Client Update
Federal Reserve Proposes Guidance on Effective Management

On January 4, 2018, the Federal Reserve Board (the "FRB") proposed guidance for effective senior management, management of business lines, and independent risk management and controls for large financial institutions ("LFIs").[1] The proposal is a companion to earlier proposals on guidance for effective boards of directors (the "BE Proposal") and a new LFI rating system (the "LFI Rating System Proposal").[2]

The new proposal and the BE Proposal, taken together, are intended to clarify expectations around a firm's governance and controls, and help to distinguish the responsibilities of management from those of the board of directors. The guidance also is intended to help define the roles and responsibilities of key individuals who are accountable for risk management within a firm. However, firms will need to evaluate carefully the prescriptiveness of the proposal against their current practices, as the proposal could limit the ability of an institution to operate efficiently its risk management function. Comments on the proposal are due by March 15, 2018. The FRB previously extended the comment periods for the BE Proposal and the LFI Rating System Proposal to February 15, 2018 and highlighted that it intends for firms to be able to evaluate the various proposals together.

KEY OBSERVATIONS

- *Scope of Application*. The proposal has a broader scope of application than the BE Proposal and LFI Rating System Proposal. It applies to: (1) bank holding companies and savings and loan holding companies ("SLHCs") with total assets of $50 billion or more; (2) the combined U.S. operations ("CUSO") of foreign banking organizations ("FBOs") with combined U.S. assets (branch and nonbranch) of $50 billion or more; (3) any state member bank subsidiaries of entities in categories (1) or (2); and (4) nonbank financial companies

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[1] Press Release, Federal Reserve Board requests comment on proposed guidance that would clarify the Board's supervisory expectations related to risk management for large financial institutions (Jan. 4, 2018). To access a copy of the proposal, see the FRB's website here.

[2] Proposed Guidance on Supervisory Expectation for Boards of Directors, 82 Fed. Reg. 55841 (Aug. 9, 2017); Large Financial Institution Rating System; Regulations K and LL, 82 Fed. Reg. 39049 (Aug. 17, 2017). For more discussion about the BE Proposal and the LFI Rating System Proposal, *see* this Client Update.

designated by the Financial Stability Oversight Council for supervision by the FRB. In contrast, the LFI Rating System Proposal would apply to an FBO's U.S. intermediate holding company ("IHC") only and the BE Proposal would not apply to FBOs at all. In addition, the LFI Rating System would apply only to non-insurance, non-commercial SLHCs, as opposed to all SLHCs, with total assets of $50 billion or more. For firms that are subject to the new proposal, but not the LFI rating system, the proposed guidance would be used to inform the FRB's evaluation of the firm's overall safety and soundness and the effectiveness of its risk management practices.

- *Application to an FBO's CUSO*. Notably, for FBOs, the proposed guidance would apply to FBOs with combined U.S. assets at the $50 billion-plus level, meaning that it would apply to all FBOs subject to Regulation YY, subpart O, including those not required to have an IHC. The FRB proposes tailoring the application of the guidance to FBOs and provides some additional color on its expectations for interactions between CUSO-level management and global management. These aspects of the proposal, however, will need to be evaluated carefully.

- *Timing*. The proposal notes that the FRB expects to finalize the management effectiveness guidance and BE Proposal in time to assign ratings under the new LFI rating system in 2018.

- *Interaction with Existing Standards*. The FRB notes that the proposed guidance is intended to consolidate and clarify the FRB's existing supervisory expectations regarding risk management. In particular, the proposal would supersede Supervision and Regulation Letter 95-51. One important question to examine will be whether and to what extent there is a substantive difference between the standards set forth in the proposed guidance and those that already apply to firms subject to the proposal. Further, from a conceptual perspective, the proposal "builds upon" and fills in details about how the organizational risk management structure required by the FRB's Regulation YY should be implemented. Notably, some firms subject to the proposal (*e.g.*, SLHCs, nonbank financial institutions supervised by the FRB) are not fully subject to Regulation YY; in this sense, the proposal creates a uniform standard for FRB-regulated institutions, notwithstanding the different statutory frameworks that apply to such institutions.

- *$50 billion Asset Threshold*. The proposed guidance uses a threshold of $50 billion in assets (or, for FBOs, combined U.S. assets). There is a broader policy discussion in Washington, D.C. about whether and how the $50 billion threshold used in the Dodd-Frank Act should be revised.[3] One immediate question is whether there will be calls to change this threshold in the proposal or delay finalizing the proposal until there is more clarity on the broader policy debate regarding the $50 billion threshold.

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[3] For more discussion about proposals to revise the $50 billion asset threshold, *see* this Client Update and this Client Update.

- *Requests for Comment*. The proposal includes a range of specific questions on which the FRB requests comment. Among those, we find notable the question of whether the tailoring for FBOs could be improved and in what ways, if any, the proposal diverges from industry practice (and could better reflect industry practice while facilitating effective risk management and controls).

THE CORE PRINCIPLES

The proposed guidance sets out core principles for the following three areas, each of which is summarized below: effective senior management; management of business lines; and independent risk management ("IRM") and controls.

Core Principles of Effective Senior Management

Principle: Senior management is responsible for managing the day-to-day operations of the firm and ensuring safety and soundness, and compliance with internal policies and procedures, laws, and regulations, including those related to consumer protection.

