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BANKING & FINANCE | A SPECIAL REPORT

The Consumer Financial Protection Bureau hasn't been shy about asserting its authority, securing concessions through the threat of litigation that go beyond what's possible from formal rulemaking. We examine the bureau's tactics in this special report, also looking into federal overseers' increased willingness to go after individual corporate officers and the heightened scrutiny on corporate directors.

Risk-Management Burden Grows for Directors

Regulators appear to be demanding closer management oversight at financial institutions.

BY M. PATRICIA OLIVER

The life of financial institutions in this post-Dodd-Frank Act era has been a topic of continuing discussion among industry leaders and a matter of intense political debate. A major focus has been the increased regulatory and compliance burdens, more stringent exam standards and heightened focus on enterprise risk management for banks and thrifts of all shapes and sizes. To date, however, little attention has been paid to what these changes mean to the perceived role of some key players entrusted with overseeing their implementation.

Over the years, I have counseled directors of community and regional banks about their fiduciary duties in many different contexts—including informal discussions with interested candidates; onboarding sessions for newly elected directors; and governance updates at planning retreats. In the pre-recession days, these presentations would focus on the duty of care and the duty of loyalty under applicable state corporate law, coupled with whatever regulatory mandates and real-life examples were pertinent to that client's circumstances.

As I prepared last month for a governance update at a national bank client's planning retreat, I was struck by how much recent emphasis the regulators have been putting on enterprise risk management and, in particular, the duty of directors to provide effective risk oversight. My presentation focused largely on the continuing evolution of enterprise risk management and the ever increasing regulatory emphasis on overseeing an institution's risk-management framework, along with its risk-related policies, processes and personnel.

For instance, during the client's planning retreat we reviewed the Office of the Comptroller of the Currency's guidance on capital planning published in June 2012 (OCC Bulletin 2012-16). Although on its face the Bulletin deals with capital adequacy and the key components of a capital planning process, risk-identification and risk-management techniques are imbedded in the discussion.

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Without addressing it specifically, the Bulletin essentially serves as an enterprise risk-management primer. We also discussed the more direct comments on the board's role made by Deputy Comptroller Carolyn DuChene in her speech at a community banking enterprise risk-management seminar on Oct. 22, 2012. In particular, we talked about the critical tie between enterprise risk management and a bank's strategic planning process, and the need for a "fully loaded" strategic plan that covers specific risks as well as risks across all business lines.

Finally, we spent time reviewing the parameters of the Office of the Comptroller's guidelines dealing with "Heightened Expectations Regarding Risk Management Standards and Governance" issued in early September 2014 (12 C.F.R. Part 30, Appendix D).

FIVE HEIGHTENED STANDARDS

In discussing the five heightened standards outlined in these guidelines, we focused on:

- The risk-governance framework that needs to be created, which encompasses front-line business units.
- The need for an independent risk-management function as well as an internal audit function.
- The board's role in overseeing this risk framework and the independent risk function.
- The board's role in overseeing a strategic plan that includes a comprehensive risk analysis and assessment.
- The requirement for active oversight over a bank's risk-taking activities that includes having directors question, chal-

lenge and, in some cases, oppose management's recommendations.

We also explored what these guidelines may mean for banks and thrifts (beyond the systemically significant institutions they technically apply to), whether raised as a safety and soundness concern during an examination or as an evolving industry "best practice" that regulators encourage all banks and thrifts to embrace.

At the bank holding company level, we explored the Federal Reserve Board's governance approach to risk management as part of the Dodd-Frank reforms (Section 165) that went into effect as a final rule in February 2014. Again, we considered the future domino effect on the community-sized banking world of having to create a board risk committee consisting of inde-

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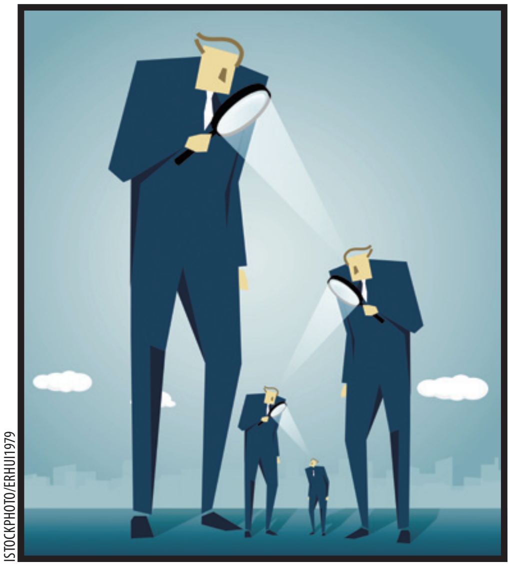
pendent directors, and in some instances, designating a chief risk officer.

We rounded out our discussion with a review of case law addressing breach of fiduciary duty claims in some of the failed bank lawsuits, including the Federal Deposit Insurance Corp.'s claim that the business-judgment rule defense should not be available in such situations.

To make things even more interesting, I handed out Federal Reserve governor Daniel Tarullo's commentary from June 2014, proposing further study of expanding the fiduciary duties of bank directors to explicitly cover risk oversight, along with a lowering of the standard for breach to a simple negligence standard (rather than traditional, gross negligence).



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In summary, all this made for a very different discussion of director fiduciary duties, with a distinctive risk-management oversight flavor that permeated the entire presentation. As a practical matter, however, my assessment is that bank directors have always been responsible for risk oversight. For national banks, the Director's Book makes this abundantly clear. Although the book has not been updated yet to specifically address enterprise risk management-related duties, I expect that will happen in the Office of the Comptroller's next edition.

Now that we are talking about some version of enterprise risk management as a necessary (and, in my mind, desirable) industry practice for financial institutions of all asset sizes, the Bulletin and the 2012 commentary from the Office of the Comptroller are helping banks figure out how best to make enterprise risk management part of their operations.

BIGGER ROLE FOR DIRECTORS

Likewise, the governance structure around risk management offered by the Federal Reserve under Section 165 of Dodd-Frank is a useful guide for holding companies striving to integrate enterprise risk management. However, the more recent guidelines, while beneficial in identifying the key players needed for an effective risk-management framework and their respective roles, seem to go beyond what is necessary by putting directors of our largest financial institutions dangerously close to managing the bank as they engage in the active, "credible challenge to management" oversight that the guidelines require.

Although this enhanced focus on enterprise risk management and director oversight may give some directors pause, for the most part they are up to the challenge and are quite focused on incorporating enterprise risk management as a useful management tool for their respective institutions.

However, they may not be willing to accept expanding their fiduciary obligations to a level (not applied to any other industry) that would hold them personally accountable for risk-management

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errors based on a simple negligence standard. Banking is a complex, sophisticated, changing industry and we need to attract the best and the brightest to our bank and thrift boards.

There could be a dramatic chilling effect on finding new, capable bank directors and retaining some of our talented, seasoned directors, if we either expand their fiduciary duties or lower the legal standard by which their actions are judged, or a serious effort is launched to amend state corporate laws to effect such sweeping changes.

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