Sarah A. Miller
Chief Executive Officer
E-mail: smiller@iib.org

INSTITUTE OF INTERNATIONAL BANKERS

299 Park Avenue, 17th Floor
New York, N.Y. 10171
Direct: (646) 213-1147
Facsimile: (212) 421-1119
Main: (212) 421-1611
www.iib.org

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regs.comments@federalreserve.gov

Ann E. Misback
Secretary
Board of Governors of the Federal Reserve System
20th Street and Constitution Avenue, N.W.
Washington, DC 20551

Re: Proposed Guidance on Supervisory Expectation for Boards of Directors (Docket No. OP-1570)

Dear Ms. Misback:

The Institute of International Bankers ("IIB") appreciates the opportunity to offer these comments on the Federal Reserve Board's ("FRB") proposal addressing supervisory expectations for boards of directors.[1] The Proposal consists of three parts: (1) proposed supervisory guidance addressing effective board of directors (the "Proposed BE Guidance");[2] (2) a refocus of supervisory guidance found in existing Supervision and Regulation ("SR") letters, and (3) proposed guidance that clarifies expectations for communicating supervisory findings to an institution's board of directors and senior management. The Proposed BE Guidance would be a central feature of the "Governance and Controls" component of the new rating system the FRB has proposed for large financial institutions ("LFIs"),[3] together with the recently proposed guidance describing core principles of effective senior management, the management of business lines, and independent risk management and controls for LFIs.[4]

The Proposed BE Guidance does not apply to the U.S. intermediate holding companies ("IHCs") of foreign banking organizations ("FBOs") established under Regulation YY, but the FRB anticipates proposing at a later date board effectiveness guidance for IHCs and has requested specific comment on

[1] 82 Fed. Reg. 37219 (Aug. 9, 2017) (the "Proposal").

[2] The Proposed BE Guidance applies to the board of directors of U.S.-headquartered bank holding companies ("U.S. BHCs") and savings and loan holding companies which have total consolidated assets of $50 billion or more (together with U.S. BHCs, "U.S. Holding Companies").

[3] See 82 Fed. Reg. 39049 (Aug. 17, 2017) (the "LFI Rating System Proposal"). Today the IIB submitted comments on the LFI Rating Proposal.

[4] See 83 Fed. Reg. 1351 (Jan. 11, 2018) (the "Management Proposal).

The Institute's mission is to help resolve the many special legislative, regulatory and tax issues confronting **internationally headquartered** financial institutions that engage in banking, securities and/or insurance activities in the United States.

how the Proposed BE Guidance should be refocused and adapted to apply to boards of IHCs. All FBOs that are required to establish IHCs under Regulation YY are members of the IIB and would be directly affected by any such guidance. Accordingly, our comments focus primarily on how the Proposed BE Guidance might best be tailored to recognize the unique characteristics of IHCs and their boards. As discussed below, the question of how to adapt the BE Guidance to the circumstances of IHCs entails the related question of how IHCs will be assessed under the "Governance and Controls" component of the LFI Rating System Proposal. While our principal concern in this letter is the IHC question, we also relatedly suggest that, when revisiting SR letters concerning the role of boards of U.S. Holding Companies, the FRB should adopt appropriate adjustments for their application to FBOs.

The Proposed BE Guidance identifies five key attributes of effective boards of directors to sharpen boards' focus on performing their core responsibilities, and it appropriately distinguishes supervisory expectations for boards from those of senior management. As the FRB's multi-year review of board practices revealed, supervisory expectations for boards of directors and senior management have become increasingly difficult to distinguish, resulting in boards frequently devoting significant resources in satisfying supervisory expectations that do not relate to the boards' core responsibilities.

The Proposed BE Guidance represents a welcome delineation of board and senior management responsibilities. The extensive reforms adopted in the wake of the financial crisis have significantly expanded the role and responsibilities of directors of large banking firms. To a considerably greater extent than before the crisis, board approval of the firms' strategy and associated risks requires directors to oversee such critical and complex matters as stress testing, capital and liquidity requirements and resolution planning. Additionally, directors must evaluate the overall compensation practices of the firms on whose boards they sit so that the correct incentives are in place to encourage positive behavior and culture.

