

March 15, 2018

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

Via Electronic Mail/Electronic Submission

Re: Proposed Supervisory Guidance – Core Principles of Effective Senior Management, Management of Business Lines, and Independent Risk Management and Controls for Large Financial Institutions (Docket No. OP–1594)

Dear Secretary Misback:

The American Bankers Association (ABA)¹ appreciates the opportunity to comment on the Federal Reserve’s proposed supervisory guidance on core principles of effective senior management, management of business lines, and independent risk management and controls for large financial institutions (the Proposed Guidance).² The Proposed Guidance would apply to domestic bank holding companies with total consolidated assets of \$50 billion or more, savings and loan holding companies with total consolidated assets of \$50 billion or more, the U.S. operations of foreign banking organizations with combined U.S. assets of \$50 billion or more, state member bank subsidiaries of the foregoing, and systemically important nonbank financial companies designated by the Financial Stability Oversight Council for supervision by the Federal Reserve (collectively, Covered Institutions).

ABA members are deeply engaged in the ongoing process of risk governance enhancement, to keep governance standards current and appropriate for a particular institution’s business model, complexity, customers, and markets. Such standards must take account of the interests of shareholders, customers, and other stakeholders concerned with effective governance. At the same time, our members have worked diligently to meet supervisory expectations, which have evolved in part in response to the myriad new regulatory requirements promulgated since 2010. Appropriate guidance from bank supervisors is beneficial in meeting this challenge, and ABA

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 nearly \$10 trillion in loans.

² Federal Reserve System, Proposed Supervisory Guidance, 83 Fed. Reg. 1351 (January 11, 2018).

appreciates the Federal Reserve's efforts reflected in the Proposed Guidance, as well as in other recent related actions and statements.³

As discussed in more detail below, ABA wishes to highlight the role of supervisory guidance in the broader scheme of supervisory activity, which also includes promulgation of regulations; conduct of examinations; and general dialogue with the industry, other governmental authorities, and the public. Each of these activities has a distinct role in effective supervision and the maintenance of safety and soundness of the banking industry. To be effective, each supervisory element should be used appropriately without blurring the distinctions. Guidance in its appropriate role is very useful in supporting compliance in general and maintaining the productivity of dialogue between supervisors and supervised institutions. Abused, it may undermine the supervisory process as well as the efficient management of institutions.⁴

Many of ABA's detailed comments seek to clarify the Proposed Guidance's role as supervisory guidance. Focusing on key principles should allow for varying approaches appropriate for each Covered Institution. ABA notes several concerns, however, about the Proposed Guidance's details and offers the suggested changes below to improve the success of implementation.

- The Proposed Guidance's coverage of roles and responsibilities should be more flexible, allowing each Covered Institution to determine a generally appropriate division of labor, if all necessary functions and responsibilities are adequately covered across the organization.
- Many aspects of the Proposed Guidance should be revised to take into account materiality of the risks in question.
- Some terminology, such as the word, "ensure," may inadvertently create an inappropriate standard or lead to confusion and inconsistent interpretation.
- The Proposed Guidance's treatment of exceptions to risk limits should be modified to reflect the more nuanced approach common in Covered Institutions, in which exceptions below certain thresholds may be handled within business lines under established parameters.
- The Proposed Guidance should be clarified to state that governance for development and approval of new products and services can allow testing and prototypes without complete buildout of risk controls and other safeguards more appropriate for a fully deployed product or service. The final guidance could simply specify that there should be in place controls appropriate to the material risks likely inherent in the testing phase.

³ See Federal Reserve System. Proposed Guidance on Supervisory Expectation [sic] for Boards of Directors, 82 Fed. Reg. 37,219 (August 9, 2017).

⁴ See, e.g., Speech by Federal Reserve Chairman Jerome H. Powell, The Role of Boards at Large Financial Firms, at the Large Bank Directors Conference, Chicago, Illinois, at <https://www.federalreserve.gov/newsevents/speech/powell20170830a.htm> (August 30, 2017), referring to the need to reduce imposition through supervisory guidance of "check-the-box" exercises on bank boards.

