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Risk Management and Governance for Large Financial Institutions

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Introduction

The financial crisis that led to the Great Recession of 2008–2009 compelled the banking regulators worldwide to reexamine and strengthen their approaches to supervising large, systemically important global financial institutions—the so-called "too-big-to-fail" banks. This practice note provides a summary of the consolidated supervision framework—specifically in the area of corporate governance—for large financial institutions that has since been put in place by these banking regulators, the U.S. Board of Governors of the Federal Reserve System (Federal Reserve) being foremost among them.

"Large Financial Institutions" Defined

Large financial institutions pose potential risk to the national and global financial systems because of their size, complexity, and interconnectedness. As articulated in its on-point Supervision and Regulation Letter SR 12-17, issued on December 17, 2012 (SR 12-17), the Federal Reserve considers three categories of financial institutions to be "large financial institutions" that must be kept strong and resilient to adverse market conditions so that they may continue to contribute to a robust U.S. financial system and economy:

- Large Institution Supervision Coordinating Committee (LISCC) portfolio firms
- Large banking organizations (LBOs)
- Large foreign banking organizations (Large FBOs)

In practice, these institutions actually fall into only two categories: the LISCC firms, and the rest.

To the first category belong the largest, most complex bank holding companies and nonbank financial companies (designated by the Financial Stability Oversight Council for Federal Reserve supervision) that are considered to pose the greatest systemic risk to the U.S. economy. To the second category of large financial institutions fall LBOs and large FBOs—those with total consolidated assets of at least $50 billion—which are not considered to be as systemically important as LISCC firms. The failure of an LBO or large FBO in this second category is deemed unlikely to have the same effect as the failure of a systemically important institution.

LISCC Firms

The Federal Reserve has the responsibility in the United States for the supervision of systemically important financial institutions. In order to carry out this mandate, the Federal Reserve created the LISCC, a committee within the Federal Reserve System that is charged with overseeing the supervision of the largest, most systemically important financial institutions in the United States. The LISCC's mission is to understand the systemic risks posed by the LISCC portfolio firms and to take steps designed to increase their financial and operational resiliency. The ultimate goal of this committee's work is to reduce the probability of, and the cost associated with, the material financial distress or failure of the LISCC firms.

In deciding whether to include a particular financial institution among LISCC firms, the Federal Reserve considers the size of the financial institution, its interconnectedness, lack of readily available substitutes for the services it provides, its complexity, and its global (i.e., cross-jurisdictional) activities. The following is the list of current LISCC portfolio firms, which is modified by the Federal Reserve from time to time following its review of the systemic importance of financial institutions doing business in the United States:

- American International Group, Inc.
- Bank of America Corporation
- The Bank of New York Mellon Corporation
- Barclays PLC
- Citigroup Inc.
- Credit Suisse Group AG
- Deutsche Bank AG
- The Goldman Sachs Group, Inc.
- JP Morgan Chase & Co.
- Morgan Stanley
- Prudential Financial, Inc.
- State Street Corporation
- UBS AG
- Wells Fargo & Company

The Federal Reserve's general framework for supervising LISCC firms is focused on four priority areas:

1. Capital adequacy and capital planning
2. Liquidity sufficiency and resiliency
3. Corporate governance (assessing the effectiveness of senior management and boards of directors),
4. Recovery and resolution planning

As noted above, the focus of this practice note is on item (3), corporate governance.

LBOs

The second category of large financial institutions consists of LBOs, which are U.S. bank holding companies and savings and loan holding companies with consolidated assets of $50 billion or more that are not included in the LISCC portfolio.

Large FBOs

The third and last category of large financial institutions is comprised of Large FBOs, with combined assets of U.S. operations of $50 billion or more that are not included in the LISCC portfolio.

Framework for Consolidated Supervision

The post–Great Recession framework for the consolidated supervision of large financial institutions has two principal focuses

1. Microprudential considerations to enhance resiliency of an individual firm,
2. Macroprudential considerations to reduce the impact of a firm's failure so as to lessen the potential threat to the stability of the financial system as a whole

Microprudential Considerations – Enhancing Resiliency of a Firm

Each large financial institution is expected to ensure that the consolidated organization (or the combined U.S. operations in the case of foreign banking organizations) and its core business lines (i.e., those business lines that upon failure would result in a material loss of revenue, profit, or franchise value) can survive under a broad range of stresses, internal as well as external. In the view of the Federal Reserve, this level of survivability requires financial resilience by maintaining sufficient capital and liquidity and operational resilience by maintaining effective corporate governance, risk management, and recovery planning.

In a nutshell, the primary focus of these microprudential considerations is to prevent a large financial institution's failure under economically catastrophic circumstances.

