PUBLIC CITIZEN Protecting Health, Safety and Democracy

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Chair, Governors
Federal Reserve Board of Governors
1801 K St NW
Washington, D.C. 20551

Via email: regs.comment@federalreserve.gov

Proposed Guidance on Supervisory Expectations of Board of Directors

Docket No. OP-1570

Dear Governors,

On behalf of more than 400,000 members and supporters of Public Citizen, we submit the following comments on the Federal Reserve Board's (Fed) Proposed Guidance on Supervisory Expectations of Boards of Directors. In summary, we believe that misconduct by the major banks undetected by their respective boards of directors argues for strengthening the oversight requirements, with more detailed scrutiny rules, and more aggressive intervention by the Fed to remove directors. Instead, the Fed here proposes to remove many of the specific requirements of board oversight and replaces them with overly broad, unmeasurable objectives.

Context for Board Oversight

Leading to the financial crash of 2008 and in the near-decade following this global tragedy, boards of directors, especially of the mega-banks, failed in their basic management oversight responsibilities.

- The major Wall Street firms packaged loans with poor underwriting into toxic securities then sold them to unwitting investors. We are unaware of evidence that boards of the major banks questioned this practice.
- Major banks committed violations of the anti-money laundering rules covering trillions of dollars, effectively aiding global drug cartels, terrorists, and tyrannies. We are unware of evidence that boards of the major banks investigated these activities.
- Major banks conspired to manipulate lending rates, largely through LIBOR. We are unware of evidence that this issue was surveyed by the relevant boards before the announcement of criminal charges.
- J JPMorgan's board commissioned outside investigators to probe and report on its London Whale error, where the bank lost some $6 billion, sending the stock down by 30 percent. But

the board failed to uncover even the fundamental fact that the trade was not based on a hedge, as management said.[1]

- The major banks engage in predatory loan making in low income neighborhoods. We are unaware of evidence that their respective boards question this activity.

Now, we face the ongoing scandals perpetrated by Wells Fargo. Most conspicuous was the creation of at least 3.5 million fake accounts by sales personnel facing onerous quotas, resulting in at last 5,000 known terminations of personnel, including the CEO, the head of the firm's Community Banking division, and several other department heads. In addition, Wells Fargo misconduct included illegal student loan servicing practices; inappropriate checking account overdraft fees; and unlawful mortgage lending practices, such as overcharging veterans for refinancing loans. The firm also faces allegations that include enrolling customers in life insurance policies without their consent; delaying mortgage closing dates until after the expiration of borrowers' interest rate lock to levy additional fees; and charging more than 570,000 customers for auto insurance policies they did not need, which resulted in at least 20,000 customers, including active duty service members, having their vehicles inappropriately repossessed.[2]

The Wells Fargo board of independent directors examined the problems at the firm and published a report in April, 2017. The report itself notes that account "gaming" issues came before the board as early as 2002.[3] Yet this same report reveals no steps taken by the board to investigate this issue. The report also notes discussion about dismissals of employees for fabricating customer accounts, whistleblowers pointing to problems, and a senior manager bringing the quota pressure problem to the chair. And yet the board did nothing. Moreover, given its single-minded focus on the already-revealed scandal involving the creation of checking and savings accounts, the 2017 board report failed to address the scope of the problem. The report showed that less than 2 million accounts were fabricated yet it has since been revealed that the figure is more than 3.5 million. In other words, even when the Wells Fargo board intentionally and actively examined the problem, it failed to detect nearly half of it. Nor does this board investigation touch on the many issues that have been publicized since the fake account scandal, such as the unwanted auto insurance, problematic student loan practices, and more.