- Successful implementation of any final guidance will entail significant training of frontline and supervisory examination staff.
- The final guidance should expressly acknowledge that the Federal Reserve will rely on and give deference to the supervisory framework and conclusions of the primary federal regulator of any insured depository institution subsidiary of a Covered Institution.

Discussion

1. A more flexible approach to establishing roles and responsibilities will promote effective risk governance tailored to each Covered Institution’s business model, complexity, customers, and markets.

The Proposed Guidance offers broad, generic definitions of “senior management”⁵ and “management of business lines.”⁶ Though it notes that management of a business line may also be part of senior management,⁷ ABA recommends that the final guidance make clear that the division of labor and responsibilities among managers responsible for day-to-day management of one or more business lines, and that of the firm as a whole, is in management’s discretion. The final guidance could, of course, state that accountability for the total scope of key responsibilities contemplated in the Proposed Guidance’s definitions of the two groups should be clearly allocated and the allocation clearly communicated.

For example, the Proposed Guidance affirms that business line management “should provide training and development to its staff to ensure sufficient knowledge of business line activities; compliance, operations and risk management processes; controls; and business continuity.”⁸ In many Covered Institutions, training is not managed or controlled by business line management – other functions outside the business lines, such as Human Resources and/or Compliance, may fulfill all or part of that responsibility. The guidance should allow that as long as the responsibility for furnishing training is clearly allocated and adequate resources are delivered according to the Covered Institution’s particular organization, the Proposed Guidance’s supervisory objectives will be served.⁹

Similarly, business lines at Covered Institutions in many cases do not have captive information technology functions, for which they control hiring, budgeting, strategic planning or day-to-day activity. The Proposed Guidance’s language suggests, however, that business line management should be responsible for delivering management information resources and other infrastructure

⁵ “Senior management” is defined as, “the core group of individuals directly accountable to the board of directors for the sound and prudent day-to-day management of the firm.” Proposed Guidance at 1356, n. 28.

⁶ “Management of business lines is defined as, “the core group of individuals responsible for prudent day-to-day management of a business line and accountable to senior management for that responsibility. Proposed Guidance at 1357.

⁷ See Proposed Guidance at 1357, n. 35.

⁸ Proposed Guidance at 1359.

⁹ Of course, business line management may appropriately have input into what scope and depth of training its business line’s staff should receive.

to their businesses.¹⁰ In many institutions, these admittedly critical goals will be shared responsibilities of business line management, support functions, and senior management outside one or all business lines.

In yet another example, the Proposed Guidance states that, “[b]usiness line management should regularly test to ensure the controls within its business line are functioning as expected and are effective in managing risks.”¹¹ Some Covered Institutions may more effectively implement testing and monitoring through control functions, such as independent risk management (IRM) or Compliance, rather than through business lines. As with other granular responsibilities of various parts of management, the key concern should be that accountability for the activity be clearly allocated and that appropriate resources, including personnel with appropriate knowledge, experience, and stature within the firm, be available to support successful risk management. The Proposed Guidance acknowledges as much in the discussion of risk management and control functions,¹² and the final guidance as a whole should acknowledge the same logic.

This approach would appropriately permit different Covered Institutions to align management functions according to their respective business models, and also according to the talent and experience of their executives, whose mix of skills may support management structures different from those that fit other institutions.

2. Central to any risk governance system should be appropriate recognition of the materiality of various risks, and the Proposed Guidance’s language should be clarified to be consistent on this point.

