Financial Services Management

Senior/Line/Risk-Management Governance Standards

Cite

FRB, Proposed Supervisory Guidance, Management Governance Standards

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Impact Assessment

- Large FBOs will come under implicit FRB capital, liquidity, and risk-management regulation.
- BHCs, SLHCs, and FBOs not directly subject to these standards will still be judged by them, making them essentially an industry-wide requirement.
- Fed standards will indirectly govern entities regulated by other U.S. agencies due to the importance of the parent-company rating. Conflict is possible, especially with regard to consumer-protection responsibilities and source-of-strength/TLAC obligations.
- Senior, line-, and risk-management duties are likely to increase to compensate for the less onerous governance duties proposed for boards of directors.

Overview

Building on prior proposed guidance establishing board-of-directors management standards[1] and a new large-BHC rating system[2] the FRB has proposed supervisory principles that would govern senior and line management along with the independent risk management (IRM) function. Taken together and given their broad direct and indirect scope, these new Fed standards redefine key elements of Federal Reserve supervisory policy, diminishing reliance on compliance with specific capital, liquidity, or other rules in favor of robust stress-test results and robust adherence to examiner expectations. This more subjective standard should reduce direct burden on boards of directors, but increase it across the rest of senior-, line-, and risk-management officers. The guidance also signals a new, more demanding policy with regard to foreign banks doing business in the U.S.

[1] See **CORPGOV23**, *Financial Services Management*, August 8, 2017.

[2] See **CORPGOV24**, *Financial Services Management*, August 15, 2017.

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Impact

The rating-system proposal noted above presaged this proposal in substance, but the Board has decided to expand its scope. The ratings proposal applies to BHCs and traditional SLHCs with assets over $50 billion, IHCs, and state member bank subsidiaries of covered firms. The new proposal expands coverage also to all foreign banking organizations (FBOs) with combined U.S. assets over $50 billion. Smaller institutions are not directly covered, but the proposal makes it clear that the Fed will nonetheless rely on these criteria to set BHC, SLHC, or FBO safety-and-soundness ratings. As a result, they apply *de facto* across the scope of holding companies and foreign banks governed by the FRB.

The board-of-directors proposal did not apply to IHCs but it seems likely the FRB will do so in the final standards given the approach it has taken here to other personnel. Although recovery-planning expectations here only apply, as in the earlier proposals to domestic companies, the scope of the Fed's rating system (sure to be extended to large FBOs in final form) and this guidance signal a new, tougher approach to FBOs regardless of whether they conduct their U.S. operations in branches, agencies or IHCs, reflecting views voiced most recently by former FRB Gov. Tarullo that FBOs pose risks in the U.S. due to the parent-company operations under more liberal home-country regimes. These, it is said, not only pose risks to the U.S. financial system and to the Fed itself, but also to U.S. bank competitiveness due to direct challenges in the U.S. from banks able to offer preferential terms based on lighter capital regulation or exemption from certain U.S. prudential requirements.

Mr. Tarullo had in fact pushed for direct capital requirements on FBO branches and agencies, but these posed a number of international problems (most notably growing "ring-fencing" threats aimed at U.S. bank branches in other nations). The proposed guidance is a compromise with less clear effect but it is likely nonetheless to lead to demands from Fed examiners for considerably greater FBO adherence to U.S. requirements.

The goal of the proposed Board-evaluation criteria is to ensure that directors focus on strategic matters, not the minutiae of regulatory compliance about which many have long complained. This proposal for the next management tier is, the FRB says, designed to complement the Board proposal by ensuring that senior-, line-, and risk-management officers take hands-on responsibility for and control over the most important aspects of regulatory compliance now delegated to them by the Board. In the absence of the two standards, the FRB fears that issues not addressed by the Board could be neglected elsewhere in a banking organization. Many of the principles in this guidance have long governed both Fed activities and company policies, but the new and formal way the Board now lays them out will likely lead to more work across the range of covered management on the issues specified by the Board as their core responsibilities in this area.

Consolidating these high-level principles with all the express injunctions for Boards and management in many individual rules and guidance will also be challenging to the extent that the guidance specifies one approach and current rules dictate another, possibly a more hands-on one for the Board or other affected personnel. Different perspectives from primary regulators may also mitigate burden relief, although the FRB says here that it will do its best to coordinate with the other agencies.

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An area where this coordination could prove particularly challenging is consumer protection. As noted below, core principles consistently emphasize the need to comply not only with financial risk tolerances, but also to ensure consumer protection. Actual consumer-protection regulation and enforcement is now the purview of the CFPB, but the banking agencies continue to have extensive and overlapping duties here evident in the Wells Fargo case and several other recent actions. It remains to be seen how the CFPB, OCC, or FDIC under the Trump Administration will view their responsibilities in this area. The Fed has a long history of being somewhat less energetic in this arena than the other agencies under prior administrations, but if this changes now, Fed staff may nonetheless take on a greater role due to their independence if this is sanctioned by the new Vice Chairman for supervision.

