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Federal Reserve Proposes to Refocus Expectations for Banking Organization Directors on Core Responsibilities

Proposal Recognizes the Distinct Role of the Board as Compared to Management and the Adverse Impact of Unduly Extensive Requirements on the Board's Attention and Effectiveness

SUMMARY

On August 3, the Board of Governors of the Federal Reserve System (the FRB) proposed supervisory expectations for banking organization boards of directors that are intended, among other things, to better distinguish the roles and responsibilities of the board from those of management. The proposal would:

- Establish five attributes of an effective board (applicable to large bank and savings and loan holding companies and systemically important nonbank financial companies, but not intermediate holding companies of foreign banking organizations):
 - setting clear, aligned and consistent direction regarding the firm's strategy and risk tolerance;
 - actively managing information flow and board discussions;
 - holding senior management accountable;
 - supporting the independence and stature of independent risk management and internal audit; and
 - maintaining a capable board composition and governance structure.
- Include a review of existing supervisory guidance for all holding company boards to identify and revise or eliminate board expectations that go beyond the core board responsibilities.
- Provide that supervisory findings (MRAs and MRIAs) should generally be directed to senior management for corrective action, and should be directed to the board only if they relate to the board's governance responsibilities or where senior management has failed to take remedial action.

Comments on the proposal are due 60 days after publication in the *Federal Register*.

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The FRB concurrently issued a related proposal to establish a new rating system for the supervision of large financial institutions, which is discussed in a separate memorandum.¹

BACKGROUND

The preamble accompanying the proposal notes that the FRB has been engaged in a multi-year review of the practices of boards of directors, particularly at the largest banking organizations. The results of this review, and the FRB's discussions with independent directors, indicate that supervisory expectations for boards have become increasingly difficult to distinguish from those of management, in a way that has made it more difficult for boards to devote sufficient resources and attention to their core oversight responsibilities. The preamble also notes that the use of standardized, process-oriented board expectations, as compared to a more principles-based approach, fails to take into account the differences in firms' activities, risk profiles and complexity.

The concerns that the FRB is seeking to address have been raised by a number of commentators in recent years, as bank regulation has often taken the form of specific mandates for board review or action. The cumulative effect has been to impose on banking organization boards an overwhelming number of specific compliance responsibilities, many of which are more appropriately within the scope of management's authority. This situation has made it far more challenging for boards to focus on their critical oversight and strategic responsibilities.²

DISCUSSION

The proposal has three parts: (i) new guidance on board effectiveness; (ii) an announced review of existing guidance for rescission or revision; and (iii) changes to the manner of responsiveness to Matters Requiring Attention (MRAs) and Matters Requiring Immediate Attention (MRIAs).

A. NEW GUIDANCE ON BOARD EFFECTIVENESS FOR LARGE BANKING ORGANIZATIONS

The first part of the proposal would apply to bank holding companies and savings and loan holding companies with total consolidated assets of \$50 billion or more, and to systemically important nonbank financial companies designated by the Financial Stability Oversight Council for supervision by the FRB.³ The proposed guidance would be used in connection with the supervisory assessment of board effectiveness for purposes of the "Governance and Controls" component of the proposed new rating system for large financial institutions under the related proposal issued concurrently by the FRB.

The proposal states that a board is most effective when it focuses on its core responsibilities, in particular by "establishing a firm-wide corporate strategy and setting the types and levels of risk it is willing to take (also referred to as risk tolerance), making certain⁴ that senior management effectively carries out that strategy within the established risk tolerances, and holding management accountable for its actions, including effective risk management and compliance."

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The proposal discusses five attributes of an effective board to be used by supervisors in assessing board effectiveness, certain of which are prescriptive in a granular manner. These attributes, and certain elements of the discussion, are presented below. For the proposal to achieve its objective of refocusing supervisory expectations on the board's core responsibilities, it will be important that these attributes do not become items on an examiner's process-oriented checklist.

