

XII. The Federal Reserve Board's Proposed Guidance on Risk Management at Large Financial Institutions — Response to Wells Fargo Scandal

A. Introduction

From August 2017 to early 2018, the Federal Reserve Board (FRB) issued a series of proposed guidance (Guidance) to clarify risk management and better distinguish the roles of the board of directors at large financial institutions (LFIs).¹ The Guidance is a response to the 2007–2009 financial crisis (Financial Crisis, Crisis) as well as subsequent misbehaviors from LFIs, specifically Wells Fargo & Company (Wells Fargo).²

The Financial Crisis resulted from “overleveraged institutions that had insufficient capital to support their excessive risk-taking” and “short-term wholesale funding that was susceptible to runs.”³ The Crisis and its detrimental consequences not only demonstrated the risks LFIs posed to U.S. financial stability, but also the importance of federal regulatory bodies heightening their supervisory expectations.⁴ Nevertheless, LFI misbehaviors continued when in September 2016, various regulatory bodies fined Wells Fargo \$185 million for creating fraudulent savings and checking accounts without client consent.⁵

¹ Proposed Supervisory Guidance, 83 Fed. Reg. 1351, 1351 (proposed Jan. 11, 2018); Large Financial Institution Rating System; Regulations K and LL, 82 Fed. Reg. 39,409, 39,409 (proposed Aug. 17, 2017) (describing a new proposed rating system for LFIs); Proposed Guidance on Supervisory Expectations for Board of Directors, 82 Fed. Reg. 37,219, 37,219 (proposed Aug. 9, 2017) (describing supervisory expectations for the board of directors).

² Large Financial Institution Rating System; Regulations K and LL, 82 Fed. Reg. at 39,049 (explaining that the responses of the FRB after the 2007–2009 Financial Crisis include heightened supervisory expectations and establishment of new supervisory committees).

³ *Id.*

⁴ *Id.* (explaining the heightened supervisory actions the FRB took after the Financial Crisis, including developing a supervisory program to address the risks posed by LFIs and establishing the Large Institution Supervision Coordinating Committee to coordinate supervisory oversight for systemically important firms).

⁵ Matt Egan, *5,300 Wells Fargo Employees Fired over 2 Million Phony Accounts*, CNNMONEY (Sept. 9, 2016, 8:08 AM), <https://money.cnn.com/2016/09/08/investing/wells-fargo-created-phony-accounts-bank-fees/index.html?iid=EL> [<https://perma.cc/3V3A-3QEA>].

This lack of transparency and risk management negligence resulted in new Guidance which strives to “consolidate and clarify the Federal Reserve’s existing supervisory expectations regarding risk management” and to update the FRB’s supervisory rating system.⁶ The guidance pertains only to LFI, which the FRB defines as “all bank holding companies with total consolidated assets of \$50 billion or more.”⁷ Although the LFI definition also extends to an array of other non-insurance and non-commercial savings and loan holding companies, this article will mainly focus on the Guidance’s impact on commercial banks.⁸

This article will detail the FRB’s Guidance and the responses from a variety of financial, legal, and corporate entities. Section B outlines the history of the Wells Fargo account fraud scandal and the bank’s initial response. Section C reviews the FRB’s response to Wells Fargo’s continued misbehaviors after 2016. Section D highlights the main features and changes in the FRB’s Guidance. Section E analyzes commenters’ differing opinions on the Guidance. Section F briefly examines other political and economic considerations. Finally, Section G concludes by discussing the likelihood of the Guidance being codified.

B. The Wells Fargo Account Fraud Scandal

In September 2016, federal regulators revealed that Wells Fargo employees secretly created millions of unauthorized bank and credit card accounts using customer information without consumers’ consent.⁹ To increase profits, Wells Fargo had encouraged its employ-

⁶ See Large Financial Institution Rating System; Regulations K and LL, 82 Fed. Reg. at 39,049 (outlining a new modified supervisory rating system for bank holding companies since the 2007–2009 Financial Crisis); see also Steven Minsky, *The Wells Fargo Scandal Is a Failure in Risk Management*, LOGIC MANAGER (Sept. 20, 2016), <https://www.logicmanager.com/erm-software/2016/09/20/wells-fargo-scandal-risk-management/> [<http://perma.cc/C86M-JXS4>].

⁷ Large Financial Institution Rating System; Regulations K and LL, 82 Fed. Reg. at 39,049.

⁸ *Id.*

⁹ Class and Collective Action Complaint for Damages, Declaratory Relief, and Injunctive Relief at 3, *Hogan v. Wells Fargo & Co.*, No. 3:16-cv-07360 (N.D. Cal. Dec. 12, 2016) [hereinafter Complaint] (explaining that respondent’s analysis concluded that Wells Fargo employees opened over 1.5

ees to “cross-sell,” a banking business model based on selling customers multiple banking and financial products.¹⁰ However, management often set unreachable quotas that were impracticable simply because there were not enough new customers for employees to reach their goals through traditional means.¹¹ Wells Fargo employees complained about the toxic sales culture, threats from management, and strict sales quotas that resulted in ethical and moral breaches.¹²

Thus, employees resorted to “non-traditional” means, such as “pinning,” where a Wells Fargo banker assigns a Personal Identification Number (PIN) to customers’ ATM cards with the intention of impersonating customers and enrolling them in online banking without their consent.¹³ In fact, senior management were likely aware that employees were engaging in sales misconduct to boost sales numbers.¹⁴

Consequently, about 5,300 employees, including senior managers, were fired, Chief Executive Officer (CEO) John Stumpf retired, and Carrie Tolstedt, who headed the division that created the fake accounts, stepped down.¹⁵ Wells Fargo also eliminated its sale goals

million deposit accounts using customer information without their knowledge or consent).

