Jerome Powell: The role of boards at large financial firms

Speech by Mr Jerome H Powell, Member of the Board of Governors of the Federal Reserve System, at the Large Bank Directors Conference, Chicago, Illinois, 30 August 2017.

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Good morning. Thank you to President Evans for inviting me to speak here today about the role of boards of directors of large banking firms.[1] Ten years ago this month, the world witnessed the first tremors of what we now think of as the Global Financial Crisis and the subsequent Great Recession. For the United States and many other countries, this would turn out to be the most painful economic period since the Great Depression.

In the wake of the crisis, governments around the world instituted a wide range of reforms that were designed to reduce the likelihood and severity of a recurrence. In the United States, the core elements of those reforms included significantly higher capital standards; new liquidity requirements; forward-looking stress tests; and resolution planning. Our largest banking firms are without question much stronger than before the crisis. We are nearing completion of the major parts of this reform program, and are undertaking a thorough review to help assure that the reforms we put in place are both effective and efficient.[2]

During the crisis, some large banking firms incurred massive losses. Some of these losses were from products—such as super-senior collateralized debt obligations (CDOs) or structured investment vehicles (SIVs)—whose risks were not even on the radar screen of the firm's board of directors. After the crisis, the Federal Reserve significantly raised our expectations for the boards of directors of large banking firms. Taking risk in service of clients is an essential part of the business of banking, including credit risk, interest rate risk, and various forms of operational risk. Our reforms were designed to assure that boards of directors understand and approve the strategy of the company and the risks inherent in that strategy, and that the institution has the capital, liquidity, and risk management capabilities necessary to manage those risks.

Today, the role of a director of a large banking firm is more expansive, more challenging, and more important than ever. Boards now oversee management's participation in highly challenging annual exercises, such as stress testing, capital planning, and resolution planning, that have fundamentally changed the business of our largest institutions. Boards now more carefully evaluate the compensation practices of these large institutions to assure that they reinforce positive incentives and discourage unwanted risk taking. Across a range of responsibilities, we simply expect much more of boards of directors than ever before. There is no reason to expect that to change.

We do take seriously our obligation to assess whether our reforms are achieving their desired effects, without imposing unnecessary burden. In 2014, we began a review of these higher expectations for directors. We found that many boards have significantly improved their practices. We also found some ways to make our reforms both more effective and more efficient. For example, while directors generally say that they understand and embrace their more challenging responsibilities, we consistently hear that directors feel buried in hundreds or even thousands of pages of highly granular information, to the point where more important strategic issues are crowded out of board deliberations. Some of this granular information was likely driven by our supervisory guidance, which included specific expectations not only for the management of the institution, but also for the board of directors. Over time, this guidance has increased the number of specific directives aimed at boards well into the hundreds, which may have fostered a "check-the-box" approach by boards.

There is also a widespread feeling that our supervision seems to have downplayed the difference in roles between boards and management. Our current ratings system for bank holding

companies, which for large banking firms would be replaced by the currently proposed LFI ratings system, refers to the “board and senior management” as a subcomponent rating of risk management.[3] We have also combined the roles of the board and senior management in many of our supervisory feedback letters.

After careful consideration, last month we proposed a new framework for our oversight of boards.[4] In formulating this proposal, we had discussions with academics, consultants, legal practitioners, and directors of banking firms.

Let me start by saying what the new approach will not do. We do not intend that these reforms will lower the bar for boards or lighten the loads of directors. The new approach distinguishes the board from senior management so that we can spotlight our expectations of effective boards. The intent is to enable directors to spend less board time on routine matters and more on core board responsibilities: overseeing management as they devise a clear and coherent direction for the firm, holding management accountable for the execution of that strategy, and ensuring the independence and stature of the risk management and internal audit functions. These were all areas that were found wanting in the financial crisis, and it is essential that boards get these fundamentals right.

Our new proposal will move to a principles-based approach. We have identified five common attributes that effective boards should exhibit, and for which we will have high expectations. This principles-based approach recognizes that large firms have a broad range of business models, structures, and practices. While we want to be clear about our expectations, we also want to give directors the flexibility to meet them in a manner that works for their particular boards.

First, an effective board should guide the development of a clear and coherent strategy for the firm and set the types and levels of risks it is willing to take. Alignment of business strategy and risk appetite should minimize the firm’s exposure to large and unexpected losses. In addition, the firm’s risk management capabilities need to be commensurate with the risks it expects to take.

Second, an effective board should actively manage its information flow and deliberations, so that the board can make sound, well-informed decisions that take into account risks and opportunities.