The subject of corporate governance is addressed below. For additional information regarding resolution planning requirements, capital and liquidity planning, and management of core business lines and permissible activities, please see Summary of the Dodd-Frank Act: Resolution Plans (Living Wills) for Financial Institutions, Summary of the Dodd-Frank Act Bank Capital Requirements, and Bank Holding Companies: Supervision, Regulation, and Activities, respectively.

Macroprudential Considerations – Reducing the Impact of a Firm's Failure

Each firm is expected to ensure the sustainability of its critical operations (i.e., those operations that upon failure or discontinuance could pose a threat to the financial stability of the United States) and banking offices under a broad range of stresses—again, both internal and external. According to the Federal Reserve, this requires effective resolution planning that addresses the complexity and the interconnectivity of the firm's operations. In other words, the point of these macroprudential considerations is to minimize the potentially contagious impact that a large financial institution's failure would have on the global financial systems and the world economy as a whole.

Conduct of Supervisory Activities by the Federal Reserve

The Federal Reserve uses a range of supervisory activities to maintain a comprehensive understanding and assessment of large financial institutions, including:

- **Coordinated horizontal reviews.** Coordinated horizontal reviews involve examination of several institutions simultaneously, encompassing firm-specific supervision and the development of cross-firm perspectives. Examples include analysis of capital adequacy and planning via the Comprehensive Capital Analysis and Review, as well as horizontal evaluations of resolution plans and incentive compensation practices.

- **Firm-specific examination and continuous monitoring activities.** Firm-specific examination and continuous monitoring activities are undertaken to maintain an understanding and assessment across the core areas of supervisory focus for each firm. These activities include review and assessment of changes in strategy, inherent risks, control processes, and key personnel, and follow-up on previously identified concerns or emerging vulnerabilities.

- **Internal audits and internal control functions.** In certain instances, Federal Reserve supervisors may rely on a firm's internal audit or internal control functions in developing a comprehensive understanding and assessment.

Corporate Governance

In order for any financial institution, large or small, to maintain its sustainability under profound economic, operational, legal, or other stresses, its board of directors, working in tandem with senior management, must be capable of providing effective corporate governance. In this regard, the Federal Reserve expects the board of a large financial institution to "establish and maintain the firm's culture, incentives, structure, and processes that promote its compliance with laws, regulations, and supervisory guidance." SR 12-17, at 5. Specifically, the Federal Reserve expects the following from each large financial institution's board of directors and relevant committees, with support from senior management:

- The board must maintain a clearly articulated corporate strategy and institutional risk appetite. In this regard, the board is expected to direct and oversee revenue and profit generation, as well as risk management and control functions.

- The board must ensure that the firm's senior management has the expertise and level of involvement required to manage the firm's core business lines, critical operations, banking offices, and other material entities. These areas should receive sufficient operational support to remain in a safe and sound condition under a broad range of stressed conditions.

- The board must maintain a corporate culture that emphasizes the importance of compliance with laws and regulations and consumer protection, as well as the avoidance of conflicts of interest and the management of reputational and legal risks.
- The board must ensure that the organization's internal audit, corporate compliance, and risk management and internal control functions are effective and independent, with demonstrated influence over business-line decision making that is not marginalized by a focus on short-term revenue generation over longer-term sustainability. In its Supervision and Regulation Letter SR 08-8, issued on October 16, 2008 (SR 08-8), the Federal Reserve provided in detail its expectations regarding compliance risk management programs and oversight at large banking organizations with complex compliance profiles. A summary of SR 08-8 is provided below.
- The board must assign senior managers with the responsibility for ensuring that investments across business lines and operations align with corporate strategies, and that compensation arrangements and other incentives are consistent with the corporate culture and institutional risk appetite.
- The board must ensure that management information systems support the responsibilities of the board to oversee the firm's core business lines, critical operations, and other core areas of supervisory focus.

The aforementioned litany of Federal Reserve expectations with respect to the corporate governance component of microprudential considerations, all stated clearly in SR 12-17, leads to the conclusion that the board of directors of a large financial institution needs to be hands-on and intimately involved in every facet of its business and operations, including strategic planning, business expansion, operational control, risk management, and compliance.

Compliance Risk Management Programs and Oversight (SR 08-8)

In April 2005, the Basel Committee on Banking Supervision published a paper entitled Compliance and the *Compliance Function in Banks.* The principles outlined in that paper are widely recognized by financial institutions and regulators, including the Federal Reserve, as the standard of sound practices for compliance risk management and oversight. SR 08-8 further clarified Federal Reserve views applicable to large banking organizations with complex compliance profiles in the following areas:

- Organizations that should implement a firm-wide approach to compliance risk management and oversight
- Independence of compliance staff
- Compliance monitoring and testing,
- Responsibilities of boards of directors and senior management regarding compliance risk management and oversight

Firm-Wide Compliance Risk Management and Oversight

Organizations supervised by the Federal Reserve, regardless of size and complexity, should have effective compliance risk management programs that are tailored to the organizations' risk profiles. Large financial institutions generally conduct a wider range of business activities that are subject to complex compliance requirements and, as such, typically must deploy a firm-wide, rather than compartmentalized, approach to compliance risk management and oversight. This means large financial institutions must establish processes to manage compliance risk firm-wide, both within and across business lines, support units, legal entities, and jurisdictions of operation. The need for such an approach perhaps is self-evident in areas such as anti-money laundering, privacy, affiliate transactions, conflicts of interest, and fair lending, where legal and regulatory requirements may apply to multiple business lines or legal entities within the banking organization.

