Greetings from the Chair!

We hope that you will enjoy the Winter 2020 edition of the Banking Law Committee Journal! In this edition, you will find four timely and informative articles:

- **Dodd-Frank 2.0: The Contours of the Policymakers’ Debate**
  Arthur S. Long, Gibson Dunn & Crutcher LLP

- **Tee Up Your OFAC Compliance Commitments: Pillars, Critical Factors, and Essential Components**
  Stephanie R. Hager and Frank A. Mayer, III, Stevens & Lee

- **Accounts That Go Up in Smoke: To Bank or Not to Bank, the Marijuana Industry**
  Adrian Snead, Holland & Knight LLP and Logan Hill, University of Mississippi School of Law

- **Banks’ Enhancements In Risk Management Provide a Prudential Backstop In This Deregulatory Cycle**
  Alexander Dill, University of California Los Angeles

Once again, thank you to the authors for submitting articles on such interesting topics. I also wish to thank Banking Law Committee Journal Chair Juan Sempertegui, Editorial Board Member André Cotten, and BLC Content Director Andrew Samuels for their efforts in compiling the Journal.

The Banking Law Committee Journal is always looking for articles for future editions! Articles should be between 500 to 1,500 words and on a substantive topic that is of interest to Committee members. If interested, please reach out to Juan Sempertegui (Juan.Sempertegui@BofA.com).

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We are now two years into the “reform” of Dodd-Frank, and although there has been unanimity on a number of issues, certain changes have drawn dissent. The pruning of certain aspects of the original regulations has been a goal of Federal Reserve Vice Chair Randal Quarles, who has been supported by the other Board governors, except for Governor Lael Brainard on six matters. Similarly, for changes on which the Federal Deposit Insurance Corporation (FDIC) Board has also issued its approval, support has been unanimous other than for Director Martin Gruenberg on five matters. This article analyzes these competing schools of thought.

Governor Brainard has dissented from six Federal Reserve actions since April 2018. The first was the Federal Reserve’s proposal to tailor further the enhanced supplementary leverage ratio (E-SLR) that applies to U.S. global systemically important banks (G-SIBs), followed by dissents to the October 2018 “tailoring proposal” for U.S. banks, the March 2019 revisions to CCAR’s “qualitative objection,” the March 2019 decision to leave the Countercyclical Capital Buffer (CCB) at 0%, the April 2019 foreign bank “tailoring proposal,” and the April 2019 proposal relaxing resolution planning requirements.

As for Director Gruenberg, at August 31, 2019, he had dissented from all four of the six proposals above that came before the FDIC (E-SLR, the “tailoring proposals,” and the resolution planning proposal). In addition, he dissented from the revision to the regulations implementing the Volcker Rule.

From these divisions, certain principles may be derived. Despite the dissents, there does seem to be agreement that most of Dodd-Frank reforms that relate to G-SIBs are appropriate. No member of the Federal Reserve or FDIC has sought a material reduction in the capitalization of the nation’s largest, most complex banks. The changes to the E-SLR may appear to be an exception, but here the debate is best seen as whether the E-SLR should be a backstop to the risk-based capital rules, or whether it should continue to be— as it was for half of the U.S. G-SIBs at the holding company level, and all of their lead bank subsidiaries—the binding constraint. This debate has always followed use of the leverage ratio and is not new. It turns on two positions: (1) whether, if the leverage ratio is the binding constraint, does that encourage more risk-taking, versus (2) are risk-based capital ratios truly trustworthy? According to staff data, the recalibration of the E-SLR will not materially reduce capital at G-SIB holding companies, but it will result in a $121 billion reduction in capital at their lead bank subsidiaries. At June 30, 2019, however, those lead banks’ traditional leverage ratios were anywhere from 132 to 840 basis points above well-capitalized.

A second exception could be Governor Brainard’s dissent on setting the CCB at zero; however, here, it is possible that the Federal Reserve’s position will change. Vice Chair Quarles has recently spoken positively of the CCB, and therefore it may return at a percentage higher than 0% when or after the Federal Reserve finalizes its stress capital buffer regulations. Setting the CCB at a higher percentage should mean more G-SIB capital.

Third, although the revisions to the Volcker regulations benefit G-SIBs, Director Gruenberg’s dissent leaves out the principal weakness of the original version—it’s refusal to define in any meaningful way the very activity that the Volcker Rule proscribes: trading undertaken with short-term intent. The dissent also ignores that a very substantial amount of trading activity beyond the Market Risk Capital Rule prong is caught by the new regulation’s non-statutory “dealer” prong, which was not revised. To run with former Federal Reserve Chairman Volcker’s analogy to obscenity, the essence of the new Volcker regulations is that they have freed only certain National Geographics from being required to be wrapped in a regulatory brown paper bag.