In allocating time, attention, and resources across the businesses of financial institutions, professional risk executives are constantly concerned with the likelihood and potential magnitude¹³ of adverse events. Collectively these two factors establish the materiality of the risks in question. A misallocation of resources could potentially rise to the level of doing harm to an institution’s safety and soundness by either overestimating or underestimating the risk of some part of its operations. In almost every case, failure to recognize the point that (in the context of a particular institution’s business model, complexity, customers, and markets) some risks will be highly material and others immaterial (with many gradations in between) will inevitably lead to misallocation of resources of some degree. Among the more commonplace results could be unnecessarily high expense ratios, reduced profitability with no concurrent risk reduction, and, potentially, impairment of the institution’s long-term strategic position.

It would be desirable to qualify the final guidance throughout to take into account the materiality of the risks in question. In any case, however, the final guidance should clearly state that assessing materiality of risk elements is a core aspect of effective risk management, and that effective governance may and should take appropriate account of the materiality of risks.

¹⁰ See Proposed Guidance at 1358.

¹¹ Proposed Guidance at 1359.

¹² See Proposed Guidance at 1360, n.47 [“Other officers of the firm [besides the Chief Risk Officer] may oversee portions of functions involved in risk management and control activities.”].

¹³ “Magnitude” in this context can be expressed in terms of the aggregate impacts on revenues, profits and losses, reputation, strategic position, and other risk dimensions.

Though judging the materiality of risk will depend to some extent on the specific context, in general that judgment should take account of both the likelihood of an adverse impact on the institution's business or condition and the potential magnitude of that impact. Supervisors' assessment of an institution's risk governance should be aligned accordingly – risks, extant or emerging, that are not material should not adversely affect an institution's governance and controls rating. It would also be appropriate to note in the final guidance that a general acknowledgment that risk management should focus on material risks does not imply a materiality judgment concerning whether an institution should comply with statutory and regulatory requirements.¹⁴

Concerning one key aspect of the Proposed Guidance, the Federal Reserve should not treat as equally material all business lines of Covered Institutions that are subject to the Large Institution Supervision Coordinating Committee process (LISCC). The Proposed Guidance states that this treatment is based on the “size, risk profile, and systemic importance” of these institutions.¹⁵ Not all business lines, even of LISCC firms, represent “critical operations,” however.¹⁶ Accordingly, it seems illogical to suggest that management of all business lines must take into account systemic importance. Moreover, the criterion for applying the business lines aspects of the Proposed Guidance to a particular business line of a non-LISCC Covered Institution is whether “a significant control disruption, failure, or loss event [with respect to that business line] could result in a material loss of revenue, profit, or franchise value, or result in significant consumer harm.”¹⁷ By its terms, this aspect of the Proposed Guidance focuses on the materiality (as defined) of those business lines to the firm. The final guidance should conform its application to business lines of LISCC firms with this standard, which by protecting the safety and soundness of the institution will adequately protect financial stability generally, including, in the case of LISCC firms, their critical operations. Under final guidance thus clarified, a governance issue in a business line that is not material (under the standard already proposed for non-LISCC Covered Institutions) would not adversely affect the rating of any LISCC or non-LISCC firm.

3. Some terminology in the Proposed Guidance seems inconsistent with a “principles-based” guidance document.

Some of the terminology in the Proposed Guidance should be clarified to prevent misinterpretation. In many instances, the Proposed Guidance defines management's responsibility by stating that it must “ensure” that certain conditions exist or certain things happen. Here are some examples:

¹⁴ Compliance testing and similar controls, however, can appropriately take a risk-based approach, i.e., concentrating relatively more effort and resources on riskier products, activities, etc. and less on less-risky ones.

¹⁵ See Proposed Guidance at 1357.

¹⁶ “Critical operations” as defined by the Federal Reserve, are those operations, including associated services, functions, and support, the failure or discontinuance of which, in the view of the firm or the Federal Reserve, would pose a threat to the financial stability of the United States. See Proposed Guidance at 1357.

¹⁷ Proposed Guidance at 1357.

