American Bankers Association
Building Success. Together.

Hu Benton
Vice President, Banking Policy
Office of Regulatory Policy
202-663-5042
hbenton@aba.com

Ms. Ann E. Misback
Secretary
Board of Governors of the Federal Reserve System
20th Street & Constitution Avenue, N.W.
Washington, DC 20551
Docket No. OP-1570

Via Electronic Mail/Electronic Submission

February 15, 2018

Re: Proposed Guidance on Supervisory Expectation [sic] for Boards of Directors (Docket No. OP-1570)

Ladies and Gentlemen:

The American Bankers Association (ABA)[1] appreciates the opportunity to comment on the proposed supervisory guidance (Proposal)[2] from the Board of Governors of the Federal Reserve System (Federal Reserve) on assessment of effectiveness of boards of directors of 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.

More than eight years since the financial crisis banks are significantly stronger and better positioned to serve their customers and communities. At times, however, that service has been impaired in some respects by regulatory mandates that have diverted attention from customer and community needs. As leaders of their banks, directors have key responsibilities related to positioning their institutions to serve their communities and perform for their stakeholders. In recent years, however, regulators have frequently engaged boards with overly detailed compliance tasks which would have been better placed as responsibilities of management, subject to the directors' oversight.

In light of those concerns, the banking industry appreciates and supports the Federal Reserve's willingness to step back and consider appropriate adjustments to the division of responsibility between the board and management and to review regulatory requirements for boards and other

[1] The American Bankers Association is the voice of the nation's $17 trillion banking industry, which is composed of small, regional, and large banks that together employ more than 2 million people, safeguard $13 trillion in deposits, and extend more than $9 trillion in loans.
[2] Federal Reserve System, Proposed Guidance on Supervisory Expectation for Boards of Directors, 82 Fed. Reg. 37,219 (August 9, 2017).

aspects of governance. In particular, the proposed shift to what is essentially a principles-based approach is positive, since it allows for varying approaches appropriate for each bank.
The industry has several concerns, however, about the Proposal's details, and offers the suggested changes below to improve the success of implementation:

- **The Proposal should be clarified to avoid an overly prescriptive approach to information furnished to directors, handling of board self-assessments, and requirements for board composition.**

- **The Proposal should be revised to remove duplication of or conflict with some requirements of other regulatory regimes applicable to financial institutions.**

- **Successful achievement of the Proposal's objective will depend on a broad reduction in the granular duties imposed in recent years on directors.**

- **Successful implementation of any final guidance will require significant training of frontline and supervisory examination staff.**

- **The Federal Reserve and other prudential regulators should adopt an enforcement approach that is consistent with the Federal Reserve's new direction in assessing board effectiveness and governance.**

Key Aspects of the Role of Boards of Directors

First and foremost, all regulatory requirements and guidance focused on boards of directors must affirmatively support directors in the execution of their fundamental responsibilities, among which are the following:

- Guiding the overall strategic direction of the bank;

- Monitoring the bank's financial performance;

- Adopting a framework for the bank's risk appetite and tolerance;

- Overseeing management's execution of the strategy within the limits of the institution's risk tolerance, including its compliance with legal requirements, and holding management accountable; and

- Overseeing talent management - putting in place the right senior management and overseeing a positive framework for attracting the needed talent at all levels of the staff.[3]

[3] In reviewing board performance of these and other functions, supervisors' judgment should be informed by the principles concerning business judgment discussed below.

ABA supports the Federal Reserve's proposed shift to a principles-based approach, because these duties inherently involve significant variation in approach among banks, as varied as different banks' businesses. Moreover, many of the specific proposed changes, including revisions to numerous Supervision and Regulation Letters, represent progress in rebalancing the roles of directors and bank management and reducing the current supervisory burden. As described in detail below, ABA recommends a number of additional steps that will better achieve the goals of the Proposal, strengthen directors' ability to meet their key responsibilities, and improve the performance and safety and soundness of the institutions. Perhaps above all, the Guidance should be clarified to state explicitly that there is no "one-size-fits-all" approach and that examples given are for illustrative purposes. As appropriate in any guidance document, examples do not create requirements.