¹⁰ *Id.* at 3; see Adam Davidson, *How Regulation Failed with Wells Fargo*, NEW YORKER (Sept. 12, 2016), <https://www.newyorker.com/business/currency/the-record-fine-against-wells-fargo-points-to-the-failure-of-regulation>.

¹¹ Complaint, *supra* note 9, at 44 (explaining Wells Fargo employees found themselves pressuring friends and families in order to meet sales quotas and resorting to creating fake accounts).

¹² E. Scott Reckard, *Wells Fargo’s Pressure-Cooker Sales Culture Comes at a Cost*, L.A. TIMES (Dec. 21, 2013, 12:00 PM) <http://www.latimes.com/business/la-fi-wells-fargo-sale-pressure-20131222-story.html>.

¹³ Complaint, *supra* note 9, at 41 (explaining the definition of pinning).

¹⁴ *Id.* at 43 (explaining that customers often complained to management about unauthorized accounts, management had access to—and frequently monitored—actions taken on its computers by employees, and management required all customer accounts to be approved by a branch manager).

¹⁵ Jackie Wattle et al., *Wells Fargo’s 20-month Nightmare*, CNNMONEY (Apr. 24, 2018, 7:16 AM), <https://money.cnn.com/2018/04/24/news/companies/wells-fargo-timeline-shareholders/index.html> [<http://perma.cc/8HMJ-Q6W6>] (illustrating a timeline of events that occurred after news broke regarding the account fraud).

system and temporarily suspended cross-selling.¹⁶ Nonetheless, thousands of consumers were detrimentally affected and the unauthorized accounts ultimately accrued over two million dollars in fees.¹⁷

Despite the \$185 million fine imposed by various regulators, Wells Fargo continued its string of misbehavior and noncompliance.¹⁸ Throughout 2017, Wells Fargo admitted it “charged at least 570,000 customers for auto insurance they did not need,” “overcharg[ed] small businesses for credit card transactions by using a ‘deceptive’ 63-page contract to confuse them,” and “wrongly fined mortgage clients” for missing payment deadlines.¹⁹ On April 20, 2018, regulators fined Wells Fargo a significantly greater one billion dollars for auto insurance and mortgage abuses.²⁰

C. Federal Reserve Board’s Response to Wells Fargo

Due to Wells Fargo’s continued dubious business practices, on February 2, 2018, the FRB issued a cease and desist order indefinitely enjoining Wells Fargo from growing its assets.²¹ In the same order, Wells Fargo is also required to replace three current board members by April 2018 and a fourth board member by the end of the year.²²

¹⁶ Jim Puzzanghera, *Panel to Eye Wells Fargo Sales*, L.A. TIMES, Sept. 13, 2016, at C5 (reporting that in response to the Senate Panel announcing a hearing, Wells Fargo is planning to change its sales practices).

¹⁷ Matt Levine, *Wells Fargo Opened a Couple Million Fake Accounts*, BLOOMBERG (Sept. 9, 2016, 6:30 AM), <https://www.bloomberg.com/view/articles/2016-09-09/wells-fargo-opened-a-couple-million-fake-accounts> (“[A]bout 2.1 million fake deposit and credit-card accounts. . . . The total fee income was \$2.4 million . . .”).

¹⁸ Wattles et al., *supra* note 15 (stating that on December 13, 2016, Wells Fargo was fined for failure to comply with the Dodd-Frank Act, which was unrelated to the institution’s previous fraudulent account scandal).

¹⁹ *Id.*

²⁰ *Id.* (explaining the Consumer Financial Protection Bureau and the Office of the Comptroller of the Currency announced that they were fining Wells Fargo \$1 billion for the car insurance mortgage abuses).

²¹ Press Release, Bd. of Governors of the Fed. Reserve Sys., Responding to widespread consumer abuses and compliance breakdowns by Wells Fargo, Federal Reserve restricts Wells’ growth until firm improves governance and controls. Concurrent with Fed action, Wells to replace three directors by April, one by year end (Feb. 2, 2018) (on file with author) <https://www.federalreserve.gov/newsevents/pressreleases/enforcement20180202a.htm> [<http://perma.cc/JLV5-7PFV>] [hereinafter Press Release].

