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**Guidance for Supervisory Expectations for Boards of Directors.**

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

Docket No.OP-1594

Re: Proposed Supervisory Guidance.
Proposed Guidance describing core principles of effective senior management, the management of business lines, and independent risk management and controls for large financial institutions.

Dear Ms Misback

Thank you for the opportunity to comment on the Proposed Guidance on Supervisory Expectations for the principles of effective senior management, the management of business lines and independent risk management.

I offer my comments based on my membership of the board of the UK Financial Services Authority, of the Gibraltar Financial Services Commission, of financial services companies both in the UK and internationally. I have published extensively on financial services regulation, including *Fannie Mae and Freddie Mac: Turning the American Dream into a Nightmare; Lehman Brothers: A Crisis of Value* and (forthcoming), *Holding Bankers to Account.* I shall draw on my personal experience and knowledge of the UK Corporate Governance Code and the UK regulatory requirements set out in the Senior Management Regime and my extensive published works.

The first consultation describes the Board's core responsibilities:-
It appears that the supervisory expectations of boards should consist of:
- Set clear, aligned, and consistent direction regarding the firm's strategy and risk tolerance;
- Actively manage information flow and board discussions;
- Hold senior management accountable;
- Support the independence and stature of independent risk management, including compliance;

The proposal suggested that both the Matters Requiring Immediate Attention and Matters Requiring Attention 'would only be directed to the Board if the Board needs to address its corporate governance responsibilities or when senior management fails to take appropriate remedial action. Boards of directors would remain responsible for holding senior management to accountable for remediating supervisory findings.' The Federal Reserve defines matters requiring immediate attention as those having the potential to pose significant risk to the safety and soundness of the institution; those representing significant non-compliance with applicable laws and regulation.

The Federal Reserve Board has requested comments on the proposed guidance describing core principles of effective senior management, the management of business lines and risk management and controls.

The Federal Reserve invites comments on the proposed guidance, including responses to the following questions:-

- "What considerations *beyond those* (italics mine) outlined in this proposal should be considered in the Federal Reserve's assessment of whether an LFI has sound governance and controls such that the firm has sufficient financial and operational strength and resilience to maintain safe and sound operations"?
- "How could the roles and responsibilities between the board of directors, set out in the proposed board effectiveness guidance and between the senior management, business line management and IRM be clarified"?

The first issue to be considered is the structure of the board and then its relationship to senior management and key officers. My view is that the structure of the board, the mandatory (as opposed to the voluntary separation of the roles of chairman and chief executive, as may be the case with some companies and financial institutions in the USA), and the clarification of reporting lines and responsibilities, should be an essential part of the Federal Reserve's assessment of an LFI's sound governance and controls. The structure outlined here also enables the roles and responsibilities to be clarified.

The UK Corporate Governance, published by the Financial Reporting Council, requires the separation of the roles of chairman and chief executive. It is true that this falls under the rubric of 'comply or explain', as part of the Listing Rules of the Stock Exchange, but that is a more effective means of enforcement than it might appear at first sight. More than that, the Listing Rules require companies to make a statement of how they apply the Code and the associated Principles. The Rules also require companies to make a statement of how they have applied the Principles 'in a manner that would enable the shareholders to evaluate how the Principles and associated guidance have been applied.' That enables the company to do more than baldly state that the roles have been separated but it should show how the board has been able to set the company's purpose and strategy, met objectives and achieved outcomes through the decisions it has taken. A failure to separate the roles has to be noted in the company's annual report and will raise questions from investors, analysts and commentators.

The chairman is expected to 'lead the board and is responsible for its overall effectiveness in directing the company. The chair should demonstrate independent and objective judgement, and promote a culture of openness and debate by facilitating constructive relationships between directors; in particular, the chair should ensure the effective contribution of all non-executive directors'.

The Code requires a division of responsibilities between the leadership of the board and the executive leadership of the bank. The responsibilities of the chairman (and the chief executive, senior independent directors, board committees and management ) are defined not only in terms of general principles but also must be set out in writing, agreed by the board and made publicly available. The general principles also set out the parameters for the division of responsibilities, which suggest that the division cannot deviate from those principles, since these are set out the expected relationship between the chair and the CEO. 'The CEO is responsible for proposing strategy to the board, delivering it as agreed and ensuring timely and balanced information is presented in order for the board to make decisions effectively'. The chair should also set 'clear expectations concerning the company's culture, values and behaviours, and the style and tone of the board discussions'. Those are the expectations set out in the UK's Corporate Governance Code. The Financial Reporting Council's Guidance for chairman provides a useful summary of the expectations of the chairman and the differences in the revised guidance on board effectiveness, in their proposed revisions to the Code, issued in December, 2017. The chair's role is, for example' setting the agenda for the board which is primarily focussed on strategy, performance, value creation, and accountability and ensuring that issues which are relevant to the board are reserved for board decision, based on a timely flow of accurate, high quality and clear information.

