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OCC Seeks to Formalize Risk Governance Expectations of Large Banks

The proposed guidelines demonstrate the Office of the Comptroller of the Currency's continued emphasis on strong risk management for large banks.

On January 16, the Office of the Comptroller of the Currency (OCC) issued proposed rules and guidelines establishing minimum risk governance standards for certain large insured financial institutions (the Proposed Guidelines).[1] The content of the Proposed Guidelines is not unexpected; as the OCC states in its commentary to the Proposed Guidelines, its intention is to formalize the "heightened expectations" that it has been applying for the last several years during its supervision and examination process. Overall, the Proposed Guidelines are a continuation on a regulatory theme that has been paramount since the financial crisis—robust risk management and risk management accountability. However, the potentially broad scope of applicability of the Proposed Guidelines, as well as the formalization of what have been softer regulatory "expectations," may result in unforeseen consequences for some financial institutions that would otherwise not expect to be subject to the same risk management expectations as large banks.

Scope of Applicability

The Proposed Guidelines would generally apply to insured national banks, insured federal savings associations, and insured federal branches of foreign banks with average total consolidated assets of $50 billion or more (each a Bank, and collectively Banks). The OCC retains the authority to apply the Proposed Guidelines to a financial institution whose total consolidated assets are below $50 billion if the OCC determines that such entity's operations are highly complex or otherwise present a heightened risk as to require compliance with the Proposed Guidelines. The Proposed Guidelines would require the risk governance standards to be developed at the Bank level, unless the risk profiles of the Bank's parent company and the Bank are "substantially the same," in which case, the Bank may use its parent's risk governance framework. In turn, parent company and Bank risk profiles would be considered "substantially the same" if the Bank's total consolidated assets, total assets under management, **or** total off-balance sheet exposures represent 95% or more of the parent company's corresponding assets, assets under management, or off-balance sheet exposures.

The OCC notes that it may apply the Proposed Guidelines to smaller banks (with less than $50 billion in total consolidated assets) that are subsidiaries of the same parent company if the total consolidated assets of the banks and their holding company is $50 billion or more. The OCC also asks for input on whether the Proposed Guidelines should apply to uninsured entities, such as trust banks and federal branches or agencies of foreign banks. Currently, the heightened expectations regarding risk management are applied informally to a select number of these uninsured entities.

In addition, the OCC is applying a version of the "Hotel California rule" to the applicability of the Proposed Guidelines—meaning that once a Bank becomes subject to the Proposed Guidelines, it would be required to comply with the Proposed Guidelines even if its average total consolidated assets drop below $50 billion, unless

1. OCC Guidelines Establishing Heightened Standards for Certain Large Insured National Banks, Insured Federal Savings Associations, and Insured Federal Branches; Integration of 12 CFR Parts 30 and 70 (proposed Jan. 16, 2014), *available at* http://www.occ.gov/news-issuances/news-releases/2014/nr-occ-2014-4a.pdf.

or until the OCC determines otherwise. The OCC retains the discretion to determine whether continued compliance is necessary. There is no formal procedure for a Bank to petition the OCC for relief from the applicability of the Proposed Guidelines.[2]

Requirements Under the Guidelines

The Proposed Guidelines set an expectation that a Bank will establish a formal, written risk management policy (Framework) that covers credit risk, interest rate risk, liquidity risk, price risk, operational risk, compliance risk, strategic risk, and reputation risk. The Framework would be required to be reviewed and updated on at least an annual basis. The Proposed Guidelines identify three key organizational units—"front line units," "independent risk management," and "internal audit"—that are charged with the development, implementation, and testing of the Framework. In turn, the Proposed Guidelines set out, in some detail, the expected roles and responsibilities of the front line units and independent risk management in developing and implementing the Framework, with the overarching focus being on communication, independence, accuracy, and responsibility and "ownership."

Banks would also be required to develop a written three-year strategic plan that is developed by the CEO with input from the applicable business units (front line, risk management, and internal audit). The Bank's board of directors (Board) would be required to evaluate, approve, and actively monitor implementation of the strategic plan. In addition, each Bank will be required to have a comprehensive written statement (containing qualitative components and quantitative limits) that articulates that Bank's risk appetite; the written statement would serve as the basis for the Bank's Framework.

The Proposed Guidelines also set out heightened expectations of the Bank's Board, mostly concerning the independence of the Board from the Bank's parent company and the Board's role in managing and overseeing risk management. Significantly, each Bank's Board would be required to have at least two independent members who are not part of the Bank's or its parent company's management.