Third, an effective board should hold senior management accountable for implementing the firm’s strategy and risk appetite and maintaining the firm’s risk management and control framework.

Fourth, an effective board should ensure the independence and stature of the independent risk management and internal audit functions. It is difficult to overstate the importance of this. Risk management systems and controls may discourage or limit certain revenue-generating opportunities. Failure to ensure the independence of these functions from the revenue generators and risk takers has been shown to be dangerous, and this is something for which the board is accountable.

Finally, an effective board should have a composition, governance structure, and set of established practices that are appropriate in light of the firm’s size, complexity, scope of operations, and risk profile. Boards need to be aware of their own strengths and weaknesses, and to ensure that directors bring an appropriately diverse range of skills, knowledge, experience, and perspective. Significant events, such as an unexpected loss or compliance failure, should cause boards to reflect and reassess their structure, composition, and processes. An effective board takes a preventative approach and engages in probing self-assessments regularly and systematically.

Before I conclude, let me say a few words about an aspect of the proposal that has attracted some attention, which is the reversal of a relatively recent practice of directing all examination

and inspection findings—what we call “matters requiring attention” (MRAs) and “matters requiring immediate attention” (MRIAs)—to the board as well as to management.[5] The practice resulted in boards of directors reviewing and signing off on management’s compliance with every MRA and MRIA. When we began that practice in 2013, our intention was to ensure that directors were in a position to hold management accountable in addressing risk management shortcomings. By 2014, we realized that the practice was “almost surely distracting from strategic and risk-related analyses and oversight by boards".[6] For perspective, a large banking firm may have one hundred or more MRAs outstanding at a given time, many of which are at a level of granularity that is more appropriate for management to remediate, with board oversight. The new proposed framework is designed to make boards more effective in holding management accountable in these efforts. While we have proposed that most MRAs and MRIAs be addressed in the first instance to management and not to the board, the board would continue to receive MRAs where board practices are at issue or where management has failed to promptly and adequately take the required actions. The board would also continue to receive copies of examination and inspection reports, including formal communications with the institution. In the parlance of the proposed guidance I just outlined, we fully expect the board to actively manage the information flow related to MRAs and to hold management accountable for remediating them. In doing so, a board may choose to track progress and closure of MRAs through an appropriate board committee, rather than getting into the granular detail on every individual MRA.

Conclusion

We need financial institutions that are strong enough to support economic growth by lending through the economic cycle. To achieve that goal, we need strong and effective boards of directors at firms of all sizes. A strong and effective board provides strategic leadership and oversight, which is much more challenging and important than checking off lists of assigned tasks. I look forward to our continuing dialogue on this subject today and in the months to come, and reviewing carefully the comments received on the proposal.

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[1] The views I express here are my own and not necessarily those of the Board of Governors of the Federal Reserve System.

[2] Jerome H. Powell, “Relationship Between Regulation and Economic Growth,” (testimony before the Committee on Banking, Housing, and Urban Affairs, U.S. Senate, June 22, 2017).

[3] See SR letter 04–18, “Bank Holding Company Rating System,” 69 FR 70444 (December 6, 2004).

[4] See www.federalreserve.gov/newsevents/pressreleases/bcreg20170803a.htm.

[5] MRIAs are matters of significant importance and urgency that the Federal Reserve requires banking organizations to address immediately and include, for example, matters that have the potential to pose significant risk to the safety and soundness of the banking organization, matters that represent significant noncompliance with applicable laws or regulations and repeat criticisms that have escalated in importance due to insufficient attention or inaction by the banking organization. MRAs, on the other hand, are matters that are important and that the Federal Reserve is expecting a banking organization to address over a reasonable period of time, but when the timing need not be “immediate.” See Supervision and Regulation (SR) letter 13–13/Consumer Affairs letter 13–10, “Supervisory Considerations for the Communication of Supervisory Findings."

[6] See “Corporate Governance and Prudential Regulation,” remarks by Governor Daniel J. Tarullo at Association of American Law Schools Midyear Meeting, June 9, 2014. (“We should probably be somewhat more selective in creating the regulatory checklist for board compliance and regular consideration. One example, drawn from Federal Reserve practice, is the recent supervisory guidance requiring that every notice of a “Matter Requiring Attention” (MRA) issued by supervisors must be reviewed, and compliance signed off, by the board of directors. There are some MRAs that clearly should come to the board’s attention, but the failure to discriminate among them is almost surely distracting from strategic and risk-related analyses and oversight by boards.”)