The UK Corporate Governance Code has long required the separation of the role of chief executive and chairman on the basis of 'comply or explain' as detailed above. However, the separation of the roles is now a regulatory requirement, as part of the senior management regime introduced after the financial crisis and effective since 2014, but elaborated in the Prudential Regulatory Authority and the Financial Conduct Authority's Supervisory Statement, "Strengthening Accountability in Banking" in May, 2017. The functions of the chairman are described as 'chairing and overseeing the performance of the board, leading the development and overseeing the firm's policies and procedures for the induction and development of all directors' and 'leading the development of the firm's culture by the board'. More importantly, the PRA adds that the role of chairman is ' integral to the firm's safety and soundness'. The PRA then expects the chairman to proactively to remain apprised of matters related to the board and its individual committees by, for example, having regular discussions with the chairs of the Audit, Risk and Remuneration outside board meetings. All of this means that the chairman's role is more demanding than that of the other non –executive directors, a role demanding up to three days a week depending on the size and complexity of the bank.

One of the issues for which the chairman and the board would be held responsible is the failure of the chairman and non-executive directors who had serious concerns about an overly dominant CEO, to address, record or discuss in the board meetings or with the supervisors. The UK regulators had good reason to regret the overweening power of a dominant CEO. That was the case with the Royal Bank of Scotland in the hands of Sir Fred Goodwin as CEO and a weak chairman, who was in fact the former CEO. Of course, that was one element in the complex reasons for the failure of the bank, but an examination of the causes of the failure shows that to a large extent they were caused by the way in which the bank was run, such as an over reliance on short-term funding; the bank's underlying asset quality and substantial losses in credit trading activities. The straw that broke the camel's back was the acquisition of ABN-AMRO on the basis of wholly inadequate due diligence. The decision was taken without an understanding of the risks involved in integrating such a complex organisation into RBS, but motivated by self aggrandisement, the desire to become a major global player. The Financial Services Authority's report on the bank's failure cites its 'governance arrangements' and refers to the CEO's 'management style discouraged robust and effective challenge.' (The Failure of the Royal Bank of Scotland, Financial Services Authority Board Report, 2011).

Another example from the crisis is that of Lehman Brothers. Dick Fuld was both chairman and chief executive, a man well-known for a strong and dominating personality. His ambition was to make the company the largest and wealthiest investment bank. To achieve that he was determined to set aside the recommendations of his chief risk officer, Madelyn Antoncic. She was well-qualified for the role, a former Goldman Sachs mortgage trader with a Ph.D in Economics from New York University. She set up a well-managed and well respected risk management team with a staff of 170 and an admirable risk management function. Fuld ignored the risk management limits set by the CRO; indeed, deliberately overruled them as he sought to expand into commercial real estate and investing in MBSs. He first sidelined her and then replaced her with the CFO Chris O'Meara, who was supportive of Fuld and had no formal risk management training. Antoncic was dismissed in 2007, but then became Vice President and Treasurer of the World Bank.

Following the financial crisis, Basel recommended a different structure for management of risk. The Guidelines Principles for Corporate Governance for Banks in July 2015. It clearly distinguishes between the function of the board and of senior management. The board has ultimate responsibility for the banks' business strategy and financial soundness, key personnel decisions, internal organisation and governance structure and practices, risk management and compliance obligation. Apart from setting out the organisational structure of the bank, and define the responsibilities of the board, the chairman and the CEO, and of senior management and the board.

Basel describes the business units as the 'first line of defence,' as they take risks and are responsible and accountable for the management of such risks. The business units should 'identify, assess and report such exposures' within the limits of the bank's risk appetite and its policies, procedures and controls. The risk management function is the 'second line of defence' for risk management. It monitors the business lines' risk activities and oversees them and assesses them independently of the business line. Part of that second line of defence is an 'independent and effective compliance function.' The board should approve the compliance policies to be communicated to all staff and report to the board on how the bank is managing its compliance risk. The third line of defence is the internal audit, capable of providing an 'independent and effective' review and objective assurance of the quality and effectiveness of the bank's internal control system'.

The UK regulatory authorities have implemented the Basel's Corporate Governance Principles for Banks in such a way that the roles and responsibilities of the risk management function, internal audit and compliance and their reporting lines are clearly defined and their independence is more easily guaranteed. The Senior Management Regime establishes four board subcommittees. They are as follows:-

- Audit Committee;
- Risk Committee;
- Remuneration Committee
- Nominations Committee.

Each of these committees is chaired by a non-executive member of the Board. Both the chair of the audit and the risk committees have to meet further requirements beyond the fitness and propriety required of all members of the board.

The chair of the audit committee is both responsible for overseeing the performance of the audit committee-and also for overseeing the integrity and independence of the firm's internal audit.

The nominations committee and the remuneration committee oversee appointments to the board and the development and implementation of the firm's remuneration policies and practices.