Where the debate between the Quarles and Brainard-Gruenberg positions seems to focus is on the rules for institutions above $100 billion in assets and below the range of the G-SIBs. It is there that Governor Brainard has been vocal, critiquing the reduction in the liquidity coverage ratio (LCR) and AOCI capital requirement opt-out for banks with between $250 billion and $700 billion in assets, as well as the elimination of the LCR for banks with assets between $100 billion and $250 billion. In two public dissenting statements, she has referred to the effects of the Washington Mutual failure ($300 billion), and two distress acquisitions of banks in $100 to $250 billion range during the Financial Crisis, as among the reasons for her “no” vote. She further contended that the Financial Crisis reduced the number of banks that could acquire such large competitors and thus raised the specter of a future depletion of the Deposit Insurance Fund. On this point, Director Gruenberg has also agreed. And by voting against the revisions to the Volcker Rule, Director Gruenberg opposed the tailored regulatory relief the new regulation provides to banks without significant trading assets and liabilities—non-G-SIBs to be sure.

The response to these concerns from Vice Chair Quarles is that the recalibration is modest and must be judged with respect to the totality of existing regulation. For example, with respect to the domestic tailoring proposal, Vice Chair Quarles stated:

But liquidity risk still exists for firms [between $100 billion and $250 billion] and, accordingly, liquidity requirements would not disappear altogether. The firms’ internal liquidity stress testing, risk management, and reporting requirements would continue . . . For capital, these firms would move to a two-year cycle for supervisory stress testing . . . The total amount of capital maintained by large bank holding companies that are subject to stress testing requirements is currently about $1.3 trillion. The cumulative effect of the proposed changes we are considering today would result in a decrease of $8 billion of required capital, or a change of 0.6 percent.
On the liquidity side, the same set of firms maintains approximately $3.1 trillion of high quality liquid assets. The cumulative effect of the proposed changes, would be a reduction of between 2 to 2.5 percent of high quality liquid assets, depending on where the final rule lands in the proposed 70-85% range.

Similarly, on the elimination of the qualitative objection to stress testing, he commented:

Examination work would continue on a year-round basis, taking into account the firm’s management of other financial risks, and culminating in a rating of the firm’s capital position and planning. Firms with deficient practices would receive supervisory findings through the examination process, and would be at risk of a ratings downgrade or enforcement action.

Focusing on banks in the $100 billion to $700 billion range, it seems that the debate therefore is over the right amount of regulatory “deterrence” to prevent another Washington Mutual or similar failure. This, of course, is a matter of judgment, and an answer to this debate will only come in a situation of material distress. Nonetheless, it is noteworthy that Vice Chair Quarles’ claimed effects of the U.S. domestic tailoring proposal on reductions in capital and liquidity are not material in either case.

Also relevant to the debate is the Economic Growth, Regulatory Relief, and Consumer Protection Act of 2018 (EGRRCPA), which passed Congress with bipartisan support. The Quarles vs. Brainard/Gruenberg debate extends to whether the tailoring proposals are appropriately consistent with the statute. By retaining the original Dodd-Frank concept of tailoring, but raising the threshold of mandatory enhanced prudential standards to $250 billion and discretionary standards to $100 billion, Congress intended that G-SIBs be treated differently from large and medium-sized regional banks in some ways.

Dodd-Frank 2.0 is still not finally implemented, and the debate outlined in this article will undoubtedly continue. In addition, the 2020 election is underway, and bank regulation has not died as a significant issue. In particular, how the Quarles vs. Brainard/Gruenberg debate is seen in light of the bipartisan statutory changes to Dodd-Frank made by EGRRCPA will be critical in the event there is a new President but no congressional appetite to strengthen bank regulation statutorily. If the current recalibration is viewed as a reasonable approach to implementing EGRRCPA, attempts to increase requirements after 2020 will bear a higher justificatory burden.

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The 18th week of 2019 very well could have been the highlight of the year for professionals in the compliance space. On Tuesday, April 30, 2019, the Criminal Division of the U.S. Department of Justice (DOJ) released its guidance document for prosecutors of white-collar crime, The Evaluation of Corporate Compliance Programs. The DOJ’s guidelines advise federal prosecutors of certain factors to consider when evaluating the adequacy and effectiveness of corporate compliance programs for purposes of a criminal investigation. The new document is an extension of earlier guidance issued by the Criminal Division’s Fraud Section in February 2017, and represents an effort to better harmonize the prior Fraud Section publication with other Department guidance and legal standards. Later that same week, on Thursday, May 2, 2019, the U.S. Department of the Treasury’s Office of Foreign Assets Control (OFAC) published its guidance document, A Framework for OFAC Compliance Commitments, to promote greater understanding of U.S. sanctions laws and requirements.

