Volume 9, Number 3 ⁓ March 2003
FEDERAL RESERVE BANK OF NEW YORK

Current Issues
IN ECONOMICS AND FINANCE

www.newyorkfed.org/rmaghome/curr_iss

Governing the Financial or Bank Holding Company: How Legal Infrastructure Can Facilitate Consolidated Risk Management

Thomas C. Baxter, Jr.

On October 25, 2002, Thomas C. Baxter, Jr., General Counsel and Executive Vice President of the Federal Reserve Bank of New York, presented the following remarks at the Puerto Rico Bankers Association conference "Financial Transparency and Corporate Governance of Financial Institutions after the Sarbanes-Oxley Act of 2002" in San Juan, Puerto Rico.

Today's conference is devoted to financial transparency and corporate governance, two related but distinct topics. I commend the Association for devoting time to these timely and important topics and for giving me the opportunity to share my views. The recent accounting scandals involving some well-regarded U.S. firms are a sharp reminder of what can happen when corporate governance is neglected. In a speech earlier this month, Comptroller of the Currency John D. Hawke, Jr., observed that this series of scandals might serve as a powerful catalyst for constructive change.[1] I agree with the comptroller's observation and believe that the way we respond to corporate misconduct today will make for a stronger business and financial community tomorrow.

My remarks will focus on the governance of a financial or bank holding company and, specifically, the relationship between the holding company and an insured depository institution subsidiary. For ease of reference, I will refer to the financial or bank holding company as the "holding company" and its insured depository institution subsidiary as the "bank."

I begin with a preliminary statement about a shared objective: We want the governing body of the holding company to perform two critical functions. First, we want it to understand the risks to the "enterprise," meaning the risks in all of the company's constituent parts. Second, we want the holding company to take reasonable steps to manage those risks and keep them within acceptable limits.

By "we," I mean those persons who might be described as having a stake in the success or failure of the enterprise. These stakeholders include the holding company's shareholders, to be sure. In addition, when there is a bank in a corporate family, the government also has a prime interest.

The Sarbanes-Oxley Act and Its Antecedents in Banking Law

For lawyers, the Sarbanes-Oxley Act, which was signed into law on July 30, 2002, was a watershed event. The act has significant implications for publicly traded companies, the people who govern those companies, company auditors and attorneys, and analysts and investment banks. Many of the speakers today will explain why this is so. The act is important not only for its content but also for its symbolism; it has placed corporate governance at the top of current policy issues.

Interestingly, many of the remedial provisions of the act are not completely new to bankers and bank counsel. In fact, bankers have told me informally that their institutions will not need to make substantial changes to satisfy some of the provisions because they have been complying with similar provisions for years.

Let me give you two specific examples. In 1991, in the wake of a series of insured depository institution failures, Congress enacted legislation known as the Federal Deposit Insurance Corporation Improvement Act, or FDICIA. Section 36 of FDICIA is titled "Early Identification of Needed Improvements in Financial Management."[2] Isn't it telling how well this decade-old title fits the problems we have seen in nonbank companies during the last several months? Section 36 and the regulation that implements it—Title 12, Part 363, of the Code of Federal Regulations (C.F.R.)—require each insured depository institution to prepare a report, to be signed by the chief executive officer and the chief accounting officer, acknowledging management's responsibilities for the annual financial statements, for establishing and maintaining an adequate internal control structure and procedures for financial reporting, and for complying with laws and regulations relating to safety and soundness.[3] Another requirement is an assessment by management of the effectiveness of the insured depository institution's internal control structure and procedures, and of the institution's compliance with such laws and regulations.[4] Bankers have been complying with Section 36 and Part 363 for ten years.

> The [Sarbanes-Oxley] act is important not only for its content but also for its symbolism; it has placed corporate governance at the top of current policy issues.

The certification provisions of the Sarbanes-Oxley Act clearly draw on the FDICIA rules. Like FDICIA, the Sarbanes-Oxley Act requires, among other things, that the principal executive officer and the principal financial officer acknowledge in each annual or quarterly report their responsibility for internal controls and present their conclusions as to the effectiveness of those internal controls. To be sure, the certification required by Sarbanes-Oxley is more robust than that mandated by FDICIA. While FDICIA requires that internal controls be adequate, Sarbanes-Oxley requires that internal controls ensure that information material to the company and its consolidated subsidiaries is made known to the appropriate officers. Sarbanes-Oxley also goes further than FDICIA in detailing the kind of information that must be included in reports concerning the effectiveness of controls and procedures.