The chairman or the chair of the Audit Committee are responsible for ensuring and overseeing the integrity and independence of the compliance function, including the head of compliance. The advantage here is that each of the heads of compliance, risk management, finance and internal audit can discuss any issues which cause them concern with either the head of the relevant committee or the chairman. As already noted, the chairman is expected to actively remain fully informed of all the issues relating to the board and its individual committees by having regular meetings with the chairs of each of the committees and would also have informal meeting with those in charge of finance, compliance, risk management and internal audit. The chair's role requires such meetings to take place and, where serious matters are involved which might require the board to take action, the meetings would be extended to meetings of the board attended only by non-executive directors. Thus, the Dr Antoncics of risk management would always have had another means of handling the issues of risk limits being overridden.

The UK's senior management regime clarifies the distinction between the roles of senior management and the board, as each senior manager has to sign a 'statement of responsibility' setting out clearly the role they are undertaking and describing those areas of the they are activities for which they are responsible. The UK regulators also require a management responsibilities map, which describes the bank's management and governance arrangements in a single document. What is also very important about this map is that it includes key reporting lines, committee structures and details about key management and their responsibilities. These documents and the detailed descriptions required also make the distinction between the roles of the board and its members clear. From that point of view, the UK requirements assist with the distinction between the role of the board and of senior management. Splitting the roles of chairman and the CEO make the distinction clear as well. Far from being an onerous requirement, banks use their annual reports to spell out their risk management procedures and what kind of risks the bank is prepared to take on. Risk limits may not be set out in the annual report but a clear indication of the level (low) and qualitative nature of the risks the bank is prepared to handle as part of its business model.

An acceptance of this framework would ensure that the Board as access to 'timely, useful and accurate information to the board.' That would not just be the responsibility of senior management; indeed, that is the responsibility of the chairman. The board's chairs of each committee and the chairman receive the reports from Internal Audit, Finance and the Chief Risk Officer. In addition, it would alter the supervisory expectations relating to the assessment of the risk management framework. The same issues arise for the implementation and execution of strategy and risk tolerance, where the specific business and risk objectives should align with firmwide strategy and risk tolerance should be agreed with senior management and assessed by the risk management department, not only reported to senior management. The CRO should be more than 'involved in any proposal to make exceptions to established risk limits, including on a temporary basis, should provide an assessment of any such proposal, and escalate the proposal to the board of directors as appropriate.' Changes in the wording here, though apparently minor, are important. The CRO should not be 'involved in' any such proposal as that implies being part of the decision –making process. The CRO should be in a position to assess the implications of any such proposal, warn against its adoption if the risks are too great, and escalate this to the Chair of the Risk Committee and the Chairman, if it appears that the advice or warnings are being overridden or ignored or if the board should be fully aware of the additional risks. The board should be able to discuss the issue in depth and agree the proposed changes.

One feature which is necessary for the CRO and all senior management to assess the risks faced by the bank is the ability to assess the risks faced by the bank as a whole. For that, the bank should be able to identify concentrations of risk. Both the proposed supervisory guidance for the core principles of the management of business lines and of Independent Risk Management and Controls should incorporate Basel's Principles for effective risk data aggregation and risk reporting.

The guidance for risk management should include more guidance on aggregating risk exposures so that concentrations can be identified quickly and accurately across business lines and between legal entities. Risks cannot be properly managed without efficient risk data aggregation. Some banks were unable to manage risks adequately for this reason during the financial crisis. What a bank has to do is to develop the ability to define, gather and process risk data according to the bank's reporting requirements so that the total risk can be measured against its risk tolerance/ risk appetite limits.

The bank's board and senior management should require the identification, assessment and management of data quality risks as part of its overall risk management framework. The framework should include 'agreed service level standards for both outsourced and in-house risk data-related processes, and a bank's policies on data confidentiality, integrity and availability as well as risk management policies. The bank's data aggregation and risk reporting framework with sufficient resources should be reviewed and approved by the board and senior management. With mergers and acquisitions, or indeed the development of any new business or product, banks should consider as part of their due diligence, what the impact will be on their own risk data aggregation and risk reporting capabilities.

The bank's senior management should be fully aware of and understand the limitations that prevent full risk data aggregation in terms of technical abilities, coverage, that is, risks not captured or in legal terms. The bank must be ready to provide the necessary resources since they have legacy systems and need to ensure that the resources are available to update and adapt IT systems to provide the data quickly and efficiently. This is not without advantages for the banks themselves, since they will be able to operate more efficiently and will not have to waste time and money sorting out the problems from risk mismanagement arising from a lack of awareness of concentration of risk. Basel's Principles for effective data aggregation and risk reporting should be included in the supervisory guidance for risk management.

The separation of roles and the structure outlined in this brief response has the advantage both of clarifying the roles of the board and senior management and providing independent assessments of the bank's finance, all matters falling under internal audit and risk management. These can then be provided to the relevant board committees and the chairman. In this way, the dominance of a powerful CEO can be mitigated, whilst at the same time, strong and thoughtful leadership for the bank can be provided.