DON'T FIGHT THE FED

BE FED-READY INSTEAD

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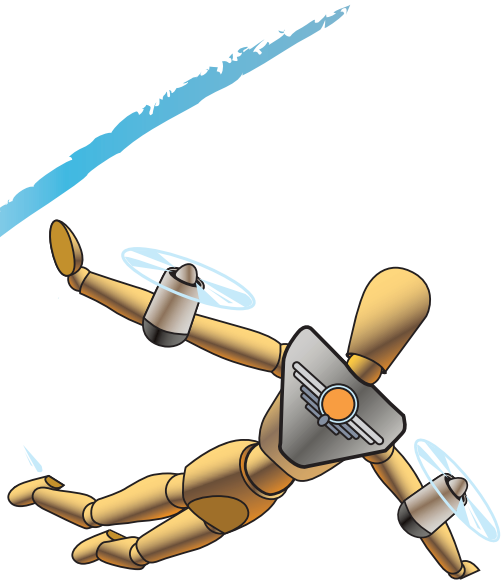
Rather than be pushed through the regulatory door, banks should walk through of their own accord—with the CRO leading the team.



BY JOHN BUGALLA, JAMES KALLMAN, AND KRISTINA NARVAEZ

THE NEED FOR a reformed risk-governance model is undeniable; at least that's the view of regulators and the informed public. The tone for reforms was set by the first major finding of the Financial Crisis Inquiry Commission (FCIC):

"We conclude this financial crisis was avoidable. The crisis was the result of human action and inaction, not of Mother Nature or computer models gone haywire. The captains of finance and the public stewards of our financial system ignored warnings and failed to question, understand, and manage evolving risks within a system essential to the well-being of the American public."

According to the FCIC, banks:

- Are highly interdependent.
- Built risk portfolios composed of complex financial instruments.
- Have risk concentrations within their portfolios that are far more correlated to each other than previously considered.
- Aggregate accumulations susceptible to a high degree of both volatility and velocity.
- Have traditionally been managed in individual functional silos.
- Have a risk culture that incentivizes risk taking, not risk management.

When negative public sentiment toward banks is added to the findings, the question was never going to be if new regulations were coming, but how deep they would go.

Perhaps working under the well-known George Santayana axiom, "Those who cannot remember the past are condemned to repeat it," financial regulators typically take a reactionary approach:

- The Federal Reserve was created after the Panic of 1907.
- The Securities Act of 1934 created the Securities and Exchange Commission (SEC) following the 1929 stock market crash and ensuing Great Depression.
- The Sarbanes-Oxley Act was created in 2002 and COSO created in 2004 after a series of financial reporting scandals that devastated industry giants such as Enron and WorldCom.
- SEC Amended Rule 33-9089 and the Dodd-Frank Act were enacted in 2010 following the financial crisis and the Great Recession of 2008-09.

When Congress passed the Dodd-Frank legislation in the summer of 2010, it was expected that the already voluminous law would receive even greater heft and depth when the final and more detailed provisions were developed and added over a prescribed legislative timeline.

One of the original and shorter provisions in Dodd-Frank was Section 165B, which was groundbreaking from

a risk management perspective. The governance structure of the largest banks in the U.S. was going to change—by government mandate.

Banks would be required to form a board-level risk committee composed entirely of independent directors—one of whom would have to be a risk management expert. Moreover, banks would be required to adopt an enterprise-wide risk management (ERM) program in order to break down the traditional silo approach to risk management.

The Board of Governors of the Federal Reserve System gave greater heft and depth to Dodd-Frank in 2012 when it proposed *Enhanced Prudential Standards and Early Remediation Requirements for Covered Companies*. The proposed rules extend the reactionary response to an industry that is viewed by its critics, especially when it comes to the large global banks, as unable or unwilling to manage its risks in a meaningful way. However, what should be noted about the *Enhanced Prudential Standards* is its level of scope and depth.

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It might be time for the financial sector to take stock and reconsider its views of risk management regulations. Rather than oppose new regulations or view them only as an additional compliance expense, "Don't fight the Fed" might be a better operating axiom when it comes to risk management policies, procedures, and execution.

The rest of the financial services industry, such as large community banks, credit unions, and nonbank financial firms, should also consider adopting the "Don't fight the Fed" axiom. Continued opposition to regulations will inevitably lead to additional reactionary responses from the regulators, leaving bank CEOs to ponder: Who is really running this institution?