Key Improvements to Proposed Guidance

1. **Supervisors should give due consideration to allowing boards to make the judgment about what information flow to use and the details *of assessing management's* accountability.**

Among the Proposal's elements of board effectiveness is "[active management of] information flow and board discussions."[4] The information flow that directors require is ultimately a function of the business model and lines of business of the bank in question and their inherent risks and roles in the bank's overall strategy. Therefore, the directors should be allowed to address this element in ways they judge appropriate to their institution. An assessment based, for example, on a notion of "best practices," (which are inevitably gleaned from banks and possibly other companies with widely varying business models, levels of complexity, and risk profiles, and which tend to homogenize supervision rather than tailor it) would not only be inapposite but could actually impede the directors of a given bank in getting the most appropriate information for their oversight responsibilities.

A leading legal practitioner[5] notes that under general Delaware corporate law (directly applicable to many bank holding companies, and strongly persuasive guidance about the responsibilities of directors of corporations and banks generally), information flows appropriate for a board of directors are a matter for the directors to determine in good faith. An important caveat is that there must be no compelling evidence of the board disregarding "red flags" suggesting that the board is aware that an internal compliance issue or risk is inadequately controlled.[6] The Delaware Supreme Court has ruled that directors would not be liable unless they either failed to implement any reporting or information system or controls, or consciously failed to oversee or monitor the company's operations so as to prevent becoming informed of risks or problems

[4] Proposal at 37,220.
[5] Lee, Paul L.: "Directors' Duty to Monitor – Experience in the Banking Industry," Banking L. J., Vol. 133, September 2016 [hereafter cited as Lee].
[6] Lee at p. 424, citing the Delaware Supreme Court in Stone ex rel. AmSouth Bancorporation v. Ritter, 911 A.2d 362 (Del. 2006).

requiring their attention.[7] Thus, under the final guidance directors must be allowed to address the details of the information they require in ways they judge appropriate to their institution.

A related point, critically important to the Federal Reserve's overall objective of restoring the correct balance between directors and management, is clarifying the notion of an "active" board. Acknowledging that directors should not passively accept management's views and conclusions, without raising pertinent questions, the final guidance should clearly acknowledge that management will typically make recommendations to the board. That is, management will propose policies, procedures, risk tolerances, etc. for board review or approval, which practice reflects the board's appropriate oversight role. Language inconsistent with this widely understood and accepted division of governance responsibilities should be removed from the final guidance. Of course, as noted above, the board could appropriately evaluate its own information flows and designate topics for regular or specific briefing and discussion by management, together with other matters directly affecting board operations. This approach would be consistent with Delaware and other corporate laws and practices adopted under them.[8]

Similarly, the Proposal includes a second critical measure of board effectiveness, "hold[ing] senior management accountable."[9] The details of the board's assessment of management's performance under the strategic direction and risk appetite approved by the board should reflect the board's judgment of that performance, based on broad parameters and the unique character of the institution. Therefore, the final guidance should acknowledge that factors in the assessment of management's performance should be left to the board's determination. Final guidance that results in "one-size-fits-all" metrics, in the name of "best practices" or otherwise, would be inconsistent with the Federal Reserve's objectives to avoid a "check-the-box" approach to governance and to restore a strategic oversight role for directors.

Consistent with these views, the final guidance should acknowledge also that what constitutes effective board oversight of management (and what information such oversight requires) is not static. It changes over time, as business models, responses to market conditions and customer and competitive needs, risk environments, and legal and compliance requirements change. Supervisory practices, including formal and informal guidance, should provide the flexibility to allow a board's oversight practices, including its information flows, to evolve as circumstances warrant.

Supervisors can reasonably review the directors' decisions about information flow to see how well aligned they appear with the board's responsibilities for oversight of strategic planning, holding management accountable for execution and overseeing compliance with approved risk tolerances. The same is true for a board's specific approach to holding management accountable. Boards can determine the reasonable alignment between the board's available information, on the one hand, and its oversight of management's actions under the approved strategic direction and risk appetite, on the other. This information would be available to supervisors as part of

[7] Stone v. Ritter, 911 A.2d 362, 370 (Del. 2006).
[8] See, e.g., id. See also Commentary accompanying New York Stock Exchange (NYSE) Listed Company Manual, §303A.07(b)(iii)(D).
[9] Proposal at 37,220.

information requests already common in the examination process. As noted above, however, such alignment is appropriately a matter for the directors' judgment given the circumstances of their unique institution, absent the sort of "red flags" corporate law generally makes directors responsible for monitoring.