²² *Id.*

Furthermore, the FRB requires Wells Fargo to “improve its governance and risk management processes” and “strengthen the effectiveness of oversight by its board of directors.”²³ Specifically, Wells Fargo is required to submit detailed written plans for improving firm-wide compliance and risk management.²⁴ After the FRB approves these plans, Wells Fargo has to complete two separate, individual reviews of its improvements to the FRB’s satisfaction.²⁵

This type of broad and indefinite restriction is unprecedented.²⁶ Although bank regulators “have in the past issued enforcement actions limiting banks from increasing their total assets, these actions have been reserved for deeply troubled institutions . . . and not for financially strong institutions such as Wells [Fargo].”²⁷ The FRB likely took these actions because it had already barred Wells Fargo from making subsequent acquisitions.²⁸ The cease and desist order also has a deterrent effect as such pervasive restrictions likely signal to other banks that the FRB takes consumer protections seriously.²⁹ Although some critics have called for harsher punishments (e.g., holding Wells Fargo executives personally accountable), the cease and desist order will nonetheless likely have substantial consequences for

²³ *Id.*

²⁴ Edward D. Herlihy et al., *Federal Reserve Takes Severe and Unprecedented Action Against Wells Fargo: Implications for Directors of all Public Companies*, HARV. L. SCH. F. ON CORP. GOVERNANCE & FIN. REG. (Feb. 5, 2018), <https://corpgov.law.harvard.edu/2018/02/05/federal-reserve-takes-severe-and-unprecedented-action-against-wells-fargo-implication-for-directors-of-all-public-companies/> [http://perma.cc/3A7F-BR66] (“[R]equired that Wells submit written plans to enhance its board’s effectiveness in carrying out its oversight and governance functions . . .”).

²⁵ *Id.* (spelling out that “[o]nce the Federal Reserve has approved these plans . . . Wells must arrange for an independent review of the improvements Wells must then arrange for a second independent review to assess the efficacy and sustainability of the improvements”).

²⁶ *Id.* (“These actions are a sharp departure from precedent, both in their severity and their public nature.”).

²⁷ *Id.*

²⁸ *Id.* (“The Federal Reserve likely took this unusual step because Wells was already barred from making acquisition as a result of other legal and regulatory restrictions.”).

²⁹ See Press Release, *supra* note 21 (“We cannot tolerate pervasive and persistent misconduct at any bank and the consumers harmed by Wells Fargo expect that robust and comprehensive reforms will be put in place . . .”).

Wells Fargo.³⁰ The cap on total assets could not only cost the bank \$400 million in profits this year, but also handicap it by giving competitors an opportunity to grow.³¹ As of early February, Wells Fargo shares had fallen by over eight percent.³²

The FRB took another unprecedented step and publicized the letters sent to Wells Fargo's former CEO John Stumpf and former director Stephen Sanger, stating "their performance in those roles, in particular, did not meet the [the FRB's] expectations."³³ The letter claimed the former senior management of Wells Fargo "were made aware of sales practices and other compliance issues" but "did not appear to initiate any serious investigation or inquiry."³⁴ The FRB emphasized the importance of directors and senior management to serve in the interests of the firm and to provide effective oversight; Wells Fargo failed to do so.³⁵

D. Federal Reserve Board's Guidance

From August 2017 to early 2018, the FRB released a series of Guidance aimed at clarifying corporate governance, risk management, and updating the FRB's supervisory rating system.³⁶ The public had

³⁰ Renae Merle, *Wells Fargo CEO Raked over Coals by Congress*, WASH. POST, Sept. 21, 2016, at A14.

³¹ Laura J. Keller & Shahien Nasiripour, *Fed's Wells Fargo Punishment Sets Precedent for Harsher Era*, BLOOMBERG (Feb. 5, 2018, 9:43 AM), <https://www.bloomberg.com/news/articles/2018-02-05/harsher-era-greets-banks-if-wells-fargo-punishment-is-precedent>.

³² *Id.*

³³ Letter from Michael S. Gibson, Dir., Div. of Supervision & Regulation, Bd. of Governors of the Fed. Reserve Sys., to Stephen Sanger, Dir., Wells Fargo & Co. (Feb. 2, 2018) (on file with author), <https://www.federalreserve.gov/newsevents/pressreleases/files/enf20180202a3.pdf> [<http://perma.cc/S5KK-EYBA>] (describing the many pervasive and serious compliance and conduct failures that occurred during Sanger's tenure and his failure to effectively provide oversight).

³⁴ *Id.*

³⁵ *Id.*

³⁶ Proposed Supervisory Guidance, 83 Fed. Reg. 1351, 1351 (proposed Jan. 11, 2018) (describing proposed guidance regarding effective senior management, management of business lines, and independent risk management for LFIs); Large Financial Institution Rating System; Regulations K and LL, 82 Fed. Reg. 39,409, 39,409 (proposed Aug. 17, 2017) (describing a new proposed rating system for LFIs); Proposed Guidance on Supervisory

the opportunity to comment on each of the proposals.³⁷ The main features of each proposal are outlined below.

1. Large Financial Institution Rating Proposal

The first of the proposals concerns a new rating system (New Rating System, NRS)³⁸ that more closely aligns with the FRB's new LFI supervisory methods.³⁹ Since 2004, the FRB has used the "RFI/C(D)" rating system (RFI rating system) in assessing each LFI "regardless of its asset size, complexity, or systemic importance."⁴⁰ The RFI rating system focuses on risk management practices (R component) and financial condition (F component) of the consolidated organization, and assesses the potential impact (I component) of a LFI's non-depository entities on its subsidiary deposit institution(s).⁴¹ However, this rating system has not been modified since the Financial Crisis and likely does not adequately address the corresponding changes to the FRB's supervisory expectations.⁴²

The NRS strives to (i) fully align with the FRB's current supervisory programs and practices which "focus on reducing the probability of LFIs failing or experiencing material distress"; (ii) enhance clarity and consistency of supervisory assessments; and (iii) incentivize LFIs to maintain financial and operational strength, which include compliance with laws and regulations by more clearly defining the consequences of a given rating.⁴³

Expectations for Board of Directors, 82 Fed. Reg. 37,219, 37,219 (proposed Aug. 9, 2017) (describing supervisory expectations for the board of directors).

