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Prepare To Meet New Fed Expectations On Effective Boards

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On Feb. 26, the board of governors of the Federal Reserve System published supervisory guidance[1] regarding the effectiveness of boards of directors at large financial institutions.[2]

The guidance, which finalizes proposed guidance from 2017,[3] sets forth five "principles-based" attributes of an effective board. The Federal Reserve intends to use this to inform its supervisory assessment of board effectiveness for purposes of the governance and controls component of its large financial institution rating system.

In adopting this principles-based approach, the Federal Reserve made clear that it would take into account "material differences in activities, risk profile, and complexity among large financial institutions," although the guidance itself provides little detail regarding how it may do so.

The five attributes of an effective board are as follows:

1. An effective board sets "clear, aligned, and consistent direction regarding the firm's strategy and risk appetite."

2. An effective board "direct[s] senior management regarding the board's information needs."

3. An effective board "oversee[s] and hold[s] senior management accountable for effectively implementing the firm's strategy, consistent with its risk appetite, while maintaining an effective risk management framework and system of internal controls."

4. An effective board "support[s] the independence and stature of independent risk management and internal audit."

5. An effective board "maintain[s] a capable board composition and governance structure."

This article describes the practical implications of this guidance for large financial institutions.

Helpful Clarity Regarding Expectations for Boards

The five attributes, while principles-based in nature, clearly describe a range of specific actions that the Federal Reserve expects an effective board to take. For this reason, the attributes are likely to be employed as a de facto checklist for supervisors in assessing and rating a firm's governance and controls component.

Together with the Federal Reserve's accompanying effort to revise or rescind related supervision and regulation letters,[4] the new guidance streamlines the Federal Reserve's regulatory expectations for boards, which should make compliance more straightforward and allow boards to adapt their oversight to their principal responsibilities and emerging risks.

In addition, throughout the guidance, the Federal Reserve distinguishes between the board's duty of oversight and senior management's responsibilities. Such a distinction has long been a significant industry concern.[5]

A (Somewhat) More Flexible Approach Than the 2017 Proposal

The guidance contains a number of small changes relative to the 2017 proposal that, taken together, should give the boards of large financial institutions greater leeway in key respects to appropriately tailor their activities to their unique business and risk profiles. For example:

- The guidance has been revised to make clear that a board may review appropriately detailed summaries of the significant policies, programs, and plans that it reviews and approves, rather than their entirety.[6]

- The guidance clarifies that a board is expected to "challenge" management only where weaknesses or gaps are identified or information is incomplete, walking back language in the 2017 proposal that suggested adversarial "challenge" as a standing expectation, even in the absence of cause for concern.[7]

- The guidance makes clear that a board should evaluate its strengths and weaknesses on an ongoing basis, but does not include aspects of the 2017 proposal that some commenters worried would allow supervisors to require formal board self-assessments in the ordinary course.[8]

New, Formal Expectations Regarding the Review of Complaints

Unlike the 2017 proposal, the guidance includes a new expectation that "[a]n effective board also reviews reports of internal and external complaints, including 'whistleblower' reports."

While the guidance only suggests that boards should "review" such reports, the scope of the expected review is unclear, and, in contrast to other guidance provisions, the Federal Reserve did not include a materiality qualifier, a description of the complaint types a board should review, or the kinds of follow-up actions that supervisors would consider appropriate.

New, Formal Expectation That Boards Consider a Diverse Pool of Potential Director Nominees

In another change from the 2017 proposal, the guidance notes, in the context of an effective board's establishment of "a process designed to identify and select potential director nominees with a mix of skills, knowledge, experience, and perspectives," that "[t]his process takes into account, for example, a potential nominee's expertise, availability, integrity, and potential conflicts of interest and considers a diverse pool of potential nominees, including women and minorities."

In introducing the latter language, the guidance's focus on diversity suggests that the Federal Reserve may formally consider, in rating a financial institution under the large financial institution rating system's governance and controls component, the extent to which a board fails to consider a diverse pool of potential nominees when selecting new directors.[9] It remains to be seen how supervisors will apply this new expectation in practice.

Falling Short of the Guidance May Lead to Adverse Consequences

While the guidance does not place affirmative requirements on financial institutions or their boards, the Federal Reserve's indication that it will use the attributes to inform governance and controls ratings strongly suggests that the guidance will set regulatory expectations for boards during supervisory examinations. Failing to adhere to these standards likely will result in potential large financial institution rating downgrades and/or other supervisory findings.

By articulating clearer standards, the guidance may provide a vehicle for the Federal Reserve to link board ineffectiveness to unsafe or unsound practices or other violations of law. Such findings, in turn, may form the basis for issuing matters requiring attention or matters requiring immediate attention, which themselves may serve as predicates to informal or formal enforcement action.

Potential Trickle-Down Effects for Bank Holding Companies That Are Not Large Financial Institutions

On its face, the guidance applies only to the very largest financial institutions subject to the large financial institution rating framework, and not to the much larger number of bank holding companies that are instead subject to the RFI/C(D) system.[10] However, much of the guidance addresses governance topics that are relevant to firms of all sizes, and in practice supervisors may nonetheless look to the guidance to inform their own assessments of smaller firms.