2. **Board self-assessments already play a useful role at many firms, and supervisory requirements should not compromise those benefits.**

Many boards and committees already perform periodic self-assessments for their own information in managing their performance, to demonstrate thoroughness and diligence to a variety of stakeholders, and to meet other regulatory requirements.[10] The scope of these self-assessments may in many cases address some or all of the Federal Reserve's five proposed effectiveness factors, but boards often include other or different factors, based on developing corporate practices and their own institutions' specific characteristics and needs.

For these reasons, the Federal Reserve should not mandate self-assessments or encourage including them in the supervisory assessment process, because either action would compromise the other benefits of existing board practice, including those not necessarily related to supervisory concerns.

In addition, self-assessments should not be treated as confidential supervisory information. In some cases boards of directors may wish to keep self-assessments confidential (i.e., to limit sharing of the results to the membership of the board itself), because, otherwise, the guidance may chill candor among board members and make assessments less effective. Regardless of whether that is the board's preference, however, treating self-assessments as confidential supervisory information would deprive the board and other stakeholders of the full benefits of assessments and compromise effective governance.

3. **The proposed responsibilities of the risk committee may lead to duplication of those of audit committees under New York Stock Exchange listing requirements.**

ABA acknowledges and appreciates the Federal Reserve's effort in connection with the Proposal to achieve consistency with the numerous other legal and regulatory requirements to which financial institutions and their holding companies, especially large publicly traded organizations, are already subject. ABA notes that other regulatory authorities, such as the Securities and Exchange Commission (SEC) and New York Stock Exchange (NYSE), have long-standing governance requirements, including specifying the responsibilities of board audit committees.[11] Under NYSE requirements, for example, the audit committee's responsibilities must include "assist[ing] board oversight of the listed company's compliance with legal and regulatory requirements,"[12] and "discuss[ing] policies with respect to risk assessment and risk management."[13] The Federal Reserve's expressed willingness to return boards of directors to a

[10] See, e.g., NYSE Listed Company Manual, §303A.07(b)(ii).
[11] See, e.g., SEC Rule 10A-3, 17 CFR §240.10a-3, and NYSE Listed Company Manual, §303A.06-07.
[12] NYSE Listed Company Manual, §303A.07(b)(i)(A).
[13] NYSE Listed Company Manual, §303A.07(b)(iii)(D).

focus on their core responsibilities will be best served by avoiding duplication of effort resulting from inconsistent regulatory mandates.[14]

4. The proposed guidance on board composition is too restrictive.

ABA agrees that the appropriate composition of a financial institution's board is a key aspect of good corporate governance. The Proposal, however, potentially could cause constraints on bank innovation: the language could be interpreted to require that board members (or at least some board members) must have or acquire a significant degree of new relevant technical expertise before their bank can, for example, enter a new type of business. Though understanding the overall risk profile of the institution's material business lines (and satisfying itself with management's understanding of those risks) is a board responsibility, requiring a level of expertise comparable to that of management is an unrealistic and overly restrictive expectation. Management shares a common full-time engagement in operating the business, while the board's responsibility is oversight of management. Thus, clarifying the final guidance to acknowledge that boards do not need the technical expertise that is more appropriate for management will help achieve the Federal Reserve's goal of rebalancing the roles of directors and management.

As with other aspects of the Proposal, the final guidance should also allow financial institutions to evolve and innovate. Changes to market and competitive conditions, as well as innovations to enhance services to customers and communities, mean that both management and directors will have to assure that appropriate expertise is available to the institution. The final guidance should, however, reflect that requirements among directors, management, and outside resources available to the bank may differ appropriately according to their respective roles.

Furthermore, the final guidance should reflect that the determination of appropriate board qualifications is, in the first instance, a matter for the board's business judgment. Boards collectively should be responsible for determining their composition on an ongoing basis, based on the needs of the specific institution. This approach is consistent with other well-established governance regimes.[15]

[14] ABA acknowledges that NYSE rules do not prohibit other board committees, e.g., risk committees, from addressing matters that audit committees must review. See, e.g., Commentary accompanying NYSE Listed Company Manual, §303A.07(b)(iii)(D). Moreover, realizing maximum efficiency may suggest a review of requirements under Regulation YY, 12 CFR 252.33. Nevertheless, avoiding duplicative effort that inconsistent governance requirements can produce will strongly support the Federal Reserve's professed objective in the Proposal.

