# A Job That Passeth Understanding:
# Or, Can Anyone Be a Bank Director Anymore?

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It is a pleasure to speak today on an issue that strikes at the heart not just of the current challenge of effective corporate governance, but even more profoundly at the causes and cures of the global financial crisis. In my view, the financial crisis was perhaps most fundamentally a corporate-governance one – after all, if boards had really understood the risks being taken, none that were any good at their fiduciary duties would have stood by. Regulators failed, the tools to handle huge troubled firms were not at hand, rating agencies got a lot wrong and much else needs a post-crisis redo. But, had banks and other financial-services firms gotten a grip on their own risk exposures, the critical missing element – meaningful market discipline – would have applied and the trillions lost in the crisis would have been minimized if not altogether saved.

Many of the reforms the SEC is required under Dodd-Frank to undertake are focused on the fiduciary lapses that exacerbated financial-institution board malfeasance – a word I use intentionally, since that's what it was at some problem firms. But, the corporate-governance reforms for banks and other financial institutions mandated in the Dodd-Frank Act and in a set of separate regulatory actions now well under way go still farther. As I read them, we are asking directors not just to be real fiduciaries, but also to be regulators in residence or even philosophers and priests. As I read the new rules, directors are to take on day-to-day risk management responsibilities even as they are to ensure that their financial institutions operate not just profitably for shareholders, happily for employees and prudently for regulators, but also properly for the greater good of society as a whole.

That's a lot to do well in a day job, let alone for independent directors at monthly board meetings. What I would like to do today is first to review the pending regulatory landscape to make clear why it's so formidable. Then, I will step back to posit a few clear, measurable ways financial-institution directors can do the better job rightly demanded of them without so much burden and so much risk that no one with any sense would choose to take this on. Key, in my view, is better board attention to what regulators have come to call the "risk appetite" of financial institutions, reviewing just how hungry firms are enterprise-wide and at each material business line. I'll lay out ways directors can do a better job here, but also contrast this to demands now being made in pending rules. These go beyond making boards the arbiters of risk appetites they should be also to require them to run the cafeteria line as each management decision passes before them, handing out only peas and carrots in measured bits to the skinniest kids.

## **The Financial-Industry Governance Landscape**

Let me be clear, financial-industry directors, banks included, are among those culpable for the financial crisis. As a recent report from the Group of Thirty rightly stated:

> In the wake of the crisis, financial institution (FI) governance was too often revealed as a set of arrangements that approved risky strategies …, was blind to the looming dangers on the balance sheet and in the global economy, and therefore failed to safeguard the FI, its customers and shareholders, and society at large.[1]

The Group of Thirty is a distinguished assembly of global financial-industry CEOs and regulators with significant policy impact. It goes on rightly to say that industry corporate governance has improved since the crisis laid bare its inadequacies and, then, to recommend a set of still more potent, lasting improvements. I draw many of my remarks today from these recommendations.

But, the G-30 also goes on to say something totally startling: boards must ensure that financial institutions play a "palpably positive role in society."[2] This is striking – we're not just talking warm and fuzzy about a few photos in the annual report showing some community-development efforts by caring employees. This is a radical rewrite of corporate governance. That it comes from the G-30 makes clear how potent calls for change have become.

And, these calls come not just from outside experts. They are increasingly the premise on which new financial-institution governance rules are based. I say financial institutions, not banks, because the Dodd-Frank Act mandates these standards for all "systemic" financial companies. These are defined in the law as bank holding companies (BHCs) with assets over $50 billion (including foreign banking organizations above this level at the parent firm), although many of the new governance standards also apply in slightly less onerous form to BHCs with assets over $10 billion. Any nonbank deemed a systemically-important financial institution (SIFI) under new rules from the Financial Stability Oversight Council also will come under this governance gun.[3] For now, there aren't any nonbank SIFIs, so the rules are of immediate concern – panic? – only to big BHCs. But, they will pack a punch soon enough for some large insurers, asset managers and other financial-services firms.

## **Topography of the Financial-Institution Governance Landscape**

When one discusses the new SIFI governance standards in broad strokes, the rules seem a reasonable correction to the lapses that precipitated the financial crisis. But, on a close read, the number of complex criteria which boards must not just review, but also approve and validate redefine corporate governance. We have counted 184 new requirements for SIFI boards in a pending proposal from the Federal Reserve[4]– a number that comes atop the literally hundreds of other board requirements stipulated in a wide array of old and new standards from all of the banking agencies.

Indeed, each and every new standard from all of the federal banking agencies now comes with an express injunction that the board independently review the specifics of each

issue, establish risk parameters for it, determine the degree to which these risk parameters are being met and hold management accountable for compliance. The concept is sound – setting risk appetites and ensuring management meets them on an ongoing basis – but the particulars of each of the specific standards is, in some cases, mind-blowing.

Let me turn now to the new FRB rules – the ones with 184 new things for directors to do when they aren't worrying about shareholders. These include not only new requirements for risk-management committees to which I will turn in a moment, but also a set of specific capital, liquidity, stress-test and credit-risk standards over which boards must reign. Again, the concept is sound – these are vital prudential risks that affect shareholder value. But, the express requirements proposed by the FRB would keep most boards at work for weeks on nothing else. Take, for example, the liquidity-risk provisions in the notice of proposed rulemaking (NPR). These not only require the board to set risk appetite for liquidity risk in a disciplined, clear and accountable way, but also to:

- Approve the liquidity costs, benefits and risks of each significant new business line and product before the firm offers it. Annually, all significant activities would need specific liquidity-risk analysis by the board;
- on a quarterly basis, review cash flow projections, stress testing (doing this even more often if circumstances change) and relevant management information systems;
- on a quarterly basis, approve the size and composition of the liquidity buffer and of specific limits on liquidity-risk sources;
- periodic review of independent liquidity-risk validation;
- consideration of liquidity risk more frequently whenever circumstances warrant; and
- specification by board action the content of the management reports in this area it will consider.