OFAC’s guidelines on the essential components of OFAC compliance programs and the DOJ’s guidelines for the evaluation of corporate compliance programs share a number of common themes with what have become known as the “five pillars” of Bank Secrecy Act/anti-money laundering (collectively, BSA/AML) compliance under the Department of the Treasury’s Financial Crimes Enforcement Network (FinCEN) regulations. This article will briefly explore the conceptual overlap of the three compliance regimes, with particular regard to management commitment, risk assessment, internal controls, independent testing, and training in order to distill core components of compliance across the board and help financial institutions get their compliance commitments teed up in the new year.

The DOJ’s Critical Factors

The new DOJ guidelines bring to mind the seven elements of an effective compliance program as laid out in the U.S. Sentencing Guidelines. The 2019 guidance is organized around three main questions that a prosecutor would raise when evaluating corporate compliance programs: (1) whether the program is well-designed; (2) whether the program has been effectively implemented; and (3) whether the program actually works in practice.

The 2019 guidance document discusses how the three main questions can be applied in order to determine whether the compliance program is ultimately effective. First, to determine whether a compliance program is well-designed, prosecutors should consider, inter alia, (i) the quality and effectiveness of the company’s risk assessment process, (ii) whether policies and procedures give content and effect to ethical norms and are aimed at reducing the risks identified during the risk assessment, (iii) the appropriateness of training and internal communications, (iv) mechanisms for internal reporting, and (v) risk-based controls for third-party oversight.

Second, to determine whether the program has been effectively implemented, prosecutors should consider (i) the commitment by senior and middle management and conduct at the top, (ii) autonomy and resources, including the sufficiency of personnel, and (iii) incentives for compliance and disciplinary measures for non-compliance.

Third, to determine whether the program actually works in practice, prosecutors should consider (i) continuous improvement, periodic testing and review of the compliance program, (ii) whether investigations of misconduct are timely and thorough, and (iii) thoughtful analysis and timely remediation of any underlying misconduct. The 2019 guidance carries forward a number of questions from the 2017 guidance, and augments the prior guidance by inserting a number of direct references to the Justice Manual, “Principles of Federal Prosecution of Business Organizations,” bringing an air of formality not found in the earlier guidance.

OFAC’s Essential Components

According to the new OFAC guidance, an institution’s sanctions compliance program, or “SCP,” is strongly encouraged to employ a risk-based approach that is predicated on “at least five essential components of compliance: (1) senior management commitment, (2) risk assessment, (3) internal controls, (4) testing, and (5) training.” The guidance breaks down each essential component into a list of criteria through which an organization’s compliance efforts can be measured. For example, having a dedicated OFAC sanctions compliance officer may evidence senior management’s commitment to ensuring that compliance units are receiving adequate resources. When applying the guidelines to a given situation, OFAC will favorably consider subject persons that had effective SCPs at the time of an alleged sanctions violation. The OFAC guidance contains an appendix that outlines common root causes that have led to apparent violations of sanctions programs, such as the lack of a formal SCP, inconsistent applications of an SCP or improper or incomplete due diligence on the entity’s customers.

FinCEN’s Five Pillars

By statute, Congress required the Treasury Department and each financial institution supervisory agency to require every covered financial institution to establish its own internal compliance program for BSA/AML which must be in writing, be approved by the financial institution’s board of directors and must include, at minimum the following five pillars: (1) internal controls to ensure ongoing compliance with the institution’s BSA and AML requirements, (2) procedures for independent testing of the institution’s BSA and AML requirements, either by in-house personnel or an outside party, (3) designated persons responsible for coordinating and monitoring the compliance program on a
day-to-day basis, (4) training for appropriate personnel, and (5) Customer Identification Program with risk-based procedures that allow the institution to form a reasonable belief that it knows the true identity of its subscribers.

**Getting “Teed” Up**

Bank examiners will evaluate if and how weaknesses within an institution's compliance program and internal control environment contributed to a violation or deficiency, and in a case in which civil money penalties (CMP) are being considered, the more areas in which the institution's compliance program or internal control environment show weakness generally will result in a higher CMP Matrix score and therefore risk of greater penalties. With this background in mind, the following themes emerge when considering the effectiveness of corporate compliance programs:

- **Tone at the Top.** The board of directors, executives and senior management set the tone for the rest of the company, and their commitment to, and support of, an organization’s compliance program is essential for a successful program. FinCEN has previously categorized corporate culture as “critical” to a company’s BSA/AML compliance efforts.