[15] See, e.g., Commentary accompanying NYSE Listed Company Manual, §303A.07(a): "Each member of the audit committee must be financially literate, as such qualification is interpreted by the listed company's board in its business judgment... In addition, at least one member of the audit committee must have accounting or related financial management expertise, as the listed company's board interprets such qualification in its business judgment."

5. ***The Federal Reserve's revised guidance should yield a significant reduction in the level* of granularity of matters requiring board approval.**

Supervisory approaches to board governance have increasingly focused on review of policies and (especially) procedures, even if not critical either to strategic direction or to risk management. The Federal Reserve acknowledges in the Proposal, and the industry strongly agrees, that the role of directors has been severely diluted by required attention to "check-the-box" exercises aimed at addressing compliance concerns. For example, boards of directors have been exhorted to review specific regulatory concerns related to energy lending,[16] agricultural lending,[17] commercial loans,[18] other lending policies,[19] third-party risk management policies,[20] and foreign exchange trading,[21] at a level of detail exceeding legitimate board roles. It is not relevant to an analysis of the Proposal to dissect these regulatory directives or delve into their merits; it is essential, however, to acknowledge that they range far afield from the central duties of the board of directors described above. The predictable consequence of raising issues of this sort to boards of directors generally, apart from whatever discussion may be appropriate among supervisors, directors, and management of a specific institution, is long-term impairment of the strategic progress of institutions generally, and thus of both their ultimate soundness and their ability to serve customers and communities and benefit the economy.[22] The guidance should be clear that matters that go to the board should be material to their oversight and monitoring responsibilities as discussed throughout this letter.

In addition, this aspect of the board governance process would improve significantly with the Federal Reserve's acknowledgement that many boards execute their responsibilities through committees.[23] The guidance should explicitly provide that, absent a specific legal requirement (a statute, regulation, or express binding order, or an existing provision of a corporate charter or bylaw) for action by the full board, financial institution boards have the discretion to act through committees of the board.[24]

Final Guidance Should Be Supported with Intensive Examiner Training

The significant shift in emphasis that the Proposal contemplates, from a "check-the-box" approach to one that is principles-based, will be prone to fail unless it is successfully

---

[16] SR 16-17, "Supervisory Expectations for Risk Management of Reserve-Based Energy Lending Risk".
[17] SR 11-14, "Supervisory Expectations for Risk Management of Agricultural Credit Risk".
[18] SR 98-18, "Lending Standards for Commercial Loans".
[19] Section 2010.2.1 of the Federal Reserve's Bank Holding Company Supervision Manual ("BHC Manual").
[20] SR 13-19, "Guidance on Managing Outsourcing Risk."
[21] SR 90-22, "Policy Statement on the Use of "Points" in settling foreign exchange contracts".
[22] In the same vein, final guidance should make clear that, though examiner engagement with the board may be appropriate to discuss specific board-related issues as they arise, regular examiner observation of board meetings is not an appropriate routine practice or consistent with the board's role as distinct from management's. The Proposal's approach to MRAs and MRIAs is based on the same logic. See Proposal at 37,223.
[23] See, e.g., 8 Del. C. §141(c)(1)-(2).
[24] In a related vein, regulations that require action by a full board should be revised to permit boards to act through committees, unless there is a compelling reason to do otherwise. These correlated changes would promote efficiency and apply the most relevant expertise at the committee level, with no loss of accountability.

implemented in routine supervisory activities. The increase in supervisory focus on governance that helped to foster the "check-the-box" approach occurred over a relatively short period since the financial crisis. Accordingly, the Federal Reserve should focus on significant training efforts for its field examiners so that they understand and are comfortable with a revised, principles-based approach. Assessing the effectiveness of governance (whether of board or of management) differs in many respects from other aspects of safety and soundness supervision, such as evaluating asset quality or compliance. Overall, however, because governance involves a series of business judgments, examiners must evaluate them as such. Thus, to achieve the Proposal's return to the proper roles of boards and management, respectively, examiners should be equipped and trained accordingly. Fortunately, much literature and professional expertise related to corporate governance is available that can assist examiners in taking a new approach. Lawyers and consultants that advise boards, corporate stakeholders, and other interested parties can assist in familiarizing supervisory staff with legal and other aspects of the standards for board performance.[25]