Importantly, the Proposed BE Guidance does not reduce but rather refocuses board responsibilities. As Chairman Powell has commented, the proposed reforms do not "lower the bar for boards or lighten the loads of directors," rather the reforms are intended to allow strong and effective boards to provide strategic direction and oversight, free from the granular specifics of supervisory guidance.[5]

As discussed below, in determining how the Proposed BE Guidance should be adapted and tailored to IHCs it is critical to focus on two characteristics of IHCs that fundamentally distinguish them from the U.S. Holding Companies with respect to which the Guidance has been developed:

1. An IHC is an *intermediate* holding company that operates as part of a larger, global group. In stark contrast to U.S. Holding Companies, each of which is the publicly-traded, U.S.-headquartered, top-tier entity of its group, an IHC is a U.S. subsidiary controlled, directly or indirectly, by a single shareholder that is organized and headquartered, and conducts a broad array of activities, outside the United States – its parent FBO, which itself is subject to

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[5] See Remarks by Governor Powell, "The Role of Boards at Large Financial Firms" delivered at the Large Bank Directors Conference, Chicago, IL, Aug. 30, 2017.

consolidated regulation by the appropriate home country authority and whose board of directors is subject to the requirements of its home country's corporate governance framework. This structure imposes important constraints on IHC board members, including with respect to their role in setting strategy and risk tolerance, and their control over allocation of budgetary, funding and other resources, as well as compensation.

2. As permitted under Regulation YY, many FBOs have elected to have the risk committee of their IHC board also serve as the risk committee for their combined U.S. operations ("CUSO"), including, notably, the FBO's U.S. branches and agencies. Given the regulatory mandate of having a U.S. risk committee, we believe this flexibility is helpful, but it raises especially challenging governance issues as it places in the hands of the IHC board responsibility for operations that are not part of the IHC.[6]

The IIB believes that, with appropriate adaptation as discussed below, it would be beneficial for the FRB to propose guidance that addresses both of these distinguishing characteristics and clarifies the FRB's corresponding supervisory expectations for IHC boards. Importantly, this approach should be sufficiently flexible to take into account and facilitate its application to the particular organizational and business circumstances of an FBO's U.S. operations, as well as the consolidated supervision applicable to the FBO itself in its home country. As discussed below, the IHC's status as a subsidiary of its parent FBO is an essential consideration in adapting the BE Guidance, but that guidance would be limited to the board of the IHC and not extend to the board of the parent FBO. We would anticipate that such guidance, like the Proposed BE Guidance applicable to U.S. Holding Companies, would enhance the safety and soundness and resiliency of both FBOs' IHCs and, as applicable, their CUSO.

DISCUSSION

The governance provisions of Regulation YY require IHCs to be governed by a board and have a U.S. risk committee of the board consisting of at least one independent member and one member with experience in identifying, assessing and managing risk exposures of large, complex financial firms.[7] As mentioned above, more often than not these same risk committees also serve as the FBO's CUSO risk committee. Respectful of the goals of Regulation YY and despite the fact that Regulation YY only requires one independent member of the IHC risk committee, FBOs, required to establish IHCs, have often appointed several independent directors to their boards and established additional board committees.

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[6] In contrast to the Proposed BE Guidance, which expressly excludes IHCs from its coverage, the Management Proposal expressly includes both IHCs and all other components of CUSO within its scope. The core principles contained in the proposal and applicable to FBOs are derivative of those developed with U.S. Holding Companies in mind. As we will discuss in our letter on the Management Proposal, we believe the FRB instead should a more direct and comprehensive approach to the application of the core principles to FBOs in order to, among other things, better reflect the significant challenges presented in integrating BE Guidance for IHCs with core management principles for FBOs' CUSO.

[7] See 12 C.F.R. § 252.153(e)(3).

Proposed BE Guidance

The Proposed BE Guidance posits that a board is most effective when it focuses on establishing a firm-wide corporate strategy and setting the types and levels of risk it is willing to take ("risk tolerance") and then makes certain that senior management effectively carries out that strategy within the established risk tolerances and holds management accountable for doing so through effective risk management and compliance. The Proposed BE Guidance highlights the following five key attributes of an effective board:

- Set Clear, Aligned and Consistent Direction;
- Actively Manage Information Flow and Board Discussions;
- Hold Senior Management Accountable;
- Support the Independence and Stature of Independent Risk Management; and
- Maintain a Capable Board Composition and Governance Structure.