The Federal Reserve notes that, in addition to the oversight provided by the board of directors of an organization, a key component of firm-wide compliance oversight in large financial institutions is a corporate compliance function that has day-to-day responsibility for overseeing and supporting the implementation of the organization's firm-wide compliance risk management program. Such a function would play a key role in controlling compliance risks that transcend business lines, legal entities, and jurisdictions of operation.

With respect to oversight, foreign banking organizations (or FBOs) too should provide effective oversight of compliance risks within their U.S. operations, including risks that transcend business lines or legal entities. An FBO, however, has a measure of flexibility in organizing its oversight structure. For instance, compliance oversight of U.S. activities may be conducted in a manner that is consistent with the FBO's broader compliance risk management framework that is established and maintained under its home-country regime. Alternatively, a separate function may be established specifically to provide compliance oversight of the FBO's U.S. operations.

Independence of Compliance Staff

The Federal Reserve is of the view that compliance staff at large financial institutions should be independent of the business lines for which they have compliance responsibilities. This apparently is based on Federal Reserve staff's belief that compliance independence facilitates objectivity and avoids inherent conflicts of interest.

A particular challenge, in their view, is attaining an appropriate level of independence with respect to compliance staff operating within the business lines. While the Federal Reserve does not prescribe a particular organizational structure for compliance functions that it would deem sufficiently independent, it does encourage large financial institutions with complex compliance profiles to avoid inherent conflicts of interest by ensuring that accountability exists between the corporate compliance function and compliance staff within the business lines. Such accountability, it is believed, would provide the corporate compliance function with ultimate authority regarding the handling of compliance matters and personnel decisions and actions relating to compliance staff, including retaining control over compliance staff budgeting and remuneration processes. It goes without saying, however, that compliance independence does not preclude close working relationships between compliance staff, on the one hand, and the management and staff of the various business lines, on the other hand.

Compliance Monitoring and Testing

The scope and frequency of compliance monitoring and testing activities should be a function of a comprehensive assessment of the overall compliance risk associated with a particular business activity. The Federal Reserve encourages large financial institutions to implement comprehensive risk assessment methodologies and to ensure that compliance monitoring and testing activities are based upon the resulting risk assessments.

The testing of controls and remediation of deficiencies identified as a result of testing activities are essential to maintaining an effective internal control framework. The scope and frequency of compliance testing activities should be based upon the assessment of the specific compliance risks associated with a particular business activity. The Federal Reserve encourages periodic testing of compliance controls by compliance staff. If, however, compliance testing is performed exclusively by the internal audit function, particular care should be taken to ensure that high-risk compliance elements are not otherwise obscured by a lower overall risk rating of a broadly defined audit entity.

Responsibilities of the Board of Directors and Senior Management

The board of directors, senior management, and the corporate compliance function are responsible for working together to establish and implement a comprehensive and effective compliance risk management program and oversight framework that is reasonably designed to prevent and detect compliance breaches and issues.

The board has the responsibility for promoting a culture that encourages ethical conduct and compliance with applicable rules and standards. The board members therefore need to have an understanding of the types of compliance risks to which the organization is exposed. The board should ensure that senior management is fully capable, qualified, and properly motivated to manage the compliance risks arising from the organization's business activities in a manner that is consistent with the board's expectations.

The board should also ensure that the following elements of a sound compliance program are in place:

- The board's views about the importance of compliance are understood and communicated by senior management.
- Senior management has established appropriate incentives to integrate compliance objectives into the management goals and compensation structure across the organization, and appropriate disciplinary actions are taken when serious compliance failures are identified.
- The corporate compliance function has an appropriately prominent status within the organization—that is, senior compliance personnel, both within the corporate function and within individual business lines, should have the appropriate authority, independence, resources, and access to personnel and information within the organization.

Senior management should implement and enforce the compliance policies and compliance risk management standards that have been approved by the board. Senior management of the corporate compliance function should establish, support, and oversee the organization's compliance risk management program. The corporate compliance function should report to the board on significant compliance matters and the effectiveness of the compliance risk management program.

Senior management of an FBO's U.S. operations should provide sufficient information to governance or control functions in its home country and should ensure that responsible senior management in the United States and in the home country maintain a thorough understanding of the risk and control environment governing U.S. operations.

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