Thomas H. Stanton
5410 Lambeth Road
Bethesda, MD 20814
(202) 965-2200
Tstan77346@gmail.com
www.thomas-stanton.com

February 4, 2018

Ms. Ann E. Misback
Secretary
Board of Governors of the Federal Reserve System
20th Street and Constitution Avenue, NW
Washington, DC 20551

RE: Proposed Guidance on Supervisory Expectation for Boards of Directors
Docket No. OP-1570; and
Proposed Supervisory Guidance on LFI ratings
Docket No. OP-1594

Dear Ms. Misback:

Thank you for the opportunity to comment on the proposed Guidance on Supervisory Expectations for Boards of Directors (the "BE proposal"), and, by extension, on the Guidance that proposes a new rating system for Large Financial Institutions (the "proposed LFI rating system"). As the proposed guidance points out, these two proposals are interrelated in important aspects.

I offer the following comments based on my analysis of governance, management, and risk management at firms that successfully navigated the Financial Crisis compared to those that did not. I served for a year on the staff of the Financial Crisis Inquiry Commission (FCIC) where much of my focus was on governance and risk management. The Commission obtained large volumes of documents, examined hearings, books and reports, and interviewed CEOs, risk officers, bankers, traders, and others. We also interviewed present and former regulators who had been charged with protecting safety and soundness of financial companies and the financial system. After the Commission concluded its work I conducted further research and wrote a book, *Why Some Firms Thrive While Others Fail: Governance and Management Lessons from the Crisis* (Oxford University Press, 2012; translated into Chinese, 2017). Since publishing the book, I have adapted lessons from the contrast between successful and unsuccessful firms in the crisis

and applied them to helping establish Enterprise Risk Management (ERM) at federal government agencies.[1] In addition these comments relate to my experiences as a Senior Executive with the Federal Trade Commission, a federal regulatory agency, and what I learned about the way that a federal agency can use persuasion and the implicit ability to regulate, as a means of trying to enhance the culture and risk management of firms in an industry. [2] My background is presented in a brief resume attached to this comment letter.

I would like to make four basic points:

1. **The Guidance on Board Effectiveness seeks to tackle a major issue facing LFIs and the financial system: the need for an LFI board actually to improve the quality of decision making at an LFI on major issues. Improving governance at an LFI is especially difficult because of the effects of complacency and short-term incentives in reducing the quality of LFI decision making over time.**

2. **Improving governance involves improving an LFI's organizational culture, and strengthening a culture takes time. To be effective over the longer term, both sets of Proposed Guidance need to adopt a dynamic rather than static approach to LFI governance. One useful tool would be a "Governance Maturity Model" to allow boards, LFI executives, and supervisors to monitor and measure year-by-year progress of an LFI in integrating stronger governance practices into the organization's decision making and culture.**

3. **The Federal Reserve System is well positioned to influence the governance cultures of the LFIs that it supervises. To be successful, this needs to be a long-term systematic effort, not only to encourage continuing governance improvements, but also to help monitor and address possible loss of quality of LFI governance and decision making that may occur.**

4. **Because continuously improving governance enhances the quality of LFI decision making, it is an efficiency-enhancing benefit rather than a burden on supervised financial firms. The presence or absence of continuously improving LFI governance is also an early warning indicator showing whether a firm engages in (1) effective risk management and, more generally, (2) sound assessment of risk-reward tradeoffs when making major decisions.**

---

[1] See, e.g., Thomas H. Stanton and Douglas W. Webster, *Managing Risk and Performance: A Guide for Government Decision Makers* (John Wiley & Sons, 2014); and Thomas H. Stanton, "An Agency Guide for ERM Implementation," AGA, February 2017, available at https://www.agacgfm.org/AGA/Resources/Online%20Library/Research%20Reports/AGA_ERM_Research_Series_2017.pdf.

[2] Some of these lessons are reflected in, Thomas H. Stanton, "Leverage and the Regulatory Process," Chapter 8 in David M. Anderson, ed., *Leveraging* (Springer, 2014).

I. The Guidance on Board Effectiveness seeks to tackle a major issue facing LFIs and the financial system: the need for an LFI board actually to improve the quality of decision making at an LFI on major issues. Improving governance at an LFI is especially difficult because of the effects of complacency and short-term incentives in reducing the quality of LFI decision making over time.

