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Back to basics:
Lessons learned from recent banking turmoil and evolution of governance practices

June 2024

Center *for* **Regulatory Strategy** **US**

In response to recent market events, US banking regulators have continued to reinforce their supervisory expectation across three key areas—strong governance, risk management, and controls—through new regulations, supervisory guidance, and targeted inspections and examinations.[1]

The first wave of heightened regulatory focus following the financial crisis of 2008 saw the introduction of the Dodd-Frank Wall Street Reform and Consumer Protection Act,[2] the Federal Reserve Board of Governors' (FRB) Consolidated Supervision Framework for Large Financial Institutions,[3] FRB's Regulation YY Enhanced Prudential Standards (EPS),[4] and the Office of the Comptroller of the Currency's (OCC) Heightened Standards.[5] These reforms introduced a new regulatory and supervisory paradigm for financial institutions' governance practices that, together, articulated extensive standards for board and management governance, risk management and controls. Between 2018 and 2019, these regulations saw some tailoring according to size and complexity of the financial institutions,[6] with a focus on the systemically important financial institutions and the FRB's new rating system for large financial institutions. Additional governance guidance was issued by the FRB on effective board oversight practices .[7]

Over the same period, regulators continued to find shortcomings in many institutions' implementation of these standards and from 2020 through 2023, the industry saw risk and governance-related penalties and public enforcement measures that garnered public attention.[8] The next wave of heightened regulatory attention unfolded with the banking turmoil in early 2023, which exposed lapses in banks' governance, oversight, risk, and control practices that brought pockets of the financial system under the spotlight of increased regulatory scrutiny, with special attention on regional banks, as well as the board of directors' role and responsibility in supervising and holding management accountable.[9] Recent and pending actions by the banking regulators to amend their examination framework to increase the escalation of examination issues could result in a more difficult examination environment extending well into the future.[10]

As the regulatory pressure continues, regulators will likely continue to be assertive in identifying supervisory concerns, documenting them with expectations for timely remediation, and escalating their concerns regarding supervisory findings to boards and considering further action.[11]

Lessons learned

Organizations can benefit from understanding the lessons learned over the last several years, especially with the banking crisis highlighting the need to improve governance, risk, and control practices appropriately. Organizations should consider the following principles:

- The linkages and balance among strategy, risk, and financial performance should be adequate and closely coordinated by business leaders, chief financial officer (CFO), and chief risk officer (CRO) with oversight through the board.
- Governance and risk management frameworks should be integrated, keep pace with rapid growth, address regulatory feedback, and be implemented at different levels across the bank and holding company, as required.
- Banks should be prepared for heightened expectations and requirements in advance of crossing regulatory thresholds.
- Banks should prioritize the quality of risk and financial information and foster effective challenge, decision-making, and escalation through senior management, committees, and the board.
- Proactive and sustainable self-improvement should be a key objective across the three lines model with a focus on issue management systems and escalation protocols that drive self-identification and remediation.
- Banks should strengthen accountability across the three lines model and establish an effective risk and reward culture.
- The board and senior management should be proactive and be prepared to respond promptly to fast-changing environments, especially in today's age of social media.

Recent regulatory action

Regulators have increasingly turned their attention toward the role of the board in overseeing the governance and risk appetite of the institution and holding senior management accountable. In October 2023, the Federal Deposit Insurance Corporation (FDIC) issued corporate governance and risk management guidelines for depository institutions with at least $10 billion in total assets.[13] The guidelines would require boards to maintain dedicated committees to focus on areas such as risk, audit, and compensation.

More recently, several agencies jointly issued proposed rules on incentive-based compensation arrangements which would require such arrangements include risk adjustment of awards, deferral of payments, and forfeiture and clawback provisions.[14] These focus areas, as well as the growing concept of "too big to manage,"[15] will feature into how boards and senior management are organized and govern themselves.

How are banks responding?

Many banks and their boards are undergoing transformation efforts as a result of the 2023 banking turmoil, including:

- Enhancing risk management frameworks and monitoring and control programs to proactively manage the risk profile of the institution in line with board-approved risk appetite;
- Strengthening the three lines governance model to clarify roles and responsibilities and improve accountabilities across the organization;
- Reviewing data and management information systems (MIS) to support monitoring, review and challenge, decision-making, and escalation;
- Building resiliency and identifying interconnectedness of internal and external factors that shape the organization's strategy, including assessing a third-party ecosystem (including its service providers); and,
- Evaluating board structure, composition, skills, and reporting to improve oversight and management accountability.

Many organizations are also actively adapting and reflecting on their strategies and governance frameworks in response to the evolving regulatory environment. Banks and their boards are working to understand and apply the lessons from recent bank failures, question the adequacy of their reporting information, and confirm they are fulfilling their oversight responsibilities effectively. An important step is outlining metrics and activities to determine the effectiveness of the governance model and monitor outcomes.