In one area, however, FDICIA appears to be more exacting than Sarbanes-Oxley—its stipulation that management acknowledge responsibility for complying with laws and regulations relating to safety and soundness.[5] The fact that legal compliance certification exists in FDICIA but not in Sarbanes-Oxley is very significant: It is emblematic of a view that banks are different from other types of firms, and that the government has an interest in banks. Compliance with law and regulation is necessary to protect the government's interest. Still, despite these differences between Sarbanes-Oxley and FDICIA, it is apparent that the certification requirements in the 2002 act are conceptually very similar to those in the earlier banking legislation.

Another provision within Sarbanes-Oxley that has its roots in preexisting banking law is Section 402 of the act. Section 402 makes it unlawful for an issuer to extend or maintain credit, or arrange for the extension or renewal of an extension of credit, to any director or executive officer of the issuer. I think nearly every banker and bank lawyer is mindful of the insider lending provisions of Section 22(h) of the Federal Reserve Act and its implementing regulation, Regulation O. These provisions address the problem of insider abuse in a banking organization, and they have existed in banking regulation for many years. The drafters of the act clearly had these prudential legal provisions in mind, because the prohibition in the act does not apply if the issuer is an insured depository institution. Instead, the provisions of Section 22(h) and Regulation O apply.

Corporate Governance in Banks and Holding Companies after Sarbanes-Oxley

I assume by now you are willing to accept my proposition that many of the provisions of Sarbanes-Oxley have their genesis in banking law. How does all of this relate to my topic, which looks to the governance of the holding company? The short answer is that prudential banking laws and regulations, at least as they relate to safety and soundness, were designed to safeguard the government's interest in the bank. Sarbanes-Oxley picks up some of those principles and employs them to protect the stakeholders interested in publicly traded companies, including the company shareholders.

Prudential banking laws and regulations, at least as they relate to safety and soundness, were designed to safeguard the government's interest in the bank. Sarbanes-Oxley picks up some of those principles and employs them to protect the stakeholders interested in publicly traded companies, including the company shareholders.

Of course, because many of the Sarbanes-Oxley provisions are safety and soundness provisions, they extend a safety net to other persons interested in issuer safety, such as creditors and employees, and even retirees whose 401(k) plans include stock in the bank or holding company.

The act and its implementing regulations will likely apply to the holding company, assuming that it is publicly traded. The applicability of Sarbanes-Oxley to foreign companies is complicated, and many of the foreign institutions here will need to work closely with counsel. Of course, FDICIA and Part 363 will continue to apply to the wholly owned bank. In addition, the holding company will likely be subject to measures being adopted by the New York Stock Exchange, the American Stock Exchange, or NASDAQ. Finally, there are fiduciary obligations imposed on the board of directors and the audit committee by the law of the place where the holding company is incorporated. If the bank has a state charter, state law may also impose requirements on the board of directors or the audit committee.

How can all of this legal infrastructure relating to the governance of a holding company be reconciled? Let me offer you some principles that might be of practical utility. I must caution you, however, that compliance with the letter of the law will always turn on the unique facts presented.

Banks and the Importance of Holding Company Control

In his recent speech about governance, Comptroller Hawke observed that "banking organizations are different." While I agree with the comptroller, I believe that E. Gerald Corrigan, former president of the Federal Reserve Bank of New York, said it even better. In his words, "banks are special."[6]

Mr. Corrigan offered two distinct reasons why banks are special. First, unlike other corporate entities, banks have special access to the credit facilities of the Federal Reserve. Monetary theorists would call this *access to the lender of last resort*. Second, unlike corporations of the garden variety, banks have liabilities called deposits that are insured by an agency of the U.S. government, namely, the Federal Deposit Insurance Corporation. Deposit insurance enables banks to have a lower funding cost than nonbanks.

Why is it significant that banks have a privileged status in our legal infrastructure? Because with the special privileges come special obligations. As Comptroller Hawke suggested, banks must take into account a stakeholder other than the owner/shareholder. For banks, this other interest is the "public interest."

From these settled principles, Comptroller Hawke asked a question that must be considered by the governing body of any holding company. He asked, "Who speaks for the bank?" When the bank has a stakeholder constituency that is broader than just its holding company, the question does not have an obvious or clear answer.

In considering corporate governance practice in the context of a holding company structure, Comptroller Hawke referred to the issue of whether a holding company should control the management of the bank by controlling the bank's board of directors. The concern is that overlapping directors would speak only for the holding company and that no one at the bank level would speak for the public interest. In my view, this concern makes too much of the feared conflict between the public interest and the interest of the holding company, and much too little of their shared goal of ensuring the safe and sound operation of the enterprise. Let me explain.