Importantly, these five key attributes are intended to provide a framework for assessing a firm's board of directors that appropriately recognizes differences in firms' business models, risk profiles and complexity and rejects the current supervisory approach that employs a standardized approach for evaluating boards. The IIB strongly supports an approach to FRB board supervision that is tailored and based on the specifics of a firm's business strategy and risk.

This same approach should guide any future FRB proposed guidance for IHC board governance. The Proposed BE Guidance contemplates, appropriately so, that the boards to be assessed under the framework are top-tier parent company boards.[8] As their name denotes, IHC boards are not top-tier parent boards but rather intermediate boards formed as required under the FRB's Regulation YY with responsibility for overseeing the FBO's U.S. non-branch operations within the parameters established by the board of the parent FBO.[9] As such, IHC boards are in a markedly different position than that of a top-tier parent company board of a publicly-traded U.S. Holding Company. Accordingly, any future FRB governance guidance applicable to IHC boards should be sufficiently tailored to recognize these differences.

For example, the Proposed BE Guidance provides that boards are most effective when directors focus on establishing a firm-wide corporate strategy, set the types and levels of risk and then ensure that senior management follows the board's direction. Corporate strategy and risk tolerance are critical responsibilities for IHC boards, but the purview of those responsibilities is necessarily limited to the IHC (and, where applicable, oversight of CUSO risks), and an IHC board's ability to exercise its authority in

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[8] Indeed, the FRB noted that in developing the Proposed BE Guidance that it consulted with other statutory and regulatory authorities that impose requirements on company boards, including, among other sources, public company requirements under Securities and Exchange Commission regulations and various listing requirements. As a general matter, these requirements apply only at the top-tier parent level.

[9] It merits noting that, in contrast to U.S. Holding Companies, in some countries the parent FBO has a two-tier board structure, which should be taken into account when assessing the relationship between the boards of the IHC and parent FBO.

these areas is subject to budgetary, funding and other resource constraints beyond the directors' direct control. Unlike the boards of parent company U.S. Holding Companies, IHC boards do not set global, firm-wide corporate strategy and risk tolerance. Rather, it is the FBO parent company board that approves global strategy on the firm's global business mix and its global risk tolerances, and the board of the parent FBO, like the board of a U.S. Holding Company, controls the allocation of resources across the bank's global operations, including, of course, those outside the home country. In addition, in the critical area of compensation, an IHC board may be constrained by requirements prescribed by the home country which apply globally. The IHC board, in turn, oversees appropriate implementation at the local level of the global parent company's strategic, risk appetite and resource allocation decisions.

Further, and unlike parent company boards of firms which are generally publicly held, IHCs generally have only one shareholder —the global parent – and it is the parent FBO to which the directors have fiduciary duties. Other stakeholders with a vested interest in the IHC operations include the home country regulator that has an interest in ensuring that the global banking operations, including its U.S. operations, are effectively managed on a global "enterprise wide basis", that may include the application of certain home country laws, regulation and supervisory activity,[10] just as is so with respect to U.S. Holding Companies vis-à-vis the Federal Reserve and other U.S. regulatory authorities.

However, it is important to underscore that IHC boards are not powerless in relation to their parent FBOs and have critical and very real obligations for oversight of the IHC's operations as a separate legal entity. While as a corporate governance matter IHC directors must act in the best interests of their single shareholder, at the same time they must discharge their responsibilities within the limits of applicable laws and regulations, including most notably the requirements prescribed in Regulation YY.

1. Board Responsibility for Strategy and Risk Tolerance

The Proposed BE Guidance discusses more fully board responsibilities with respect to developing and approving strategy; setting types and levels of risk and giving clear, aligned and consistent direction to senior management.[11] For IHC boards, this section should be realigned to recognize the limits of their authority, namely to oversee the appropriate implementation of the global parent company's strategic, risk and resource allocation decisions.