- ***Setting clear, aligned and consistent direction regarding the firm's strategy and risk tolerance***
 - The board's direction regarding strategy should be sufficiently clear and detailed to allow senior management to identify the firm's strategic objectives; create an effective management structure; implement strategies, plans, and budgets for business lines; and establish effective audit, compliance and risk management and control functions.
 - The board's direction regarding risk tolerance should be sufficiently clear and detailed to allow the Chief Risk Officer and independent risk management function to set firmwide risk limits by concentration and risk type, and to set more granular limits as appropriate.
 - The board should consider the capacity of the firm's risk management framework when approving the firm's strategy and risk tolerance, so that strategic plans are commensurate with the firm's ability to identify and manage its risk.
 - The board should assess whether the firm's significant policies, programs and plans are consistent with the firm's strategy, risk tolerance, and risk management capacity. As examples of significant policies, programs, and plans, the proposal identifies capital plans, recovery and resolution plans, audit plans, enterprise-wide risk management policies, liquidity risk management policies, a firm's compliance risk management program, and incentive compensation and performance management programs.
- ***Actively managing information flow and board discussions***
 - The goal of this process is to enable the board to make sound, well-informed decisions, and entails evaluating information flows and engaging senior management on improvements.
 - Directors may seek relevant information outside routine board and committee meetings, such as through special sessions, outreach to staff, discussions with senior supervisors, and training on specialized topics.
 - Directors should take an active role in setting board meeting agendas.⁵
- ***Holding senior management accountable for implementing strategy and risk tolerance and maintaining the firm's risk management and control framework***
 - The board should actively engage senior management, including by structuring sufficient time in board meetings to facilitate frank discussion and debate, considering how senior management's assessment and recommendations support the approved strategy and risk tolerance, and challenging senior management's assessments and recommendations when warranted.
 - This engagement should include robust and active inquiry into, among other matters, current and emerging risks, material or persistent deficiencies in risk management and control practices, and the development and implementation of performance management and compensation programs that encourage prudent risk-taking behaviors and business practices, including legal compliance.
 - The board should include independent directors who are sufficiently empowered to serve as a check on senior management. This may include the election of a lead independent director with authority to set meeting agendas or call board meetings with or without the CEO or chair present.

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- The board should establish clear financial and nonfinancial performance objectives for the CEO, Chief Risk Officer, and Chief Audit Executive that are aligned with the firm's strategy and risk tolerance.
- The board should approve and periodically reassess succession plans for the CEO and, as needed, the Chief Risk Officer and Chief Audit Executive, as well as other members of senior management when warranted.
- **Supporting the independence and stature of independent risk management and internal audit**
 - This includes active engagement by the board's audit committee and risk committee regarding, among other matters, material or persistent breaches of risk appetite and risk limits, timely remediation of material or persistent internal audit and supervisory findings, and the appropriateness of the annual audit plan.
 - The risk committee should support the independent risk management function, including compliance, by communicating directly with the Chief Risk Officer on material issues, reviewing the function's budget, staffing and systems, providing the function with direct and unrestricted access to the risk committee, and directing the appropriate inclusion of risk management personnel on senior management-level committees.
 - The audit committee should support internal audit by meeting directly with the Chief Audit Executive; supporting internal audit's budget, staffing, and systems relative to the firm's asset size and complexity and the pace of technological change; and reviewing the status of actions recommended by internal audit to remediate and resolve material or persistent deficiencies.
- **Maintaining a capable board composition and governance structure**
 - The board's composition, governance structure, and practices should support the firm's governance in light of its asset size, complexity, scope of operations, and risk profile.
 - The board should reflect a diversity of skills, knowledge, experience, and perspectives, and the board's process for identifying and selecting director nominees should support this diverse composition.
 - The board should have an appropriate committee structure and management reporting lines, and should have the ability to engage third-party consultants and advisors as appropriate.
 - The board should assess its performance and those of its committees, and adapt its structures and principles over time to address identified weakness or changes to the firm.

A board of directors would be permitted (but not obligated) to provide to supervisors a self-assessment of its effectiveness relative to these five attributes, which the supervisors would take into account along with other sources of information.⁶

B. REVIEW OF EXISTING GUIDANCE

The second part of the proposal describes the comprehensive review being conducted by the FRB of supervisory expectations and regulatory requirements relating to the boards of directors of bank holding companies and savings and loan companies of all sizes (not only the large institutions that would be subject to the new guidance on board effectiveness). The purpose of this review is to identify supervisory expectations for boards of directors that do not relate to their core responsibilities, are not aligned with the FRB's supervisory framework, or are otherwise unnecessary, redundant or outdated.

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The first phase of this review will focus on guidance in existing Supervision and Regulation (SR) letters. The FRB has preliminarily identified 27 SR letters for potential elimination or revision, as set out in a table included in the proposal. Generally speaking, the goal will be to modify existing guidance to align with the new guidance on board effectiveness discussed above, in the case of larger bank organizations, or the guidance on board oversight of risk management set out in SR letter 16-11, in the case of smaller organizations.