- **Tailored Risk Assessment.** Risk-based compliance programs will vary depending on a variety of factors — including the company’s size and sophistication, products and services, customers and counterparties, and geographic locations. The starting point for determining whether a compliance program has been well-designed requires an understanding of how the organization has identified, assessed, and defined its risk profile. A prosecutor would consider the effectiveness of the company’s risk assessment and the manner in which the company’s compliance program has been tailored based on that risk assessment.

- **Targeted Internal Controls.** Internal controls should include policies and procedures targeted towards identifying, interdicting, escalating, monitoring, reporting as appropriate, and keeping records pertaining to the matters covered by the compliance program.

- **Talent.** An employee, such as a dedicated BSA officer or OFAC compliance officer should be assigned the responsibility for coordinating and monitoring the compliance program on a day-to-day basis.

- **Training.** An effective compliance program should provide job-specific knowledge, adequate information and periodic instruction to relevant employees, directors and officers.

- **Testing.** Comprehensive, independent, and objecting testing or auditing will help ensure that organizations are aware of how their compliance programs are performing and should be updated, enhanced, or revised to account for a changing risk assessment.

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Imagine that you run a store. Everything you sell is legal, according to the law where you live. You have inventory, employees and a very advanced sales tracking system. Yet, you cannot accept credit cards, and you can't pay your employees, suppliers or bills with checks. Paying state and federal taxes requires you to haul bags of cash to the Internal Revenue Service and state revenue offices. In fact, everything you do has to be paid with cash.

However, this isn't a 19th-century shop on the frontier; this is how nearly every cannabis business has to operate today. It is both inefficient and dangerous.

While 33 states, the District of Columbia, Guam, Puerto Rico, the Northern Mariana Islands and the U.S. Virgin Islands have legalized marijuana for recreational and/or medical use, marijuana remains a Schedule I drug and illegal under federal law.

It may be helpful for readers to understand some of the basic terminology used in the industry. Cannabis refers to both marijuana and hemp, which are derived from the *Cannabis sativa* plant. Federal prohibitions on hemp were lifted on Jan. 1, 2019. The 2018 Farm Bill defines hemp as the plant *Cannabis sativa* L, with no more than 0.3% THC content (the psychoactive ingredient in cannabis) by dry weight volume. Growers and dispensers of cannabis and its products are referred to as touch-the-plant businesses. Individuals and businesses that provide services to the marijuana industry, including attorneys, accountants, utility companies, real estate owners, plumbers and others, are referred to as ancillary businesses. Touch-the-plant and ancillary businesses are all considered marijuana-related businesses (MRBs).

Despite official federal prohibition, the state-legalized marijuana industry continues to gain momentum. At the end of 2019, the U.S. cannabis industry was worth an estimated $12 billion and is projected to nearly triple by 2025, reaching $30 billion. Amazingly, the vast majority of this industry remains unbanked, operating completely in cash.

Federal prohibition of marijuana affects all MRBs. Any contact with money that can be traced back to MRBs, no matter how ancillary, could be considered laundered and, therefore, at risk of seizure. Banking institutions serving the industry risk losing their master account with the Federal Reserve and could face additional scrutiny. For most banks, the risk of working with the marijuana industry is simply too high. Lawyers, Native American tribes, and even politicians and interest groups supporting cannabis reform have seen longstanding banking relationships ended for earning money from the industry.

The Obama Administration took a cautious but progressive approach to state-legalized marijuana. In 2013, then-Deputy Attorney General James Cole released his Guidance Regarding Marijuana Enforcement memorandum, better known as the Cole Memo, which established eight federal law enforcement priorities for marijuana—none of which was to stop the state-legalized marijuana industry. In 2018, then-Attorney General Jeff Sessions rescinded the Cole Memo. However, his successor, Attorney General Bill Barr, recently said that the U.S. Department of Justice (DOJ) continues to follow the Cole Memo's priorities.

Building on the precepts set forth in the Cole Memo, in 2014, the U.S. Department of the Treasury's Financial Crimes Enforcement Network (FinCEN) issued guidance for banks working with the cannabis industry. The FinCEN document attempted to clarify Bank Secrecy Act (BSA) expectations and "how financial institutions can provide services to marijuana-related businesses consistent with their BSA obligations, and align the information provided by financial institutions in BSA reports with federal and state law enforcement priorities."

FinCEN's 2014 guidance established four banking due-diligence requirements, the most important of which was the requirement to file special Suspicious Activity Reports (SARs) for all marijuana-related transactions, including those with ancillary businesses.

FinCEN also laid out three different categories for marijuana SARs that relate to various law enforcement priorities based on the risk posed by the transacting company. The baseline Marijuana Limited SAR must be filed for any and all transactions that directly or indirectly relate to MRBs. This includes something as innocuous as a one-time payment made by a dispensary to a contractor for making a repair. All marijuana SARs must be filed within 30 days of the transaction. As with other SARs, additional continuing reports must be filed 90 days after the initial SAR, and every 90 days thereafter if the activity continues. Banks must also keep records of the SARs and their underlying transactions for five years. These marijuana SARs impose increased regulatory burdens on financial institutions. As of September 30, 2019, FinCEN had received 102,807 marijuana-related SARs.