Financial Stability Oversight Council

Dodd-Frank also extended the reach of regulations to the nonbank financial community. Subtitle A of Title 1 of Dodd-Frank created the Financial Stability Oversight Council (FSOC) on July 21, 2010. The duties of the FSOC include promoting stability and transparency in the financial system, ending "too big to fail," protecting American taxpayers by ending bailouts, and protecting consumers from abusive financial services practices.

FSOC has the authority to designate nonbank financial companies (companies that do not have a bank holding company parent, but are predominantly engaged in financial activities) that will be subject "to supervision by the Board of Governors of the Federal Reserve System and to enhanced prudential standards." The goal is to determine if material distress at the designated company—were it were to occur—could pose a threat to the financial stability of the United States.

The first group of nonbank financial companies named by FSOC was American International Group Inc. and General Electric Capital Corporation in July 2013, followed by Prudential Financial Inc. in September 2013.

FSOC also has the authority to name foreign nonbank financial companies that will be supervised by the Federal Reserve. The decision to name a company (foreign or domestic) is based on criteria also contained in Dodd-Frank. They include:

- The extent of the company's leverage.
- The extent of the company's off-balance-sheet exposure.
- The extent and nature of the company's transactions and relationships with other significant nonbank financial companies.
- The amount and type of the company's liabilities, including the degree of reliance on short-term funding.

The FSOC has been given additional latitude with the inclusion of a provision that extends the criteria to "any other risk-related factors that the Council deems appropriate."

Examinations

Bank safety and soundness examinations by regulators are nothing new to banks, but they are new to nonbank financial companies. Dodd-Frank grants the Federal Reserve authority to obtain reports from nonbank financial companies about their financial condition. The Fed also has the authority to conduct examinations of those nonbanks falling under the Fed umbrella. Just as with any other bank examinations, the results may produce recommendations that the Fed has the authority to enforce.

Meanwhile, the Consumer Protection Act in Dodd-Frank gives the Consumer Financial Protection Bureau (CFPB) the authority to conduct examinations of 1) banks and credit unions with assets of more than $10 billion, 2) consumer mortgage companies, 3) "payday" lenders, 4) private education lenders, and 5) "larger participants" in the market for consumer financial products or services. The issue here is that the focus of the CFPB examinations is very different from that of a traditional bank examination. Banks examinations are about safety and soundness, while the CFPB will focus on the consumer experience.

When consumer products companies want to research or test a new product, they sometimes turn to focus groups that provide feedback. When lawyers want to test their approaches in a given case, they sometimes use a mock jury to determine how ordinary people might respond to their arguments.

As a result of Dodd-Frank and the 2012 *Enhanced Prudential Standards,* some companies, for the first time, will be asking, "Are we Fed ready?" To answer that question, CEOs and boards are encouraged to follow the lead of consumer products companies and the legal profession: They should conduct a mock Fed examination in preparation for the real thing. Abraham Lincoln's statement about preparation is applicable: "Give me six hours to chop down a tree and I will spend the first four sharpening the axe."

Chief Risk Officer

One of the more interesting elements of Dodd-Frank and the follow-on *Enhanced Prudential Standards* is the requirement for a chief risk officer (CRO) or a person with CRO responsibilities to chair the executive risk committee and report directly to the CEO and board-level risk committee.

The presence of CROs has increased beyond large global institutions, and they can now be found in community banks and some credit unions. CROs in other industries, such as insurance, energy, and utilities, are now common. All these industries have the common thread of being highly regulated. CROs in less regulated industries in the U.S. are not as common, but they are still growing in number. Paralleling the increasing number of CROs is the increasing number of companies adopting an ERM process.

Having a CRO does not, however, guarantee risk management success. MF Global is perhaps the most famous example of a textbook ERM program that failed at the executive level. MF Global's enterprise-wide risk management operation and the hiring of a CRO were driven by a history of documented failures in the area of risk management.

The firm adopted a sophisticated ERM operation after specialist consultants were brought in to review a rogue-trader incident. Some pundits classified the newly formed ERM operation as an example of industry best practices, even calling it progressive at the time.

The ERM program performed as it should have until a clash developed between the CRO and the CEO over the firm's risk appetite and tolerances. The CRO challenged the CEO over the size of the firm's bet on European sovereign debt. Unfortunately, the breach between the CRO and the CEO over the amount of sovereign debt had ruinous consequences for publicly traded MF Global.