Similarly, this section calls for the board to assess whether the firm's significant policies, programs and plans concerning, among others, capital, recovery and resolution, liquidity management and incentive compensation are consistent with the firm's strategy, risk tolerance and risk management capacity. Any proposed guidance applicable to IHC boards should properly recognize that many of these significant policies and programs, like strategy and risk tolerance, as well as compensation decisions, are global

[10] For example, the requirements regarding remuneration policies set forth in Articles 92 - 95 of EU's Capital Requirements Directive (EU Directive 2013/36/EU) and Article 450 of the Capital Requirements Regulation (Regulation (EU) No 575/3013)).

[11] These issues are particularly relevant with respect to the discussion under the first key attribute, "A. Set Clear, Aligned and Consistent Direction".

issues managed by the parent and that, within this framework, the IHC board is responsible to, and may act only within the limits established by, the parent for directing the adaptation of the IHC's business and activities to achieve, among other things, an acceptable risk profile, taking into account the decisions made at the parent FBO level.

An IHC board must clearly and accurately communicate the global board's strategy, risk tolerance and resource allocation to senior management for their implementation and oversee that implementation. If clearly articulated, senior management is in a better position to ensure that the audit, compliance, risk management and control functions have the necessary tools to ensure effectiveness. Unlike the CRO of a top-tier U.S. Holding Company, who has firm-wide, global responsibilities for setting risk limits, the IHC CRO's "firm-wide" focus is limited to the IHC (and, pursuant to Regulation YY, the CUSO), the CRO must establish those limits within the constraints set by the parent FBO's global risk limits and in a manner consistent with the parent FBO's global strategy and risk appetite.

IHC directors have some latitude in discharging their duties to the parent FBO shareholder, but their discretionary authority is dependent to a large degree upon the support of the parent company and its management. If the IHC board and its management disagree with global management (or, as the case may be, the parent's board), the IHC Board generally may escalate the issue to parent company management for review and subsequent follow-up. Alternatively, the directors must direct their efforts to adapting the IHC's activities in order to achieve an acceptable risk profile, taking into account decisions made at the parent.

Similar considerations apply where an FBO has elected under Regulation YY to empower the IHC risk committee to exercise oversight responsibilities with respect to the U.S. branch network. U.S. branches are offices of the parent bank and, as such, directors of the global parent are charged with responsibility for overseeing strategy implementation and risk. IHC risk committee members when fulfilling their responsibilities under Regulation YY with respect to the operations of the U.S. branches of the FBO are not acting as "directors" when overseeing the branch network, rather their duties with respect to the branch network are specified under contract with, or delegation from, the global parent.

Importantly, escalation techniques may differ depending on the organization. Different banks have different organizational and business structures, as well as different decision-making structures. For example, some IHCs have Head Office personnel sit on the IHC Board. Others may also have the same personnel serve on the IHC's risk committee. Under these structures, escalation to "Head Office" effectively occurs during the course of the board and risk committee meetings. Other banks have a different business model where personnel from the global board and risk committees do not overlap with those serving on the U.S. IHC board and risk committee. In these situations, escalation occurs through communication to the global board or global risk committee as appropriate. The FRB should be indifferent to these organizational and escalation methods so long as the particular IHC structure and escalation techniques work together to promote sound risk management and solid decision making at the IHC and the global parent with respect to U.S. IHC and CUSO activities. Any FRB guidance should take this relationship into account.

2. Managing Information Flows and Board Discussions

The second key attribute for an effective board of directors requires that the board actively manage its information flow to allow for informed decision-making. To do this, the Proposed BE Guidance suggests that an effective board should direct senior management to provide information that is timely and accurate with the appropriate level of detail and context.

The IIB agrees that for a board to be effective the information flows to the board must be actively managed. This has been challenging for internationally active financial firms generally given the pace and complexity of new, significant and complex regulations adopted here and abroad post-crisis but especially so for FBOs required, by regulation and for no organic business purpose, to form an IHC. As the governing body of a subsidiary organization, IHC boards are responsible for communicating to the global board their recommendations with respect to the impact new U.S. regulatory requirements may have on the global parent's business strategy and resource allocation. The degree to which the IHC board successfully manages the flow of information on these matters from its senior management influences the quality of these recommendations and is important to the proper functioning of the IHC board, but the impact of those recommendations on the global board, and the resulting implications for the IHC's strategy and operations, is considerably more limited. We would urge the FRB to bear in mind these constraints in drafting board effectiveness guidance for IHCs in this area.

