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OCC Proposes Heightened Supervisory Standards for Large Insured National Banks, Insured Federal Savings Associations, and Insured Federal Branches

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The Office of the Comptroller of the Currency recently published proposed guidelines that would formalize heightened supervisory expectations for large national banks, federal savings associations, and federal branches of foreign banks. The authors of this article explain the proposed guidelines.

The Office of the Comptroller of the Currency (the "OCC") recently published proposed guidelines in the *Federal Register* ("Proposed Guidelines") that would formalize heightened supervisory expectations for large national banks, federal savings associations, and federal branches of foreign banks. The OCC already has been examining some large institutions under these heightened standards since 2012 and meeting with management of these institutions quarterly for progress updates. Through the Proposed Guidelines, the OCC seeks to make these heightened expectations formal, enforceable and potentially applicable to a greater number of institutions.

The Proposed Guidelines would require the development of structural functions, risk assessments, cultural support and oversight in order to meet the OCC's standards. The Proposed Guidelines would apply to any national

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bank, federal savings association and federal branch of a foreign bank, with average total consolidated assets of US$50 billion or greater (together "Covered Banks" and each a "Covered Bank"), as well as other institutions deemed highly complex or of heightened risk. The OCC is proposing these guidelines through its authority to prescribe safety and soundness standards under Section 39 of the Federal Deposit Insurance Act[1] ("FDI Act"). In accordance with this authority, the OCC has the discretion to require the submission of a compliance plan should the agency determine that a Covered Bank failed to meet the standards of the guidelines. The OCC requested comments on all aspects of the Proposed Guidelines by March 28, 2014.

SCOPE

The Proposed Guidelines apply to entities that the OCC has determined to be so large and/or complex that they require heightened expectations due to the exposure that they present to capital markets and the economy. These Covered Banks include insured national banks, insured federal savings associations and insured federal branches of foreign banks with average total consolidated assets of US$50 billion or more.[2] Once a Covered Bank crosses the US$50 billion threshold, it would remain subject to the Proposed Guidelines regardless of whether it fell below the threshold at a later date. The OCC would have to make a determination that a Covered Bank was no longer highly complex or of heightened risk in order for that Covered Bank to be relieved of heightened supervisory expectations.

The OCC could also apply the Proposed Guidelines to an entity with less than US$50 billion in average total consolidated assets if the OCC determined that the entity had highly complex operations or otherwise presented a heightened risk. In making that determination, the OCC would consider an entity's complexity of products and services, risk profile and scope of operations. On an informal basis, the OCC has already applied heightened expectations on mid-size banks below the Proposed Guidelines' US$50 billion threshold. Therefore it is likely that the OCC would use its discretion to apply the standards of the Proposed Guidelines to a number of mid-size banks.

The OCC limited the scope of the Proposed Guidelines to insured entities, making the Proposed Guidelines generally inapplicable to non-depository trust banks and other uninsured entities. However, the OCC has indicated that it may apply the Proposed Guidelines to certain uninsured entities at a later date, either informally through the issuance of a policy statement, or through a separate regulation.[3]

The Proposed Guidelines assimilate existing guidelines applicable to federal savings associations with national bank guidelines. Specifically, the *Guidelines Establishing Standards for Safety and Soundness* and the *Guidelines Establishing Information Security Standards* originally issued by the Office of Thrift Supervision would continue to apply to federal savings associations under regulations and guidelines that currently apply to national banks and federal branches of foreign banks. Also, *Guidelines Establishing Standards for Residential Mortgage Lending Practices*, which currently apply only to national banks, federal branches of foreign banks and their operating subsidiaries would, for the first time, also apply to federal savings associations and their operating subsidiaries under the Proposed Guidelines.

RISK GOVERNANCE FRAMEWORK

The Proposed Guidelines require Covered Banks to establish a risk governance framework ("Framework") for the management of risks inherent in their activities, and set forth minimum standards for the permissible design, implementation and oversight of the Framework. The Proposed Guidelines state that Covered Banks should address the following eight risk categories:

- credit risk;
- interest rate risk;
- liquidity risk;
- price risk;
- operational risk;
- compliance risk;
- strategic risk; and
- reputation risk.

The OCC also notes that it expects Covered Banks to address third party risk as well, even though it is not one of the eight designated risk categories.

The Proposed Guidelines also permit a Covered Bank to satisfy the Framework requirements through the risk governance framework of the Covered Bank's parent company ("Parent Company"). In order for this substitution to occur, a Parent Company must have a risk governance framework that meets the minimum standards of the Proposed Guidelines. Also, the Covered Bank must show through an annual documented assessment that the risk profiles of the Covered Bank and the Parent Company are substantially similar.