Banks that managed to navigate through the crises with minimal impact often have undertaken or leveraged public postmortem analyses,[16] sharing findings with their boards to illustrate potential risks and responses. This exercise has highlighted the importance of continuous self-examination and improvement, focusing on assessing appropriateness of risk appetite and governance frameworks, as well as strategy changes and the impacts to the organization.

Furthermore, many bank boards are becoming more proactive to better respond to market and regulatory changes. This includes increasing the frequency of meetings, enhancing the focus and calibration of information for decision-making, and conducting informal and off-cycle interactions with management to aid in agility and responsiveness. Boards are increasingly focused on evaluating the effectiveness of current committees and the potential need for ad hoc committees, especially for compliance, remediation, and crisis efforts. Boards are also reassessing their composition, seeking to ensure they possess the necessary expertise for current and future challenges, including risks, technology, and strategic expansion. Increased engagement with external advisers is another strategy to maintain board independence and informed decision-making. Additionally, boards are increasingly relying on subcommittees to manage technical topics, such as cybersecurity, mergers, and enterprise transformation programs, enabling more focused and informed oversight.

Senior management and their boards are deeply reflecting on their governance structures, striving for greater oversight, responsiveness, and resilience in the face of a complex and evolving regulatory landscape. This will position them better for future success, helping to navigate the uncertainties of the financial sector.

Thematic pain points for boards

Despite years of effort and investment by institutions, some boards continue to face significant challenges. These pain points underscore the need for clear communication, effective information management, strategic alignment, and strong governance practices.

Information overload and relevance: Boards often grapple with the challenge of receiving too much information, sometimes with stale data, making it difficult to discern actionable insights and understand critical risk factors. The vital task is finding the right balance of information and granularity that allows board members to engage in detailed inquiry, challenge management, and make informed decisions without being overwhelmed.

Confusion between board and management roles: There is confusion regarding the distinct roles of the board and management, partly due to the unique regulatory requirements in banking compared to other sectors. This confusion can lead to inefficiencies and misunderstandings about responsibilities, especially when regulators hold both entities accountable in times of crisis.

Adapting to challenges posed by social media: Social media presents a complex challenge for bank boards today, amplifying the need for effective oversight, adaptive communication strategies, and overseeing reputational risk differently. While social media provides platforms for banks' engagement and transparency with stakeholders, it also exposes banks to the exposure of misinformation and fear, potentially leading to destabilizing deposit runs and reputational damage. Addressing these challenges requires a nuanced understanding of social media's role in shaping financial narratives and a commitment to leveraging digital platforms responsibly to safeguard and enhance institutional reputation.

By addressing these challenges, boards can enhance their oversight capabilities, promote a strong risk and compliance culture, and contribute to the overall resilience and success of their institutions.

This is all the more important given that most outstanding supervisory findings at large financial institutions are related to governance and controls.[17]

Board and management actions

Boards and management should keep a few key actions in consideration:

- **Agility and responsiveness:** Boards should be flexible and dynamic, and keep pace with strategy, market, and regulatory changes. Boards are increasing the frequency of meetings and forming ad hoc committees to swiftly address changes and strengthen oversight (e.g., remediation, information security). It is crucial that the board's composition aligns with the required expertise for current and future challenges.
- **Information and communication:** Boards should find the right balance in the granularity of the information they receive from management, with materials needing to be clear, concise, and understandable. The board's role includes holding management accountable for accurate content, timely delivery, and fully comprehending regulatory expectations and risk factors.
- **Clarity between board and management roles:** Clarifying the distinct roles of the board and management is essential. Boards have the responsibility to establish and enforce policies, safeguard efficient administration, and oversee the institution in a safe and sound manner.
- **Integration of strategy, risk, and financial planning:** Boards should align business strategy, risk appetite, and financial planning and view all as an integrated process. Boards should also critically evaluate new strategies and impact of changes to existing strategies, taking into account past crises and the changing market landscape. Aligning incentives with strategic goals is also vital.
- **Oversight and specialization:** Boards should strengthen oversight by requiring quality information that highlights critical risk factors, understanding changes to strategy and risk appetite and the impact to the organization, and challenging enterprise change and transformation programs. Boards should also consider creating specialized, ad hoc subcommittees to manage complex issues more effectively, such as cybersecurity and mergers, to provide more detailed attention to technical topics and alignment with management.
- **Accountability and culture:** Boards should foster a strong culture of accountability and compliance by engaging management in probing discussions, posing effective challenge regarding management's assumptions and decisions, and integrating risk into performance management. Management is also responsible for promoting a strong risk and compliance culture through operationalizing the governance and risk management frameworks. This needs to be supported by tangible assessment, metrics, and independent validation.