While the de jure risk to banks serving the marijuana industry might be elevated, the de facto risk is low. Continuing congressional appropriations riders prohibit the DOJ (but not banking regulators) from prosecuting individuals who are operating in compliance with state medical, but not recreational, marijuana laws. Nevertheless, there have been no documented prosecutions of banks serving the marijuana industry where the banks otherwise comply with FinCEN and DOJ guidance.

Yet, banking institutions remain wary of entering the space. Out of approximately 12,000 U.S. banks and credit unions, only about 560 banks and 160 credit unions provide services to the cannabis industry. However, these institutions may charge substantially increased fees to cannabis-related clients as a reflection of the risk and expense required to implement and maintain a compliant anti-money laundering program for MRBs.
Many financial institutions have remained so concerned about banking the cannabis industry that they are still reluctant to work with hemp farmers and retailers, even though the 2018 Farm Bill legalized hemp. This may be why FinCEN, the Federal Reserve Board, Federal Deposit Insurance Corporation (FDIC) and Office of the Comptroller of the Currency (OCC), in consultation with the Conference of State Bank Supervisors, released joint guidance on Dec. 3, 2019, clarifying that banking hemp was now legal.

Congress has long acknowledged the challenges posed by offering banking products and services to the cannabis industry. In 2013, Rep. Ed Perlmutter (D-Colo.) introduced the Marijuana Businesses Access to Banking Act in the House, and in 2015, Sen. Jeff Merkley (D-Ore.) introduced an updated companion bill in the Senate. The bill, now further updated and known as the Secure and Fair Enforcement Act (SAFE Banking Act), would create a federal safe harbor for depository institutions and account holders. It would also prevent federal regulators from penalizing or discouraging financial institutions from serving the state-legalized industry or incentivizing or even recommending the closing or downgrading of any individual account of any MRB or individual tied to an MRB acting in compliance with state law. Notably, while the SAFE Banking Act would prevent federal bank regulatory agencies from bringing a supervisory action solely on the basis that a bank was serving the cannabis industry, such agencies could still bring a supervisory action of the bank’s activities constituted other violations of law or unsafe or unsound banking practices. Moreover, ancillary businesses, insurers, Federal Reserve and Federal Home Loan Bank employees would receive explicit protection from money laundering statutes.

Significantly, the bill does not do away with the onerous marijuana SARs but instructs FinCEN to issue guidance “consistent with the purposes and intent of the SAFE Banking Act.” When that provision was first drafted, the hope was that FinCEN would ultimately do away with the marijuana SARs as the industry matured and federal law changed.

The SAFE Banking Act is a popular bill, and the House version passed on Sept. 25, 2019, by a vote of 321-103. It has gained 33 Senate cosponsors, and has a notable level of support in the senate. For example, Sen. Corey Gardner (R-Colo.), formerly an opponent, has become a champion of the bill and testified in support of it in a July 2019 Senate Banking Committee hearing.

Unfortunately for proponents of the bill, a variety of hurdles remain. Sen. Mike Crapo (R-Idaho), chairman of the Senate Banking Committee, issued a statement on Dec. 18, 2019, documenting his concerns about the legislation. Namely, that the SAFE Banking Act "does not address the high-level potency of marijuana, marketing tactics to children, lack of research on marijuana's effects, and the need to prevent bad actors and cartels from using the banks to disguise ill-gotten cash to launder money into the financial system."

Ironically, proceeding with the current legal and regulatory framework enables issues such as money laundering to persist. This may be partly why Federal Reserve Chairman Jerome Powell noted that the current system "puts financial institutions in a very difficult place and puts the supervisors in a difficult place, too. It would be nice to have clarity on that supervisory relationship."

Sen. Crapo’s concerns, while substantive and understandable given the complexity of the issue, also signals a broader Senate bottleneck. This is unfortunate. The SAFE Banking Act is meant to conservatively address issues related to cannabis banking in a bipartisan manner. The issues raised by Sen. Crapo will continue to exist until MRBs can access the financial system.

Sen. Crapo invited input from all interested stakeholders. Recently, the ABA’s Cannabis Law and Policy Committee within the Tort Trial and Insurance Practice section submitted a resolution to the ABA House of Delegates asking the ABA to support marijuana banking reform. The ABA will vote on the resolution at the mid-year conference in Austin, Texas, this February. Interested parties should contact Sen. Crapo’s office directly and ask to speak to the chief of staff or legislative director, or contact the Senate Banking Committee and ask to speak to the majority staff’s policy director.

