

# LESS IS MORE

PARSING NEW FEDERAL RESERVE GUIDANCE  
ON BOARD EFFECTIVENESS

A Quick Reaction Note by

Til Schuermann

Jeffrey Brown

Elizabeth St-Onge

Are bank boards expected by supervisors to do the jobs of bank management? This question has been asked by banks with increasing frequency since the financial crisis. Big banks just got an opportunity, indeed a mandate from the Federal Reserve Board, to simplify their board's tasks while increasing their effectiveness. We urge banks to move quickly and to frame their approach while there is the maximum openness by the authorities to support constructive change.

On August 3<sup>1</sup> the Federal Reserve Board proposed supervisory guidance on Board Effectiveness (BE) for large financial institutions (LFIs, those with >\$50 BN in assets<sup>2</sup>). At the same time they issued a new supervisory rating system for LFIs, replacing a system dating back to 2004<sup>3</sup>. The timing is not accidental: the proposed guidance on BE represents an important piece in the radically revamped edifice of post-crisis supervision by the Federal Reserve. It is hard to overstate the importance of especially the proposed BE guidance, and in this note we summarize that guidance and explain what it means. The proposed new supervisory rating system is not the focus here, though we provide a high level synopsis to provide context for the proposed BE guidance.

## OVERVIEW AND 5 KEY ATTRIBUTES FOR EFFECTIVE BOARD GOVERNANCE

Directors of large banks, domestic and foreign, especially those supervised by the Federal Reserve, have been subjected to increasing expectations since the financial crisis. Every director has felt rising pressure from the regulators to engage more, do more, review more, understand more, approve more, all of which requires significant time, knowledge and expertise, as well as just a lot more information. Directors feel totally overwhelmed! And so it is a welcome development that the proposed Board Effectiveness guidance from the Federal Reserve acknowledges this reality and provides not only clear guidance on the totality of expectations, but also greatly streamlines the scope of oversight. It does so in part by consolidating or eliminating some previous elements of Federal Reserve guidance which are deemed to be redundant, unnecessary or outdated. Indeed the Federal Reserve identified 27 existing supervision and regulation (SR) letters with about 170 expectations for directors that are impacted by this proposed guidance. The Federal Reserve recognized that the post crisis piling on may be making boards less effective because they can't devote sufficient time and focus on what really matters; less is indeed more.

The proposed BE guidance is built around five key attributes of what the Federal Reserve believes to be effective board governance; we use original text for emphasis and clarity.

- A. **Approve the firm's strategy together with its risk appetite:** "[A]n effective board guides development and approval of the firm's strategy and sets the types and levels of risk it is willing to take". It is noteworthy that the very first key attribute makes clear that the Federal Reserve views strategy and risk appetite as two sides of the same coin, inextricably linked. This is an important theme, echoed throughout the proposed guidance and even the proposed new rating system.

1 <https://www.federalreserve.gov/newsevents/pressreleases/bcreg20170803a.htm>

2 The proposed BE guidance would not apply to U.S. intermediate holding companies (IHCs) of foreign banking organizations (FBOs) established pursuant to Regulation YY. The Board recognizes the distinct governance issues presented by ownership of U.S. banking companies by foreign parents and anticipates proposing guidance on board effectiveness for IHCs at a later date. For smaller institutions the Federal Reserve clarified its expectations in 2016 with SR 16-11, "Supervisory Guidance for Assessing Risk Management at Supervised Institutions with Total Consolidated Assets Less than \$50 Billion."