The Guidance on Board Effectiveness seeks to address the major issue that boards even of nominally well managed institutions may lack knowledge of important events. Examples include JPMorgan Chase in the London Whale incident and Wells Fargo and its board's professed ignorance of the pattern of fraudulent creation of consumer accounts. This is in addition to the many LFI boards seen in the Financial Crisis that absolutely failed to add value to their companies' decisions even when informed, as in the case of the Lehman board, of risky bets that management was making. The proposed BE Guidance is both useful and pertinent.

The problem of improving LFE board performance is difficult for many reasons:

(1) The Federal Reserve Board raised one of the most important issues in the preamble to its proposed BE Guidance: boards often lack the information needed to do their jobs. Management may provide too little information or perhaps even may bury important information in reams of other less-useful information.

The problem of poor information flow can be especially pronounced because of the huge size of many LFIs, including hundreds of thousands of employees, hundreds or thousands of affiliates or subsidiaries, and operations in perhaps a hundred countries. Top management themselves may lack the information needed to make good decisions

(2) The problem of information flow can be compounded by hubris, as likely contributed to both the JPM failure to detect problems with the London Whale in time and the current Wells debacle. There is an extensive literature on this problem.[3] When times are good for too long, as in the housing and credit bubbles before the Financial Crisis, complacency can compound the tendency to hubris that can affect LFI boards and executives.

(3) Board performance also can be weakened by other factors such as (1) a lack of willingness or ability constructively to challenge a strong executive, (2) lack of professional knowledge sufficient to raise appropriate questions or understand warning

[3] See, e.g., Sydney Finkelstein, *Why Smart Executives Fail, and What you Can Learn From Their Mistakes* (New York: Portfolio, 2003).

signs of major risks, (3) lack of cognitive independence from top management,[4] and (4) very low legal standards for accountability of directors to shareholders.[5]

The bottom line is that the Federal Reserve BE Guidance addresses very important behavior that can be difficult for examiners to address. The best way to approach board and top management performance is to view it as an exercise in strengthening the culture of an LFI and its governance.

II. Improving governance involves improving an LFI's organizational culture, and strengthening a culture takes time. To be effective over the longer term, both sets of Proposed Guidance need to adopt a dynamic rather than static approach to LFI governance. One useful tool would be a "Governance Maturity Model" to allow boards, LFI executives, and supervisors to monitor and measure year-by-year progress of an LFI in integrating stronger governance practices into the organization's decision making and culture.

Improving governance at an organization, and especially at a large complex financial institution that may have hundreds of thousands of employees scattered over hundreds (or thousands) of subsidiaries and affiliates in a hundred countries, inevitably is a long-term process. A set of static standards, while helpful, such as encouraging the flow of major risk information to a board, or calling for thoughtful board consideration of risk-reward circumstances of a major decision, cannot capture the need for an LFI to continually improve its governance culture, systems, and processes.

A dynamic perspective is especially necessary because of the many times that an organization can regress rather than progress to improved governance. Wells Fargo was a classic example. While a culture of cross-selling helped to protect the firm in the Financial Crisis, Wells pushed cross-selling to an extreme that resulted in multiple forms of exploitation of the firm's retail consumers. The consequent loss of consumer trust poses a strategic risk to Wells that is compounded in its impact because of the LFI's cross-selling strategy.

The Wells debacle occurred under the same CEO who had led the firm successfully through the crisis. The same pattern of success followed by failure occurred with Lehman's Richard Fuld, who drove the firm into bankruptcy in 2008 after having successfully led the firm through the Asian debt crisis of the 1990s. Examples abound as well of changes in leadership, such as in the transition at CitiGroup around the year 2000, or the shift in leadership at AIG before the Financial Crisis, that led to governance failures that threatened the LFI's viability. As such examples show, a dynamic perspective is needed to address the problem how inertia can mask