- “ensure the business line has the appropriate system of internal control, and ensure accountability for operating within established policies and guidelines and in accordance with laws and regulations;”¹⁸
- “ensure the firm’s infrastructure, staffing, and resources are sufficient to carry out the firm’s strategy and manage the firm’s activities in a safe and sound manner, and in compliance with applicable laws and regulations,”¹⁹
- “ensure effective communication and information sharing across the entire firm.”²⁰

Language of this nature could be interpreted as requiring that management or the board guarantee a particular outcome. Such an interpretation, besides being a practical impossibility, would be wholly inconsistent with the broad body of law defining responsibilities of directors and officers of corporations, which in turn forms the basis of corporate governance generally.

Though the language of the guidance (by its nature as guidance) is not intended to have legal consequences, in the context of governance, the implication of the current language is unnecessary and inappropriate. The final guidance could, for example, state that senior management responsibilities include “providing” appropriate resources to business lines for execution of their business plans in accordance with the firm’s risk tolerance. Other terms likely will be appropriate in other contexts, but none should imply a guarantee of results.

More generically, to allow Covered Institutions some flexibility in designing their risk management and controls, the final guidance should provide that business line management may fulfill its responsibilities either alone or in conjunction with another organizational unit whose purpose is to assist a business line in fulfilling its risk management responsibilities. In such cases, the institution’s risk policies and procedures could appropriately establish authority and accountability for each responsibility.²¹

Another point of concern is alternative uses of “emerging” versus “potential” risks. It is unclear that the Proposed Guidance means a distinction through this different terminology, but it does include an explanation of the former: “emerging risks” include those that have yet to create a material impact or would only arise during stressful or unlikely circumstances.²² It appears that any use of the term “potential risks” means essentially the same thing, and the final guidance should be clarified and made consistent.

In another example, the Proposed Guidance suggests that, “[b]usiness line management should reinforce balanced risk-taking and provide incentives for appropriate behaviors through talent

¹⁸ Proposed Guidance at 1354.

¹⁹ Proposed Guidance at 1357.

²⁰ Proposed Guidance at 1357.

²¹ This approach is consistent with risk management guidelines previously adopted by the Office of the Comptroller of the Currency. See 79 Fed. Reg. at 54,529 (September 11, 2014).

²² Proposed Guidance at 1358, n. 38. It should be noted that this definition, like many other aspects of the Proposed Guidance, should be considered in the context of materiality of risks (discussed above).

management processes, compensation arrangements, and other performance management processes.”[emphasis added]²³ If, as appears from the context, the intention is to promote risk taking and behavior that align with the Covered Institution’s strategic plan and risk tolerance, ABA recommends that the final guidance state the point accordingly. The Proposed Guidance’s language may increase the risk of an unnecessarily subjective judgment, when the overall direction of the guidance is to promote consistency with the firm’s risk tolerance.²⁴

The Proposed Guidance states that, “[t]he standards [for all risk identification and measurement practices] at a firm should be dynamic, inclusive, and comprehensive.”²⁵ It is unclear what practical guidance this language provides to Covered Institutions. More importantly, it cannot fairly or reasonably be considered a standard that would form part of the basis for a Covered Institution’s governance and controls rating. Acknowledging that many aspects of an institution’s risk identification and measurement practices must be assessed, along with other matters, to arrive at a controls rating, this terminology should be deleted.

4. The Proposed Guidance’s language should be clarified to acknowledge that some exceptions to risk limits, such as those taking into account mitigating factors, can appropriately be made within business lines, subject to clear limits on business line management’s authority to make such determinations.

The successful implementation of an institution’s strategic plan and risk profile typically involves establishing parameters for individual managers’ authority to approve transactions and other business actions. It is common practice among business organizations of all types and levels of complexity to include express delegations of authority to various levels of management in all parts of the firm. Covered Institutions may express a manager’s authority to approve transactions and make other business decisions in terms of dollar limits, use or waiver of standard terms, and other parameters that define limits on managers’ authority. The degree of risk a manager may be authorized to assume under delegations of management authority is part of the definition of the manager’s level of responsibility, and a higher level of responsibility usually encompasses authority to assume a higher level of risk.