3 In contrast to the proposed BE guidance, the new rating system does apply to large IHCs.

- B. **Actively manage information flow and board discussions:** If the board is to “make sound, well-informed decisions in a manner that meaningfully takes into account risks and opportunities”, it can only do so by “actively manag[ing] its information flow and its deliberations.” Effective challenge is a core idea in board effectiveness (we see this again in attribute C), and it can’t happen without directors being on top of the necessary information and ensuring that important matters (like anything mentioned in the five attributes) receive sufficient airtime at board meetings.
- C. **Hold senior management accountable:** “An effective board of directors holds senior management accountable for implementing the firm’s strategy and risk tolerance and maintaining the firm’s risk management and control framework. An effective board of directors also evaluates the performance and compensation of senior management.” Accountability goes to the heart of the role of a board as shareholder (i.e. owner) representatives who have hired professional managers (executives and senior management) to run the firm. Effective challenge is required to create appropriate accountability, and in order to do that, institutions and their boards need: (i) good information and engagement (attribute B), (ii) an independent 2nd and 3rd line of defense (attribute D), and (iii) a capable board (attribute E).
- D. **Support the independence and stature of Independent Risk Management and Internal Audit:** “Active engagement by directors on the board’s risk committee and audit committee entails a director’s inquiry into, among other things, 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.” A strong and independent 2nd and 3rd line of defense is so critical to the management of a financial institution that it gets its own attribute for BE. It is no accident that the CRO and CAE (chief accounting executive) have a direct line to the board, allowing them to bypass the CEO if needed.
- E. **Maintain a capable board composition and governance structure:** “An effective board has a composition, governance structure, and established practices that support governing the firm in light of its asset size, complexity, scope of operations, risk profile, and other changes that occur over time.” While the Federal Reserve’s supervisory approach is always tailored to the size and complexity of the firm, it is noteworthy that it appears in the first sentence for this attribute. It reminds the largest and most complex institutions – the LISCC firms<sup>4</sup> – that expectations on directors’ expertise, skill and experience are especially high, and that the complexity of the firm and its business organization must be accounted for in the board’s governance structure.

The language in the proposed guidance conveys a strong sense of back-to-basics for board governance. There is frequent mention of the role of oversight vs. direct involvement, and of separation of roles for senior management and the board – essentially acknowledging that those lines had become blurred resulting in “boards unnecessarily addressing matters that are better suited for senior management, and would support the board’s core responsibility of holding senior management accountable.” Revisiting how this line has moved is perhaps especially important because it has led to distractions and potential conflicts – who is in charge of what – and thus reduced board effectiveness. Moreover, we have seen increased

<sup>4</sup> LISCC: Large Institutions Supervision Coordinating Committee. Committee formed in 2010 to coordinate supervision of the US GSIBs (globally systemically important banks) plus foreign GSIBs with a significant footprint in the US plus designated systemically important non-bank financial institutions. For more detail and a list see <https://www.federalreserve.gov/supervisionreg/large-institution-supervision.htm>.

divergence between board governance of a supervised financial institution and that of any other publicly traded company. Many directors sit on multiple boards, bank and non-bank, and thus experience this difference acutely. Some differences are, of course, expected and needed, but the distance between the two regimes had grown uncomfortably and, frankly, unproductively wide.

This proposed guidance arose from the first of a two-part re-evaluation of the Federal Reserve's overall expectations of boards for its supervised entities based on existing rules and guidance plus informal discussions with directors. The second part will involve direct evaluation of boards using these five attributes to both further refine and help to draft new rules and interagency guidance. This will have to happen quickly as the proposed guidance forms part of the new financial institutions rating system (more on that below). The Federal Reserve encourages boards to conduct a self-assessment against these five attributes which will be an input to the Federal Reserve's own evaluation. Given the proposed guidance, it is important for the board to ask itself key questions such as: how do board meeting agendas over the last several years stack up? Is the committee structure, charters, and meeting agendas commensurate with the needs? Is the board meeting material appropriately comprehensive yet user friendly? And so on. Banks should view this as an opportunity to both learn about their gaps, and if any are uncovered, develop a remediation plan, as well as a way to raise the level of dialog between the board and its supervisor. It is a chance for a board to demonstrate engagement, showcase strengths, and acknowledge shortcomings (before the Federal Reserve does!). These chances don't come often, so we strongly encourage banks to embrace the self-assessment fully.

## COMMUNICATION OF SUPERVISORY FINDINGS

The Federal Reserve also clarified and plans to change how supervisory findings are communicated to senior management and the board. This change impacts primarily the communication of MRAs and MRIAs (Matter Requiring [Immediate] Attention). Since 2013, all supervisory findings were communicated directly to the board, and directors reasonably wondered whether they were therefore on the hook to get more deeply involved in their resolution. Essentially, the impression received was that everything was the most important thing – this is, of course, neither useful nor reasonable. Going forward, most MRAs and MRIAs will go to senior management, and only “when the board needs to address its corporate governance responsibilities or when senior management fails to take appropriate remedial action” will supervisory communication go directly to the board. The board is expected to hold senior management accountable for the timely resolution of all supervisory findings. This change alone should bring significant relief from the intensity and scope of involvement directors have felt in the last several years.

## NEW 3 COMPONENT RATING SYSTEM

Every year the Federal Reserve assigns a set of ratings along several dimensions, as well as an overall rating, to its supervised entities, and board effectiveness is an important consideration. These ratings reflect the Federal Reserve's assessment of the safety and soundness of the financial institution. If significant deficiencies are found, ratings are

lowered, curtailing the firm's freedom of actions, e.g. through restrictions on business expansion. That rating system has not really changed since 2004, but the supervisory programs have changed dramatically since the crisis. Stress testing, whether for capital or liquidity purposes, and recovery and resolution planning dominate the supervisory calendar.

