Although the extensive amount of meetings and document reviews might not be needed now because conditions have generally improved, one interviewee emphasized that examiners are reluctant to cancel requests for documents or meetings. We noted that examiners were reluctant to cancel requests for documents and meetings because of concerns that reducing the scope of the team's continuous monitoring activities may result in the team being unaware of important events at a firm. As a result, more periodic meetings may be scheduled and requests for recurring MIS reports may be added to those previously established by former team members. In our opinion, rationalizing the need for these requests for meetings and MIS reports periodically might help to focus and prioritize a supervisory team's continuous monitoring reviews.

Storing and Retrieving Continuous Monitoring Documentation

Examiners indicated that there are several repositories and potential locations within those repositories that can be used to store continuous monitoring documents that Reserve Bank teams receive or produce as a result of routine continuous monitoring. We also learned that multiple SharePoint sites can exist for each supervisory team or each risk group. We understand that the Board expects examiners to store the results of continuous monitoring activities in specific supervisory team repositories; however, interviewees noted that it can be difficult to locate and retrieve information once it has been uploaded.

Supervisory team members indicated that SharePoint may not be searchable or effectively filtered to find a specific document or information on a topical issue about which examiners have posted. When uploading documents, examiners can tag the document with one of a number of preset topics or areas of supervisory focus. We learned that those areas of supervisory focus may not be granular enough to properly tag much of the documentation. Further, challenges may arise if a document addresses multiple areas of supervisory focus or if the specific area of supervisory focus a team member seeks has not been tagged.

We also learned that the approach to storing documentation on continuous monitoring activities can vary by supervisory teams or individual examiners. For example, when individual examiners upload documents to the various databases, two examiners may tag the same document with different areas of supervisory focus, which could affect whether and how quickly that information can be retrieved in the future.

During interviews, we heard that the approach to supervision has been evolving as a result of new supervisory initiatives established since the financial crisis. Further, team members indicated that it is difficult to find information that they are looking for and that categories and filters examiners use when uploading or searching for a document need to have additional flexibility. We noted that information-sharing improvements related to the SharePoint team sites were made in 2015, but team members indicated that additional improvements are necessary to allow examiners to organize and search for documents.

Reserve Banks Demonstrate Best Practices Related to Continuous Monitoring

We found instances of best practices for continuous monitoring at the Reserve Banks we visited. Reserve Banks we did not visit may have implemented similar best practices or created best practices that we did not identify, so our list is not exhaustive. As a result, we recommend that the Board assess whether additional practices should be included in the prospective guidance.

Best Practice: Annual Rationalization

FRB Richmond requires its supervisory teams to annually rationalize their routine continuous monitoring activities, for both meetings and document reviews, to assess whether each meeting held or document received contributes to the effectiveness of the team's supervision and determine whether to continue with those activities and information requests.¹¹ An FRB Richmond official noted the challenges sifting through all the information provided by supervised institutions and emphasized that examiners need to be thoughtful about which activities they conduct. Conducting this rationalization process on an annual or other periodic basis helps to keep continuous monitoring activities focused on the most relevant topics and emerging risks. Other Reserve Banks could begin to address examiner concerns about receiving too much information as part of routine continuous monitoring by adopting this best practice.

11. We noted that FRB San Francisco has a similar process to rationalize continuous monitoring activities. Also, the LISCC Supervisory Activities Toolkit instructs examiners to identify key meetings and MIS reports.

In addition to this Reserve Bank best practice, we also understand that LBO portfolio teams Systemwide use an automated tool to assist in periodically revisiting the routine continuous monitoring events with supervised firms that team members attend. This automated tool requires teams to input data on periodic routine continuous monitoring events. The tool automatically populates a sunset date. This sunset date forces the teams to consider the benefits to be derived from continuing to allocate resources to a specific event at a future date. This sunset process for meetings can help the supervisory team to monitor and manage its routine continuous monitoring commitments. Although the Board has issued guidance requiring teams to input meeting data into the automated tool, the process to consider the benefits to be derived from continuing or discontinuing routine continuous monitoring events appears to be happening on an informal basis and has not been captured in policy or guidance.

Best Practice: Continuous Monitoring Documentation Framework

Supervisory team members stated that they receive updates on the condition of firms through continuous monitoring but indicated that the outputs of continuous monitoring can vary by supervision team. Interviewees indicated that there are differing perspectives about whether the outputs of continuous monitoring should include team members' independent analysis or simply reflect the information reported by the institution.