It is fully consistent with supervisory standards for risk governance, including the establishment of an overall risk tolerance and oversight by an independent risk management function, to allow business line managers authority to approve exceptions to specific policies and procedures, usually based on the presence of mitigating circumstances. In any institution, some degree of exception approval is central to business line managers’ successful performance of their duties. The Proposed Guidance’s language may, however, lead to some confusion concerning this common governance approach. Language such as, “Business line management should consult with senior management before allowing any exceptions to risk limits”²⁶ suggests that delegation of exception approvals to business line management would draw supervisors’ criticism. Similar

²³ Proposed Guidance at 1359.

²⁴ The use of a principles-based approach and the risk of subjective judgments underscores the importance of examiner training, discussed below.

²⁵ Proposed Guidance at 1361.

²⁶ Proposed Guidance at 1358.

statements in the Proposed Guidance²⁷ are likely to prove unnecessarily restrictive without contributing to prudent risk management. This language could be read to suggest that any approval of an exception to a policy, procedure, or other business direction must involve IRM and potentially the firm's Chief Risk Officer.

An appropriate balance of effective risk control with efficient business line management is clearly possible within the scope of the Proposed Guidance's objectives. The implementation of a firm's approved risk tolerance and related policies and procedures can appropriately include delegations of authority to line management, including authority to approve exceptions to policies and procedures, , requiring in specified cases the review and concurrence of IRM. This approach could embrace clear limits on which exceptions require such concurrence and which exceptions business line management can make without it, such that all exception decisions were properly within the firm's approved risk tolerance. Similarly, business line management and IRM could track such exceptions through the institution's risk reporting framework. The final guidance should include revised language making clear that delegations of authority to business line management can include exception authority that, in appropriate cases, does not require involvement of IRM.

As with any exception authority involving risk limits, legal requirements and compliance matters would usually have distinct treatment. That is, policies concerning legal and compliance requirements would not include authority, at any level, to disregard such requirements in situations to which they apply. Although policies and procedures in this area often involve risk-based testing and other controls designed with materiality of the related risks in mind, exceptions to testing and similar policies should be treated with particular sensitivity and include the requisite involvement of legal, compliance, and other institution staff with appropriate expertise.

5. The Proposed Guidance should be clarified to acknowledge that risk management and controls for new products and services in a testing phase should have a scale appropriate to the scale of the test, rather than that required for a full-scale product or service.

A key element of banking organizations' health and business success is the ability continuously to evolve and innovate to meet customers' needs amid changing market conditions. Innovations are rarely successful, however, unless real-world testing and refinement play a role in the development process, market reception being the most demanding test. Banks will be more successful if they can test their ideas, refine and adjust them according to demonstrated customer preferences, and identify and resolve other problems, including attention to unforeseen compliance and risk management concerns. This can often be done more nimbly and satisfactorily in some type of pilot initiative before a full-scale program is deployed. ABA believes that supervisors should be enabled to encourage this aspect of product and service

²⁷ See Proposed Guidance at 1358 ["Business line management should subject any exceptions to risk limits to the firm's formal approval process."]; Proposed Guidance at 1360 ["The CRO or IRM should be involved in any proposal to waive or make exceptions to established risk limits, including on a temporary basis, should provide an assessment of any such proposal, and should escalate the proposal to the board of directors as appropriate."].

development. This would both facilitate adoption of new technological solutions (by permitting testing prior to full-scale commitment) and enhance risk management (by permitting discovery of unforeseen problems and learning prior to larger-scale commitment).