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Banks’ Enhancements in Risk Management Provide a Prudential Backstop in this Deregulatory Cycle

Alexander Dill

Recent bipartisan amendments to the Dodd-Frank Wall Street Reform and Consumer Protection Act (Dodd-Frank) in 2018, the loosening of Volcker rule provisions in August 2019, discussed in the Journal’s November issue, and the final rules issued in October 2019 that reduce regulatory obligations by tiering bank holding companies (BHCs) and designated nonbank financial institutions by size and risk have led to no small amount of controversy. Dodd-Frank had originally imposed enhanced prudential standards, which include liquidity, stress testing, and resolution planning requirements, among other things, on firms with $50 billion or more in consolidated assets to safeguard the financial system against systemic risk. The 2018 and 2019 changes have removed or lightened these obligations by raising this threshold significantly. The October rules go beyond Congress’s 2018 bipartisan amendment that set the threshold at $250 billion by reducing requirements for banking and designated firms with assets up to $700 billion. In Fed Governor Lael Brainard’s view, the October rules weaken the protections put in place in 2010 before they have been tested through a full economic cycle.

Whatever one’s view of these changes to the 2010 regulatory framework, one should not overlook the significant enhancements that banks have made to their risk management systems, either in response to Dodd-Frank rulemaking and supervisory expectations or as a matter of good corporate practice in the aftermath of the global financial crisis of 2007-9 (GFC). Shortly after the onset of the crisis, large, complex financial institutions had already begun to bolster processes and procedures for identifying, assessing, monitoring, and controlling risk. Enhancements banks have made to date should continue to promote financial stability as the deregulatory cycle runs its course and will provide important protections in the next financial crisis that will inevitably occur. Faulty risk management practices during the subprime mortgage bubble prepared the ground for the liquidity and credit crisis that began in late summer 2007. The government eventually spent billions of dollars in bailing out financial conglomerates that had created highly risky capital structures by bulking up on long-term, illiquid subprime assets funded by cheap, runnable short-term debt.

This article discusses three aspects of the reforms in banks’ risk management. First, beginning in the 1990s banking agency supervisors increasingly focused on firms’ corporate governance systems and practices to manage the risks arising from their business model. Second, the GFC fundamentally changed policymakers’ relatively sanguine view of firms’ ability to manage their own risks, accelerating the long-term trend in banking agencies’ increasing supervisory expectations regarding the risk management function. Examiners’ newfound skepticism regarding a bank’s internal control environment represents a paradigm shift that can be expected to outlast the current deregulatory cycle. The agencies now expect the large banks to think strategically and systematically about effective firm-wide management of their volatile basket of risks, an expectation most recently reflected in 2017 and 2018 guidance by the Federal Reserve Board (FRB). Finally, banks’ and nonbank financial firms’ own experience in the GFC incentivized them to significantly upgrade the risk management function by endowing it with senior executive status, independence, and necessary resources.

Decades-Long Trend in Supervisory Focus on Banks’ Risk Management Function

First, the crisis significantly accelerated a long-term trend of bank supervisors to look increasingly to banks’ systems of corporate governance and risk management practices to ensure their bank’s safety and soundness. In former Governor Daniel Tarullo’s words, bank regulation over the last three decades changed from relying on general rules toward an individualized “supervisory approach”. The agencies have continually raised expectations for banking firms to develop sophisticated risk management systems to identify, assess, and reduce risks or exit a business if necessary.

Regulators had little choice but to rely increasingly on bank’s ability to manage their complex mixture of market, credit, operational, and, increasingly, compliance risks. In turning from a reliance on regulatory, “rules-based”, approach to a “supervisory approach”, the banking agencies stressed the importance of a particularized, granular examination of individual banks. Bank capital regulation was necessary but not sufficient to ensure the prudential operation of a banking institution. The “supervisory” regime gained impetus from the rise of the multiservice BHC conglomerate in the 1980s and 1990s. In 1991, only one US-based BHC had over 500 subsidiaries. By the third quarter of 2011, the four most complex banking firms had over 2,000 subsidiaries. Moreover, regulators increasingly imposed legal obligations on financial holding companies. As Howell Jackson of Harvard Law School has observed, these often took the form of guarantees of regulated subsidiaries’ obligations in order to transfer front-line supervisory responsibility from governmental agencies to the holding companies.

By the 1990s, regulators had formalized their increasing emphasis on corporate governance and management quality by requiring bank examiners to place particular emphasis on the ability of senior bank executives to manage their banks’ complex set of risks. For this reason, in addition to the individual management component of a CAMELS rating, special consideration is given to this component in assigning a bank’s overall composite CAMELS rating. Further, bank management’s ability to identify, measure, monitor, and control risk a critical element in each of the other five CAMELS components.