ORGANIZATIONAL STRUCTURE

The Proposed Guidelines require a Framework that engages three separate functions within a Covered Bank: front line units, an independent risk management department and an internal audit department.

Front Line Function

The front line units are the revenue generating business functions of the Covered Bank, as well as the support service departments such as legal, human resources, treasury, operations and information technology. The OCC expects these departments to own the risks of their activities. Under the Framework, these departments are responsible for providing ongoing assessments of the risks of their activities and establishing policies and procedures for managing these risks. These departments must report whether they are compliant with risk limits of the Framework to the Covered Bank's independent risk management department on at least a quarterly basis.

Independent Risk Management Department

Independent risk management (or risk organization or enterprise risk management) is the department within a Covered Bank responsible for monitoring aggregate risk. It creates the written Framework and updates it at least annually. The department also establishes risk management policies and processes for the Covered Bank and conducts ongoing monitoring of material risks.

Independent risk management must be subject to a reporting structure that maintains its independence from business lines and, at times, from the CEO of the Covered Bank. The head of the independent risk management department, the chief risk executive, must be one level below the CEO, and the Board or Board's risk committee approves the hiring, removal and compensation of this officer. The independent risk management department reports material risks of front line business departments to both the CEO and the Board or Board's risk committee. No front line business executive may oversee any independent risk management department. While the CEO may oversee the chief risk officer's day-to-day activities, the independent risk management department must report to the Board or Board's risk committee whenever its assessment of risk differs from the CEO's or when the CEO is not holding front line units accountable to the Framework.

Internal Audit Department

The internal audit department assesses the effectiveness of the Framework. Through an audit plan, this department evaluates whether the front line units and the independent risk management department are compliant with the policies and processes developed through the Framework. The internal audit department must maintain an exhaustive inventory of the Covered Bank's business lines, product lines, services, and functions, then assess the risks of these areas. The OCC has requested comment as to whether, in addition to the internal audit department, the independent risk management department should also be required to maintain a separate additional inventory of a Covered Bank. Through internal audit's inventory of the Covered Bank and corresponding risk assessment, the department should create an audit plan for rating the risks of each front line unit, product offering and service including services outsourced to third parties. The department must update the audit plan at least quarterly. The department should also utilize the audit plan ratings to conduct an independent annual assessment of the Framework culminating in a conclusion as to whether the Covered Bank is compliant with the Framework and whether the Framework is consistent with leading practices in the industry.

Internal audit must also notify the Board's audit committee whenever there are significant deviations from the Framework by front line units or the independent risk management department.

The internal audit department must be independent of any front line department and the risk management department. The head of internal audit, the chief audit officer, must be one level below the CEO, and the Board's audit committee is responsible for approving the hiring, removal or compensation of this officer. The CEO or the Board's audit committee may supervise the day-to-day activities of the chief audit officer, but no executive of a front line department may oversee the chief audit officer.

RISK GOVERNANCE FRAMEWORK REQUIREMENTS

In addition to organizational and structural elements, the Proposed Guidelines also require several written components to the Framework including a strategic plan, a risk appetite statement, a risk profile, and concentration risk limits.

Strategic Plan

The CEO of the Covered Bank is responsible for developing a written strategic plan covering at least a three-year period. The strategic plan must state the mission of the organization, strategic objectives and the manner in which these objectives will be achieved. The strategic plan must also assess current and future risks of the Covered Bank and explain how the Framework will evolve to address anticipated risks. The strategic plan itself must also evolve should the Covered Bank's risk profile change. The Board must approve the strategic plan and evaluate its implementation on at least an annual basis.

Risk Appetite Statement

The Covered Bank must develop a comprehensive risk appetite statement articulating the organization's risk tolerance in both qualitative and quantitative manners. Qualitatively, the risk appetite statement should describe the organization's risk culture and leadership's expectations regarding how risks should be treated, especially those risks that are not easily quantifiable. The quantitative component of the risk appetite statement should specify limits related to the earnings, capital and liquidity positions of the Covered Bank. These limits may be in the form of triggers, thresholds or impermissible activity boundary lines and they must be crafted to induce a proactive risk management response. Accordingly, the OCC has discouraged the use of indicators such as delinquencies, problem asset levels and losses as risk appetite limits and encouraged the use of stress testing to set the limits. The risk appetite statement must be approved by the Board or Board's risk committee and explicitly communicated and reiterated throughout the organization.

