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January 24, 2014

OCC Proposal Sets Minimum Standards for a Risk Governance Framework - The Additional Process Requires Consideration and Comment

The January 17th proposed guidelines from the Office of the Comptroller of the Currency ("OCC") seeks to establish minimum standards for financial institutions to design and implement a Risk Governance Framework and standards for the oversight and participation by an institution's board of directors and internal audit department (the "Proposal"). The Proposal is part of the OCC's "heightened expectations" applicable to financial institutions with over $50 billion in assets or institutions determined to be "highly complex or present a heightened risk as to require compliance with the Guidelines." However, the OCC has been advising of these expectations since 2010, and it should be anticipated that the OCC will apply the Guidelines more broadly to all regulated institutions as best practices or by formally adopting broader applicability of the Guidelines.

The Proposal outlines the responsibilities of an institution's board of directors, front line management, independent risk management, and internal audit as part of the institution's Risk Governance Framework. Institutions should provide comments on the requirements contained in the Proposal that are unclear or present undefined parameters for compliance. Some of the terms of the Proposal that deserve consideration and comment are set forth below. The comment period ends on March 18, 2014 and a full copy of the Proposal can be found here.

Requirement to Establish a Risk Governance Framework - Front Line Unit Procedures

Institutions are required to develop and adhere to a formal Risk Governance Framework, that includes establishing policies and supporting processes appropriate for the institution's size, complexity, and risk profile in order to effectively identify, measure, monitor and control the institution's concentration of risk (*"Framework"*). The Framework should incorporate an institution's formal statement of its "risk appetite," which defines the institution's risk culture and is the basis for the Framework. While many institutions have appointed a Chief Risk Executive and established a risk management structure in recent years, the Proposal outlines specific roles and responsibilities relating to the risk management function. Each front line unit is required to establish its own policies and procedures and risk limits. The Chief Risk Executive will need to work with the front line units, internal audit, the CEO and board of directors to establish specific policies and procedures and risk limits that flow from each front line unit to the institution's comprehensive Framework. The Proposal broadly defines "front line unit", leaving the applicability and scope of policies and procedures to interpretation by each institution.

Comment: Institutions should consider requesting guidance from the OCC as to the expectations regarding (i) how broadly or narrowly a front line unit can be defined within the Framework to determine the scope of the required policies and procedures; and (ii) how certain service-oriented front line units (e.g., finance, treasury and legal) should be included and evaluated within the Framework when the risk appetite statement is defined in significant part by traditional examination criteria (i.e., impact on earnings, capital and liquidity) as set forth in the Proposal. Also, if "legal" is considered a front line unit, is it possible for an institution's general counsel to also be its Chief Risk Executive or be part of the independent risk management team?

Increased Internal Audit Responsibilities

The Proposal requires an institution's internal audit department to include, as part of its audit program and reporting an evaluation of the Framework, including the newly established separate policies and procedures. Independence of internal audit is to be maintained by having the ability to report directly to the board of directors or the board's audit committee. Internal audit will be required to inventory each of the institution's products and services (to the extent not already managed); in order to establish a process for independently assessing the design and effectiveness of the Framework as to each material business unit, as well as establish a separate quality assurance department within internal audit to monitor compliance with regulatory guidance. Internal audit is required to update this audit program on at least a quarterly basis to take into account changes to the institution's risk appetite.

Comment: Institutions should consider commenting on the requirement to update the new audit program quarterly, which seems too frequent for an audit program as broad as outlined in the Proposal and request that this requirement be changed to no more than annually. Quarterly review does not allow time to evaluate audit results and adjust the program appropriately. Institutions will always maintain the ability to revise the audit program if the risk appetite or Framework changes between audits. Also, the final Guidelines should clarify whether the requirement to audit each "material business unit" is the same as each front line unit, or whether and what are the differences in the terms being used.

The OCC specifically requested comment on whether internal audit's assessment of the institution's Framework should include a conclusion regarding whether the Framework is consistent with "leading industry practices." The Proposal recognizes the wide range of practices in the industry and the challenges associated with determining what constitutes a leading industry practice. Each institution is required to develop a Framework unique to the institution's own risk appetite and structure; therefore, verification that the Framework is consistent with leading industry practices is not practical. Additionally, the focus of an institution's Framework should not be whether it complies with industry practice, but rather whether the Framework is appropriate for the institution's defined risk appetite.

Comment: Institutions should consider requesting that the OCC remove from the final Guidelines the requirement that internal audit's assessment of the Framework include a conclusion as to whether the Framework is consistent with leading industry practices.

Additional Board of Directors Responsibilities

The Guidelines are incorporated as part of a board of directors' responsibility for the general safety and soundness of the institution; but go further to specifically call for a more active board that challenges executive management, helps define the institution's risk appetite and requires compliance with those parameters. The Proposal sets forth specific mandates for an institution's board including ongoing training on the laws and regulations applicable to the institution. Directors are also required to undertake an annual self-assessment to evaluate their effectiveness in meeting their responsibilities under the Guidelines.

Comment: Institutions should consider commenting to request guidance on how a self assessment should be performed and compiled by the board of directors, and whether the board of directors is permitted to task internal audit, a board or management committee or a third party vendor with performing the assessment. Also, request guidance addressing whether, once the results of the self assessment are obtained, the board of directors has a reporting requirement or only the requirement to remediate areas where deficiencies are noted?

Additional Compliance Item and Comment Summary

The Proposal sets forth the minimum requirements for a Framework, but the detailed structure and implementation of the Framework are largely left to each institution. One area for compliance would be in new product approvals. Institutions should consider adding a statement in any new product review and approval process proposed by a front line unit, or request to engage a new third party vendor, that such new product or service or vendor complies with the risk appetite of the front line unit and the institution generally. Internal audit should be required to confirm that the new product is in compliance with the institution's risk appetite statement as part of its sign-off process for the new service, product or vendor.

As set forth above, institutions should consider commenting to request that the OCC:

- Better define front line units and how broadly or narrowly they should be structured to comply with policy and procedure requirements;
- Clarify how legal and other administrative units of an institution are to be considered as a front line unit for purposes of the Framework;
- Reduce the frequency of updates to the audit program relating to the Framework to conform to a more traditional audit cycle;
- Remove the requirement to verify that a Framework is consistent with leading industry practices; and
- Provide guidance or modify the requirement of the board of directors to conduct an annual self-assessment of its compliance with the requirements of the Guidelines.

The above provides only a few considerations for comments and questions on the Proposal. Additional terms in the Proposal should be evaluated, such as the compensation and succession planning issues, to make certain an institution can develop compliant policies and procedures based on the terms in the Proposal.

For More Information

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