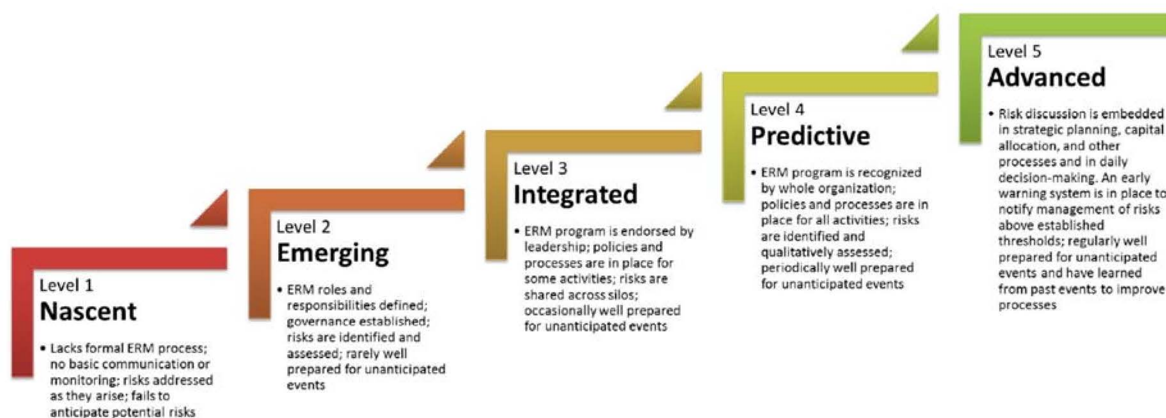
[4] This mindset is comparable to Willem Buiter's analysis of cognitive regulatory capture of some supervisors by the institutions that they supervise. See, Willem Buiter, "Lessons from the North Atlantic Financial Crisis," revised May 28, 2008, available at https://willembuiter.com/NAcrisis.pdf .

[5] See, e.g., *In Re Citigroup Inc. Shareholder Derivative Litigation*, Delaware Court of Chancery, 964 A.2d 106 (2009).

the degradation of formerly good governance at an LFI. Examiners must be able to apply measures, not only of the value that governance processes add, but also of the extent that the quality of governance has changed from one period to the next.

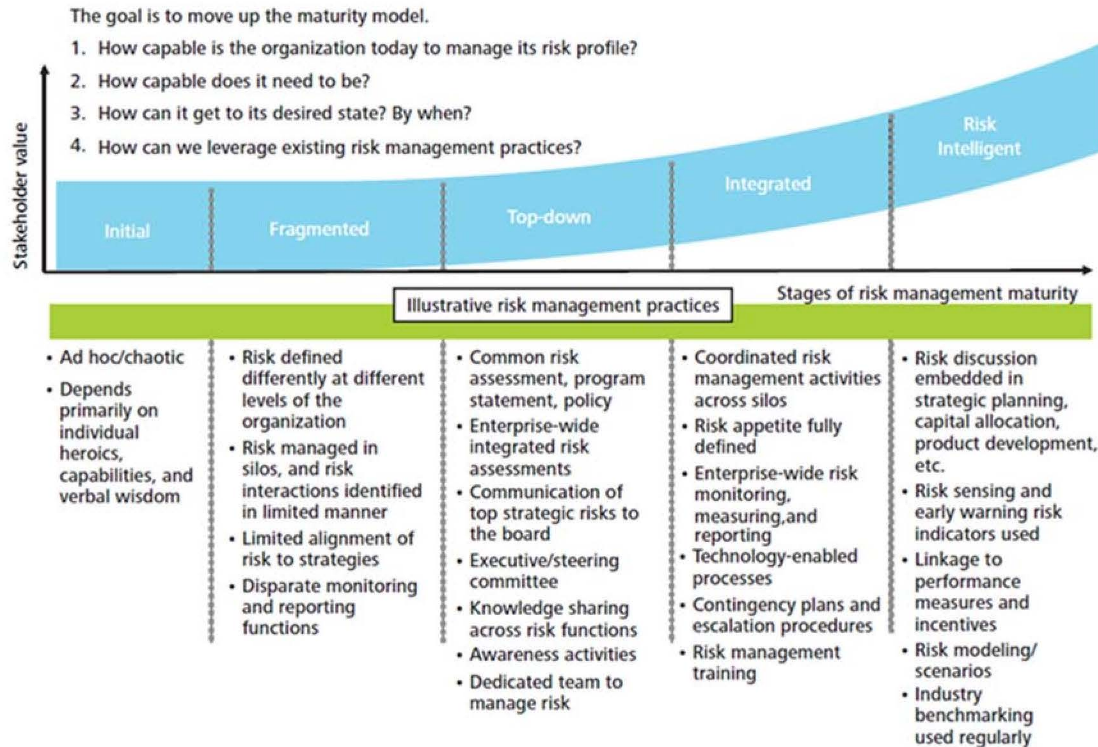
One useful tool to monitor and encourage temporal progress in quality of governance would be a "Governance Maturity Model" to allow boards, LFI executives, and supervisors to monitor and measure year-by-year progress of an LFI in integrating stronger governance practices into the organization's decision making and culture. The Guidance could require that an LFI Board develop, and possibly publish, a Governance Maturity Model with milestones that allow supervisors to measure the LFI's progress towards better governance.