- **Proactive resilience:** Boards should monitor and encourage banks' work to improve resilience by understanding emerging risks, such as the influence of social media, and actively participating in regular risk reviews, understanding stress testing and tabletop exercise outcomes, and analyzing post-action reviews for actionable insights.
- **Strategic performance management and reporting:** Management's role includes consistent delivery of board materials, utilization of metrics like objectives and key results (OKRs) and key performance indicators (KPIs) for performance management, conducting stress tests, and developing a crisis management plan.
- **Continuous learning and self-evaluation:** Boards and management should engage in continuous learning and improvement through regular risk reviews, postmortems, stress testing, and both self-evaluations and independent evaluations.

Weaknesses in corporate governance, including inadequate risk management practices and poor data quality, contributed to some bank failures in spring 2023.[18] Given the current regulatory landscape, it is critically important for the board and management to work together to find the right balance in information quality. Senior management and the board should be aligned on the necessary steps for effective decision-making and remediation where required, empowering the boards to comprehend key issues and contain potential risk of harm.

The need to strengthen governance, risk, and control practices will continue to be amplified. Regulatory scrutiny will not lessen, and if something goes wrong, both the board and management may be held accountable by the regulators.

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We're grateful for the panelists who participated in Deloitte's webinar "The evolution of governance in banking: Its role and importance today" for their thoughtful perspectives and insights: ***Caroline Swett****, partner, Debevoise & Plimpton;* ***Irena Gecas-McCarthy****, principal, Deloitte & Touche LLP;* ***David Puth****, senior advisor, Deloitte & Touche LLP; and* ***Richard Rosenthal****, principal, Deloitte & Touche LLP.*

Endnotes

1. See Deloitte, 2024 banking regulatory outlook, January 2024; Deloitte, "Prepare for more stringent regulation and agile supervision after bank failures," May 2023.

2. Dodd-Frank Wall Street Reform and Consumer Protection Act, Pub. L. 111-203, 111th Cong., 2010.

3. Federal Reserve Board of Governors (FRB), "SR 12-17 / CA 12-14: Consolidated Supervision Framework for Large Financial Institutions," December 17, 2012.

4. 12 CFR Part 252 (Regulation YY).

5. 12 CFR Appendix D to Part 30 (Heightened Standards).

6. FRB, "Federal Reserve Board finalizes rules that tailor its regulations for domestic and foreign banks to more closely match their risk profiles," press release, October 10, 2019. See Deloitte, "Federal Reserve Board finalized tailoring Prudential Standards for large banking institutions," 2019.

7. FRB, "SR 21-3 / CA 21-1: Supervisory Guidance on Board of Directors' Effectiveness," February 26, 2021.

8. See Deloitte, "Prepare for more stringent regulation and agile supervision after bank failures."

9. FRB, "Remarks by Vice Chair for Supervision Michael S. Barr before the US Senate Committee on Banking, Housing, and Urban Affairs," March 28, 2023; See Deloitte, 2024 banking regulatory outlook.

10. See FRB "Remarks by Vice Chair for Supervision Michael S. Barr before the Committee on Financial Services, US House of Representatives," May 15, 2024.

11. See Deloitte, "Prepare for more stringent regulation and agile supervision after bank failures."

12. FRB, Review of the Federal Reserve's supervision and regulation of Silicon Valley Bank, April 28, 2023; Office of the Inspector General (OIG) and FRB, Material loss review of Silicon Valley Bank, September 25, 2023; Federal Deposit Insurance Corporation (FDIC), FDIC's supervision of Signature Bank, April 28, 2023; OIG and FDIC, Material loss review of Signature Bank of New York, October 24, 2023; Government Accountability Office (GAO), Preliminary review of agency actions related to March 2023 bank failures, April 28, 2023; New York State Department of Financial Services (NYDFS), Internal review of the supervision and closure of Signature Bank, April 28, 2023; California Department of Financial Protection and Innovation (CA DFPI), Review of DFPI oversight and regulation of Silicon Valley Bank, May 8, 2023; Bank for International Settlements (BIS), Report on the 2023 banking turmoil, October 5, 2023.

13. FDIC, "Guidelines Establishing Standards for Corporate Governance and Risk Management for Covered Institutions with Total Consolidated Assets of $10 Billion or More," October 11, 2023. See Deloitte, "FDIC focuses on bank boards for governance and risk enhancements."

14. FDIC, OCC, National Credit Union Administration (NCUA), and the Federal Housing Finance Agency (FHFA), "Agencies issue proposal on incentive-based compensation," press release, May 6, 2024.

15. OCC Acting Comptroller of the Currency Michael J. Hsu Remarks at Brookings, "Detecting, Preventing, and Addressing Too Big To Manage," January 17, 2023.

16. See e.g., FRB, Review of the Federal Reserve's supervision and regulation of Silicon Valley Bank; FDIC, FDIC's supervision of Signature Bank.

17. FRB, "Supervision and Regulation Report," May 2024.

18. Ibid.

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