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No taxpayer bailout money came to the rescue of MF Global. After its bankruptcy filing, a scandal ensued over segregated accounts and missing customer funds. With all

of this coming on the heels of the financial crisis, Congress called hearings to examine the actions of the principal actors.

A snippet of their testimony before Congress indicates their positions:

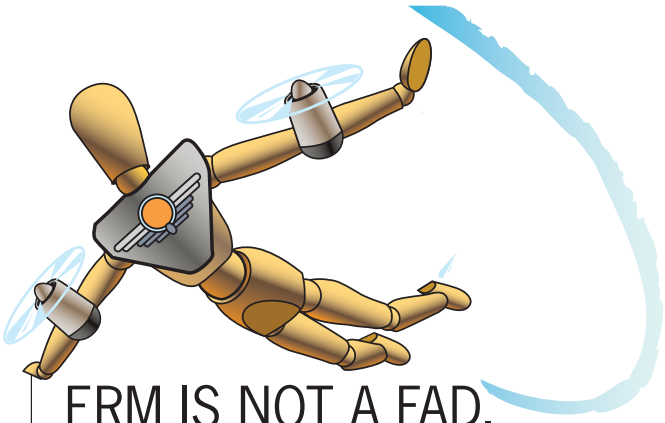
- "I simply do not know where the money is, or why the accounts have not been reconciled to date." **–Jon Corzine, former CEO, MF Global.**
- "…I, unfortunately, have limited knowledge of the specific movement of funds at the U.S. broker-dealer subsidiary MF Global, Inc., during the last two or three hectic business days prior to the bankruptcy filing." **–Henri Steenkamp, former chief financial officer, MF Global.**
- "However, the risk scenarios I presented were challenged as being implausible." **–Michael Roseman, former chief risk officer, MF Global.**
- "On advice of counsel I respectfully decline to answer based on my constitutional rights." **–Edith O'Brien, former assistant treasurer, MF Global.**

Chief Risk Officer Michael Roseman was dismissed shortly after he challenged his CEO. Another CRO was hired, but the position no longer reported directly to the CEO. This individual's tenure was limited because of the firm's demise. However, it is critical to understand that the ERM process worked at MF Global—up until the CEO chose not to follow it.

In June 2013, the Commodity Futures Trading Commission (CFTC) filed a complaint charging MF Global and the other defendants with unlawful use of customer funds. In November 2013, the CFTC obtained a consent order against MF requiring it to pay $1.212 billion in restitution and a $100 million civil penalty. CFTC's litigation continues against the remaining defendants: MF Global Holdings Ltd., Jon S. Corzine, and Edith O'Brien.

If the MF Global disaster were a stand-alone example, it would be considered an unfortunate anomaly, but this condition proved to be prevalent. As Thomas Stanton, staff member of the Financial Crisis Inquiry Commission, stated in his recent book, *Why Some Firms Thrive While Others Fail: Governance and Management Lessons from the Financial Crisis:*

"In the crisis, too many major firms nominally managed risk but took actions that threatened the firms' survival. One firm that failed (Freddie Mac) fired the chief risk officer and another (Lehman) sidelined the CRO to a less important position at the company. At a third firm (AIG) a part of the firm that was taking excessive risk (AIG Financial Products) simply denied the corporate CRO access to information. Other firms (such as Citigroup) lacked capacity to aggregate information about risk exposures across the enterprise."



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Conclusion

ERM is not a fad. The regulators, the credit-rating agencies, and the risk management community have all embraced it. The ERM process can be used not only to minimize the impact of adverse events that inevitably occur over time, but also to exploit opportunities that arise over time.

Congress and the American taxpayer are in no mood to bail out firms that fail to have adequate risk management programs. Where ERM is legally required, those firms will have chief risk officers and board-level risk committees and expect them to actually function. As a consequence, risk management governance, processes, and procedures will likely come under greater scrutiny during the examination process. Those organizations coming under the umbrella of the Fed for the first time should prepare in advance by conducting a mock Fed examination. And leading the mock examination efforts should be their key resource, the CRO.

Some organizations will adopt ERM because of government mandates and turn their focus to compliance. The current hiring boom in the compliance departments of global banks attests to this. We suggest that rather than be pushed through the regulatory door, businesses should walk through of their own accord. Don't fight the Fed. ❖

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