Reasonable templates for a Governance Maturity Model exist. One set of maturity models is found in analyses of the quality of Enterprise Risk Management (ERM), which also involves a multi-year progression to strengthen the organization's culture.[6] As the two ERM maturity diagrams below illustrate, a model need not be complex (although some are):



Source: *Playbook: Enterprise Risk Management for the US Federal Government*, July 2016, p. 75

[6] Examples of ERM maturity models are found, among many other places, in the *Playbook: Enterprise Risk Management for the US Federal Government*, issued by the US Chief Financial Officers Council and Performance Improvement Council, July 2016, pp. 75-78, available at https://cfo.gov/wp-content/uploads/2016/07/FINAL-ERM-Playbook.pdf.



Source: Henry Ristuccia and Maureen Bujno, Deloitte, "Six Actions Boards Can Take Toward Improved Risk Governance," *Wall Street Journal*, June 27, 2014.

The cultural change required to make ERM effective in an organization offers lessons that apply directly to an LFI's governance culture:

1. Neither ERM nor governance can be viewed as a mere compliance exercise; measures of quality relate to actual improvements in decision making rather than the number of boxes that can be checked.
2. Progress along the maturity curve should be seen as an iterative process; especially for a large complex financial institution, there always will be parts of the organization that need attention.
3. Threats to sound risk management and to good governance are always evolving; changes in market forces, technology, and the nature of financial products and services require constant vigilance by supervisors and by LFIs themselves.
4. Above all, progress must be measured by actual results rather than merely formal structures and processes. For LFIs, examiners need to test the actual extent that important information flows to LFI decision makers who need it and to the LFI board, the extent that the LFI leadership responds appropriately to warning signs, and the extent that LFI executives and managers are willing to engage in

constructive dialogue with the LFI board, subordinates or others who raise a warning flag, and with supervisors themselves.

One can imagine that a firm's board and executive leadership could construct a clear maturity progression for the LFI's governance maturity comparable to the ERM maturity models above. As with establishing ERM, improving governance at an LFI necessarily is a long-term process that the LFI's board and leadership and examiners need to be able to track. Through the Large Institution Supervision Coordinating Committee (LISSC), the Federal Reserve can consider the quality of LFI Governance Maturity Models that LFIs propose adopting, the quality of LFI progress along stages of the maturity model, and the development of measures to help supervisors and LFIs to ascertain the quality of an organization's governance and changes in quality over time.

III. The Federal Reserve System is well positioned to influence the governance cultures of the LFIs that it supervises. To be successful, this needs to be a long-term systematic effort, not only to encourage continuing governance improvements, but also to help monitor and address possible loss of quality of LFI governance and decision making that may occur.

There was a significant difference between firms with cultures that saw reports of "bad news" successfully inform top decision makers as the Financial Crisis broke, and firms that lacked that capacity. Interviews by the Financial Crisis Inquiry Commission are replete with examples. When we asked the head of the Goldman Sachs mortgage desk why he reported losses to top management, he replied, ""Part of my job was to be sure people I reported to knew what they needed to know." In response to the warning, top Goldman executives conducted a thorough investigation and responded by bringing the firm into a defensive financial position. By contrast, when the Senior Vice President and Chief Credit Officer of Fannie Mae tried to tell his superior that he thought Fannie Mae wasn't pricing for the risks of mortgages the company was buying, the superior challenged his models and retorted, "Can you show me why you think you're right and everyone else is wrong?" Unfortunately, the dialogue ended there, without Fannie Mae making necessary adjustments to its pricing. The difference between those two approaches reflects a cultural divide that, in the case of those two companies, spelled the difference between navigating the crisis and failing. Good governance needs to become embedded in the culture of an LFI so that it becomes the way the firm does business, rather than merely an add-on to other business processes.

