Client Update

The Regulatory Pendulum Swings Back: Fed Proposals for Board Governance and a Supervisory Rating System for Large Institutions

On August 3, 2017, the Federal Reserve Board (the "FRB") issued two sets of proposals: (1) a package of governance expectations intended to back away from the granular requirements and expectations that the FRB had increasingly imposed on boards of directors; and (2) a new large financial institutions rating system (the "LFI Proposal"). The proposals are subject to a 60-day comment period.

Broadly speaking, these proposals indicate that the bank regulatory agencies are actively taking steps to re-calibrate the post-crisis framework to streamline and reduce unnecessary regulatory burdens, a welcome development for institutions large and small. As we outline below, different aspects of the proposals apply to different categories of regulated entities. That said, overall the proposals have a significant breadth of coverage, suggesting a fundamental change in approach for the FRB. As a practical matter, these proposals indicate that banking organization boards will be able to shift their time commitments away from the details of regulatory and compliance issues and towards strategic oversight.

THE GOVERNANCE PROPOSALS

The FRB has foreshadowed the governance proposals for some time. On April 20, FRB Governor Jerome H. Powell stated that the FRB should "allow boards of directors and management to spend a smaller portion of their time on technical compliance exercises and more time focusing on the activities that support sustainable economic growth" and that "boards of directors need to be able to focus on setting the overall strategic direction of the firm, while overseeing and holding senior management accountable."[1]

The FRB states that following a multi-year process, it has arrived at the following views:

[1] *See, e.g.*, Speech by Governor Jerome H. Powell at The Global Finance Forum, Washington, D.C. (Apr. 20, 2017).

- Supervisory expectations for boards of directors and senior management have become increasingly difficult to distinguish.
- Boards of directors often devote a significant amount of time satisfying supervisory expectations that do not directly relate to the board's core responsibilities.
- Boards of directors of large financial institutions face significant information flow challenges, especially in preparing for and participating in board meetings.

The governance proposals seek to address these issues by clarifying supervisory expectations for boards of directors of FRB-regulated institutions in three ways: first, by proposing new guidance on attributes for an effective board; second, by revising FRB guidance for boards of directors to redirect responsibilities away from the board to management; and, third, by no longer directing supervisory matters requiring immediate attention ("MRIAs") and matters requiring attention ("MRAs") to boards, except under narrow circumstances.

Board Effectiveness Guidance

The proposed board effectiveness guidance (the "BE Guidance") would apply to domestic bank holding companies ("BHCs") and savings and loan holding companies ("SLHCs") with total consolidated assets of $50 billion or more, as well as nonbank financial companies supervised by the FRB ("nonbank SIFIs").

The BE Guidance would not apply to U.S. intermediate holding companies ("IHCs") of foreign banking organizations established pursuant to Regulation YY. The FRB states that it anticipates proposing guidance on board effectiveness for IHCs at a later date. The FRB also requests comment on how the BE Guidance should be adapted for IHC boards, providing a useful opportunity for foreign banks to comment on this question.

Generally, the BE Guidance seeks to better distinguish the supervisory expectations on boards from those of senior management, describing five key attributes of effective boards of directors, summarized below.

The guidance states the FRB's view that a board is most effective when focused on "establishing a firm-wide corporate strategy and setting the types and levels of risk it is willing to take, making certain that senior management effectively carries out that strategy within established risk tolerances, and holding management accountable for its actions, including effective risk management and compliance." The five key attributes are meant to reflect a board that has this orientation.

<u>Attribute 1</u>: Set clear, aligned and consistent direction regarding the firm's strategy and risk tolerance.

- This attribute is focused on the board's traditional role in guiding the development of and approving a firm's strategy, as well as setting the types and levels of risks a firm is willing to take. In our experience, some banking organization board members have expressed concern that the granular requirements imposed by the FRB have detracted from their ability to fulfill this essential role.
- The attribute includes providing management sufficient detail to identify strategic objectives and otherwise implement a strategy and manage risks.
- A firm's strategy and risk tolerance should be consistent, developed, considered and approved together.

Attribute 2: Actively manage information flow and board discussions.

- This attribute recognizes that managing information flow is necessary to make sound, well-informed decisions in a manner that meaningfully takes into account risks and opportunities.
- In our experience, many clients continually assess the level of detail for materials that are provided to the board. This attribute states that the board should "direct" senior management to provide information that has the level of detail needed for the board's decision-making process.

Attribute 3: Hold senior management accountable.