³⁷ Proposed Supervisory Guidance, 83 Fed. Reg. at 1351 (listing comment period as open until March 15, 2018); Large Financial Institution Rating System; Regulations K and LL, 82 Fed. Reg. at 39,409 (listing comment period as open until October 16, 2017); Proposed Guidance on Supervisory Expectations for Board of Directors, 82 Fed. Reg. at 37,219 (listing comment period as open until October 10, 2017).

³⁸ The name and abbreviation are designated by the author and are not identifiers used by the FRB.

³⁹ Large Financial Institution Rating System; Regulations K and LL, 82 Fed. Reg. at 39,049 (describing the proposed "Large Financial Institution Rating System" as closely aligned with the Federal Reserve's new supervisory program for LFIs).

⁴⁰ *Id.* at 39,050.

⁴¹ *Id.*

⁴² *Id.*

⁴³ *Id.*

LFIs are rated on three components: capital planning, liquidity risk management, and governance and controls.⁴⁴ Capital planning assesses the effectiveness and sufficiency of a firm's capital positions in complying with regulatory requirements, covering risks and exposures, and supporting commercial banking activities.⁴⁵ Liquidity risk management assesses the effectiveness of a firm's liquidity governance and risk management processes.⁴⁶ Lastly, governance and controls assesses the effectiveness of a firm's board of directors and committees, the management of a firm's core business lines, and recovery planning.⁴⁷

Unlike what the FRB has done in the past, the NRS will not assign a standalone composite rating.⁴⁸ Rather, each component rating "communicate[s] supervisory assessments and associated consequences for each of the core areas . . . considered critical to a firm's strength and resilience."⁴⁹ Such a change seems to indicate the FRB's efforts towards promulgating more streamlined, clear, and distinctive guidelines.⁵⁰ Furthermore, the NRS also emphasizes the FRB's goals of long-term sustainability and regulatory compliance, which is likely a direct response to both the Financial Crisis and the Wells Fargo scandal.⁵¹

2. Governance Proposal

The second of the proposals addresses the corporate governance of LFIs, with a focus on the board's core responsibilities.⁵² The Governance Proposal also better delineates the roles and responsibilities between the board of directors and senior management.⁵³

⁴⁴ *Id.*

⁴⁵ *Id.*

⁴⁶ *Id.* ("The Liquidity Risk Management and Positions component rating would encompass assessments of (i) the effectiveness of a firm's governance and risk management processes used to determine the amount of liquidity necessary to cover risks and exposures . . . (ii) the sufficiency of a firm's liquidity positions to comply with applicable regulatory requirements . . .").

⁴⁷ *Id.*

⁴⁸ *Id.* at 39,051.

⁴⁹ *Id.*

⁵⁰ *See id.*

⁵¹ *Id.* at 39,050.

⁵² Proposed Guidance on Supervisory Expectations for Board of Directors, 82 Fed. Reg. 37,219, 37,219 (proposed Aug. 9, 2017).

⁵³ *Id.*

Clarified roles and expectations not only “improve corporate governance overall, [but also] increase efficiency, support greater accountability, and promote compliance with laws and regulations.”⁵⁴

The Governance Proposal has three parts: (i) proposed board effectiveness guidance (BE Guidance); (ii) rescission or revision of twenty-seven existing Supervision and Regulation Letters (SR Letters); and (iii) clarification of the FRB’s expectations for communicating supervisory findings to a firm’s board and senior management.⁵⁵ The BE Guidance identifies five key attributes of an effective board, which are a firm’s risk tolerance, information flow, accountability, internal risk management (IRM), and audit functions.⁵⁶ The BE Guidance also streamlines regulatory expectations by eliminating redundant and outdated SR Letters—another instance of the FRB pursuing increased compliance and transparency.⁵⁷

The third part of this proposal specifies that senior management will handle most corporate governance matters and the board of directors will only intervene when senior management fails to take appropriate action.⁵⁸ One of the FRB’s major critiques of Wells Fargo was that, despite the CEO having been aware of the sales practice problems, this information was not communicated between senior management and the board of directors.⁵⁹ The FRB recognizes that boards are “inherently disadvantaged given their dependence on senior management for the quality and availability of information.”⁶⁰ Thus, by shifting most of the day-to-day responsibilities to senior management, the proposed strategy can both decrease disclosure failures, but

⁵⁴ *Id.*

⁵⁵ *Id.* at 37,220–22 (outlining the three parts of the Governance Proposal).

⁵⁶ *Id.* at 37,220 (outlining the five key attributes of an effective board: (i) setting clear, aligned, and consistent direction regarding the firm’s strategy and risk tolerance; (ii) actively managing information flow and board discussions; (iii) holding senior management accountable; (iv) supporting the independence and statute of independent risk management and internal audit; and (v) maintaining a capable board composition and governance structure).

⁵⁷ *Id.* at 37,220.

⁵⁸ *Id.* at 37,223.

