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Federal Reserve Proposes New Guidance on Management of Large Financial Institutions

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The Federal Reserve's proposed core principles on management of large financial institutions are another welcome addition to its efforts to clarify and better distinguish between the roles of boards of directors and the management of large financial institutions. The **new guidance** (Management Guidance) describes core principles of effective senior management, the management of business lines, and independent risk management and controls that would apply to large financial institutions (LFIs). The Management Guidance expands on the Federal Reserve's two previous proposals for large financial institutions:

- a new LFI supervisory rating system (LFI Rating Proposal); and
- supervisory expectations for an effective board of directors (Board Guidance).

Please click **here** and **here** for our blog posts on the LFI Rating Proposal and the Board Guidance.

The Management Guidance would apply to all U.S. bank holding companies and savings and loan holding companies with total consolidated assets of $50 billion or more and to any non-bank SIFIs. It also would apply to the combined U.S. operations of foreign banking organizations (FBOs) with combined U.S. assets of $50 billion or more (unlike the Board Guidance, not just the U.S. intermediate holding companies of FBOs), as well as any state member bank subsidiary of any of the firms covered by the guidance.

The Management Guidance is organized in three parts:

1. **Core Principles for Effective Senior Management.** These principles apply to senior management, the core group of individuals directly accountable to the board of directors for the sound and prudent day-to-day management of the firm.
   - For an FBO, senior management may be located inside or outside the United States, and are accountable to the intermediate holding company board, U.S. risk committee or global board of directors for the FBO's U.S. operations.
2. **Core Principles of the Management of Business Lines.** These principles apply to the management of business lines (including critical operations), the core group of individuals responsible for prudent day-to-day management of a business line and accountable to senior management for that responsibility , and focus on strategy and risk tolerance, risk identification and risk management, resources and infrastructure, business controls, and accountability.
   - This guidance applies to every business line of a Large Institution Supervision Coordinating Committee (LISCC) firm, whereas for other LFIs it effectively applies only to material business lines.
   - For FBOs, if a business line is part of a larger business conducted outside the United States, this guidance applies only to the portion of the business conducted in the United States.
3. **Core Principles of IRM and Controls.** These principles apply to address the roles and responsibilities of the firm's chief risk officer (**CRO**) and chief audit executive (**CAE**), IRM (including Compliance), internal controls, and Internal Audit. The guidance builds on the framework of Regulation YY and requires a firm's IRM and internal audit functions and their governance to be appropriate for its size, complexity, and risk profile.
   - For FBOs, the guidance applies to the U.S. CRO and the U.S. risk committee for the FBO's combined U.S. operations, over which the FBO's Internal Audit function should have "appropriate independent oversight."

Overall, we commend the Federal Reserve for a number of the principles underlying the Management Guidance, including:

- the continued recognition of the need to allow firms to tailor their governance and management structure, and IRM, Internal Audit and internal controls to their risk profile and complexity,
- the recognition, in the preamble to the Management Guidance, that business line management can provide input into or even drive the development of a firm's risk tolerance, and
- the recognition that for FBOs there is a distinction between how the guidance may be applied to U.S. subsidiaries of an FBO and to U.S. branches of its foreign bank.

But in our view the Management Guidance could be improved in a number of ways. For example:

- Like the Board Guidance, the Management Guidance –especially in the core principles of effective senior management and the management of business lines—is unbalanced in its focus on risk and risk management to the virtual exclusion of responsibility for financial performance and earnings capacity. Yet if a firm is unable to generate sustainable earnings, its capital base, liquidity and ability to perform its core function of contributing to the strength of the credit and capital markets in the United States would all suffer.
- The proposed application of the business line management principles to every business line of a LISCC firm, regardless of whether it meets the applicable criteria for material business lines, seems inconsistent with the underlying principle that a firm should tailor its board and management governance, risk management and controls to its risk profile and complexity.
- The Management Guidance's expectations for the role of IRM in setting and enforcing risk limits for a firm is in some tension with the Board Guidance that it is the role of the board to approve the firm's level of risk appetite and the recognition in the principles of effective senior management that senior management is responsible for the firm's strategy and risk tolerance.
- The Management Guidance, like the Board Guidance, is silent on the importance of a firm having a sufficiently robust Legal Department with appropriate resources, budget and independence. This seems to be an odd omission of attention for this critical function.

- The Management Guidance should more explicitly defer to applicable home-country requirements applicable to the U.S. branches or agencies of an FBO's foreign bank. To the extent a business line is conducted by the U.S. branch network of an FBO's foreign bank as part of a larger business line outside the United States, that foreign bank may already be subject to its own home-country governance and risk management requirements and supervisory expectations. Requiring an FBO to comply with the Management Guidance with respect not just to its U.S. intermediate holding company and U.S. subsidiaries, but also with respect to its U.S. branch network without an explicit recognition that different home-country guidance may apply, creates the risk that an FBO would be placed in the unenviable position of having to comply with conflicting supervisory requirements.

Comments on the Management Guidance are due March 15, while the comment period for the LFI Rating Proposal and the Board Guidance ends on February 15.

We will publish a visual memo on the Management Guidance and its relationship with the LFI Rating Proposal and the Board Guidance.