Ouch! Should a board and its risk committee do all this even if it actually can? If SIFI boards set risk appetites – as well they should – then they need not judge risk down to each persnickety detail in every rule. That's what the company's risk-management staff supervised by the chief risk officers (CROs) mandated also in Dodd-Frank should do.

And, importantly, the more regulators make boards do what management should, the less governance the board in fact exerts. In the run-up to the crisis, boards blessed all sorts of risky activities they didn't understand, often because those presenting the latest variation on a complex structured financial product just looked so darn cool. That was a failure in risk governance – boards didn't push past complexity to question and test the fundamental assumptions underpinning financial products. But, if we now substitute for complex product presentations, even more daunting risk-management ones, boards will be just as flummoxed and, ultimately, just as supernumerary to a critical governance function.

## Making Materiality Matter

The problem in all of these proposals and an array of other financial-industry governance requirements on the books since Dodd-Frank is the lack of a materiality threshold. Because risk led to the financial crisis and boards overlooked it all too often, the corpus of new governance standards is premised on the need for directors to squash risk throughout even the most complex financial organization. We know that regulators say in many of their speeches that financial institutions must take on risk to serve their fundamental function, but this acknowledgement seems increasingly only a rhetorical flourish before the regulator goes on to defend rules like those I've outlined here today.

How much risk is so much that boards should be sure they understand it, expressly permit it and, then, ensure that only that much is in fact taken even as a complex firm responds to ever-changing industry and market conditions? In my view, this is the heart of the governance question confronting SIFI boards and, indeed, those of far smaller financial-services firms. Absolve the board of risk-management responsibility and, then, leave them unaccountable for disaster and we get what we got: a systemic financial crisis that created the gravest economic threat since the Great Depression. But, turn the dial up too high, and boards will be so overwhelmed by the latest in a series of demanding responsibilities that, over time, two things will happen: anyone who knows anything will find something better to do than sit on a board and those who do become financial-industry directors will, yet again, have a plausible defense against being held responsible for undue risk-taking. This time, it won't be because no one told them anything; now, it will be because they were told so much that sorting out who did what when will keep courts tied up in so many knots for so long that no one again will be held accountable for much of anything.

Better, I think, to give clear guidance in rule and – especially helpful – best practice as to how directors should undertake their urgent risk-management responsibility. This brings me back to the risk-appetite concept – requiring boards to understand how much shareholder equity and forward-looking revenue is put on the table for the biggest bets a firm's management wants to make. Recently, a group of global banking, securities and insurance regulators, the Financial Stability Board, has proposed a set of high-level principles laying out just how boards should set these risk appetites and, then, hold management responsible for them.[5] These principles do not go into the minutiae that take U.S. rules to lengths matched only by the Oxford English Dictionary; instead, they lay out clear standards that set the parameters for what boards can and should be required to consider when major new products are proposed, market conditions change, capital distributions are contemplated and other strategic decisions are presented to them.

Yes, I know, many financial products are extremely complex and, thus, the risks they present tempt one to demand the detail previously discussed. But, a few clear criteria can and should be set by each financial institution for how much is too much on the key criteria of credit, liquidity, operational, market, interest-rate, legal, reputational and similar risk factors. Then, when material changes are contemplated by management or presented by changing circumstance, the board can and should be able to assess if

previous thresholds may be transgressed and, if so, if this is warranted and reasonably offset by other strategic actions.

How hard is this? Plenty, but nowhere near as hard as it might seem from a read of all the new rules aimed at exactly this goal: ensuring that financial-institution boards take reasonable care with the capital entrusted to them so that no one is hurt in the making of their decisions. Sometimes, things still go wrong – that's why SIFIs are supposed to be private-sector firms, not utilities dedicated to a public mission. But, when they do go wrong, boards should have done all they could to prevent franchise risk and be held accountable when clear standards to which they could reasonably have been held responsible are neglected.

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Endnotes:

[1] Group of 30, *Toward Effective Governance of Financial Institutions* (Apr. 12, 2012), *available at* http://www.group30.org/images/PDF/TowardEffGov.pdf.

[2] *Id*. at 14.

[3] Financial Stability Oversight Council, Final Rule, *Authority To Require Supervision and Regulation of Certain Nonbank Financial Companies*, 77 Fed. Reg. 21637 (Apr. 11, 2012), *available at* https://www.federalregister.gov/articles/2012/04/11/2012-8627/authority-to-require-supervision-and-regulation-of-certain-nonbank-financial-companies.

[4] Federal Reserve System, Notice of Proposed Rulemaking, *Enhanced Prudential Standards and Early Remediation Requirements for Covered Companies*, 77 Fed. Reg. 594 (Jan. 5, 2012), *available at* http://www.gpo.gov/fdsys/pkg/FR-2012-01-05/pdf/2011-33364.pdf.

[5] Financial Stability Board, *Thematic Review on Risk Governance* (Apr. 3, 2012), *available at* http://www.financialstabilityboard.org/publications/r_120404.pdf.