⁵⁹ Letter from Michael S. Gibson, Dir., Div. of Supervision & Regulation, Bd. of Governors of the Fed. Reserve Sys., to John Stumpf, Chief Exec. Officer, Wells Fargo & Co. (Feb. 2, 2018) (on file with author), <https://www.federalreserve.gov/newsevents/pressreleases/files/enf20180202a4.pdf> [http://perma.cc/UTL9-PGS3].

⁶⁰ Proposed Guidance on Supervisory Expectations for Board of Directors, 82 Fed. Reg. at 37,219.

also allow boards to focus on big-picture risk management and oversight.⁶¹

3. *Management Proposal*

The third of the proposals focuses on core principles of LFI management by distinguishing the boards of directors' roles from senior management.⁶² The Management Proposal addresses three groups of core principles: effective senior management, management of business lines, and IRM and controls.⁶³

The first part of the proposal applies to senior management who are directly accountable to the board and monitor the day-to-day management of the firm.⁶⁴ The second part guides business line management, who oversee and guide risk tolerance, risk identification and management, resources and infrastructure, business controls, and accountability.⁶⁵ The third part of the proposal address the roles and responsibilities of the firm's chief risk officer (CRO) and chief audit executive (CAE), as well as IRM, controls, and audit.⁶⁶ The Management Proposal requires a firm to consider its size, complexity, and risk profile when developing its governance.⁶⁷ The proposal also has some flexibility as to who should oversee risk management and allow LFIs to use a framework that best supports their organizational structure—an effort towards more specifically tailored risk supervision.⁶⁸

⁶¹ *See id.* (explaining that a board's core responsibilities include guiding the development of the firm's strategy and the types and levels of risk the firm is willing to take, overseeing senior management and holding them accountable for effective risk management, supporting the independence of the firm, and adopting effective governance practices).

⁶² Proposed Supervisory Guidance, 83 Fed. Reg. 1351, 1351 (proposed Jan. 11, 2018).

⁶³ *Id.* at 1353.

⁶⁴ *Id.*

⁶⁵ *Id.* at 1354.

⁶⁶ *Id.*

⁶⁷ *Id.* (explaining expectations for a firm's IRM include evaluating the firm's risk tolerance, establishing enterprise-wide risk limits and monitoring adherence to those limits, measuring and aggregating risks, providing an independent assessment of the firm's risk profile, and providing risk reports to the board and senior management).

⁶⁸ *Id.* ("Depending on a firm's organizable structure, it may be appropriate for business line management to provide input into risk tolerance or drive its development.").

4. *Relevance*

Due to their expansive nature and significant role in society, bank failures are particularly dangerous because they can have systemic effects.⁶⁹ However, completely eliminating this systemic risk may not be the economically appropriate solution.⁷⁰ Rather, regulators should allow each bank to consider its optimal level of risk.⁷¹ An obvious concern, however, is that senior management might either do a poor job in managing risk or might have incentives to take misaligned risks—as seen in Wells Fargo’s case.⁷² Thus, to avoid bank failures, the solution is to ensure firms have processes in place to “measure its risk, understand how firm value is related to risk, and maintain the right level of risk.”⁷³ For instance, the FRB’s Management Proposal pursues this goal by establishing core principles of risk management.⁷⁴

The importance of having strong IRM functions is further highlighted by empirical evidence finding that banks with stronger risk management functions in place before the Financial Crisis had lower tail risk, a smaller fraction of non-performing loans, better operating performance, and higher stock return performance during the Crisis years.⁷⁵ The evidence suggests that strong and independent risk management functions can limit future risk in banks.⁷⁶

⁶⁹ René M. Stulz, *Governance, Risk Management, and Risk-Taking in Banks*, 427 EUR. CORP. GOVERNANCE INST. 1, 8 (2014) (“If a producer of widgets fail, as long as there are other producers of widgets, the impact on society will be extremely limited and will be immaterial for most of society. The same is not true if a large bank . . . fails.”).

⁷⁰ *Id.*

⁷¹ *Id.*

⁷² *Id.* at 9 (observing that an obvious concern for shareholders is that management may do a poor job in managing the firm’s risk or have incentives to take risks that are not in shareholders’ interests).

⁷³ *Id.*

⁷⁴ *See supra* Section D3.

⁷⁵ Andrew Ellul & Vijay Yerramilli, *Stronger Risk Controls, Lower Risk: Evidence from U.S. Bank Holding Companies*, 68 J. FIN. 1757, 1759–61 (2013) (hypothesizing that U.S. bank holding companies with a higher risk management index before the onset of the Financial Crisis performed better during the Financial Crisis and had lower tail risk).

⁷⁶ *Id.* at 1761.

Another crucial element in the FRB's Management Proposal is the creation of a CRO and clarification of responsibilities.⁷⁷ Data shows that banks with a CRO in the executive board exhibit both higher return on equity and higher return on assets.⁷⁸ Moreover, banks with a CRO generally have stronger risk management capabilities because they have a dedicated risk committee that directly reports to the board or CEO.⁷⁹ A risk committee assists in effective risk management by identifying and measuring risks, and then communicating essential information to senior management.⁸⁰ A CRO can also lessen risk taking because of his ability to restrain executives from taking unnecessary risk.⁸¹ Thus, the requirement of a CRO on board can significantly improve bank IRM.⁸²

E. Public Response to Guidance

Overall, the public response has been in support of the Guidance.⁸³ However, various legal, financial, business, and government

⁷⁷ Proposed Supervisory Guidance, 83 Fed. Reg. 1351, 1359 (proposed Jan. 11, 2018) (requiring LFIs to employ a CRO to establish and monitor compliance with enterprise-wide risk limits, identify and aggregate the firm's risks, assess the firm's risk positions, and provide relevant risk information to senior management).