The Fed's New Guidance

The Fed claims that its current proposed guidance was informed by a multi-year review of practices of boards, particularly at the largest banking organizations. That review has not been made public. It is difficult to conceive that a thorough review could have overlooked the massive, repeated failures of mega-bank boards to detect-- if not deter-- the massive, repeated misconduct by management. And if the review noted this failure, it is difficult to understand how it could have informed this proposed relaxation of directives or the vague goals that it proposes to replace the current directives. It is difficult

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[1] Bartlett Naylor, *TOO Big: the Mega-Banks are Too Big to Fail, Too Big to Jail, and Too Big to Manage,* PUBLIC CITIZEN (June 2016) https://www.citizen.org/sites/default/files/toobig.pdf

[2] Honorable Maxine Waters , *The Case for Holding Mega-Banks Accountable,* HOUSE FINANCIAL SERVICES COMMITTEE (Sept. 29, 2017) https://democrats-financialservices.house.gov/uploadedfiles/09.29.17_staff_report_final.pdf

[3] Independent Directors of the Board of Wells Fargo & Co, *Sales Practices Investigation Report,* p. 98, WELLS FARGO (April 10, 2017), https://www08.wellsfargomedia.com/assets/pdf/about/investor-relations/presentations/2017/board-report.pdf

to understand to whom Fed staff would have conversed at mega-banks to understand best practices, since most were associated with rampant misconduct.

Instead of this proposal to lessen requirements for boards of directors, we believe that the Federal Reserve should conduct a public examination of how boards failed in the years leading to the financial crisis, and how they have failed since to detect and deter the kinds of misconduct manifest at Well Fargo.

Supervision and Regulation Letters Rescinded

The Fed proposes to rescind numerous Supervision and Regulation (SR) guidance letters from the list of director responsibilities. These are issues on which regulators address the board directly, as opposed to management only. For example, the Fed would no longer require banks' directors to be mindful of problems arising from "Lending Standards for Commercial Loans."[4] Given that the primary business of a commercial bank is, or at least should be, loan-making, the board of directors should be concerned with this arena of risk. This letter begins with a cautionary note:

> A careful review of asset quality, credit standards, and lending practices has long been a major focal point of on-site supervisory examinations conducted by the Federal Reserve. Over the past several years, surveys of bankers and supervisors, as well as comments and anecdotal indications from examiners, bankers and industry groups, have confirmed that banks have been easing their lending terms and standards, largely because of intense competition to attract customers. This easing has occurred during a period of strong economic growth and stable market conditions. If carried too far, such easing can undermine a bank's financial health, especially if the economy weakens or the extraordinary recent performance of business profits and cash flows does not persist. [5]

Because of the failure of banks and their directors to inspect the underwriting quality of loan-making, the financial sector engaged in reckless securitization that led to the housing bubble and its subsequent rupture, which was the financial crash of 2008. Less than a decade later, the Fed proposes to rescind the letter advising boards to be diligent on lending standards. We believe this is misguided.

Or, consider the SR letter titled "Examining Risk Management and Internal Controls for Trading Activities of Banking Organizations." This letter, first published in 1993, begins with a prescient warning:

> The review of risk management and internal controls is an essential element of our examination of trading activities. In view of the increasing importance of these activities to the overall risk profile and profitability of certain banking organizations, the following guidance is being issued to highlight key considerations in examining the risk management and internal controls of trading activities in both cash and derivative instruments.[6]

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[4] *Lending Standards for Commercial Loans,* FEDERAL RESERVE BOARD (June 23, 1998) https://www.federalreserve.gov/boarddocs/SRLetters/1998/sr9818.htm

[5] *Lending Standards for Commercial Loans,* FEDERAL RESERVE BOARD (June 23, 1998) https://www.federalreserve.gov/boarddocs/SRLetters/1998/sr9818.htm

[6] *Examining Risk Management and Internal Controls for Trading Activities of Banking Organizations*, FEDERAL RESERVE BOARD (December 20, 1993) https://www.federalreserve.gov/boarddocs/srletters/1993/sr9369.htm

Since 1993, trading by major Wall Street firms expanded precipitously. Speculation on mortgage-backed securities contributed to the financial crash. The trading risk management letter appropriately instructs that:

> The board of directors should approve all significant policies relating to the management of risks throughout the institution. These policies, which should include those related to trading activities, should be consistent with the organization's broader business strategies, capital adequacy, expertise, and overall willingness to take risk. Accordingly, the board should be informed regularly of the risk exposure of the institution and should regularly re-evaluate significant risk management policies and procedures with special emphasis placed on those defining the institution's risk tolerance regarding these activities. The board of directors should also conduct and encourage discussions between its members and senior management, as well as between senior management and others in the institution, regarding the institution's risk management process and risk exposure.[7]

Had boards truly fulfilled this obligation, then many of the reckless trading positions leading to the crash would have been prevented.