As noted in our discussion of the parent-company rating guidance, another challenge with this top-down approach is how conflicts will be handled between the Board and primary regulators over a parent company's source-of-strength obligations. All of the U.S. agencies feel very strongly about these for insured depository institutions, but the FDIC has generally also insisted that subsidiary banks be able to stand on their own even with this parent-company commitment. The OCC is also increasingly open to stand-alone banks with or without a parent holding company. The role of TLAC in ensuring ongoing subsidiary support and how internal TLAC fits into this structure for FBOs is also complex, particularly given the differences between the U.S. and global TLAC standards.[3]

What's Next

The FRB released this proposal on January 4. Comments are due by March 15, a short turn-around the Board intends to coordinate with the other pending guidance so that a final set of governance standards and a new rating system can be finalized together. The Fed plans to implement this guidance and the Board standards and then use them for large-firm ratings in 2018, but if the ratings are finalized before the guidance then current practice would govern ratings.

As guidance, this standard along with all the others, may now be subject to the Congressional Review Act based on a General Accountability Office (GAO) determination that any guidance that can result in supervisory enforcement is a *de facto* rule subject to Congressional scrutiny. The extent to which this review will complicate or even derail FRB finalization of this approach will depend on the extent to which the industry protests it and Congress is willing to take on a battle that would be characterized by opponents as perpetuating soft prudential regulation for large U.S. and foreign banks.

[3] See **TLAC6**, *Financial Services Management*, December 21, 2016.

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Analysis

A. Core Principles for Senior Management

Senior management is defined as in other Fed standards, but is here clarified so that this term for IHCs and FBOs may apply to separately to IHCs and branches of the same foreign bank and include FBOs officials in or outside of the U.S.

Senior management duties related to risk management include ensuring that board-set risk tolerances are met and any problems are quickly escalated to the board if they cannot be readily remedied by business-line management or IRM-dictated action. Senior management is also responsible for:

- identification, measurement, management, and control of risk;
- promoting and enforcing prudent risk-taking behaviors and business practices, including through compensation and performance-management programs;
- developing and maintaining policies and procedures and the system of internal control to ensure compliance with laws and regulations, including those related to consumer protection;
- ensuring consistency with supervisory expectations;
- communicating relevant information and ensure information sharing; remain informed about material deficiencies and pending remedial actions;
- understanding how risk tolerances and activities fit into compliance with capital, liquidity, and other prudential regulations; and
- assessing the risk management framework as a whole to ensure it is comprehensive and has kept pace with the company's products, services, and activities as well as with changes in economic conditions and the broader market.

B. Business Line Management

This term is again defined as in other Fed standards, with these managers either also being senior or line management reporting up to senior management. Business lines are determined by reference to internal designations and include relevant sub-parts within the organization. FBO business lines are those present in the U.S. even though the internal organization may incorporate both U.S. and other entities. However, FBO risk assessments must include non-U.S. risk that could affect U.S. business lines.

The very largest firms (i.e., LSCC ones) would have to apply these standards to all business lines; smaller covered entities would need to do so only for risk- or consumer-protection critical business lines. However, exempted business lines are still to govern risk as they were if subject to the IRM principles described below.

Business-line management would be expected to:

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- execute business-line activities consistent with the firm's strategy and risk tolerance;
- identify and manage risk within the business line;
- provide sufficient resources and infrastructure to the business line;
- ensure that it has appropriate internal control; and
- ensure accountability for operating within established policies and guidelines and in accordance with laws and regulations, including those related to consumer protection.

C. IRM

These core principles apply to independent risk management defined as IRM, the system of internal control defined in the guidance, and internal audit function. The chief risk officer (CRO) and chief audit officer (CAO) are responsible for these principles even if they also come under the senior-management designation (as is likely).

The proposed guidance describes expectations for a firm's IRM including:

- the evaluating risk tolerance;
- establishing enterprise-wide risk limits and monitoring adherence to them;
- identifying, measuring, and mitigating risks; and
- providing risk reports to the Board and senior management.

The IRM would not necessarily have independent control over the firm's risk tolerance, but IRM limits should bind across the organization. Detailed standards also apply to internal controls, with responsibility shared between IRM and business-line management. Audit controls match those in current Fed standards.

D. Implementation

As noted, these standards will be referenced in Fed examinations of firms not directly covered by them. The Board also says it will coordinate with primary regulators to minimize burden, but the fact that different agencies have different standards is likely to offset much burden relief.

The Fed does not expect that all of the business lines covered by the guidance would be examined in any given year, instead using a risk-based approach to select units to examine.

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E. Request for Comment

Views are specifically solicited on:

- any additional safety-and-soundness considerations;
- the need to clarify responsibilities across the Board, senior management, line management and IRM;
- the need for more specific IRM guidance;
- better tailoring for FBOs;
- areas in which the guidance diverges from industry practice; and
- terminology alignment between these standards and the new rating system.

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