⁷⁸ Vincent Aebi, Gabriele Sabato, & Markus Schmid, *Risk Management, Corporate Governance, and Bank Performance in the Financial Crisis*, 36 J. BANKING & FIN. 3213, 3220 (2011) ("However, banks with a CRO in the executive board exhibit both higher ROE and ROA.").

⁷⁹ *Id.* (finding that banks with a CRO in the executive board are significantly more likely to have a dedicated risk committee and have CRO reporting directly to the board or CEO).

⁸⁰ Andrew Ellul, *The Role of Risk Management in Corporate Governance*, 7 ANN. REV. FIN. ECON. 279, 292 (2015) ("For risks to be managed effectively, they must be first identified and measured and then communicated to senior management.").

⁸¹ *Id.* at 294.

⁸² *Id.* at 295–96 (arguing that governance failures due to inconsiderate risky strategies make the case for a strong risk management function that can monitor and control enterprise-wide risk exposures).

⁸³ See Letter from Stefan M. Gavell, St. Street Corp., to Ann E. Misback, Sec'y, Bd. of Governors of the Fed. Reserve Sys. (Mar. 15, 2018) (on file with the Federal Reserve Board), https://www.federalreserve.gov/SECRS/2018/March/20180328/OP-1594/OP-1594_031518_131994_276322382493_1.pdf [<http://perma.cc/2G9R-N3KH>]; Letter from Luigi L. De Ghenghi, Davis Polk & Wardwell LLP, to Ann E. Misback, Sec'y, Bd. of Governors of the

entities have offered differing views on how the FRB should clarify its guidance. This section will begin by exploring the two different positions: those who recommend the FRB broaden its guidance by being more principles-based and those who ask for even more specified guidance. It is worth noting that these are general categories and the two groups are not necessarily in opposition with one another.

1. In Support of Broad Guidance

One of the main concerns commenters highlight is that examiners may misconstrue the Guidance's detailed descriptions as prescriptive requirements that must be satisfied to achieve a satisfactory rating.⁸⁴ Examiners, who are usually not sophisticated management executives, might apply the Guidance in a "check-the-box" manner.⁸⁵ Commenters argue this misapplication creates a "one-size-fits-all approach" that hinders flexibility in developing appropriate models, methods, and processes for each firm.⁸⁶ Instead, the FRB should focus on the outcomes of effective risk management, rather than listing the required elements.⁸⁷

In addition, the American Bankers Association (ABA) wrote that the generic definitions of "senior management" and "management

Fed. Reserve Sys. (Mar. 15, 2018) (on file with the Federal Reserve Board), https://www.federalreserve.gov/SECRS/2018/April/20180424/OP-1594/OP-1594_031518_132001_50191813_6611_1.pdf [<http://perma.cc/2AG9-9DL2>], Letter from Mark R. Thresher, Exec. Vice President and Chief Fin. Officer, Nationwide Mutual Ins. Co., to Ann E. Misback, Sec'y, Bd. of Governors of the Fed. Reserve Sys. (Mar. 15, 2018) (on file with the Federal Reserve Board), https://www.federalreserve.gov/SECRS/2018/March/20180328/OP-1594/OP-1594_031518_131995_281686143332_1.pdf [<http://perma.cc/7Q8Y-NJQK>].

⁸⁴ See Letter from Mark Thresher to Ann Misback, *supra* note 83.

⁸⁵ Letter from Andy Barr, Bill Huzienga, and Sean Duffy, U.S. House of Representatives, to Ann E. Misback, Sec'y, Bd. of Governors of the Fed. Reserve Sys. (Apr. 13, 2018) (on file with the Federal Reserve Board), https://www.federalreserve.gov/SECRS/2018/April/20180424/OP-1594/OP-1570_041618_132022_478065667310_1.pdf [<http://perma.cc/7QGS-6L6X>].

⁸⁶ Letter from Mark Thresher to Ann Misback, *supra* note 83.

⁸⁷ *Id.* ("[W]e believe the FRB should establish the principle that supervised firms must be able to demonstrate adherence to sound risk management principles and practices and demonstrate their selected approach results in effective board and management oversight of risk.").

of business lines” may not be applicable to each institution.⁸⁸ It advises the FRB to revise the Guidance to “make clear that the division of labor and responsibilities . . . is in management’s discretion.”⁸⁹ As an example, the ABA explains the Guidance states that business line management is responsible for training staff on business line activities.⁹⁰ However, for many institutions, Human Resources and/or Compliance may fulfill this training instead.⁹¹ Therefore, the ABA states that the Guidance should allow for such deviation within organizations so long as the responsibility of providing staff training and development is clearly allocated.⁹²

Another concern that arises is the broad definition of “business lines,” which includes every business line in a firm, has the potential to create duplicative regulatory processes that may impose operational and cost burdens on the LFI.⁹³ Eric Varvel, CEO of Credit Suisse Holdings, Inc., suggests that the FRB “should allow firms to identify which units qualify as a ‘business line’, providing they are aligned to

⁸⁸ Letter from Hu A. Benton, Vice President of Banking Policy, Am. Bankers Ass’n, to Ann E. Misback, Sec’y, Bd. of Governors of the Fed. Reserve Sys. (Mar. 13, 2018) (on file with the Federal Reserve Board), https://www.federalreserve.gov/SECRS/2018/March/20180328/OP-1594/OP-1594_0315_18_132010_411027648920_1.pdf [<http://perma.cc/DG3A-ELF7>].