Complete development and deployment of risk management and controls ahead of other aspects of a product or service will likely result in misalignment and deficiencies in those controls. One goal of the testing phase is precisely the refined understanding of the new activity necessary to establishing effective controls and risk management. At best, trying to build at the start a full risk management and controls environment, suitable for a fully launched new product or service, will waste time, effort, and resources, while, instead, testing brings to light adjustments, and perhaps major changes, that full implementation will require.

The Proposed Guidance's current language may be interpreted to restrict this practical development approach. In particular, language addressing new business products and initiatives appears overly restrictive:

A firm should have policies and procedures for vetting new business products and initiatives. Risks from new businesses should be identified and captured in risk management governance, infrastructure, compliance, and processes before commencing the new business. Business line management should escalate to senior management any required changes or modifications to risk management systems or internal control policies and procedures arising from the adoption of a new business or initiative. Additionally, growth in the new business should be consistent with the firm's risk management capabilities.²⁸

[Emphasis added.] The final guidance should include express language to the effect that testing and pilot programs require risk management and controls appropriately scaled to the test or pilot, and not the same level of risk management or controls appropriate to a full-scale business activity. Adding such clarity would in no way detract from an emphasis on risk management and controls appropriate to the scale of the test or pilot program, including measures of appropriate scale to provide consumer protection.

6. The final guidance should be supported with intensive examiner training.

Assessing the effectiveness of governance (whether of boards of directors, senior management, or other management components) differs in many respects from other aspects of safety and soundness supervision, such as evaluating asset quality or compliance. Overall, because governance involves a series of business judgments, examiners must evaluate them as such. Thus, to achieve the Proposed Guidance's objectives and allow Covered Institutions to operate successfully, examiners should be equipped and trained 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, under which managers at all levels exercise judgment in their business decisions. Furthermore, the Federal Reserve should ensure that examiners receive clear instruction as to how to apply the final guidance, specifically to

²⁸ Proposed Guidance at 1358.

allow institutions the flexibility to implement the guidance in a manner that best fits their structure, activities, business model, and overall risk profile. Such training will be essential to achieve consistent and successful application of the final guidance by supervisory staff.

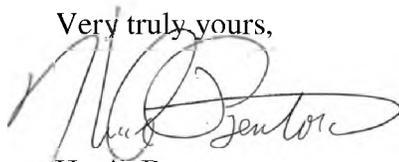
7. The Federal Reserve and other prudential regulators should harmonize their guidance concerning risk management governance to the extent possible. With respect to governance of depository institution subsidiaries other than state member banks, the Federal Reserve should rely on the work of and defer to the primary supervisors of those subsidiaries.

Recent efforts to improve the effectiveness of bank regulation highlight the need for coordination and harmonization among the regulatory agencies. Recommendations from the U.S. Department of the Treasury include eliminating regulatory overlap, duplication, and fragmentation to reduce burdens for both supervised entities and their regulators.²⁹ The final guidance should be consistent with these recommendations. Coordination with the other financial regulatory agencies, especially with respect to a Covered Institution's subsidiary insured depository institutions, is necessary to reduce burdens and inefficiencies stemming from overlapping – or potentially conflicting – regulatory standards. To reduce supervisory overlap when the depository subsidiary is already subject to a primary regulator's risk governance standards, the Federal Reserve should rely on the work and findings of the subsidiary bank's primary regulator as much as possible.

Both the Federal Reserve and the other prudential regulators have an interest in effective governance at their respective segments of the banking industry. Supervisory standards and guidance for effective risk governance is not completely within the control of the Federal Reserve, and it and the other prudential regulators should align their approaches to assessing effective governance. The Federal Reserve need not delay its process of issuing new guidance for the sake of achieving perfect alignment with other agencies, but it should recognize that the Proposed Guidance's objectives 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 A. Benton
Vice President, Banking Policy

²⁹ See U.S. Dep't of the Treasury, A Financial System that Creates Economic Opportunities: Banks and Credit Unions at p. 28-30 (June 2017); see also Financial Stability Oversight Council, 2017 Annual Report at p. 17.