This risk may be heightened by the fact that the RFI/C(D) system also takes into account, as a subcomponent of its risk management component, the quality of board oversight, but provides almost no specific information on how board effectiveness will be judged for RFI/C(D) firms.[11]

Accordingly, firms not subject to the guidance may nonetheless find it useful to carefully consider the guidance and identify potential gaps or differences that may nonetheless be subject to supervisory scrutiny.

Best Practices Moving Forward

In light of this guidance, large financial institutions should take a close look at how their boards are operating. In particular, financial institutions should consider:

- Performing a mapping of the board's responsibilities to the attributes and examples described in the guidance;

- Analyzing and documenting the board's oversight of the financial institution's strategy and risk appetite, including the dates on which relevant oversight activities took place;

- Reviewing the ways in which the board receives information from senior management regarding significant risks, and developing feedback loops that allow the board to direct senior management to provide such information;

- Reviewing the ways in which the board holds senior management accountable, including through performance management and compensation decisions, and adding more opportunities for the board to exercise this accountability, as necessary;

- Assessing the financial institution's whistleblower and other complaint processes, and making any necessary changes to elevate appropriate complaint reports to the board;

- Ensuring that the board considers a diverse pool of potential director nominees, including women and minorities, and documents its efforts to do so;

- Analyzing the ways in which the board is promoting the independence and stature of the financial institution's independent risk management and internal audit functions, and making sure that these functions are not siloed and can effectively challenge the business lines;

- Assessing the ways in which the board is challenging senior management on identified weaknesses, gaps, or incomplete information; and

- Performing ongoing evaluations of the board's composition and skillset, and performing training, as necessary, so that the board is equipped to support the financial institution's safety and soundness and compliance with laws and regulations.

The guidance, although nonbinding, sets forth clear supervisory expectations for the boards of large financial institutions. It provides helpful clarity, which should make compliance more straightforward and allow boards to focus their oversight on their principal responsibilities and emerging risks.

Failing to meet the guidance's supervisory expectations may lead to adverse consequences, including negative supervisory findings, and the potential for informal and formal enforcement action. As such, large financial institutions are well advised to consider how closely their board activities track the guidance and make any enhancements, as appropriate.

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[1] Board of Governors of the Federal Reserve System, Supervisory Guidance for Boards of Directors of

Domestic Bank and Savings and Loan Holding Companies with Total Consolidated Assets of $100 Billion or More (Excluding Intermediate Holding Companies of Foreign Banking Organizations Established Pursuant to the Federal Reserve's Regulation YY) and Systemically Important Nonbank Financial Companies Designated by the Financial Stability Oversight Council for Supervision by the Federal Reserve (Feb. 26, 2021), available at https://www.federalreserve.gov/supervisionreg/srletters/SR2103a1.pdf.

[2] The Federal Reserve's guidance applies to (i) domestic banks and savings and loan holding companies with total consolidated assets of $100 billion or more, excluding intermediate holding companies of foreign banking organizations established pursuant to Regulation YY, and (ii) systemically important nonbank financial companies designated by the Financial Stability Oversight Council ("FSOC") for supervision by the Federal Reserve.

[3] Proposed Guidance on Supervisory Expectation for Boards of Directors, 82 Fed. Reg. 37219 (Aug. 9, 2017), available at https://www.govinfo.gov/content/pkg/FR-2017-08-09/pdf/2017-16735.pdf.

[4] See Board of Governors of the Federal Reserve System, SR 21-4 / CA 21-2, Inactive or Revised SR Letters Related to the Federal Reserve's Supervisory Expectations for a Firm's Boards of Directors (Feb. 26, 2021), available at https://www.federalreserve.gov/supervisionreg/srletters/SR2104.htm.

[5] See, e.g., Bank Policy Institute, Guiding Principles for Enhancing U.S. Banking Organization Corporate Governance (Jan. 12, 2021), https://bpi.com/guiding-principles-for-enhancing-u-s-banking-organization-corporate-governance/.

[6] Compare Guidance at 3–4 to 2017 Proposal at 37225.

[7] Compare Guidance at 5–6 to 2017 Proposal at 37225–26.

[8] Compare Guidance at 7 to 2017 Proposal at 37226.

[9] In supporting this expectation, the guidance cites to a final interagency policy statement on assessing diversity policies and practices ("Interagency Policy Statement"). While the Interagency Policy Statement states that the "entity" should take "proactive steps to promote a diverse pool of candidates, including women and minorities, in its … selection of board members," it does not suggest that a board's effectiveness depends on its consideration of a diverse pool of potential director nominees. See Final Interagency Policy Statement Establishing Joint Standards for Assessing the Diversity Policies and Practices of Entities Regulated by the Agencies, 80 Fed. Reg. 33016 (June 10, 2015), available at https://www.govinfo.gov/content/pkg/FR-2015-06-10/pdf/2015-14126.pdf.

[10] See Board of Governors of the Federal Reserve System, SR 19-4 / CA 19-3, Supervisory Rating System for Holding Companies with Total Consolidated Assets Less Than $100Billion (Feb. 26, 2019), available at https://www.federalreserve.gov/supervisionreg/srletters/sr1904.htm.

[11] See Supervisory Rating System SR, Attachment 2, RFI Rating System at 3 (February 2019), available at SR 19-4 / CA 19-3 Attachment 2 – RFI Rating System (federalreserve.gov) ("This subcomponent evaluates the adequacy and effectiveness of board and senior management's understanding and management of risk inherent in the holding company's activities, as well as the general capabilities of management.").