⁸⁹ Letter from Hu Benton to Ann Misback, *supra* note 88; *see also* Letter from Stefan Gavell to Ann Misback, *supra* note 83.

⁹⁰ Proposed Supervisory Guidance, 83 Fed. Reg. 1351, 1359 (proposed Jan. 11, 2018) (“Business line management should develop and maintain an effective system of internal controls for its business lines. . .”).

⁹¹ Letter from Hu Benton to Ann Misback, *supra* note 88 (“In many Covered Institutions, training is not managed or control 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.”).

⁹² *Id.* (“The guidance should allow that as long as responsibility for furnishing training is clearly allocated and adequate resources are delivered according to the Covered Institution’s particular organization . . .”).

⁹³ Letter from Eric M. Varvel, Chief Exec. Officer, Credit Suisse Holdings, Inc., to Ann E. Misback, Sec’y, Bd. of Governors of the Fed. Reserve Sys. (Mar. 15, 2018) (on file with the Federal Reserve Board), https://www.federalreserve.gov/SECRS/2018/April/20180416/OP-1594/OP-1594_0315_18_132003_501138603947_1.pdf [<http://perma.cc/83X3-F44W>] (explaining how a broad definition of meaning every “business line” in a firm may lead to redundant reporting structures that may not align with how the institution is actually structured).

the risk profile and structure of the firm,” rather than creating an all-encompassing term.⁹⁴

Ultimately, most of the recommendations seem to ask the FRB to take more of a “hands-off” approach—focusing on outcomes rather than articulating explicit requirements.⁹⁵ Many of these commenters not only emphasize the fact that there is a myriad of effective organization structures, but also the importance of allowing a firm to be flexible and adapt.⁹⁶ Commenters also note that since corporate governance experts do not compose the FRB, it is better to defer to the judgment of directors and senior management when deciding what is best for an institution.⁹⁷

2. *In Support of More Specified Guidance*

In contrast, some commenters ask the FRB to be more specific and explicit in its Guidance. For instance, the New York State Society of Certified Public Accountants (NYSSCPA) pushes for business line management guidance that could increase the reliability of the results and decrease risk of bias or misrepresentation.⁹⁸ The NYSSCPA also suggests LFIs establish “enterprise-wide risk limits that are consistent with the firm’s tolerance.”⁹⁹ While the NYSSCPA acknowledges that IRM should have the final authority in establishing risk limits, it does ask that the Guidance explicitly encourage IRM to seek input from others.¹⁰⁰

⁹⁴ *Id.*

⁹⁵ *See supra* Section E1.

⁹⁶ *Id.* (explaining commenters’ emphasis on allowing firms to be flexible in adopting corporate governance structures).

⁹⁷ *Id.*

⁹⁸ *See* Letter from Harold L. Deiters III, President, N.Y. St. Soc’y of Certified Pub. Accountants, to Ann E. Misback, Sec’y, Bd. of Governors of the Fed. Reserve Sys. (Mar. 1, 2018) (on file with the Federal Reserve Board), https://www.federalreserve.gov/SECRS/2018/April/20180420/OP-1594/OP-1594_030118_131987_288319836115_1.pdf [<http://perma.cc/5A7Q-6D7D>] (explaining guidance makes explicit that line management self-testing and reporting activities should be conducted by individuals who do not operate the controls).

⁹⁹ *Id.* (“Risk limits should be assigned to specific risk types, business lines, legal entities, jurisdictions, geographic areas, concentrations, products or activities . . .”).

¹⁰⁰ *Id.*

Another recommendation suggests that when assessing board effectiveness, the FRB should consider the extent to which a governance aspect is appropriate for the firm's board based on the board's assessment of the firm's complexity, risk profile, and size.¹⁰¹ The rationale is LFI should tailor each key attribute of an effective board to its organizational structure.¹⁰² The BE Guidance is also recommended to include additional considerations, such as the board's financial performance responsibility, earning capacity, and generation of returns on shareholders' capital.¹⁰³ Furthermore, commenters note that the Management Proposal is "unbalanced in its focus on risk and risk management to the exclusion of financial performance and earnings capacity."¹⁰⁴ When evaluating risk tolerance, it is axiomatic to consider both the costs of activities and potential risks.¹⁰⁵ These recommendations focus on expanding the Guidance to be more specific in defining business line management's responsibilities, while also including additional factors to consider.

F. Other Political and Economic Considerations

Finally, there are both political and economic considerations worth addressing. Especially following the Wells Fargo scandal, the Guidance illuminates the FRB's increased expectations on board leaders in assuring appropriate risk management systems are in place.¹⁰⁶ However, the heightened regulation stands starkly in contrast to the current administration's emphasis on deregulation.¹⁰⁷ Although the FRB is an independent agency devoid from political pressures, the

¹⁰¹ Letter from Luigi De Ghenghi to Ann Misback, *supra* note 83.