There are two reasons why the Fed is well positioned to influence governance cultures of the LFIs that it supervises. On the one hand, thanks to the peculiar governance structure of the Federal Reserve Banks, the Federal Reserve System tends to be close in some ways to the LFIs that it supervises. On the other hand, the distinctive position and role of the Board allows for some distance from the supervised institutions. Also, the Dodd-Frank Act made the Federal Reserve the sole supervisor of bank and thrift holding companies so that LFIs no longer can shop for a more congenial regulator, as some did before the crisis. These aspects put the Federal

Reserve, so long as it does not get too close to the LFIs that it supervises, in a good position to influence LFI governance cultures.

Viewing governance as a cultural matter allows supervisors to look not merely at the formalities of a governance structure but also at the actual shared information and deliberations that add value from those structures. Supervisors can measure key indicators such as (1) whether information about major risks and opportunities flows to decision makers who need that information to make good decisions, (2) whether decision makers are willing to investigate warning signs rather than ignoring them, and (3) whether the culture allows constructive challenge of proposed decisions, by the board, by lower-level managers, and by supervisors themselves. Both at the board level and with major management decisions generally, a systematic process of constructive challenge, in an atmosphere of mutual respect, is needed to highlight strengths and limitations of options so that decision makers make choices that enhance the long-term value of the organization

Treatment of supervisors can be a significant warning sign. Thus, in the London Whale incident, growing hubris at JPMorgan Chase showed itself in hostile actions towards OCC supervisors.[7] This is not to suggest that supervisors are always correct in their judgments;[8] rather the point is that a good LFI governance culture would engage constructively with supervisors, as with any employee or other stakeholder, to explore the merits of red flags that may be raised.[9]

The Financial Crisis, and the contrast between successful and unsuccessful firms, shows the value of a culture in which executives and managers at all levels solicit feedback as a matter of course. While it is unnecessary to act on all, or perhaps most, such feedback, the fact of listening helps decision makers to develop a robust understanding of their firm and its environment that otherwise might not have been possible. This helps them to make better decisions. In the run-up to the Financial Crisis, because of their openness to feedback and the consequent improved sense of risk-reward tradeoffs, successful firms sometimes retained more capital than their competitors and many times refrained from superficially lucrative but risky types of financial products or transactions that appeared to be making so much money for their competitors.

Openness to feedback can become ingrained in company culture, and this is something that boards, senior LFI executives, and examiners can look for. One useful tool can be to conduct regular surveys of employees and stakeholders. A question from the Federal Employees Viewpoint Survey (FEVS) highlights the potential strength of this approach, so long as questions are well framed. Question 17 of the FEVS asks employees to respond whether, "I can disclose a

---

[7] Senate Permanent Subcommittee on Investigations, "JPMorgan Chase Whale Trades: A Case History of Derivatives Risks and Abuses," Majority and Minority Staff Report, pp. 222-225.

[8] Indeed, a concern expressed by some LFI executives is that examiners too often focus on easy-to-document smaller issues rather than larger less tangible issues that might deserve more careful scrutiny.

[9] See, e.g., Thomas H. Stanton, "Constructive Dialogue and ERM: Lessons from the Financial Crisis," chapter 32 in John R.S. Fraser, Betty J. Simkins, and Kristina Narvaez, eds., *Implementing Enterprise Risk Management: Case Studies and Best Practices*, John Wiley & Sons, 2014.

suspected violation of any law, rule, or regulation without fear of reprisal." When applied at an LFI's lower organizational levels, such a question can help flag whether information about major risks is properly flowing up the chain of command, for instance. Monitoring the responses over time can provide a useful indicator of whether the governance culture is improving.

Finally, the Federal Reserve is well positioned to apply remedial measures to LFIs to improve low quality governance. While a restriction on growth, combined with dismissal of directors might be appropriate in extreme circumstances of governance failure,[10] lesser remedies may be appropriate for less extreme governance failures. For instance, if an LFI's leadership systematically displays an inability to provide information about major risks to the board of directors in a timely and useful manner, the Federal Reserve might consider requiring separation of the roles of CEO and Board Chair so that the non-executive Board Chair can lead the process of setting the board's agenda and requesting information from management.