Relatedly, we believe that the FRB's recent proposals to increase transparency with respect to stress testing and CCAR processes could assist with managing information flow and board discussions and, thereby, strengthen the effectiveness of that regime. With greater transparency, senior management would be expected to have additional time to digest supervisory initiatives, develop a recommended approach for allocating resources to build out implementation, and prepare written summaries and other briefings for board members so that board members can make sound and well-informed decisions. These same principles of transparency should also guide supervisory authorities in their approach to other equally significant supervisory requirements, including the net stable funding ratio, single counterparty credit limits and the fundamental review of the trading book.

3. Board Composition and Governance Structure

The fifth attribute provides that an effective board has the composition, governance structure, and established practices that support governing the firm in light of its asset size, complexity, scope of operations, risk profile and other changes over time. FBOs have adopted a number of practices to ensure that the IHC boards can operate effectively. Board members are drawn from a pool of qualified candidates who demonstrate understanding and expertise with respect to the particular business model, size and complexity of the FBO's U.S. operations. For example, an FBO with both a sizeable retail and investment banking presence in the U.S. can be expected to recruit board members with the requisite business acumen in both retail and investment banking to guide the IHC and provide their insights to the global parent. Similarly, and as noted above, FBO IHC governance structures vary widely in terms of the number of independent IHC directors serving on IHC boards, beyond the one independent risk committee member required under Regulation YY, and the number of IHC board committees and the composition of their members.

Any forthcoming board effectiveness guidance with respect to IHC boards must recognize that IHC boards are *intermediate* boards. IHC board members must understand and have an appreciation of how the IHC fits within the parent's global operations and the legal and regulatory framework in which the FBO operates and the real limits that result from both the corporate structure and home country regulation. As such, membership on the IHC board is generally a matter best left to the determination of the global parent.

The Proposed BE Guidance suggests that it may be appropriate for a board of directors to provide supervisors with a self-assessment of its effectiveness relative to the five attributes. The FRB would use the assessment in evaluating the firm's compliance with proposed guidance. The IIB is strongly opposed to incorporating self-assessments into the BE Guidance in any manner. In the post-Sarbanes-Oxley Act environment, board self-assessments generally have proved to be useful tools in encouraging frank and open discussion among board members on ways to improve their individual and group effectiveness. However, sharing these self-assessments with regulators and incorporating them into a supervisory assessment of the board's effectiveness would undermine the usefulness of this tool. There is a very real risk that including a board self-assessment in the supervisory process, whether or not it would factor into the formal supervisory assessment of the firm's governance, would conflict with directors' exercise of their judgment in overseeing the affairs of the firm and chill the willingness to be frank and thorough, which will limit the utility of this tool. In our view, self-assessments should be left to the sole purview of the board of directors and excluded from the supervisory process entirely.

Applying the Governance and Controls Component of the Proposed LFI Rating System to IHCs

The proposed LFI Rating System would replace the RFI rating system for evaluating LFIs and, as proposed, would apply to all U.S. Holding Companies and all IHCs. Under the proposed rating system, component ratings would be assigned for capital planning and positions, liquidity risk management and positions and governance and controls. A standalone composite rating would not be assigned. Finally, the FRB proposes to assign initial LFI ratings to all applicable firms during 2018.

When fully implemented, the Governance and Controls component rating would evaluate the effectiveness of a firm's (i) board of directors, (ii) management of core business lines and independent risk management and controls, and (iii) for domestic firms included in the Large Institution Supervision Coordinating Committee program only, recovery planning. The Proposed BE Guidance, when adopted, would guide the evaluation of the effectiveness of a firm's board of directors. As discussed above, the FRB recently issued its Management Proposal.

The proposed rating system is, according to the FRB, a natural extension of the LFI supervision framework first implemented in 2012 and is intended to be evolutionary and routine in most respects. The proposed rating system makes clear that if the Proposed BE Guidance or the Management Guidance are not adopted by the time the FRB finalizes the LFI Rating System, firms would be evaluated using existing supervisory guidance until such time that the additional governance and controls guidance is finalized.