The Federal Reserve and Other Supervisors Should Acknowledge the Appropriate Role of Directors' Business Judgment

Corporate governance is generally based on a body of law (highly developed in some US jurisdictions, such as Delaware) that sets norms for directors' conduct. Under these laws, the basic requirements are a duty of loyalty and a duty of monitoring,[26] both highly consistent with bank regulators' traditional approach. Beyond the requirements of general corporate law, applicable statutes establish specific expanded board responsibilities other than those typical of corporate directors generally.[27] In addition, however, supervisors have added requirements for bank directors that well exceed express statutory requirements, and in this area the proposed shift to a principles-based approach can (and should) have the greatest impact.

Since the board has oversight responsibilities regarding both strategic success of the firm (including long-term profitability) and risk management, the board must obviously strike, and continuously adjust, a balance that takes into account a wide variety of information about both internal circumstances and external/market environment factors.[28] Except when a specific different statutory standard applies, the final guidance should be consistent with the general corporate law applicable to financial institutions, including the business judgment rule. It should acknowledge that, unless there is evidence of bad faith, self-dealing, or disregard of "red flags" revealed by the monitoring information available to the board, the board's judgment in such matters should prevail.[29]

---

[25] See, e.g., Lee, generally.

[26] See Lee at 483, citing 1 R. FRANKLIN BALOTTI & JESSE A. FINKELSTEIN, THE DELAWARE LAW OF CORPORATIONS AND BUSINESS ORGANIZATIONS, §§ 4.14-4.16 (3D ED., 1998).

[27] See, e.g., OFFICE OF THE COMPTROLLER OF THE CURRENCY, THE DIRECTORS' BOOK (JULY 2016), APP. A, for a list of statutory and regulatory provisions applicable to national banks.

[28] As noted above, matters such as the appropriate scope of information needed by the board for its monitoring responsibilities and the assessment of management's performance are matters of business judgment. See p. 3 above.

[29] In this connection, the final guidance should make clear that any examples of board actions are only illustrative. See, e.g., Proposal at 37,225.

To Realize the Benefits of the Proposal's Improved Approach to the Directors' Role, Prudential Regulators Should Adjust their Enforcement Approach to Be Consistent with New Measures of Board Effectiveness and Governance

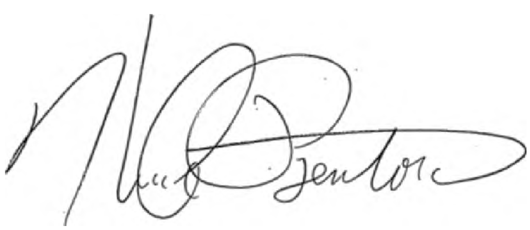
The Proposal's approach to board effectiveness should inform other aspects of prudential supervision. In other litigation contexts, courts and other authorities acknowledge that directors can rely on the "business judgment rule."[30] As noted above, financial institution directors have specific responsibilities (in some cases statutory) in addition to those of corporate directors generally, but with respect to the basic functions of overseeing the strategic direction and overall risk appetite, and overseeing management's adherence to them, the board inevitably makes judgments that require a certain degree of deference. The guidance should acknowledge that the Federal Reserve's enforcement posture will be consistent with this recognition.

Of course, other prudential regulators have both an interest in effective governance and enforcement jurisdiction over segments of the banking industry. This issue thus is not completely within the control of the Federal Reserve, and other prudential regulators should align their approaches to assessing board effectiveness and governance. The Federal Reserve should not delay its process of issuing new guidance for the sake of achieving perfect alignment with other agencies, but it should recognize that the Proposal's objective will be best served by consistency among prudential regulators. The Federal Reserve has an important role to play in coordinating that alignment with the other prudential regulators.

****

Thank you for the opportunity to respond to your request for comments. Should you have any questions or desire further discussion, please do not hesitate to contact the undersigned at (202) 663-5042 or hbenton@aba.com.

Very truly yours,



Hu Benton
Vice President, Banking Policy

[30] See Lee, Part I [collecting cases].