Banks must take into account a stakeholder other than the owner/shareholder. For banks, this other interest is the "public interest."

As I see it, the public interest in the bank subsidiary is protected by a panoply of prudential laws and regulations. The ownership interest of the holding company in the bank is protected by the holding company's ability to control the bank's board of directors. The ultimate owners, the shareholders, are interested in profitability, to be sure. A profitable bank may pass dividend value to its parent, and the parent presumably will pass value to the shareholders, either by dividend or by a higher share price. But the interests of the shareholders and the public are reconciled because compliance and profits will, in the majority of situations, go hand in hand. As the ultimate owners, the shareholders will achieve their profits only if the bank subsidiary and its parent effectively manage credit, legal, reputational, operational, and other risks.

[The bank subsidiary's] independent audit committee speaks for the public interest by having an express obligation to consider compliance with laws and regulations relating to safety and soundness.

Let's look again at FDICIA, which I think helps prove my point that the government interest is protected. Under the Part 363 regulations, the audit committee of the bank subsidiary is the body that considers management's assessment that it is complying with the laws and regulations relating to safety and soundness. According to Part 363, this committee is required to be independent of both the bank and the holding company. So, to return to Comptroller Hawke's question about who in a bank speaks for the public interest, the answer is that an independent audit committee speaks for the public interest by having an express obligation to consider compliance with laws and regulations relating to safety and soundness. Given the audit committee's special functions with respect to laws and regulations relating to safety and soundness, and in view of the audit committee's independence from the management of both the holding company and the bank, there seems to be no good reason to break that parental control.

The Job of Bank and Holding Company Audit Committees

But how should the audit committee do its job? In terms of focus, the committee should concentrate its oversight on those laws and regulations that relate to safety and soundness. FDICIA identifies these laws and regulations, but perhaps the time is ripe for a reappraisal to see whether the laws referenced are where the safety and soundness risks are currently centered.

To be effective, the audit committee must be well served by the agents who are its eyes and ears: the bank's auditors and counsel, both internal and external. These key actors must be fully engaged in and knowledgeable about the business and affairs of the bank, or the audit committee cannot possibly accomplish its intended purpose. In addition, the audit and legal resources that are devoted to compliance within the bank subsidiary must be up to the job in terms of resources, skill level, and experience. Obviously, the demands on the auditors and lawyers will vary with the particular business conducted in the bank. In a large and complex banking organization, I would expect a sizable staff of well-trained and experienced in-house auditors and attorneys.

The culture of the control group of lawyers and auditors is also very important. These individuals need to ask, and be asked, the question that Federal Reserve Governor Susan S. Bies articulated in a recent speech on corporate governance: "Are we getting by on technicalities, adhering to the letter but not the spirit of the law?"[7]

Another important element of good corporate governance is the procedure the audit committee of a bank follows when it learns that the bank has engaged in a material violation of law and regulation. Let us assume that the bank audit committee learns of this from an auditor, counsel, or both. The committee's agents have identified the violation and brought it to the attention of the responsible authority. There are, in my view, several things that the bank audit committee must do. First, it must properly disclose what it has learned. It must ensure that management reveals the material violation of law and regulation to the supervisor of the bank, because this step is required by law and regulation.[8] Second, it must ensure that management discloses the material violation either to the audit committee of the holding company or to the holding company's full board of directors. The reason

To be effective, the audit committee must be well served by the agents who are its eyes and ears: the bank's auditors and counsel, both internal and external.

for this disclosure relates to the holding company's need to manage and control the enterprise's legal and reputational risk. If the holding company does not know what is happening in the bank, then it cannot succeed in this objective. Note that holding company control is a key factor here. If there were no ability to control the conduct of the bank, there would be no means for the holding company to manage risk on an enterprise-wide basis.

The disclosure to the bank supervisor will result in a discussion about remedying the violation. Because the existence of the violation represents a threat to the public interest, this is no more than an appropriate safeguard. If the violation is of a law or regulation relating to safety and soundness—an insider lending violation, for example—then the government will likely have an immediate interest in a prompt and effective remedy. In most cases, the interests of the bank and the holding company will be identical. The need for remediation may be less critical in the case of other violations of law, but these violations will still get attention from the bank supervisor.

