NEW BANK REGULATIONS PRESSURE BOARDS TO BOOST RISK OVERSIGHT

CLIENT ALERT

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Bank regulators' expectations for board governance, committee oversight and risk management are high and rising. The bar has been raised, and the end is nowhere in sight. Two recent releases stand out. The Board of Governors of the Federal Reserve System ("FRB") finalized its rule on Enhanced Prudential Standards for Covered Companies[1] and The Office of the Comptroller of the Currency ("OCC") proposed Guidelines Establishing Heightened Standards for Large Insured National Banks, Federal Savings Associations, and Federal Branches[2], which combines many elements of the OCC's Satisfactory-to-Strong ("S2S") program. The final rule and the proposed guidelines both raise expectations for board and committee oversight and governance of risk.

A natural consequence of these heightened supervisory expectations is that banks must raise the bar on the quality of board risk management reporting. Risk and risk management reporting must be sufficient to allow informed and effective risk oversight and governance. Previously, the quality of risk reporting may have been perceived as "nice to have." Now it is essential.

The rule and proposed guidelines clearly establish regulatory expectations for quality reporting to the board of directors, though they fall short — as rules often do — in providing details regarding what is necessary to meet board oversight and governance needs and regulatory expectations. Do not let the absence of specificity fool you. We know from experience that regulators will find risk reporting inadequate if it does not analyze and synthesize data, transform data into information, and draw out issues and risks for dialogue, challenge, debate and action. Board members should, and regulators will, expect substantive analysis. Reams of paper and exhaustive lists of data will not make the grade. Neither will "elevator reports" (i.e., this went up, this went down), snap shots or dashboards that do not put risk into perspective relative to time, earnings and capital, tolerances and expectations, and the environment. To be meaningful for effective board and governance and adequate to meet regulators' expectations, risk management board reporting must regularly, clearly and succinctly provide risk committees and board members timely and accurate information born from good analysis and synthesis of underlying data about current and prospective risks, and on the efficacy of the banks' risk management program. In general, board risk committee reporting should:

- **Draw directors' attention and discussion to issues and risks that require their input, guidance and action.** A risk dashboard can be helpful in focusing attention on risks and issues for discussion, consideration and action. Dashboards should focus on levels and trends in risk and the effectiveness of controls, highlight outsized risks and those moving quickly in that direction, show imbalances between risk levels and risk management and controls, and call attention to the need for improvement or intervention. However, dashboards and other risk reports must provide a framework for informed governance. They must be more than "pretty faces."

[1] 12 C.F.R. 252, Enhanced Prudential Standards and Early Remediation Requirements for Covered Companies, NR 2014-4, dated January 16, 2014.

[2] Heightened Supervisory Expectations for Recovery and Resolution Preparedness for Certain Large Bank Holding Companies — Supplemental Guidance on Consolidated Supervision Framework for Large Financial Institutions (SR letter 12-17/CA letter 12-14).

- **Focus attention on external and internal environmental factors affecting risk and risk management.** External factors affecting risk or risk management may include trends in underwriting standards or consumer or corporate leverage; changes in market prices, liquidity or volatility; significant events and trends affecting risks in certain businesses, industries or geographies; and new or changing legislative or regulatory hot-buttons, such as money laundering, structured products, unfair, deceptive or abusive acts or practices. Internal environmental factors may include compensation systems that incentivize undesired behavior, cost cutting initiatives that may affect operational or other risks, trends in the number and severity of the findings of independent control functions (audit, loan review, compliance testing, etc.) or matters requiring attention presented by a bank's regulators.
- **Present risks and risk trends in absolute terms and relative to expectations.** This may be done using budgets, plans, or targets; risk tolerances and limits; early warning / escalation thresholds (trip-wires); and risk measures presented relative to capital (economic and / or regulatory, whatever the binding constraint), assets, earnings and peer data where available. These should be accompanied by sufficient analyses and succinct analytical commentary about underlying root causes to answer three fundamental questions: "Why?," "What does it mean?" and "What needs to be done?"
- **Provide information on the quality of risk management and trends in the effectiveness of risk management.** This information should be in the form of summarized risk control self assessments, audit or loan reviews, or findings from regulatory or compliance testing. It is essential that independent review groups are candid and clear in their assessments and in explaining the basis of their assigned risk and risk management conclusions. They must cite as many objective metrics and key risk indicators as needed to support their conclusions.
- **Provide, to the extent possible, forward measures of risk, say over the next 12 months.** In particular, liquidity and capital adequacy levels and trends should be reported relative to the current and prospective risk profile of the company, both expected and stressed. Credit metrics, like past due and loss percentages, are helpful in assessing trends in asset quality but must be supplemented by default probabilities and expected losses, which measure forward expectations of risk and trends therein.
- **Build in early warning indicators.** Key Risk Indicators (KRIs), metrics and limit thresholds should be designed to focus on changing risk levels and trends at a stage in which they can be discussed and acted upon before the risks can cause material harm to the institution.

CONCLUSION

As board and risk committee members reflect on their heightened responsibilities for risk management, they need to know they are getting the risk reports they need. Boards should be assessing the adequacy of existing risk reports relative to their risk oversight and governance responsibilities and their fiduciary duties.

Risk reports should afford directors the opportunity to easily focus on, and dig into, the details of the institution's activities and their associated risks. Board risk reporting should enable board members independent analyses and allow them to draw informed conclusions. Uninformed or ill-informed directors and risk committee members cannot effectively oversee and govern what they do not know. "Blind governance" exposes the institution to unacceptable risks and will fail regulatory scrutiny.

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