FedFin Client Report

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FedFin Analysis: Strategic Impact of Wells Fargo's Sanctions

Client Report: **CORPGOV26**

Executive Summary

In our 2017 analysis of the FRB's proposed standards for BHC boards governance (see *Client Report* **CORPGOV23**), we noted that the proposal holds directors to higher account despite criticism at the time that it relaxed them. As former Chair Yellen noted in her letter to Sen. Warren (D-MA) in concert with the FRB's Friday action against Wells Fargo, the guidance plans tougher standards, but it is striking that the Board not only did not wait for finalization before deploying them, but also made a point of placing the blame very publicly on both past and current directors as well as the former CEO. Some have speculated that this was a parting shot from Chair Yellen, but press coverage indicated that Chairman Powell led the negotiating team and senior staff wanted to go still farther. Vice Chairman Quarles was recused from doing so and Gov. Brainard's responsibilities lie elsewhere. It remains to be seen if this decision was a courtesy to Ms. Yellen, but it seems that the Board plans to hold GSIBs and perhaps other large banks to account. The statement – presaged by the draft guidance – emphasize that large-BHC boards will be held to far higher and more public accountability under a raft of rules governing compliance and operational risk along with effective governance and incentive alignment. Several aspects of the specific standards Wells now must meet are likely to be applied to other large BHCs even though not necessarily expressly required by FRB regulation. Although arguably running counter to Trump administration views, the Federal Reserve's action is consistent with the tweet sent by President Trump after suggestions that the CFPB would go easy on Wells Fargo. This report details several little-discussed aspects of the order that, if retained as the new Board takes shape, make it clear that the FRB will be a parent-company regulator ready, willing, and in its own view able to use the source-of-strength doctrine and many other standards to govern large BHCs regardless of what the primary regulator or CFPB may choose to accept.

Analysis

Key features of the consent order germane to other BHCs include:

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- The order is premised on Wells being a large, complex firm. It is therefore unclear if smaller BHCs or those with more traditional business models would be held to similar account.
- The FRB acknowledges significant efforts by Wells Fargo to improve practice, but nonetheless imposed a stiff penalty. This is a sharp departure from prior enforcement actions in which BHCs making approved efforts were treated far less punitively.
- The order is in part premised on a BHC's obligation to serve as a source of strength for subsidiary banks. This long-established principle has been litigated in the past but was at least arguably reaffirmed in the Dodd-Frank Act (see FSM Report **FHC19**). It is deployed in future enforcement actions, it would give the FRB grounds to step in even if the primary federal or state regulators and/or the CFPB chose not to punish a subsidiary insured depository to the Board's satisfaction (as appears to be the case here).
- The order is targeted at the board of directors, which is instructed to prepare a plan within sixty days on its own effectiveness and ways to improve it. Typically, directors are told to supervise senior management and/or achievement of specified goals, not to govern themselves. There appears to be significant dissatisfaction with the manner in which the board supervised senior management and held it accountable.
- A significant FRB concern is the lack of compliance and operational-risk management sufficiently independent of business-line management. This is a long standing supervisory concern coming to a head at least in this case. An improvement plan for compliance and operational-risk management is also required in sixty days. Specifics of the requirements here (e.g., the need for key-risk indicators, stress-loss forecasting) are likely to be applied to other large BHCs even though aspects of the consent agreement are not expressly provided in relevant Fed regulation beyond the aforementioned need for effective risk management and board/senior-management accountability.
- Incentive compensation is to be extensively reviewed.
- Independent, third-party review is required for the board and risk-management plans and execution by September 30, 2018. This monitoring is frequent in prior enforcement actions but may be more carefully scrutinized than in the past given prior Congressional criticism of the monitoring program.
- Wells Fargo is limited in asset size to its year-end balance-sheet, although increases are possible under a prior-approval process involving both the San Francisco Reserve Bank and senior Board staff. This asset-size limit applies until the Reserve Bank and Board agree to release it.

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- Even with this penalty, the Board may take additional action pursuant to the consent agreement. An array of written progress reports and statements of the Fed's opinion of them, along with the BHC's commitment to make witnesses freely available to the Fed, are required, making it clear that the Fed could impose still more stringent sanctions on the company.

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