There is an independent reason for disclosing a material violation of law and regulation to the bank supervisor, and this reason relates to a systemic protection. In theory, a bank that materially violates laws and regulations relating to safety and soundness avoids compliance costs that are borne by its law-abiding competitors. In the short term, these cost savings could benefit shareholders, the ultimate owners, for as long as the violation remains undetected. But the banking system will function best if everyone plays by the rules. When a violation of law is revealed, the banking system benefits, because the punishment of the violation sends a powerful message that the playing field is level. Ordinarily, this means that the violator pays a penalty that will exceed the savings realized from noncompliance or, in plain language, cheating. In this year's William Taylor Memorial Lecture, William J. McDonough, President of the Federal Reserve Bank of New York, described the supervisor's role as "ensur[ing] that markets operate in a fair, transparent, and efficient manner, and that participants comply with the rules of the game."[9]

What's Good for the Bank Is Good for the Holding Company

Let us pursue our example of a material legal violation in a bank—a violation that has been disclosed by the audit committee of the bank to both the bank supervisor and to the audit committee of the holding company. At this stage, the holding company will in most cases have powerful incentives to remedy the material violation within the bank.

First, a reputational risk to the bank will almost certainly pose a reputational risk to the holding company. Banks are expected to turn square corners because they are special. When a material legal violation by a bank becomes public, investors tend to draw the inference that if something is rotten in the bank then things must be even fouler elsewhere in the conglomerate. Bank supervisors are known to be scrutinizing the bank, so there is a rational basis for this market inference. Thus, the market exacts a very high price from a holding company that does not mind the affairs of its bank.

> [If the audit committee identifies a legal violation within the bank subsidiary,] the holding company will in most cases have powerful incentives to remedy the material violation.

Second, the holding company faces a legal risk, because it has the ability to control the remedial steps taken by the bank. A holding company is treated like an insured depository institution for purposes of the enforcement jurisdiction of the federal bank supervisors.[10] Because a violation of a remedial order occurs when an entity with control takes action "for or toward causing, bringing about, participating in, counseling, or aiding or abetting a violation,"[11] a holding company cannot responsibly remain quiet when notified of a material violation in a bank.

If a cease-and-desist order is imposed on a bank that has violated the law, and the holding company does nothing to ensure compliance with the order's provisions, then the holding company may itself face punitive action.[12] For example, in 1989, the Federal Reserve assessed a civil money penalty against a parent holding company, the National Bank of Greece, because it did not take supervisory action to prevent or cure violations of law being committed by a bank subsidiary, the National Mortgage Bank of Greece.[13] The holding company was punished for the sins of the bank.

Third, if a holding company is also a financial holding company, it will have a great interest in seeing that a subsidiary bank is rated as "well managed" by its supervisors. If a bank fails to correct a material legal violation promptly and completely, then the bank's management rating could become less than satisfactory.[14] Avoiding such a downgrade is integral to retaining financial holding company status under the Gramm-Leach-Bliley Act.

Fourth, the holding company will need to inform the Federal Reserve of the material violation in its subsidiary bank. The Federal Reserve, for the reasons stated, would be interested in seeing how the holding company handles the bank's problem.

In its role as umbrella supervisor, the Federal Reserve will assess how well the organization manages and controls the risk that the enterprise faces from a material violation of law in an insured depository institution subsidiary. In all likelihood, the Federal Reserve and the supervisor of the bank (assuming it is not the Federal Reserve) will meet together and exchange views on how the problem should be resolved.

The safe and sound operation of a bank is typically a goal shared by the board of directors of the bank, its bank supervisor, the board of directors of its parent holding company, and the Federal Reserve. ❧

Thus, in my experience, the holding company will not be resistant to correcting a material law violation in a bank. Rational self-interest will prevail. The safe and sound operation of a bank is typically a goal shared by the board of directors of the bank, its bank supervisor, the board of directors of its parent holding company, and the Federal Reserve. This unity of interest is a source of strength, not a point of weakness. Rarely would a conflict arise among these interested groups.

Some Practical Advice

Before leaving the topic of holding company governance, let me offer some practical recommendations on managing the legal risks to the enterprise arising from any subsidiary, bank or nonbank. Today, many decisions about the legal entity for booking a particular activity are made with an eye on the applicable law. On numerous occasions, I have heard members of my profession trumpet that they advise clients to book activity in a particular jurisdiction to avoid what are loosely characterized as "burdensome" laws and regulations. In some cases, I would not dispute the claim that the avoided law and regulation is burdensome. In most cases, however, the law and regulation that is avoided is prudential law and regulation.

What that means for those of you who are involved in or responsible for centralized risk management is that your job becomes harder. It is harder because your organizations have avoided a short-term cost—the cost of compliance with a stricter regulatory regime. It is a matter of time before you learn whether the short-term savings are worth the long-term price. For some banks or holding companies that book business in offshore jurisdictions (not Puerto Rico), perhaps in special-purpose entities established in those jurisdictions, the price of avoiding prudential measures may ultimately far exceed the savings.