IV. Because continuously improving governance enhances the quality of LFI decision making, it is an efficiency-enhancing benefit rather than a burden on supervised financial firms. The presence or absence of continuously improving LFI governance is also an early warning indicator showing whether a firm engages in (1) effective risk management and, more generally, (2) sound assessment of risk-reward tradeoffs when making major decisions.

Unlike some forms of regulation, the Guidance on Board Expectations, and the accompanying proposed LFI rating system, are efficiency enhancing measures. Requiring LFI boards to generate a robust Governance Maturity Model and then to demonstrate progress in meeting milestones, is a way to help enhance the quality of board involvement in major decisions, and especially decisions concerning major risks and opportunities that could benefit from a constructive dialogue between top management and the board. Long before the Financial Crisis, Edmund Clark, who guided TD Bank successfully through the crisis, described the type of board-CEO relations that reflect a strong governance culture:

> Good executive management teams want a strong board. If they're going to add value they need to ask the tough questions. They need to challenge us on our assumptions. So I tell my Board to wander through the organization; meet the executives; ask for any document you want. And if any executive refuses, tell me and I'll have a conversation with him or her and make sure they know they have to let you have it. Before each Board meeting I go through the agenda item by item. I tell the directors where the problems are and point out where they might want to press for more information on issues.[11]

[10] Board of Governors of The Federal Reserve System, *In the Matter of Wells Fargo & Company*, Order to Cease and Desist, Docket No. 18-007-B-HC, February 2, 2018.
[11] Clark, Edmund. "Corporate Transparency and Corporate Accountability - today's table stakes for senior executives," remarks to the Executive Women's Alliance Conference, Vancouver, July 12, 2004.

By systematically encouraging development of such a strong governance culture, the Federal Reserve can help to protect increasing numbers of LFIs and their customers and shareholders and the financial system, from the carnage that resulted from poor LFI governance the last time around.

Yours truly,

Thomas H. Stanton

ATTACHMENT

Thomas H. Stanton
Tstan77346@gmail.com
www.thomas-stanton.com
(202) 965-2200

My career spans the practical and the academic. I am a past-President of the Association for Federal Enterprise Risk Management (AFERM), a former member of the federal Senior Executive Service, and served for many years as a board member of the National Academy of Public Administration (NAPA), and as Chair of the NAPA Standing Panel on Executive Organization and Management. In 2017 NAPA honored me with the George Graham Award for Exceptional Service to the Academy.

I teach as an adjunct faculty member at the Center for Advanced Governmental Studies at Johns Hopkins University and have received the Center's award for Excellence in Teaching. My courses include the core course for the MBA/MA in Government, and a graduate seminar on governance, risk management, and decision making. The GAO, CBO, OMB, Farm Credit Administration, Department of Agriculture, Department of Education, Department of Housing and Urban Development, Small Business Administration, and the Treasury Department all have requested my services to help improve the design and administration of federal programs.

Among my accomplishments over the years:

1. Helping to enact legislation creating a new financial regulator for Fannie Mae and Freddie Mac;
2. Providing strategic planning to assist the Small Business Administration to launch and implement its $ 5 billion loan asset sales program,
3. Assisting the Small Business Administration to create an Office of Lender Oversight,
4. Assisting the Office of Management and Budget to set a multiyear agenda for improved management of federal credit programs, and
5. Helping to build a community of practice to promote more effective Enterprise Risk Management in the federal government.

My publications include a co-edited book on Enterprise Risk Management (ERM), *Managing Risk and Performance: A Guide for Government Decision Makers* (John Wiley & Sons, 2014). My book, *A State of Risk: Will Government Sponsored Enterprises be the Next Financial Crisis?* (HarperCollins, 1991, at p. 182) first presented the idea of contingent capital that is now being applied to reduce vulnerability of financial institutions globally. *Why Some Firms Thrive While Others Fail: Governance and Management Lessons from the Crisis* (Oxford University Press, 2012), builds on my service with the Financial Crisis Inquiry Commission, where we interviewed numerous CEOs, bankers, traders, risk officers, regulators and policymakers. I obtained a grant from the Laura and John Arnold Foundation and was primary author of the final report, "Federal Credit Programs: Outcomes Matter more than Volume," May 2017. My degrees are from the University of California at Davis, Yale University, and the Harvard Law School. I am fluent in German and have conducted research in several different countries.