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Submitted by email : regs.comments@federalreserve.gov

Re: Docket No. OP-1570
Proposed Guidance on Supervisory Expectation for Boards of Directors

Dear Federal Reserve Board Staff:

The Board of Governors of the Federal Reserve's proposal on supervisory expectations for bank and bank holding company boards of directors is the blueprint bankers have long-sought for building a better road to governance success. If implemented, it will restore the independence of bank boards that is necessary to achieve effective management accountability.

Observations from a Trend that Obscures Management and Director Responsibility

Too often in the past, supervisory guidance and examination conclusions have described expectations for boards of directors in conjunction with those of senior management—as if "senior management and the board" were one undifferentiated entity. Looking back on the development of Basel II era supervisory guidance, we see evidence of a tendency to blur distinctions between board and senior management responsibilities. A reading of interagency guidance on operating risk and retail or corporate credit risk reveals that 40 of the 58 references to a bank's board occur when describing a duty or expectation in conjunction with management, as in "IRB systems need the support and oversight of the board and senior management..." or "the board of directors and management would be responsible for maintaining effective internal controls over the [bank's] information systems...." Distinctions between board and management duties are obscured to the point of being indecipherable.

The FDIC's 2014 Study of Matters Requiring Board Attention (MRBA) illustrates repeated instances where the boards of well-rated institutions are required to undertake management duties such as loan grading, cash flow analysis, and updating workout plans. The report also illustrates the agency's track record of lumping MRBAs into the compound category, "Board/Management." This has confused roles, wasted scarce board resources and compromised the independence of the board.

Directors who are required to review and approve management's operational and compliance programs for correctness end up committing themselves to the solutions they've endorsed. They can have more at stake in seeing their judgments vindicated than in finding

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fault. Agency enforcement orders that have doubled-down on making directors rubber stamps of management operating plans have not made board members better corporate leaders. Instead, they have made directors dig in to defend the managers whose policies they have previously approved, no matter how tangentially.

A second governance issue flowing from the observed supervisory trend is the undue burden imposed on the limited resources directors have to apply to their responsibilities. The more detail that is raised to the board level the less time is available for the most significant strategic and oversight obligations. Inches thick board meeting materials imply an expectation that this information merits consideration. To focus otherwise, directors risk severe supervisory second-guessing. As a result, boards have little practical choice but to waste time on strategically inconsequential operating details while directors become bored with matters that are beneath their expertise and competencies.

A third ramification for governance arising from the observed supervisory trend is that the over-specification of board responsibilities tends to convert board service into a compliance exercise of ticking off a check list of regulatory chores, rather than a broad principle driven dynamic interaction that develops strategic direction and performance expectations tailored to the fundamental business aspirations and risk profile of the particular bank and its market across the full range of risk types in an enterprise-wide fashion. This includes financial, operational, compliance and ethical milestones. This is a substantial obligation for the best boards without the unwarranted distractions of operational level detail.

Proposing Supervisory Guidance to Better Define Governance Roles

As the Federal Reserve now acknowledges, **the best path to good governance is not to make the board a redundant form of management; but instead to make directors credible overseers of corporate strategy and management performance.**

The proposed supervisory guidance articulates five waypoints for achieving governance success: set clear, aligned, and consistent direction; actively manage information flow and board discussions; hold senior management accountable; support the independence and stature of independent risk management and internal audit; and maintain a capable board composition and governance structure.

Consistent with this guidance, the Federal Reserve also proposes to conform its expectations with respect to reporting examination findings to boards; so that governance failures are the focus, not management minutiae.

Contrary to what some critics assert, the proposal will not "reduce crucial interactions" between the board and the bank's regulator. Board members will not be sheltered from the strategically relevant information that supervisory examinations produce. In fact, by following the guidance truly "crucial" information from exams will be pinpointed in agency communications to the board and separated from the chaff of routine operational details.

The guidance expressly obligates the board to affirmatively manage the flow of information from all sources (including its supervisor) that it needs to fulfill its responsibilities of providing clear strategic direction and holding senior management accountable. Outside directors will serve the role their appointment is intended to fulfill by assuring the integrity of the information sources the board requires to guard against the potential for cooptation by insider directors.

The suggestion by some that boards should be "copied" on examinations as a routine fail-safe will only undermine the efficiencies the proposal seeks to accomplish. Indiscriminate circulation of exam reports above senior management has never assured that directors make better decisions or more effectively hold management accountable.

Under the proposal, regulators are not "tak[ing] a load off" directors; they are exchanging one obligation (operations) for another (oversight) to encourage more efficient board governance practices. To realize the benefits of this realignment, banking agencies must discipline themselves to conduct examinations, identify findings and recommend remediation that distinguish the roles of staff, management and the board so that the road to success is constructively executed in accordance with the specifications for enterprise-wide risk management that regulators have long professed to support.

The Federal Reserve is not "going in the opposite direction" of Dodd-Frank reform or away from "sharp scrutiny" by directors as some claim. "Sharp scrutiny", not operational brawn, is precisely what the proposal encourages bank directors to better exercise.