We learned that FRB New York's continuous monitoring documentation framework is an effort to improve the quality of documentation by encouraging team members to be more analytical and conclusion oriented when documenting results of continuous monitoring activities. The framework includes an automated form that prompts examiners to document key takeaways, including whether there is any effect on the supervisory plan or the assessment of the firm as a result of continuous monitoring. FRB New York introduced the framework in September 2015. In implementing the framework, FRB New York also adopted a naming convention that provides guidance to team members on how to identify documents when saving them to the team SharePoint sites.

When we spoke with FRB New York supervision employees about the continuous monitoring documentation framework form, they generally agreed with the rationale for the transition to the new form but noted concerns about its implementation and effectiveness.¹² Interviewees also noted confusion about whether the form replaced meeting minutes; how frequently to complete the form; the variety of naming conventions that could be used to save the form; and the option to save the form to several systems, which could affect retrieval of the information. We understand that FRB New York issued guidance in April 2016 to staff regarding the frequency of use of the continuous monitoring documentation framework form. In September 2016, FRB New York clarified for staff the expectations for the use of meeting minutes and the continuous monitoring documentation framework form.

Although examiners may have concerns with the initial implementation of the continuous monitoring documentation framework form, we view the form as an improvement that prompts examiners to document conclusions that arise from their continuous monitoring activities.

12. During our interviews, an FRB New York senior official noted that the Reserve Bank was in the process of addressing the concerns raised by examiners regarding the form.

Recommendations

We recommend that the Director of S&R

1. Develop guidance and training on how to conduct continuous monitoring that
 - a. reinforces the importance of analyzing the materials received to determine possible implications associated with the analysis, including developing conclusions that may affect safety and soundness.
 - b. requires Federal Reserve Banks to periodically rationalize continuous monitoring activities, including meetings and document reviews.
 - c. clarifies expectations for how to document, label, and store the outputs of routine continuous monitoring activities.
 - d. discusses and implements continuous monitoring best practices across the Federal Reserve System.
2. Improve the storage and retrieval of continuous monitoring documentation by
 - a. clarifying the use of existing systems so that users understand where to store and access continuous monitoring documentation.
 - b. ensuring that the existing systems' areas of supervisory focus are flexible and system search terms meet the needs of individuals conducting continuous monitoring.

Management's Response

In the response to our draft report, the Director of S&R concurs with our recommendations and highlights ongoing work and instances in which progress has been made to address specific recommendations.

For recommendation 1, the Director recognizes that there are opportunities for the Board to clarify its expectations for continuous monitoring through additional guidance and training. He notes that for the LISCC portfolio, the new Monitoring and Analysis Program Leadership Group will work to ensure consistent and high-quality monitoring by establishing procedures and overseeing monitoring activities. For the large and foreign banking organization portfolio, the Director notes that the Large and Foreign Banking Organization Management Group will develop additional guidance and training on routine continuous monitoring.¹³ According to the Director, this guidance will reinforce the importance of analyzing routine continuous monitoring materials; require periodic rationalization of routine continuous monitoring activities; provide guidance on

13. During much of our fieldwork, the LBO Management Group operated separately from the Foreign Banking Organizations Management Group. Effective January 1, 2016, the LBO Management Group and the Foreign Banking Organizations Management Group merged to form the Large and Foreign Banking Organizations Management Group. We use the term *LBO Management Group* throughout our report, however, because that was the body in existence during the bulk of our fieldwork.

how to document, label, and store routine continuous monitoring activities; and implement best practices across the Federal Reserve System.

For recommendation 2, the Director notes that for the LISCC portfolio, the new LISCC program manual includes documentation requirements. Additionally, he indicates that for the large and foreign banking organization portfolio, S&R is developing guidance on which systems to use for storing continuous monitoring documentation. The Director states that as new systems are developed, the LISCC and large and foreign banking organization portfolio will ensure their design includes search capabilities.

OIG Comment

The actions described by the Director of S&R appear to be responsive to our recommendations. We will follow up to ensure that these actions fully address our recommendations.

Appendix A

Scope and Methodology

We initiated this evaluation to assess the effectiveness of continuous monitoring as a supervisory tool. In October 2014, the OIG published a report titled *The Board Should Enhance Its Supervisory Processes as a Result of Lessons Learned from the Federal Reserve's Supervision of JPMorgan Chase & Company's Chief Investment Office*. Based on that evaluation, we determined that the expected deliverables from continuous monitoring were not clear because the Board had not issued guidance on these deliverables. We conducted this evaluation in conjunction with another evaluation, the results of which were reported in *Opportunities Exist to Increase Employees' Willingness to Share Their Views About Large Financial Institution Supervision Activities*.