The IIB is concerned that the LFI Rating System could go into effect after (or concurrently with) the adoption of final BE Guidance applicable to U.S. Holding Companies but *before* adoption of similar guidance with respect to IHCs. Accordingly, we would urge the FRB to address expeditiously any potential gap in supervisory guidance applicable to U.S. Holding Companies and IHCs by, for example, delaying measuring Governance and Controls under the proposed LFI Rating System until BE Guidance for both U.S. Holding Companies and, as appropriately adapted for IHCs, is adopted. Alternatively, and in consideration that the proposed LFI Rating System will not assign standalone composite ratings, the FRB could determine to apply only the capital planning and positions and liquidity planning and positions components of the proposed LFI Rating System to IHCs until such time as BE Guidance and Management Guidance, appropriately adapted for FBOs, is adopted. Under this latter approach, the Existing LFI supervision framework vis-à-vis governance would remain in place for IHCs during the interim period, and governance considerations relevant to the capital and liquidity components would be applied in a manner that ensures comparable treatment between IHCs and U.S. BHCs.

In this connection, we are concerned that the process in place for the FBO-related aspects of the BE Guidance, the governance component of the LFI Rating System, and the Management Guidance impede the type of comprehensive and integrated input and assessment necessary to ensure the most effective implementation of the new rating system as applied to IHCs. As discussed in the separate letter we have submitted today, a copy of which is included herewith, we recommend that the FRB adopt a holistic approach to these proposals.

Existing SR Letters Review

We welcome the proposed revisions to SR Letter 13-13, which are an essential step in better distinguishing the supervisory expectations for boards from the expectations placed on senior management.

In the same vein, we believe that the review of other SR letters proposed by the FRB, which is currently focused on U.S. BHCs, should, where appropriate, address the impact of these letters on FBOs. We recognize that the SR letters listed in the Board Proposal have the greatest applicability to U.S. BHCs. However, many also have significance for FBOs. These letters typically address FBO governance topics in less prescriptive ways, or are silent on how governance would translate in the FBO context.

Nonetheless, when undertaking a review of SR letters – as well as the anticipated "second phase" review of FRB rules and various forms of interagency guidance[12] – to lessen the granularity of supervisory guidance currently placed on boards, the FRB should be mindful of the impacts of these SR letters on FBO governance, both as regards FBOs that have an IHC and those FBOs that do not.

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[12] For example, it would be most helpful if the significant requirements placed on boards of directors under the Volcker Rule (see Appendix B, Section III. 4. at 79 Fed. Reg. 5536, 5803 (January 31, 2014)) and the U.S. risk committee requirements as prescribed in the FBO-specific provisions of Regulation YY were reviewed from a perspective similar to what we recommend in this letter. Taking a less prescriptive approach to these requirements, and one that more closely considers and gives due regard to, among other things, the relevance of home country governance laws and practices, would be consistent with the policy goals of the Board Proposal.

The Proposal states that supervisory expectations under SR letters for boards of larger firms would be revised to align with the Proposed BE Guidance.[13] Accordingly, our comments made above regarding the limitations of IHC boards and their CUSO responsibilities apply equally with respect to any such revisions. With respect to aligning supervisory expectations for both FBOs with U.S. operations having assets of less than $50 billion and those that do not have an IHC but have U.S. operations with assets of $50 billion or more, it is equally important to take into account the structural differences that characterize these operations, and the relevance of home country governance laws and practices, especially for those FBOs which operate largely through branches.

CONCLUSION

In conclusion, the application of the BE Guidance to IHCs should recognize that the IHC, as an *intermediate* holding company, operates within the larger regulatory framework of its parent FBO, which itself is subject to consolidated oversight by its home country authority. Further, and critically important, the board of the FBO global parent, and not the board of the IHC, sets global strategy and risk tolerance, including with respect to the FBO's U.S. operations. Guidance applicable to IHC boards accordingly should be appropriately tailored and focused upon supporting the U.S. risk management function of IHC boards and their risk committees. Similarly, the review of SR letters, as well as the proposed "second phase" review of FRB regulations and various forms of interagency guidance, should be appropriately adapted to reflect the circumstances of FBOs' U.S. operations.

We appreciate your consideration of our comments. Please contact the undersigned if we can be of further assistance.

Sincerely,

Sarah A. Miller
Chief Executive Officer

[13] See 82 Fed. Reg. at 37221.