The second phase of the review, which the FRB expects to conduct over a longer period, is focused on relevant FRB regulations and interagency guidance.

C. RESPONSIVENESS TO SUPERVISORY FINDINGS

The third part of the proposal seeks to clarify expectations regarding responsiveness to MRAs and MRIAs. The current expectation set forth in SR 13-13 is that all MRAs and MRIAs be presented to the board of directors, an approach which, according to the FRB, has led many boards to believe they should become directly involved in remediation efforts. The proposed guidance, which would apply to all FRB-supervised organizations, provides that MRAs and MRIAs should generally be directed to senior management, and should be directed to the board only if the board needs to address its governance responsibilities or if senior management has failed to take appropriate remedial actions. Boards of directors would nevertheless remain responsible for holding senior management accountable for remediating supervisory findings.

D. REQUEST FOR COMMENTS

The FRB requests public comment on all aspects of the proposal, with comments due 60 days after publication of the proposal in the *Federal Register*. The FRB is soliciting specific feedback on the following questions:

- How should the proposed guidance on board effectiveness and the review of existing guidance apply to U.S. intermediate holding companies of foreign banking organizations and state member banks?
- What other attributes of effective boards should the FRB assess?
- Should boards be required to perform a self-assessment of their effectiveness and provide the results of that self-assessment to the FRB?⁷ If so, what requirements should apply to how the board performs the self-assessment? Should such self-assessments be used as the primary basis for supervisory evaluations of board effectiveness?
- Would any parts of this proposal conflict with effective governance of insurance and commercial savings and loan holding companies? If so, what adjustments to the proposal would be warranted?
- Is the proposed guidance on the communication of supervisory findings clear with respect to the division of responsibilities between the board and senior management?
- Are there any supervisory expectations that are not included in the SR letters identified for potential elimination or revision yet interfere with a board's ability to focus on its core responsibilities? Should such expectations be rescinded or revised? If revised, how?

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The proposal does not address examiner intervention into board policies and procedures such as frequency of meetings or form and scope of minutes. Nor does the proposal address the practice of examiner attendance at board and board committee meetings, or interviews with individual directors. Commenters may wish to address these issues.

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ENDNOTES

- ¹ For a discussion of the proposed new rating system, see our memorandum to clients “Federal Reserve Proposes New Rating System: Federal Reserve Proposes to Establish a New Rating System for the Supervision of Large Financial Institutions Designed to Align with the Supervisory Program for Those Institutions and to Enhance the Clarity and Consistency of Supervisory Assessments” (August 7, 2017), available at https://sullcrom.com/siteFiles/publications/SC_Publication_Federal_Reserve_Proposes_New_Rating_System.pdf.
- ² See, e.g., Group of Thirty, [Toward Effective Governance of Financial Institutions](#) (2012) (“[B]oards may make a critical mistake if they permit their time and attention to be diverted disproportionately into compliance and advisory activities at the expense of strategy, risk governance, and talent issues [and should not be driven] to an excessive focus on detailed operational matters that are more properly the purview of management.”); *International Monetary Fund, U.S. Financial Sector Assessment Program, Detailed Assessment of Observance of the Basel Core Principles for Effective Banking Supervision, IMF Country Report No. 15/89 (2015)* (noting a concern that U.S. bank regulations and guidance often do not clearly distinguish between the board and senior management, leading to possible confusion between the roles); Clearing House Association, [Guiding Principles for Enhancing U.S. Banking Organization Corporate Governance](#) (2015) (“Regulatory actions that prescribe for a board highly detailed responsibilities, and in some cases also the manner of executing them, can in fact impede directors’ proper discharge of their duties and oversight.”).
- ³ The proposal would not apply to U.S. intermediate holding companies of foreign banking organizations; the FRB expects these companies to be the subject of future guidance on board effectiveness and, as discussed in Section II.D, has specifically asked for comment on how this subject should be addressed.
- ⁴ The proposal does not address how characterizing the board’s responsibility as “making certain” that senior management effectively carries out the strategy established by the board could be a viable standard. The preamble to the proposal characterizes this aspect of the board’s role as “overseeing senior management,” which is more consistent with the board’s role as generally understood.
- ⁵ The proposal does not address the fact that, in normal circumstances, each and every director would not participate in setting agendas.
- ⁶ The proposal does not discuss whether such a voluntary action would result in the self-assessment being treated as “confidential supervisory information.”
- ⁷ Information required to be submitted to the FRB as part of the supervisory and examination process would presumably be deemed “confidential supervisory information.”

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