First take

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Five key points from the Fed's new board expectations guidance

On August 3rd, the Federal Reserve (Fed) proposed for comment supervisory guidance for boards of directors of Fed-supervised institutions[1] (i.e., Board Effectiveness (BE) guidance). The proposed BE guidance is the result of a multi-year review by the Fed of existing guidance and practices of boards of directors across supervised firms. It is intended to consolidate and replace existing board supervisory expectations from 27 SR Letters, which include 170 supervisory expectations for boards, with 33 expectations of effective boards. The 33 proposed expectations are categorized into five attributes which the Fed intends to assess a firm's board of directors, including: (1) setting clear direction for the firm; (2) actively managing information and board discussions; (3) holding senior management accountable; (4) supporting independent risk management and internal audit; and (5) maintaining a capable board composition and governance structure.

1. **Realigning board expectations.** The proposed BE guidance clarifies board responsibilities and significantly rationalizes existing supervisory expectations. The proposal responds to criticism that supervisory expectations for boards of directors and senior management have become increasingly difficult to distinguish by refocusing board responsibilities on core activities reflected along the five key attributes. Further, by aiming to replace a large volume of existing guidance, the proposed BE guidance aligns with the Trump Administration's policy to streamline and simplify existing regulations.[2]
2. **Spotlight on board governance.** Under the proposal, board governance practices will be more explicitly evaluated and considered as part of a firm's ability to demonstrate that it is "well managed". Board governance will also be a determinant of a bank's rating under the also recently-proposed Fed rating system for large financial institutions which specifically includes a Governance and Controls component.[3] While the Fed previously considered board expectations generally in their annual evaluations, the proposed BE guidance indicates that the Fed will consider board governance more prominently in determining a bank's rating.

3. **Senior management must step up.** An additional proposed change aimed at clarifying and ultimately streamlining board responsibilities is to modify existing guidance (i.e., SR 13-13) to direct matters requiring attention (MRAs) and matters requiring immediate attention (MRIAs) to senior management, as opposed to the board, for remediation. The proposal further clarifies that the role of the board is to hold senior management accountable for remediation efforts. In addition, the proposed BE guidance defines senior management more broadly, expanding the scope of succession planning and performance and compensation evaluation activities from just the Chief Executive Officer to also include the Chief Risk Officer, Chief Audit Executive, Chief Financial Officer and other members of senior management as appropriate. This could lead to higher expectations for CROs in particular, who will be instrumental in helping boards independently evaluate whether or not the risk management capabilities of the firm are consistent with its strategy and risk tolerance.

4. **Getting in line with the OCC.** The proposed BE guidance is broadly consistent with expectations for boards outlined in the Office of the Comptroller of the Currency's (OCC's) Heightened Standards issued in 2014. When combined with the Fed's soon-to-be-proposed management guidance for core business lines and independent risk management and controls,[4] the broad consistency of the proposed BE guidance with the OCC's Heightened Standards requirements should create opportunities for increased efficiencies in the risk governance frameworks of the bank holding company (BHC) overseen by the Fed and its large national bank subsidiaries which are overseen by the OCC.

   Further enabling alignment between entities, the proposed BE guidance is also consistent with the Basel Committee for Bank Supervision's Corporate 2015 Governance Principles for Banks. To the extent a subsidiary can rely on parent components of risk governance, it eliminates the need for the subsidiary to develop its own distinct processes. The OCC expectation of board self-assessment is reflected in the proposed BE guidance as an area of comment, indicating another area for potential alignment between the Fed and OCC.

5. **Expectations uncertain for foreign banks.** While the initial proposal is not applicable to boards of directors of intermediate holding companies (IHCs) of foreign banks, the Fed invited comments on whether and how the proposed BE guidance should apply to IHCs. Underlying this wait-and-see approach, there seems to be a recognition of the additional complexities of IHC boards as it relates to their interaction with the global board at their parent companies and how certain responsibilities should be split among the two. The BE guidance would present heightened expectations for IHCs, because the guidance goes beyond having a risk committee at the board level, which is the current requirement under the Fed's enhanced prudential standards and what most IHCs have established in the US so far.

What's next?

The comment period for the proposal is open until October 10th, after which the Fed will consider industry comments and make revisions to the proposed BE guidance. The proposal is not likely to be controversial and the nominee for Fed Vice Chair of Supervision,[5] Randal Quarles, has indicated support for clear and simplified regulation. As such, we expect the BE guidance to be finalized in the first half of 2018.

Endnotes

1. Includes bank holding companies, savings and loan holding companies, state member banks, U.S. branches and agencies of foreign banking organizations, and systemically important nonbank financial companies designated by the Financial Stability Oversight Council for supervision by the Federal Reserve.
2. See PwC's *First take, Ten key points from Treasury's first financial regulation report* (June 2017).
3. See PwC's *First take, Five key points from the Fed's new rating system for large financial institutions* (August 2017).
4. The Fed also plans to separately release additional proposed guidance seeking comment on supervisory expectations relating to a firm's management of core business lines and independent risk management and controls.
5. The Fed Vice Chair of Supervision is a position created by the Dodd-Frank Act and is the Fed Board seat in charge of bank supervision and regulation.

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