- This attribute provides that a board should hold senior management accountable for implementing the firm's strategy and risk tolerance and maintaining the firm's risk management and control framework. Inherent in this notion is the concept that the board itself should not be implementing the firm's strategy (a line increasingly blurred under post-crisis guidance), but should be directing management to do so.
- Key details under this attribute are that a board should have independent directors who are "sufficiently empowered to serve as a check on senior management." The board also should evaluate the performance and compensation of senior management.

Attribute 4: Support independence and stature of independent risk management (including compliance) and internal audit.

- This attribute highlights the importance of the risk and audit committees on any board.
- The FRB states that active engagement by those committees entails an inquiry into 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.

Attribute 5: Maintain a capable board composition and governance structure.

- This attribute provides that a board also must consider whether its composition, governance structure and practices support governing a firm in light of its size, complexity, scope of operations, risk profile and other changes that occur over time.
- The FRB suggests that self-assessments are important, including of committee performance. Moreover, the FRB notes that a board may provide supervisors a self-assessment that could then be used by the FRB to review whether a board satisfies the key attributes.

Streamlining Existing FRB Expectations for Boards of Directors

The second component of the governance proposal is a series of revisions to existing FRB guidance for boards of directors consistent with the re-calibration to focus on the above-described expectations. The FRB states that, in developing this proposal, it has been conducting a comprehensive review of all existing supervisory expectations and regulatory requirements relating to boards of directors of BHCs and SLHCs.

As a part of the first phase of this review, the FRB preliminarily identified 27 supervision and regulation ("SR") letters for potential elimination or revision, which revisions the FRB expects to begin with the finalization of the proposal. In Appendix A, we have reproduced from the FRB's proposal the list of SR letters that are subject to the review. As the SR letters are revised, the details of the changes will become clearer.

The second phase of the review will be focused on requirements and supervisory expectations set forth in FRB regulations or in various forms of interagency guidance. This latter phase will inherently take more time given the more formal nature of such regulations and guidance and because it will involve notice-and-comment processes and interagency coordination.

For domestic BHCs and SLHCs with total consolidated assets of $50 billion or more, supervisory expectations for boards would be revised to align with the attributes of effective boards outlined in the proposed BE Guidance (*i.e.*, away from the more granular post-crisis requirements and towards a more traditional view of the responsibilities of a corporate board). For domestic BHCs and SLHCs with total consolidated assets of less than $50 billion, supervisory expectations would be revised to align with the expectations set forth in SR letter 16-11, "Supervisory Guidance for Assessing Risk Management at Supervised Institutions with Total Consolidated Assets of Less than $50 Billion."

SR letters could be revised in several ways, but the focus seems to be on removing responsibilities from the board that are not consistent with the more traditional role of a board, and more clearly delineating the roles and responsibilities of the board as compared to senior management. The FRB said that it hopes the revisions will eliminate uncertainty and avoid boards unnecessarily addressing matters that are better suited for senior management.

For letters on the list that have other supervisory expectations unrelated to boards of directors that remain relevant, only the specific portions of the guidance relating to boards of directors would be revised.

Revising FRB Expectations for Boards of Directors' Involvement in MRAs and MRIAs

The third component of the governance proposal would revise the FRB's approach to communicating MRIAs and MRAs in a manner consistent with appropriately delineating between board versus management responsibilities. In particular, the proposed guidance provides that examiners and supervisory staff should direct most MRIAs and MRAs to senior management (rather than the board of directors). This aspect of the proposal, which would represent a revision to SR letter 13-13, applies to all FRB-supervised institutions.

MRAs and MRIAs only would be directed to the board for corrective action "[w]here significant weaknesses in an institution's board governance structure and practices are identified" or "when senior management fails to take or ensure appropriate action is taken to correct material deficiencies or weaknesses." A banking organization's board of directors would remain responsible for holding senior management accountable for remediating MRAs and MRIAs.

THE LFI PROPOSAL

In 2012, the FRB implemented a consolidated supervisory framework for large financial institutions ("LFIs") described in SR letter 12-17. This LFI framework is intended to: (1) enhance each LFI's financial and operational strength and resilience to reduce the likelihood of an LFI's failure or material financial or operational distress; and (2) reduce the risk to U.S. financial stability overall if an LFI were to fail.

As a natural outgrowth of the LFI supervision framework, the LFI proposal seeks to apply a new rating system beginning in 2018. The new rating system would apply to: (1) BHCs with total consolidated assets of $50 billion or more; (2) non-insurance, non-commercial SLHCs with total consolidated assets of $50 billion or more; and (3) all IHCs.[2] The FRB intends to apply the LFI rating system to nonbank SIFIs at a future date through a separate rulemaking. This new rating system would replace the RFI/C(D) rating system (the "RFI rating system"), which has not been updated since the 2007-2009 financial crisis.