The proposed new rating system is also much simplified with just three components: 1) capital planning and position; 2) liquidity risk management and positions; 3) governance and controls. Board oversight cuts across all three, of course, but is captured on its own in "governance and controls." This three-component rating system clearly reflects the Federal Reserve's post-crisis approach to supervision, what with the prominence of CCAR (component 1) and liquidity stress testing and CLAR (component 2). Moreover, resolution planning has a distinct impact on both capital and liquidity requirements and thus impacts those first two components. Finally, for the LISC firms, recovery planning may result in additional demands on capital and liquidity, as well as on governance and controls.

The proposed rating system also highlights the importance that stress testing as a tool has gained since the crisis. Capital, liquidity, and controls all need to explicitly take into account how the bank fares "through a range of conditions." That range includes moderate to severe stresses (like CCAR and CLAR) through more severe (recovery) and fatal (resolution) conditions. The governance and control infrastructure must account for and embrace this approach.

With only three components, the Federal Reserve has decided to eliminate the overall or composite rating. The argument is that a single rating would detract attention from any messages about the components. The old system had effectively five components where, perhaps, a summary measure was useful.

## WHAT SHOULD BOARDS DO DIFFERENTLY?

The proposed guidance presents an opportunity to revisit the suite of board activities and agenda items that have been added over the years and parse everything through the five attributes. Boards should do the following three things immediately:

- Prepare an assessment or gap analysis of current activities against the new guidance. The Federal Reserve will use such an assessment as input to its own findings when, over the course of the next year to 18 months it comes to your institution to conduct its own assessment. There may be no gaps, but if there are, better that they are self-identified.
- Revisit board committee charters to confirm that responsibilities focus on what matters by making clear where the role of the board ends and that of senior management begins.
- Take an active role in setting the agenda of the board and its committees, and in working with bank management to define information needs.

This guidance, together with the much simplified rating system and method of communication of supervisory findings are a rare moment where regulators make a genuine attempt of streamlining, reducing and even eliminating tasks, and providing a relatively holistic picture of what they are looking for. Yes, even this guidance leaves lots of room for interpretation, but the path forward is clearer than before. Less is more.

Oliver Wyman is a global leader in management consulting that combines deep industry knowledge with specialized expertise in strategy, operations, risk management, and organization transformation.

For more information please contact the marketing department by email at [info-FS@oliverwyman.com](mailto:info-FS@oliverwyman.com) or by phone at one of the following locations:

AMERICAS  
+1 212 541 8100

EMEA  
+44 20 7333 8333

ASIA PACIFIC  
+65 6510 9700

[www.oliverwyman.com](http://www.oliverwyman.com)

#### ABOUT THE AUTHORS

##### **Til Schuermann**

Partner, Finance & Risk and Public Policy Practices  
[til.schuermann@oliverwyman.com](mailto:til.schuermann@oliverwyman.com)

##### **Jeffrey Brown**

Partner, Finance & Risk and Organizational Effectiveness Practices  
[jeffrey.brown@oliverwyman.com](mailto:jeffrey.brown@oliverwyman.com)

##### **Elizabeth St-Onge**

Partner, Finance & Risk and Organizational Effectiveness Practices  
[elizabeth.st-onge@oliverwyman.com](mailto:elizabeth.st-onge@oliverwyman.com)

Copyright © 2017 Oliver Wyman

All rights reserved. This report may not be reproduced or redistributed, in whole or in part, without the written permission of Oliver Wyman and Oliver Wyman accepts no liability whatsoever for the actions of third parties in this respect.

The information and opinions in this report were prepared by Oliver Wyman. This report is not investment advice and should not be relied on for such advice or as a substitute for consultation with professional accountants, tax, legal or financial advisors. Oliver Wyman has made every effort to use reliable, up-to-date and comprehensive information and analysis, but all information is provided without warranty of any kind, express or implied. Oliver Wyman disclaims any responsibility to update the information or conclusions in this report. Oliver Wyman accepts no liability for any loss arising from any action taken or refrained from as a result of information contained in this report or any reports or sources of information referred to herein, or for any consequential, special or similar damages even if advised of the possibility of such damages. The report is not an offer to buy or sell securities or a solicitation of an offer to buy or sell securities. This report may not be sold without the written consent of Oliver Wyman.