GFC’s Reversal of Pre-Crisis Assumptions Governing Banks’ Ability to Manage their Own Risks

A second change reinforced and accelerated this long-term trend in bank supervision. The GFC fundamentally changed the governing assumptions of market participants concerning the functioning of the financial markets. Prior to the crisis, policymakers globally had adopted a largely market-based approach to regulating and supervising banks and other financial institutions. They assumed that firms were self-regulating and that markets were self-correcting. Bank management knew their unique risks and how to manage these risks better than any banking agency examiner. Fed Governor Kohn summarized this view, which he termed the “Greenspan doctrine,” at Jackson Hole in 2005.
By allowing institutions to diversify risk, to choose their risk profiles more precisely, and to improve the management of the risks they decide to take on, they made institutions more robust. The US’s bipartisan deregulation of OTC derivatives in 2000 and the UK’s ‘light-touch’ philosophy of supervision institutionalized the market-based ethos.

The GFC overturned the consensus that was embodied in the Greenspan doctrine. It converted financial regulators into severe skeptics regarding firms’ incentives and ability to prudently manage their own risks. The change in regulatory philosophy occurred on both the regulatory front and in enhanced supervisory expectations.

**Dodd-Frank’s Regulatory Requirements**

Dodd-Frank codified the new regulatory approach in several ways. A panoply of provisions, implemented in rulemaking, either directly or indirectly are designed to enhance the banks’ risk management function. Directly impacting it is Section 165’s requirement of risk committees and credit risk officers (CROs), with enterprise-wide authority, independence, and credibility.

More indirectly, Dodd-Frank requires rigorous forward-looking stress testing and resolution plans, or “living wills”, that require BHCs to revamp and restructure corporate operations to reduce the impact on financial markets of their wind down. These rules are enterprise-wide in scope, requiring risk officers to conduct risk assessments in connection with capital planning (stress testing) and in determining corporate restructuring measures to demonstrate the feasibility of orderly liquidations (living wills).

The risk committee must approve and periodically review the risk management policies of a BHC’s global operations and oversee the operation of the global risk management framework. Such a framework must correspond to the firm’s size, risk profile, and complexity and, at a minimum, include five elements. See 12 C.F.R. 252.33.

First, Dodd-Frank mandates policies and procedures for risk management governance, procedures, and infrastructure for global operations. Second, it requires processes and systems to implement and monitor compliance with these policies and procedures. Third, risk committees must include liquidity risk management requirements that specify, in granular detail, the parameters of required liquidity risk management pertaining to contingency planning and event management, risk limits, testing, and types of acceptable collateral for counterparties.

Fourth, the risk committee must be an independent board committee with sole, exclusive responsibility for risk management policies for global operations and oversight of the global risk management framework. It must report directly to the board of the BHC and receive and review quarterly reports from the BHC CRO. It must have a written charter approved by the full board and hold quarterly meetings. Finally, at least one member of the risk committee must be experienced in identifying, assessing, and managing risk exposures of large, complex firms. The committee chair must be an independent director.

**Post-Crisis Supervisory Approach**

The change in supervisory expectations will likely be more lasting and potentially more far-reaching, which should go far in compensating for the deregulatory tiering of BHCs, which includes the risk committee and CROs, into progressively lighter regulatory baskets as they decrease in amount of assets and risk profile.

Policymakers globally, under the aegis of the Basel Committee on Banking Supervision, have adopted a more prescriptive regulatory framework and a more invasive supervisory approach toward firms’ internal governance practices that reflects the fundamental change in assumptions regarding banks’ risk management capabilities. This more invasive approach is reflected in the FRB’s recently issued guidance on board effectiveness and the role and accountability of senior and line management. The risk management guidance details many the technical elements of an effective risk management framework that the firms are expected to adopt. See 82 Fed. Reg. 37219 (Aug. 9, 2017) and 83 Fed. Reg. 1351 (Jan. 11, 2018).

This change in supervisory philosophy is also reflected in enforcement actions. In 2018, the FRB took the unprecedented action of publicly chastising the former CEO and board chairman of a global systemically important bank for prioritizing sales quotas over risk controls. It put a cap on the firm’s growth based on assets, which is yet to be lifted, until its risk management capabilities catch up to its risk appetite. See FRB, Letter to John Stumpf (Feb. 2, 2018).

**FRB Guidance on the Risk Management Function**

The FRB opines that the overall objective of a bank’s risk management function is to provide an objective assessment of the firm’s risks and to ensure that business strategies are in alignment with its risk appetite, as determined by the board. The FRB’s guidance covers three areas: (1) risk appetite and risk limits; (2) risk identification, measurement, and assessment; and (3) risk reporting.