- *Definition of Senior Management*. The proposed guidance defines "senior management" as the core group of individuals directly accountable to the board of directors (or a committee thereof) for the sound and prudent day-to-day management of the firm.
- *Strategy and Risk Tolerance*. Senior management is responsible for implementing the firm's board-approved strategy and risk tolerance (the aggregate level and types of risk a firm is willing to assume to achieve its business objectives) and identifying and escalating to the board instances in which a firm's activities collectively may deviate from the firm's strategy and risk tolerance.
- *Applicability to an FBO*. For an FBO, the proposed guidance states that the term senior management can refer to individuals located inside or outside the United States who are accountable to the IHC board, U.S. risk committee, or global board of directors with respect to the U.S. operations. The proposed guidance also notes that senior management with authority over budgeting or strategy for CUSO should allocate appropriate resources and expertise to meet the expectations of the guidance. The proposal indicates that the U.S. risk committee should approve CUSO's risk tolerance, which may be developed separately for the IHC and U.S. branches, respectively.

Core Principles of the Management of Business Lines

The proposed guidance indicates that "business line management" refers to the core group of individuals responsible for the prudent day-to-day management of a business line and accountable to senior management for that responsibility. Business line management could include members of senior management and business lines may cross legal entities or geographic jurisdictions.

For firms within the Large Institution Supervision Coordinating Committee ("LISCC") portfolio, the guidance would apply to all of a firm's business lines. For non-LISCC firms, the principles would apply only to business lines "in which a significant control disruption, failure, or loss event could result in a material loss of revenue, profit, or franchise value, or result in significant customer harm." The proposed guidance recognizes that a line of business of an FBO may be part of an international business organization and explains that the proposed guidance only applies to operations conducted in the United States, although the guidance notes that consideration needs to be given to risks arising from outside the United States.

The core principles for the management of business lines are organized into the following categories, each of which is summarized below: implementation and execution of strategy and risk tolerance; risk identification and risk management; resources and infrastructure; business controls; and accountability.

Principle for Implementation and Execution of Business Line Risk: Business line management should execute business line activities consistent with the firm's strategy and risk tolerance.

Principle for Risk Identification and Risk Management: Business line management should identify, measure and manage the risk associated with the business activities under a broad range of conditions, incorporating input from IRM.

Principle for Resources and Infrastructure: Business line management should provide a business line with the resources and infrastructure sufficient to manage the business line's activities in a safe and sound manner, and in compliance with applicable laws and regulations, including those related to consumer protection, as well as policies, procedures and limits.

Principle for Business Controls: Business line management should ensure that the internal control system is effective for the business line operations.

Principle for Accountability: Business line management and staff are accountable for operating within established policies and guidelines, and acting in accordance with applicable laws regulations and supervisory guidance, including those related to customer protection.

Core Principles of IRM and Controls

The proposed guidance defines IRM and controls to include a firm's (1) IRM function, which provides an objective, critical assessment of risks and evaluates whether a firm remains aligned with its stated risk tolerance; (2) a system of internal control to guide practices, provide appropriate checks and balances, and confirm quality of operations; and (3) an internal audit function, which provides independent assessments of the effectiveness of the risk management framework and the system of internal control. The proposed core principles for IRM and controls include two principles relating to the governance, independence and stature of the chief risk officer ("CRO") and chief audit executive ("CAE"). For FBOs, the proposed guidance applies to the U.S. CRO and the U.S. risk committee for CUSO. These and the other core principles for IRM and controls are summarized below.

Principle for Governance, Independence, and Stature (CRO): The CRO should establish and maintain IRM that is appropriate for the size, complexity and risk profile of the firm.

Principle for Governance, Independence, and Stature (CAE): The CAE should have clear roles and responsibilities to establish and maintain an internal audit function that is appropriate for the size, complexity and risk profile of the firm.

Principle for IRM (Risk Tolerance): IRM should evaluate whether the firm's risk tolerance appropriately captures the firm's material risks and confirm that the risk tolerance is consistent with the capacity of the risk management framework.

Principle for IRM (Risk Limits): IRM should establish enterprise-wide risk limits consistent with the firm's risk tolerance and monitor adherence to such limits.

Principle for Risk Identification, Measurement and Assessment (Risk identification and Measurement): IRM should identify and measure the firm's risks.

Principle for Risk Identification, Measurement and Assessment (Risk Assessment): IRM should aggregate risks and provide an independent assessment of the firm's risk profile.

Principle for Risk Identification, Measurement and Assessment (Risk Reporting): IRM should provide the board and senior management with risk reports that accurately and concisely convey relevant, material risk data and assessment in a timely manner.

Principle for Internal Controls (Internal Control System): A firm should identify its system of internal control and demonstrate that it is commensurate with the firm's size, scope of operations, activities, risk profile, strategy, and risk tolerance, and consistent with all applicable laws and regulations, including those related to consumer protection.

Principle for Internal Controls (Testing Internal Controls): A firm should regularly evaluate and test the effectiveness of internal controls, and monitor functioning of controls so that deficiencies are identified and communicated in a timely manner.

Principle for Internal Audit (Internal Audit): The internal audit function should examine, evaluate and perform independent assessments of the firm's risk management and internal control systems and report findings to senior management and the firm's audit committee. (The proposed guidance states that the FRB's previously issued guidance on the internal audit function and its outsourcing is still applicable. Key components of effective internal audit are outlined in Supervision and Regulation Letters 03-5 and 13-1.)

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