Risk Profile

The risk profile is an assessment of a Covered Bank's aggregate risks at a single moment-in-time. The independent risk management department is responsible for preparing the risk profile and monitoring the risk profile relative to the risk appetite statement. The independent risk management department must report the risk profile to the Board or Board's risk committee at least quarterly.

The OCC expects Covered Banks to have the information technology infrastructure to support the timely determination of the risk profile through risk data aggregation. For Covered Banks that are global systemically important banks, the OCC has stated that it expects these banks to adhere to risk data aggregation and reporting principles issued by the Basel Committee on Banking Supervision ("Basel Committee") for compliance by early 2016.[4] The OCC considers the Basel Committee's principles to be leading practices, and the agency would expect all Covered Banks regardless of their global systemic importance or asset size to align their risk data aggregation practices to these principles where possible.

Concentration Risk Limits

The Framework requires concentration risk limits and, as applicable, front line unit limits. These limits should align with the risk appetite statement. Accompanying these limits should be processes for addressing limit breaches. The processes should determine when breaches are to be reported to management, the Board and the OCC. The processes should also address documentation and resolution of breaches, as well as accountability measures.

BOARD OF DIRECTOR OVERSIGHT

The Proposed Guidelines require the Board to provide active and independent oversight of the Framework. The OCC expects the Board to actively challenge and oppose management when it believes that decisions could cause a Covered Bank's risk profile to exceed the risk appetite. It is likely that OCC examiners will inspect Board minutes for evidence of this active engagement. The Board must conduct an annual self-assessment of its oversight over the Framework. The Board must also consist of at least two members who are independent in that they are not part of the management of either the Covered Bank or Parent Company. These independent directors must receive ongoing formal training to ensure their abilities to provide oversight over the Framework. The OCC has specifically requested comment as to whether the two independent director requirement is appropriate.

RISK MANAGEMENT CULTURE

The Proposed Guidelines set cultural expectations for Covered Banks as to what the OCC views as elements of a safe and sound risk culture. The stature of the independent risk management and internal audit departments within a Covered Bank is a reflection of this culture according to the OCC. These departments should have all necessary resources, should be included in strategic decisions, and their reports and concerns should be regarded by management and the Board. Also, the risk appetite and limits that result from the Framework should be integrated into other areas of the Covered Bank's operations such as capital and liquidity stress testing, new product development, and acquisition/divestiture decisions.

The OCC also believes that a risk management culture is displayed through rigorous staffing and talent management efforts. The Proposed Guidelines require the establishment of processes for talent management that ensures the hiring, retaining, and succession planning of employees with the skills to effectively implement the Framework. Compensation of this talent should be competitive and tailored to incentivize effective risk management. However, the Proposed Guidelines prohibit any incentive-based compensation that could lead to material financial loss or could encourage inappropriate risk-taking.

ENFORCEMENT

If the Proposed Guidelines are finalized, then they would establish enforceable standards, subject to the OCC's discretion. If the OCC determines that a Covered Bank has failed to meet the Proposed Guidelines' standards as finalized then it has the option to initiate an enforcement proceeding under the authority of Section 39 of the FDI Act. The OCC may request that the Covered Bank submit a compliance plan within 30 days describing the corrective actions to be taken and the timeframe for these actions. If the Covered Bank does not submit a compliance plan that the OCC deems acceptable, or if the OCC determines that the organization failed to comply with the compliance plan, then the OCC may issue a formal and public Order, which is enforceable in federal district court or through civil money penalties.

CONCLUSION

Through the Proposed Guidelines, the OCC is attempting to formalize and attach additional enforceability to expectations that the agency has been informally implementing since 2012. While many large national banks and federal savings associations may be familiar with these heightened expectations, they should still consider whether these Proposed Guidelines limit any current risk governance practices or organizational structures that may be effective for their organizations. Mid-size and even smaller banks should also consider these Proposed Guidelines because the OCC is reserving the discretion to make these institutions Covered Banks on a case-by-case basis. Given the supervisory trends of the OCC it is possible that some principles from these Proposed Guidelines will still be informally imposed during examinations of institutions, regardless of size.

NOTES

[1] 12 U.S.C. § 1831p-1.

[2] The average total consolidated assets would be calculated from the Covered Bank's call reports for the four most recent consecutive quarters.

[3] Since the Proposed Guidelines are authorized and enforced under the FDI Act, they may only apply to insured depository institutions. However, the OCC could seek enforcement of the Proposed Guidelines as applied to uninsured entities under 12 U.S.C. § 1818, which applies to unsafe and unsound practices.

[4] *See* Basel Committee on Banking Supervision, Principles for Effective Risk Data Aggregation and Risk Reporting (Jan. 2013).