**Risk appetite and risk limits.** Risk management should assess whether the bank’s risk appetite appropriately encompasses its material risks and whether it is consistent with the capacity of the bank’s risk management framework. The bank should have adequate resources and a risk management infrastructure in order to achieve this end. Further, risk management should determine whether enterprise-wide risk limits align with the company’s risk appetite across the full set of its risks. It should also ensure that clear, relevant, and current risk limits apply to specific risk types, business lines, legal entities, jurisdictions, geographical areas, concentrations, and products or activities that correspond to the firm’s risk profile.
**Risk identification, measurement, and assessment.** Risk management is tasked with identifying and measuring current and emerging risks within and across business lines and by legal entity or jurisdiction. It should conduct risk identification and assessment on an ongoing basis to reflect changes in exposures, business activities, the broader operating environment, and regulatory expectations. Risk management should have access to information about all the company’s risk exposures while not relying on business line information exclusively. Moreover, it should aggregate risks across the entire firm and assess them relative to the firm’s risk appetite. It should also assess risks and risk drivers within and across business lines and risk types.

**Risk reporting.** Risk management should provide accurate, concise, and timely risk reports to the board and senior management that convey material risk data and assessments and aggregate risks within and across business lines. Reports should include information on current and emerging risks, adherence to risk limits, and the firm’s ongoing strategic, capital, and liquidity planning processes.

**Chief Risk Officer**

The FRB emphasizes the importance of the independence, authority, and stature of the CRO. To this end, the CRO should inform the board if this is not the case. Also, the CRO must report directly to the board’s risk committee and be included in key decisions relating to strategic planning and other areas of executive decision making. To ensure independence, the CRO should establish clearly defined roles, responsibilities, and reporting lines, and determine whether risk management has sufficient staffing and authority to identify and escalate material risk management and control deficiencies.

**Internal Controls**

Two principles govern internal controls. First, a banking institution should demonstrate that its system of internal controls aligns with its size, operations, activities, risk profile, strategy, and risk appetite. The operational business line management is responsible for developing and maintaining an effective internal control system. Second, the banking institution should evaluate and test the effectiveness of the internal controls on an ongoing basis following a risk-based approach. It should establish management information systems that detect weaknesses and escalate serious matters to all relevant parties, including the board.

**Banks’ Post-Crisis Incentives to Enhance their Own Risk Management Practices**

Third, the GFC incentivized banking institutions of their own accord to manage their large, increasingly complex basket of risks by enhancing the risk management function and its status and authority within the corporate hierarchy. Following the crisis, robust, firm-wide risk management practices and corporate governance became a strategic and competitive business necessity that would help preserve shareholder value, a change that is likely to continue in light of market volatility that has become a permanent feature of the financial system. Furthermore, the FRB’s risk management guidance generally aligns with the post-crisis incentives of banking firms to establish a meaningful internal risk control environment. The alignment of private incentives with regulatory expectations is not the case with other financial regulation, such as anti-money laundering law, which directly impedes banks’ revenue-generating business strategies involving deposits and other payment services. The FRB guidance also serves as a template for those firms not covered thereby.

Findings from a survey of global financial conglomerates in 2008 by the Senior Supervisors Group (SSG), financial market supervisors from several countries with advanced financial markets, help to substantiate such an alignment of business incentive and regulatory mandates and expectations. Early in the crisis, firms began reporting material write-downs concentrated in US subprime MBS-related debt, particularly in business lines specializing in warehousing, structuring, and trading of subprime-backed CDOs. The SSG divided these firms into better and more poorly performing firms based on their risk management practices. The risk management practices of the better performing firms mirror several best practice standards of the FRB’s guidance issued in 2018.

The better performing firms shared quantitative and qualitative information effectively across business lines and were thus capable of identifying sources of significant risk early in the crisis. They reduced exposures and hedged their risk positions while it was still practical and not prohibitively expensive. They had previously adopted rigorous internal processes requiring critical judgment and discipline in valuations of complex or potentially illiquid assets and developed in-house expertise in order to carry out independent assessments. They sought to apply these asset valuations consistently across their enterprise. They incentivized discipline in balance sheet growth by charging business lines for contingent liquidity exposures. Management in the better performing firms also had more adaptive risk management processes and systems, allowing them to rapidly alter assumptions to reflect current market conditions. They relied on a wide range of risk measures to gather more information and different perspectives on same exposures.

**Conclusion**

The financial crisis, despite the great damage it caused to the US and global economy and to millions of livelihoods, has had the salutary effect of turning the risk management function into a critical component of banks’ corporate governance and macro-prudential regulation. Its new, post-crisis status can be expected to outlast the current deregulatory cycle and continue to provide meaningful protections against emerging risks to financial stability.
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