Enforcement Authority

The Proposed Guidelines were issued pursuant to the OCC's safety and soundness authority under section 39 of the Federal Deposit Insurance Act (FDIA).[3] In proposing to issue the heightened expectation standards as "guidelines" rather than "regulations," the OCC stated that it will have more flexibility in determining corrective action for a financial institution's failure to comply with the Proposed Guidelines. Although such flexibility could be beneficial to a financial institution in that the OCC would not be required to seek a formal remedial plan and remediation can be individually tailored, such flexibility also risks injecting an element of uncertainty into the supervision and enforcement process. Decisions and conclusions will apparently be made by the OCC on a case-by-case basis.

In addition, if the OCC makes the determination to take formal corrective action, then the enforcement and compliance apparatus for such corrective action comes fully into play. By folding the Proposed Guidelines into the OCC's section 39 authority, the OCC would have the ability to initiate a formal, public enforcement action against a financial institution that the OCC finds to be not in compliance with the Proposed Guidelines. There would also be the possibility of civil money penalties for failure to comply with the Proposed Guidelines.

Comments to the Proposed Guidelines are due 60 days after their publication in the *Federal Register*.

Ramifications

As mentioned, the Proposed Guidelines formalize what the OCC has been informally expecting during its examination process. This formalization may benefit banks in providing clarity and transparency to the OCC's risk

2. The notice and response procedures of 12 C.F.R. § 30.4 would apply to any determination by the OCC that the Proposed Guidelines should no longer apply to a particular Bank. These procedures, however, are OCC-initiated only.

3. 12 U.S.C. § 1831p-1 (Section 39 was added to the FDIA by section 132 of the FDIC Improvement Act of 1991 (Pub. L. No. 102-242).

management expectations as well as more specific guideposts for establishing a satisfactory risk management Framework. Compliance with the Proposed Guidelines will likely involve a great deal of time and effort; the OCC's official burden hour estimate is more than 7,000 hours per Bank, which may be low, especially if a Bank cannot rely on its parent company's Framework. Yet, in the postcrisis regulatory environment, a strong and well-documented risk management Framework has become an essential best practice. However, under the Proposed Guidelines, the OCC would have enforcement authority for failure to establish adequate risk management controls, including formal orders and civil money penalties for failure to comply.

Another notable feature of the Proposed Guidelines is the OCC's statement of agency expectations for a Bank's Board. By specifying the actions that Boards are required to take under the Proposed Guidelines, the OCC is taking steps, backed by the regulatory enforcement process, to formalize a key aspect of the overall board of directors governance process. The OCC will almost certainly be taking a close look during examinations for evidence of the independence of Bank Boards and robust Board oversight.

Additionally, one important issue that remains unclear is the effect of the Proposed Guidelines on banks below the $50 billion threshold and uninsured institutions and whether the OCC will apply the Proposed Guidelines to those institutions formally or informally. Given the flexibility that the OCC has given itself to apply the Proposed Guidelines based on an overall assessment of the risk profile of the institution, certain smaller banks or uninsured institutions conceivably may find themselves being placed under the Proposed Guidelines and faced with a burdensome administrative process if they attempt to challenge the OCC's determination, although the OCC suggests that would be an infrequent occurrence. Perhaps more interesting is the possibility that the Framework standards, which presumably are intended to reflect a "gold standard" in bank risk management, may filter down into the risk management supervisory activities and expectations of the OCC examination corps across the board.

Finally, there has yet to be any indication from the Federal Reserve or the Federal Deposit Insurance Corporation (FDIC) as to whether they plan to issue similar risk management guidelines. In this regard, FDIA section 39 requires the Federal Reserve and the FDIC, as well as the OCC, to prescribe safety and soundness standards for insured depository institutions in general. This is typically done on an interagency basis—the original safety and soundness standards were jointly issued by the Federal Reserve, the OCC, and the FDIC (and the now-defunct Office of Thrift Supervision).[4] Therefore, it would not be unexpected for the other two regulatory agencies to weigh in with their own guidelines, although the Federal Reserve and the FDIC combined currently supervise significantly fewer banks of $50 billion or more than does the OCC. If the other banking agencies elect to propose risk governance standards for their constituent depository institutions, we would anticipate a coordinated approach among the agencies and the proposal of substantively similar requirements by the other agencies.

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4. These guidelines are found in Appendix D-1 to 12 CFR Part 208.

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