Under the proposed LFI rating system, the FRB would evaluate and assign ratings for three components: (1) capital planning and positions; (2) liquidity risk management and positions; and (3) governance and controls.

2 The proposed $50 billion threshold would be based on the average of a firm's total consolidated assets in the four most recent quarters, as reported on the firm's quarterly financial reports filed with the FRB. A firm would continue to be rated under the LFI rating system until it had less than $45 billion in total consolidated assets, based on the same running average.

Component 1: Capital Planning and Positions

The capital planning and positions component rating would focus on:

- The effectiveness of the governance and planning processes used by a firm to determine the amount of capital necessary to cover risks and exposures, and to support activities through a range of conditions; and
- The sufficiency of a firm's capital positions to comply with the applicable regulatory requirements and to support the firm's ability to continue to serve as a financial intermediary through a range of conditions.

The FRB expects that findings from its Comprehensive Capital Analysis and Review ("CCAR") exercise would represent a material portion of the capital planning and positions component rating.

Component 2: Liquidity Risk Management and Positions

The liquidity risk management and positions component rating would focus on:

- The effectiveness of a firm's governance and risk management processes used to determine the amount of liquidity necessary to cover risks and exposures, and to support activities through a range of conditions; and
- The sufficiency of a firm's liquidity positions to comply with applicable regulatory requirements and to support the firm's ongoing obligations through a range of conditions.

This rating would be based on findings of horizontal examinations of liquidity positions and risk management practices, as well as ongoing assessments of an individual firm's liquidity positions and risk management practices.

Component 3: Governance and Controls

The governance and controls component rating would focus on the effectiveness of a firm's

- Board of directors;
- Management of core business lines and independent risk management and controls; and
- Recovery planning (for domestic firms subject to the FRB's Large Institution supervision Coordinating Committee, or "LISCC," framework).

The FRB would use firm-specific and horizontal examination of corporate governance, independent risk management, controls and lines of business to assign a rating.

Notably, the FRB intends to use the proposed BE Guidance in connection with this rating process. The FRB also plans to separately release additional proposed guidance on supervisory expectations relating to a firm's management of core business lines and independent risk management and controls, a key piece of the governance and controls component rating.

In the event that the LFI rating system is finalized before the additional governance and controls guidance is finalized, firms would be evaluated using existing supervisory guidance until the additional governance and controls guidance is finalized. To that end, the FRB stated that the additional guidance, when proposed, is likely to cover:

- Expectations for senior management with respect to both core business lines and independent risk management and controls;
- Expectations for the management of core business lines; and
- Expectations for independent risk management and controls.

LFI Rating Scale

The proposed LFI rating system would have four different ratings for each component: Satisfactory, Satisfactory Watch, Deficient-1 and Deficient-2.

- A "Satisfactory" rating would indicate that a firm is considered safe and sound and broadly meets supervisory expectations.
- A "Satisfactory Watch" rating would be a conditional "Satisfactory" rating. Such a rating would indicate that the firm generally is considered safe and sound, but certain issues are sufficiently material that, if not resolved in a timely manner in the normal course of business, those issues would put the firm's prospects for remaining safe and sound through a range of conditions at risk.
- A "Deficient-1" rating would indicate that, although the firm's current condition is not considered to be materially threatened, there are financial and/or operational deficiencies that put its prospects for remaining safe and sound through a range of conditions at significant risk.
- A "Deficient-2" rating would indicate that financial and/or operational deficiencies materially threaten the firm's safety and soundness, or have already put the firm in an unsafe and unsound condition.

These ratings would be communicated to the firm and considered "confidential supervisory information" that may not be publicly disclosed. Unlike other supervisory rating systems, including the RFI rating system, the FRB would not assign a stand-alone composite rating under the proposed LFI rating system.

Consequences of Rating

Under the proposed LFI rating system, a firm must be rated "Satisfactory" or "Satisfactory Watch" for each of its three component ratings in order to be considered "well managed." Currently, for purposes of determining whether a firm is considered to be "well managed" under section 2(o)(9) of the Bank Holding Company Act, the RFI rating system relies on the "Risk Management" rating as the "management" rating.

The FRB expects that a "Deficient-1" component rating often would be an indication that the firm should be subject to either informal or formal enforcement action, and could result in the designation of the firm as being in "troubled condition" under Regulation Y. The FRB expects that a firm with a "Deficient-2" component rating would be subject to a formal enforcement action and be deemed to be in "troubled condition."

The FRB notes that a Deficient-1 component rating "could" be a barrier for a firm seeking approval to engage in new or expansionary activities, placing a burden on the firm to show the FRB why any such activities should not be prohibited. A Deficient-2 rating would mean that a firm is "extremely unlikely" to receive approval to engage in any new or expansionary activities.