To assess the effectiveness of continuous monitoring as a supervisory tool, we focused our review on the supervision of LISCC firms and LBOs.¹⁴ We selected a nonrandom sample of four Reserve Banks to visit—Cleveland, New York, Richmond, and San Francisco—that reflect the regional and geographic dispersion of the LISCC and LBO portfolios. We selected FRB New York because it supervises more than 70 percent of the LISCC firms and has responsibility for several LBOs. We selected FRB Richmond and FRB San Francisco because they each supervise one LISCC firm and multiple LBOs. We selected FRB Cleveland because it supervises multiple LBOs.

For the three Reserve Banks in our sample that supervise LISCC firms, we selected a sample of LISCC firm teams for our evaluation. FRB San Francisco and FRB Richmond each supervise one LISCC firm, and we included the teams that supervise these firms in our LISCC sample. FRB New York supervises 10 LISCC firms.¹⁵ We considered the following attributes, among other factors, when selecting our sample of FRB New York LISCC firm teams: the bank holding company's total assets as of March 2015, the size of the supervisory team, the firm's ratings, and any outstanding supervisory enforcement actions. In total, five LISCC firm teams were included in our LISCC firm nonrandom sample.

To determine which LBOs to include in our supervisory team LBO sample, we considered the following attributes, among several factors: the bank holding company's total assets as of March 2015, the size of the supervisory team, the firm's ratings, and any outstanding supervisory enforcement actions. We selected a nonrandom sample of teams responsible for one of two LBOs supervised by FRB Richmond, one of three LBOs supervised by FRB San Francisco, one of five

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14. The Board exercises general supervision over the 12 Federal Reserve Banks located across the United States. Each Federal Reserve Bank serves the District in which it is located. These Districts are (1) Boston, (2) New York, (3) Philadelphia, (4) Cleveland, (5) Atlanta, (6) Chicago, (7) St. Louis, (8) Minneapolis, (9) Kansas City, (10) Dallas, (11) Richmond, and (12) San Francisco. Four Reserve Banks supervise one or more LISCC firms: Boston, New York, Richmond, and San Francisco. The Federal Reserve Banks of Kansas City and St. Louis are the only two Reserve Banks that do not supervise either LISCC firms or LBOs.
15. A March 2016 federal district court order rescinded MetLife's designation by the Financial Stability Oversight Council as a systemically important financial institution. The U.S. Department of Justice, on behalf of the Financial Stability Oversight Council, has appealed the district court's decision. On June 28, 2016, the Financial Stability Oversight Council rescinded GE Capital's nonbank systematically important financial institution designation.

LBOs supervised by FRB New York, and two of five LBOs supervised by FRB Cleveland. In addition, we selected one foreign banking organization supervised by FRB New York.

We requested from the Reserve Banks a list of examiners, including risk specialists, who had been assigned to the LISCC firm and LBO supervisory teams in our sample since January 2012. We selected a nonrandom sample of examiners for interviews, considering the following attributes: (1) tenure at the Reserve Bank, (2) job title, (3) commissioned or noncommissioned examiner status, and (4) current or noncurrent examiner status on the examination team. We visited the Reserve Banks in our sample from May 2015 to December 2015. We scheduled conference calls with individuals who were unavailable during our visits. We interviewed 198 Reserve Bank employees (28 from FRB Cleveland, 36 from FRB San Francisco, 41 from FRB Richmond, and 93 from FRB New York). In addition, we interviewed the head of supervision and other responsible supervision officers at each Reserve Bank we visited. We also interviewed 34 Board employees.

We reviewed documentation provided by the Board and the four Reserve Banks in our sample regarding continuous monitoring policies and procedures. Board documents we reviewed included

- SR Letter 04-18, *Bank Holding Company Rating System*
- SR Letter 12-17, *Consolidated Supervision Framework for Large Financial Institutions*
- SR Letter 15-7, *Governance Structure of the LISCC Supervisory Program*
- *Bank Holding Company Supervision Manual*

We reviewed supervisory activities from January 2012 to December 2015, although we emphasized more recent events as supervision has continued to evolve significantly since the financial crisis.