Yet the Fed proposes to rescind this letter along with 27 other such explanations of board responsibility. The rational, according to the proposed guidance, is, in part, that "boards often devote a significant amount of time satisfying supervisory expectations that do not relate to the board's core responsibilities." We find this explanation wanting and circular. With this proposed guidance, the Fed is defining the new core responsibilities. The Fed then says that the SR letters are not part of the core responsibilities. And as they are not part of the core responsibilities, they can be rescinded.

Further, we believe the Fed's relaxation of the board's duties ignores the sizeable sums that shareholders pay for director services. The average pay of an independent director at an S&P 500 firm is $255,000. [8] At Wells Fargo, the compensation is higher. Three directors received compensation greater than $400,000. All but one received compensation greater than $300,000. (The one who received less resigned from the board early in the year.) [9] These compensation figures should command full time attention. An individual who earns $300,000 is in the top 1 percent of all earners.[10] The Fed should expect more, not less from these directors.

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[7] *Examining Risk Management and Internal Controls for Trading Activities of Banking Organizations*, FEDERAL RESERVE BOARD (December 20, 1993) https://www.federalreserve.gov/boarddocs/srletters/1993/sr9369.htm

[8] Tom Huddleston, *Here's Why it Pays to be a Corporate Director*, FORTUNE (Feb 24, 2016), http://fortune.com/2016/02/24/sandp-500-nonexecutive-directors-pay/

[9] *Proxy Statement*, p. 37, WELLS FARGO (2017) https://www.sec.gov/Archives/edgar/data/72971/000119312517083591/d305364ddef14a.htm#toc305364_20

[10] *What Percent are You*? WALL STREET JOURNAL (website visited October 4, 2017) http://graphics.wsj.com/what-percent/

Name (1)	Fees Earned or Paid in Cash ($)(2)(3)	Stock Awards ($)(4)	Option Awards ($)(5)	Non-Equity Incentive Plan Compensation ($)	Change in Pension Value and Nonqualified Deferred Compensation Earnings	All Other Compensation ($)(6)	Total ($)
(a)	(b)	(c)	(d)	(e)	(f)	(g)	(h)
John D. Baker II	207,000	180,002	-	-	-	5,000	392,002
Elaine L. Chao	127,000	180,002	-	-	-	5,000	312,002
John S. Chen	123,000	180,002	-	-	-	-	303,002
Lloyd H. Dean	196,000	180,002	-	-	-	-	376,002
Elizabeth A. Duke	201,131	180,002	-	-	-	5,000	386,133
Susan E. Engel	159,000	180,002	-	-	-	-	339,002
Enrique Hernandez, Jr.	236,000	180,002	-	-	-	5,000	421,002
Donald M. James	141,000	180,002	-	-	-	5,000	326,002
Cynthia H. Milligan	192,000	180,002	-	-	-	5,000	377,002
Federico F. Peña	200,673	180,002	-	-	-	5,000	385,675
James H. Quigley	249,000	180,002	-	-	-	-	429,002
Judith M. Runstad	76,327	-	-	-	-	-	76,327
Stephen W. Sanger	300,628	180,002	-	-	-	5,000	485,630
Susan G. Swenson	177,000	180,002	-	-	-	-	357,002
Suzanne M. Vautrinot	153,000	180,002	-	-	-	-	333,002

From Wells Fargo proxy statement

"Attributes" of "Effective Boards"

The Fed proposes that boards instead adhere to what it calls "Attributes of effective boards of directors." We note that the Fed has not explained why these attributes are associated with effective boards, nor does it provide examples of effective boards. Nevertheless, it outlines them as if they are self-explaining.