So what should you do now as a matter of good governance? I suggest that you look closely at the legal entities where your enterprise is booking business. If you see bookings in legal entities domiciled in locations where prudential law and regulation is weak, then perhaps you might wish to ask some follow-up questions. The essence of effective risk management in the holding company is identifying your risks and then taking affirmative action to keep those risks within manageable limits.

Conclusion

Let me conclude with some general principles that I believe should animate the governance of a holding company.

First, given my view that risk management is a core function of the holding company, the parent audit committee should oversee how risks are identified and managed across the enterprise. With a bank, the parent holding company needs to pay especially close attention to how the bank's audit committee oversees legal and compliance risk.

Second, the audit committee of the bank has a distinctive role with respect to laws and regulations that relate to safety and soundness. This role derives from the bank's special status under federal law and the need to protect the public interest. When there exist material violations of safety and soundness laws, the audit committee needs to make prompt disclosure to the bank supervisor and to the holding company, or to the holding company's audit committee. It also needs to fashion a remedy, and to work with the other interested parties—its supervisor, the holding company, and the Federal Reserve—to see that the remedy is acceptable and effective.

Third, when the governance of the holding company works as it should, all of the interested stakeholders become aligned. The umbrella supervisor, the holding company, the bank, and the bank supervisor should work toward the same goal: the safe and sound operation of the enterprise. Holding company control is one salutary structural feature that should remain.

To close, let me say that I am confident that the regrettable events of the last year will spur our collective efforts to achieve better governance, and that these efforts will pay a dividend as financial conglomerates operate ever more safely and soundly. The entire legal infrastructure is already in place. All we need to do is make it work.

Notes

1. John D. Hawke, Jr., remarks presented at the 2002 American Bankers Association Convention, Phoenix, Ariz., October 7, 2002. Available at <http://www.occ.treas.gov/ftp/release/2002-78a.txt>.

2. 12 U.S.C. § 1831m.

3. 12 U.S.C. § 1831m (b)(2)(A).

4. 12 U.S.C. § 1831m (b)(2)(B).

5. This point was made explicitly in a recent U.S. Securities and Exchange Commission release containing proposed rules under the Sarbanes-Oxley Act of 2002. See 67 *Fed. Reg*. 66208, 66222, and n. 128 (October 30, 2002).

6. E. Gerald Corrigan, "Are Banks Special?" Federal Reserve Bank of Minneapolis *1982 Annual Report*. Available at <http://minneapolisfed.org/pubs/ar/ar1982a.cfm>.

7. Susan S. Bies, "Corporate Governance and Risk Management," remarks presented at the Annual International Symposium on Derivatives and Risk Management, Fordham University School of Law, New York, N.Y., October 8, 2002. Available at <http://www.federalreserve.gov/boarddocs/speeches/2002/20021008/default.htm>.

8. If this is done by filing a suspicious activity report, the bank supervisor will receive the disclosure through the Financial Crimes Enforcement Network of the U.S. Department of the Treasury.

9. William J. McDonough, "Issues in Corporate Governance," lecture delivered at an event cosponsored by the William Taylor Memorial Fund and the Group of Thirty, Washington, D.C., September 29, 2002. Reprinted in Federal Reserve Bank of New York *Current Issues in Economics and Finance* 8, no. 8 (September/October 2002).

10. 12 U.S.C. § 1818 (b)(3).

11. 12 U.S.C. § 1813.

12. 12 U.S.C. § 1841 (a)(2)(A).

13. Board of Governors of the Federal Reserve System, *Federal Reserve Bulletin* 76, no. 3 (March 1990): 186.

14. For example, 12 C.F.R. § 225.81 (b)(2).

About the Author

Thomas C. Baxter, Jr., is general counsel and executive vice president of the Federal Reserve Bank of New York.

Current Issues in Economics and Finance is published by the Research and Market Analysis Group of the Federal Reserve Bank of New York. Dorothy Meadow Sobol is the editor.

Editorial Staff: Valerie LaPorte, Mike De Mott, Susan Szarkowitz, Robert Clark
Production: Carol Perlmutter, David Rosenberg, Jane Urry

Subscriptions to *Current Issues* are free. Write to the Public Information Department, Federal Reserve Bank of New York, 33 Liberty Street, New York, N.Y. 10045-0001, or call 212-720-6134. Back issues of this publication are available at <**http://www.newyorkfed.org/rmaghome/curr_iss**>.