We conducted our fieldwork from December 2014 through January 2016. We performed our evaluation in accordance with the *Quality Standards for Inspection and Evaluation*, issued in January 2012 by the Council of the Inspectors General on Integrity and Efficiency.

Appendix B

Management's Response



BOARD OF GOVERNORS
OF THE
FEDERAL RESERVE SYSTEM

WASHINGTON, D.C. 20551

DIVISION OF
SUPERVISION AND REGULATION

March 21, 2017

Mr. Mark Bialek
Inspector General
Board of Governors
of the Federal Reserve System
20th Street and Constitution Avenue, NW
Washington DC, 20551

Dear Mr. Bialek:

Thank you for the opportunity to comment on your draft report, *The Board Can Improve the Effectiveness of Continuous Monitoring as a Supervisory Tool*. We appreciate the effort that the Office of Inspector General (OIG) has put into this report and the recommendations it has provided for improving our supervisory process.

The draft report makes two (2) recommendations designed to increase the effectiveness of continuous monitoring as a supervisory tool. We agree with the recommendations and have provided our responses below.

1. *Develop guidance and training on how to conduct continuous monitoring that*
 - a. *reinforces the importance of analyzing the materials received to determine possible implications associated with the analysis, including developing conclusions that may affect safety and soundness.*
 - b. *requires Reserve Banks to periodically rationalize continuous monitoring activities, including meetings and document reviews.*
 - c. *clarifies expectations for how to document, label, and store the outputs of routine continuous monitoring activities.*
 - d. *discusses and implements continuous monitoring best practices across the Federal Reserve System.*

We agree with this recommendation and recognize that there are opportunities to clarify our expectations for continuous monitoring through additional guidance and training for both the Large Institution Supervision Coordination Committee (LISCC) and Large and Foreign Banking Organization (LFBO) portfolios.

LISCC Portfolio. Throughout 2016 and early-2017, the LISCC portfolio has drafted and distributed a near-final version of the new LISCC Program Manual, which addresses recommendations 1.a.-1.e. above. The new Monitoring and Analysis Program (MAP) includes participants from across the program including the Dedicated Supervisory Teams (DSTs). The MAP Program Leadership Group is responsible for ensuring consistent and high quality monitoring by establishing procedures and overseeing monitoring activities. The MAP Steering Committee co-chairs are working on a transition plan for standing up the MAP. This plan will be discussed with the LISCC Operating Committee during the first half of May and approved and communicated by May 31, 2017. The transition plan will be required to address how the group, which oversees all monitoring for the national LISCC supervisory program, will develop guidance and training to meet 1.a.-1.d. of the recommendation.

LFBO Portfolio: While we have developed guidance for continuous monitoring in the LFBO Supervisory Activities Guidance document and in the LFBO C-SCAPE Guidance document, the LFBO portfolio is working with the LFBO Management Group (LFBO MG) to develop further guidance and training on routine continuous monitoring. This guidance will reinforce the importance of analyzing routine continuous monitoring materials; require periodical rationalization of routine continuous monitoring activities; provide guidance on how to document, label, and store routine continuous monitoring activities; and implement best practices across the Federal Reserve System. The LFBO MG has representation from all of the Reserve Banks that supervise Large Banking Organizations and is well positioned to draw on best practices across the System for purposes of developing guidance. Regarding examiner training, the LFBO MG holds monthly meetings with supervisory teams that could be used as a venue for communicating new guidance. the

2. *Improve the storage and retrieval of continuous monitoring documentation by*
 - a. *clarifying the use of existing systems so that users understand where to store and access continuous monitoring documentation.*
 - b. *ensuring that the existing systems' areas of supervisory focus are flexible and system search terms meet the needs of individuals conducting continuous monitoring.*

We agree with the recommendation to clarify which systems to use for storage of continuous monitoring documentation and to ensure the flexibility of such systems for retrieval purposes. For the LFBO portfolio, we are developing guidance on which systems should be used to store continuous monitoring documentation. For the LISCC portfolio, we have included documentation requirements in the new LISCC Program Manual.

The LFBO and LISCC portfolios will both continue to improve the search capabilities of routine continuous monitoring documents in its existing solutions. In addition, as new systems are created, the LISCC and LFBO portfolios will ensure that they are designed to help with the search capabilities.

Thank you for the opportunity to provide comments on this report. We are committed to addressing the recommendations and increasing the effectiveness of continuous monitoring as a supervisory tool.

Regards,



Michael S. Gibson
Director

Division of Supervision and Regulation



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