The first attribute the Fed proposes is to "set clear, aligned and consistent direction." To explain what it means to be "clear," the Fed uses the term "clear" seven times in as many paragraphs, without providing actual clarity. Without a definition, this goal is meaningless. Is a board to be forgiven if it sets a policy that it believes to be clear when management does not find it clear? Second, an effective board is one that will "actively manage information flow and board discussions." Tough investigation by a board might have rooted out the Wells Fargo scam years before it became the subject of a federal investigation. But in explaining this attribute, the Fed limply proposes that "effective" directors "may" seek information from employees other than the CEO. Given that a Wells Fargo director makes $400,000 annually, the Fed can surely insist on such oversight. Third, a board "hold[s] senior management accountable." Among the activities, the effective board "engages in robust and active inquiry." The Fed does not provide any metric, such as a minimum number of meetings with management. Fourth, the Fed proposes that an effective board should "support independence and stature of independent risk management and internal audit." A board that "supports" independence is hardly held to a high bar. The Fed provides no metric, other than it encourages directors to meet with the chief risk officer. Finally, the Fed proposes that a board "maintain a capable board composition and governance structure." Here might be a time for the Fed to insist that boards are chaired by an independent director. Instead, the Fed only advises that the board assess its strengths and weaknesses.

These vague, unmeasurable attributes will hardly awaken the somnolent boards that oversaw bank management that caused the financial crash and the countless other scandals at the mega-banks since then.

Strengthening Board Oversight

Instead of relaxing requirements and replacing directives with vague principles, the Fed should be tightening requirements. Warren Buffett, manager of Berkshire Hathaway and Wells Fargo's largest shareholder, calls on pay cuts for board directors.

> "As much as possible you want the people responsible to pay," said Buffett. "The CEO and spouse should be put at risk of going broke. This is especially true of the CEO, but the board should suffer huge penalties as well. Perhaps they should have to repay the last five years of director's fees. If you run a firm that needs to be saved, then the person running that institution should be aware that it is very painful to fail." [11]

Camden Fine, president of the Independent Community Bankers of America, believes Wells Fargo directors should be terminated.

> To many in the financial services industry, the ongoing lack of accountability at Wells Fargo is as puzzling as the bank's practices are disturbing. Had a Main Street community bank engaged in such behavior, its board and senior managers would not only have been forcibly removed, they would be facing prosecution. Small, locally based financial institutions receive no such deference from the teams of regulators and bank examiners to whom they are accountable. Wells Fargo's scandals have exposed a shameful double standard in the nation's financial regulatory system — one in which $100 million community banks must meet a higher standard than $2 trillion megabanks. The nation's largest financial firms are not only too big to fail, they're too big to regulate. . . . It is long past due for Wells Fargo to be held truly accountable. Regulators can start by removing board members and senior managers who have failed to satisfy their obligations — costing the bank, its customers and the rest of us, dearly.[12]

The Fed should insist that the board address whistleblower complaints. These should be reported to the board and the board should report to regulators on all responses, and publicly, where it has taken possible illegal retaliatory action, such as the dismissal of an employee.

The Fed should insist on proven best practices in corporate governances: The chair should never be the CEO and the Board should retain staff that reports to independent directors including having full access to all management and employees.

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[11] Gillian Tan, *Warren Buffett Finally Gets Tough on Wells Fargo,* BLOOMBERG (Oct. 3, 2017) https://www.bloomberg.com/gadfly/articles/2017-10-03/wells-fargo-s-board-draws-buffett-s-ire-is-ceo-sloan-next

[12] Camden Fine, *Why are Regulators so Unwilling to Remove Wells Fargo's Leaders*, AMERICAN BANKER (September 28, 2017) https://www.americanbanker.com/opinion/why-are-regulators-so-unwilling-to-remove-wells-fargos-leaders?feed=00000158-080c-dbde-abfc-3e7d1bf30000

In the end, we believe the current mega-banks are inherently too big—too big to manage, too big to be overseen by a board of directors. Each of the four largest banks employ more than 200,000 people. They each serve around 50 million customers. Their complex derivatives transactions are hardly understood by senior managers, let alone part-time board members. We believe the misconduct leading to financial crisis and continuing to this day is the inevitable result of size. The mega-banks should be broken up. [13]

That is where the Federal Reserve, in partnership with the other members of the Financial Stability Oversight Committee, should be placing its supervisory energy, not weakening our nation's prudential oversight.

For questions, please contact Bartlett Naylor at bnaylor@citizen.org.

Sincerely,

Public Citizen

[13] Bartlett Naylor, *TOO Big: the Mega-Banks are Too Big to Fail, Too Big to Jail, and Too Big to Manage,* PUBLIC CITIZEN (June 2016) https://www.citizen.org/sites/default/files/toobig.pdf