Further Comment on Implementing the Proposed Guidance

The Board solicits additional comment on whether the guidance is adequately clear in its distinctions between management and directors. The ultimate answer to this lies less in the guidance and more in its implementation by examiners and across agencies going forward. The proposal is flexible enough to enable institutions and examiners to achieve the spirit of the guidance without being shackled by the precision of its prose. The Federal Reserve and other agencies must monitor examinations to assure implementation of the guidance adheres to its intended goals.

The most pernicious threat to successful implementation of the guidance is the impact of overbroad enforcement orders and the supervisory creep that their issuance instills. For example, in the recent CitiMortgage Consent Order the institution's board (or relevant committee) is obligated to review "all plans, reports, programs, policies and procedures" required to be submitted to the agency. (¶29) This litany encompasses detailed templates of all notices and revised notices regarding incomplete loss mitigation applications. (¶25) Yet there was no finding that the Board was a root cause of the underlying compliance deficiencies. Nor is any purpose given for such a detailed remedial review at the Board level where no such technical expertise exists. There is clearly no regulatory requirement for Board review of such notices in the regular course of business.

This is just another instance of imposing management duties on directors.

Certainly, director oversight (such as through an audit committee) of management's remedial obligations is an appropriate board responsibility to assure management's accountability. However, the Consent Order's declaration that the Board will have "ultimate responsibility for proper and sound management of Respondent and for ensuring that Respondent complies with all Federal consumer financial laws" (¶30) is wildly over-reaching and effectively converts directors into super managers. That is not their role in any accepted governance process.

Board members are not insurers of technical compliance. As the proposed guidance makes clear directors establish strategic direction, articulate corporate values and risk tolerance, and hold management accountable for operationalizing those directives and performing within tolerances. Sound management is management's responsibility. Board members scrutinize and impose accountability for such performance, not substitute themselves in that role.

Consent orders that obscure the distinction between management and board miss the opportunity to reinforce proper governance practices. Moreover, they become misguided examples to agency examiners who read their language and perpetuate their errors in regular supervisory findings and directives. Such compromise orders also are cited by industry consultants as definitive standards to be followed by bank boards generally, further spreading the errant message.

To guard against this wayward tendency, the Federal Reserve should work with its sister agency colleagues to recognize the importance of maintaining board and management governance distinctions when imposing enforcement remedies. The public nature of formal enforcement orders affords each agency a rare ability to reinforce proper governance divisions of labor under concrete and instructive circumstances. Lax drafting of consent order language misses that opportunity and undermines what otherwise could be the authoritative underscoring of sound governance principles.

It may also be useful for agencies to sponsor a forum on corporate governance to foster in-depth dialogue and improve consensus about how best to keep the roles and supervisory expectations for directors versus managers distinct and how that division can best be respected under the enterprise risk governance paradigm.

Fundamentally, the boundary between management and the board should be articulated in ways that accommodate varied institutions and varied circumstances. There must be latitude for the directors themselves to define their interface with management giving due consideration to the economic circumstances, regulatory standards and complexity of the bank's operations on the one hand, and the board's capacity and calling to be engaged as "visionary" or "watchdog" on the other hand. The key is not to have this flexibility over-ridden by the idiosyncratic preferences of individual examiners, zealous enforcers or divergent agencies ignoring the intended distinctions between board and management responsibilities.

We also believe that the proposal allows institutions to voluntarily adopt leading practices, without supervisory compulsion, so that boards can hone their scrutiny of management's conduct by improving their primary oversight function along lines such as:

Using a common vocabulary in a common framework to enable employees, management and directors to discuss enterprise risk so that expectations are clear, information flows effectively across the control structure and performance measures are understandable and resist gaming.

Creating a functional definition of materiality for gauging risk tolerances that captures the impact not only of financial shortfalls, but also shortcomings in meeting compliance requirements and corporate ethical standards.

Testing the board's perceived risk appetite against the prospect of public or supervisory exposure so that a willingness to accept risk at the margins of safe, sound, compliant or ethical behavior is not over-estimated nor miscommunicated to the lines of command.

Providing an expedited pathway for escalating ethical lapses to board oversight. When staff game the risk management system, program failure has gone beyond human error, insufficient training or lax monitoring: the bank's core values are compromised and the board must be engaged early and forcefully.

By pursuing these enhancements, directors can be more effectively interventionist when necessary, while conserving their scarce resources and specialized expertise for the primary challenges that boards face in charting their institution's strategic course for business and governance success.

<u>Conclusion</u>

In summary, the guidance warrants adoption largely as proposed. Joint agency efforts should conform other guidance and enforcement approaches to this foundation so that a unified supervisory policy will better delineate, and adhere to, the separate responsibilities managers and directors have in the governance process. This will enable managers and directors, respectively, to focus on improving their own conduct—subject to correspondingly focused supervisory verification. Agencies, banks, shareholders and customers should welcome the Federal Reserve's proposal as the best road to bank governance success—built on strong independent boards effectively overseeing accountable managers.

Respectfully submitted,

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Richard R. Riese