In addition, because BHCs and SLHCs that have elected to be treated as financial holding companies ("FHCs") are required to remain well managed, this new rating system will be important for maintaining the full benefits of FHC status and avoiding restrictions on new activities that FHCs face when they fall below well managed status.

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APPENDIX A

SR Letters in Which Guidance on the Roles and Responsibilities for Boards of Directors of Holding Companies Would be Rescinded or Revised (reproduced from the FRB's proposal)

SR/CA letter No.	Title	Would Expectations for Boards of Directors of Holding Companies with $50 Billion or More in Total Consolidated Assets Be Rescinded or Revised?	Would Expectations for Boards of Directors of Holding Companies with Less than $50 Billion in Total Consolidated Assets Be Rescinded or Revised?
SR 16-17	Supervisory Expectations for Risk Management of Reserve-Based Energy Lending Risk	Yes	N/A
SR 14-8	Consolidated Recovery Planning for Certain Large Domestic Bank Holding Companies	Yes	N/A
SR 13-19/CA 13-21	Guidance on Managing Outsourcing Risk	Yes	Yes
SR 13-13/CA 13-10	Supervisory Considerations for the Communication of Supervisory Findings	Yes	Yes
SR 12-17/CA 12-14	Consolidated Supervision Framework for Large Institutions	Yes	N/A
SR 11-15	Disposal of Problem Assets through Exchanges	Yes	Yes
SR 11-14	Supervisory Expectations for Risk Management of Agricultural Credit Risk	Yes	Yes
SR 09-4	Applying Supervisory Guidance and Regulations on the Payment of Dividends, Stock Redemptions, and Stock Purchases at BHCs	N/A	Yes
SR 08-9/ CA 08-12	Consolidated Supervision of Bank Holding Companies and the Combined U.S. Operations of Foreign	N/A	Yes

SR/CA letter No.	Title	Would Expectations for Boards of Directors of Holding Companies with $50 Billion or More in Total Consolidated Assets Be Rescinded or Revised?	Would Expectations for Boards of Directors of Holding Companies with Less than $50 Billion in Total Consolidated Assets Be Rescinded or Revised?
	Banking Organizations		
SR 08-8/ CA 08-11	Compliance Risk Management Programs and Oversight at Large Banking Organizations with Complex Compliance Profiles	Yes	N/A
SR 01-13	Supervisory guidance relating to a change to permissible securities activities of state member banks	Yes	Yes
SR 01-8	Supervisory Guidance on Complex Wholesale Borrowings	Yes	Yes
SR 00-9	Supervisory Guidance on Equity Investment and Merchant Banking Activities	Yes	Yes
SR 99-7	Supervisory Guidance Regarding the Investment of Fiduciary Assets in Mutual Funds and Potential Conflicts of Interest	Yes	Yes
SR 98-25	Sound Credit Risk Management and the Use of Internal Credit Risk Ratings at Large Banking Organizations	Yes	Yes
SR 98-18	Lending Standards for Commercial Loans	Yes	Yes
SR 98-9	Assessment of Information Technology in the Risk-Focused Frameworks for the Supervision of Community Banks and Large Complex Banking Organizations	Yes	Yes
SR 97-25	Risk-Focused Framework for the Supervision of Community Banks	N/A	Yes

SR/CA letter No.	Title	Would Expectations for Boards of Directors of Holding Companies with $50 Billion or More in Total Consolidated Assets Be Rescinded or Revised?	Would Expectations for Boards of Directors of Holding Companies with Less than $50 Billion in Total Consolidated Assets Be Rescinded or Revised?
SR 97-24	Risk-Focused Framework for Supervision of Large Complex Institutions	Yes	Yes
SR 97-21	Risk Management and Capital Adequacy of Exposures Arising from Secondary Market Credit Activities	Yes	Yes
SR 97-3	Conversion of Common Trust Funds to Mutual Funds	Yes	Yes
SR 96-10	Risk-Focused Fiduciary Examinations	Yes	Yes
SR 95-51	Rating the Adequacy of Risk Management Processes and Internal Controls at State Member Banks and Bank Holding Companies	Yes	N/A
SR 94-53	Investment Adviser Activities	Yes	Yes
SR 93-69	Examining Risk Management and Internal Controls for Trading Activities of Banking Organizations	Yes	Yes
SR 90-22	Policy Statement on the Use of “Points” in settling foreign exchange contracts	Yes	Yes
SR 90-16	Implementation of Examination Guidelines for the Review of Asset Securitization Activities	Yes	Yes