¹⁰² *Id.*

¹⁰³ *Id.* (discussing additional factors, such as a board's responsibility for financial performance, earnings capacity, and generation of returns on shareholders' capital, to be considered when evaluating board effectiveness).

¹⁰⁴ *Id.*

¹⁰⁵ *Id.* ("It is axiomatic that the concepts of risk tolerance, risk limits[,] and risk management can only make sense in the context of a banking organization seeking to balance its revenue-generating banking and other financial activities against the costs . . . of engaging in those activities.")

¹⁰⁶ Herlihy et al., *supra* note 24.

¹⁰⁷ Connor Raso, *What Does "Deregulation" Actually Mean in the Trump Era?*, BROOKINGS INSTITUTION (Nov. 1, 2017), <https://www.brookings.edu/research/what-does-deregulation-actually-mean-in-the-trump-era> [<http://perma.cc/55SZ-T4JX>].

Guidance may likely add to the growing political controversy regarding the independence of federal financial regulators.¹⁰⁸

Furthermore, according to a recently study released by the Mercatus Center at George Mason University (Mercatus Study), “federal regulatory burden on businesses has increased by twenty-eight percent in the last fifteen years.”¹⁰⁹ Although regulations can have significant social benefits, businesses faced with increased regulations may incur more costs and likely raise consumer prices.¹¹⁰ Precisely, the Mercatus Study found that on average, every ten percent increase in regulatory restrictions produces a 0.68% increase in consumer prices.¹¹¹ Such a tendency may be especially true for financial regulation where each LFI bears the burden of the FRB assessment.¹¹² Increased supervisory expectations may lead to greater assessment costs and ultimately, trickle-down to consumers or result in Wells Fargo-like behavior. Although these political and economic concerns may not necessarily affect the ultimate outcome of financial regulation, they are worth considering when looking at increased regulation.

¹⁰⁸ See Kevin Wack, *Trump’s Wells Fargo Tweet Fuels Regulatory Independence Concerns*, AM. BANKER (Dec. 8, 2017, 5:14 PM), <https://www.americanbanker.com/news/trumps-wells-fargo-tweet-left-washington-tongue-tied> (“Trump’s comments added fuel to the growing controversy regarding the independence of federal financial regulators.”); see @realDonaldTrump, TWITTER (Dec. 8, 2017, 7:18 AM), <https://twitter.com/realdonaldtrump/status/939152197090148352> [<http://perma.cc/DUE3-NQJF>] (“I will cut Regs but make penalties severe when caught cheating!”).

¹⁰⁹ Dustin Chambers & Courtney A. Collins, *How Do Federal Regulations Affect Consumer Prices?* 3 (Feb. 23, 2016) (Mercatus Center Working Paper), <https://www.mercatus.org/system/files/Chambers-How-Regs-Affect-Prices-v2.pdf> [<http://perma.cc/9UUM-22LA>].

¹¹⁰ Tanya Xu, *Regulations Could Be Increasing Consumer Prices*, REG. REV. (Sept. 29, 2016), <https://www.theregreview.org/2016/09/29/xu-regulations-could-be-increasing-consumer-prices> [<http://perma.cc/FM74-TDN6>].

¹¹¹ Chambers & Collins, *supra* note 109, at 4.

¹¹² Julie Stackhouse, *Who Funds the Cost of Bank Supervision?*, FED. RES. BANK ST. LOUIS: ON THE ECON. BLOG (June 22, 2017), <https://www.stlouisfed.org/on-the-economy/2017/june/who-funds-cost-bank-supervision> [<http://perma.cc/3B2Q-GRH7>].

G. Conclusion

The differing opinions on the Guidance highlight the long-standing conflict between regulators and private entities.¹¹³ Increased supervisory guidance for LFI is not only important for consumer protection, but for large-scale financial stability as well—especially in the context of the Financial Crisis and Wells Fargo scandal.¹¹⁴ While LFIs play a paramount role in society and can have adverse, long-lasting effects when monitored inappropriately, it is also important to consider each firm’s uniqueness.¹¹⁵ Board directors and senior management are much more aware of the inner-workings of their institution and thus, should be afforded deference.¹¹⁶ Inflexible guidance from the FRB may actually hinder a LFI’s ability to grow, adapt, and innovate.¹¹⁷ Although there are many considerations worth balancing, the FRB’s Guidance strives to provide stability and security in an often volatile financial market.¹¹⁸ Given the importance of this goal, the Guidance will likely have a clear path to codification.¹¹⁹

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¹¹³ See *supra* Part E.

¹¹⁴ See Press Release, *supra* note 21 (“We cannot tolerate pervasive and persistent misconduct at any bank and the consumers harmed by Wells Fargo expect that robust and comprehensive reforms will be put in place to make certain that the abuses do not occur again.”).

¹¹⁵ See *supra* Section E1.

¹¹⁶ *Id.*

¹¹⁷ *Id.*

¹¹⁸ See *supra* Part D.

¹¹⁹ See MICHAEL S. BARR ET AL., FINANCIAL REGULATION: LAW AND POLICY 704 (Saul Levmore et al. eds., 2d ed. 2018); Julien Courbe, *Fed’s New Risk Management Guidance*, PwC (Jan. 2018), <https://www.pwc.com/us/en/industries/financial-services/regulatory-services/library/feds-new-risk-management-guidance.html> [http://perma.cc/ER4R-D4RJ].

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