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MICHIGAN
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February 8, 2024

Via Electronic Mail

James P. Sheesley, Assistant Executive Secretary
Attention: Comments/Legal OES
Federal Deposit Insurance Corporation
550 17th Street NW
Washington, DC 20429

Re: Guidelines Establishing Standards for Corporate Governance and Risk Management for Covered Institutions with Total Consolidated Assets of $10 Billion or More (RIN 3064-AF94)

Dear Mr. Sheesley:

Thank you for the opportunity to comment on the FDIC's proposed corporate governance and risk management guidelines for FDIC-supervised depository institutions with total consolidated assets of $10 billion or more. By way of background, I am an Assistant Professor of Business Law at the University of Michigan's Stephen M. Ross School of Business and Co-Faculty Director of the University of Michigan's Center on Finance, Law & Policy. Previously, I was an attorney at the Board of Governors of the Federal Reserve System. My research focuses on bank regulation, systemic risk, and financial stability.

I write in support of the proposed guidelines. As noted in the proposal, effective corporate governance and risk management are essential for the prudent operation of an insured depository institution. The proposed guidelines would modernize and strengthen the FDIC's corporate governance and risk management standards for the largest depository institutions. These reforms are necessary in light of increased size, complexity, and systemic importance of the United States' biggest banks. Indeed, the 2023 banking crisis exposed the risks posed by banks with inadequate governance systems and the need to establish stronger risk management standards going forward.

The remainder of my comment letter addresses a specific provision in the proposed guidelines. Section II.B of the proposal states that a covered bank's board should include a majority of "outside and independent directors" who are unaffiliated with the institution or any of its affiliates.[1] I strongly support this guideline. In fact, I recommended that the federal banking agencies adopt an unaffiliated director requirement for large depository institutions in a recent law review article.[2] My research revealed that the vast majority of large-bank directors simultaneously serve as board members of their parent holding companies. These dual directorships create a conflict of interest:

[1] 88 Fed. Reg. 70391, 70405 (proposed Oct. 11, 2023) (to be codified at 12 CFR pt. 364, App. C § II.B).

[2] Jeremy C. Kress, *Who's Looking Out for the Banks?*, 93 U. COLO. L. REV. 897 (2022).

when a bank's directors serve on the board of the bank's holding company, the directors have an incentive to allow the holding company to exploit the bank and take advantage of the bank's federal safety net. Adopting the unaffiliated director guideline would help alleviate this conflict of interest and thereby enhance the safety and soundness of the banking system.

Drawing on my research, Part I of this letter explains why the FDIC should implement the unaffiliated director guideline. Part II then suggests modest changes to the proposed guideline that would help ensure it achieves its objectives.

I. The FDIC Should Adopt the Unaffiliated Director Guideline to Prevent Conflicts of Interest and the Inappropriate Expansion of the Federal Safety Net

It is well understood that banks benefit from a "federal safety net." In recognition of banks' essential role in the U.S. economy, policymakers support the banking system in several ways. For example, banks receive FDIC deposit insurance, access to the Federal Reserve's discount window, guaranteed overdraft payments made via Fedwire, and low-cost advances and generous dividends from the government-sponsored Federal Home Loan Banks.[3] Collectively, these safety net policies serve as valuable subsidies to the banking system.[4]

When a bank operates as part of a diversified financial conglomerate, the conglomerate may try to exploit the bank's federal safety net by transferring government subsidies to its nonbank affiliates. For instance, a bank's affiliate may seek to avail itself of federal subsidies through preferential loans, asset sales, or other intracompany transactions.[5] This type of exploitation is problematic because it expands the scope of government subsidies, encourages nonbank affiliates to take excessive risks, and may impair a bank's financial condition. Nonetheless, financial conglomerates have repeatedly exploited their bank subsidiaries in these ways.[6]

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[3] In addition to these explicit government subsidies, some banks benefit from implicit government support when they are perceived to be "too big to fail." *See, e.g.*, Stefan Jacewitz & Jonathan Pogach, *Deposit Rate Advantages at the Largest Banks* 2–3 (Fed. Deposit Ins. Corp., Working Paper No. 2014-02, 2014), https://www.fdic.gov/analysis/cfr/2014/wp2014/2014-02.pdf.

[4] *See, e.g.*, Myron L. Kwast & S. Wayne Passmore, *The Subsidy Provided by the Federal Safety Net: Theory, Measurement, and Containment* (Fed. Rsrv. Bd., Fin. & Econ. Discussion Series No. 1997-58, 1998), https://www.federalreserve.gov/pubs/feds/1997/199758/199758pap.pdf.

[5] Although Sections 23A and 23B of the Federal Reserve Act ostensibly restrict a bank's transactions with its affiliates, these rules are generally inadequate to prevent exploitation in the modern financial system. As Professor Saule Omarova has noted, Sections 23A and 23B were adopted decades before the Gramm-Leach-Bliley Act authorized depository institutions to affiliate with other financial companies, and the rules are "not well-suited to serve as the principal guarantee of the safety and soundness of the depository system in today's increasingly complex and dynamic financial marketplace." Saule Omarova, *From Gramm-Leach-Bliley to Dodd-Frank: The Unfulfilled Promise of Section 23A of the Federal Reserve Act*, 89 N.C. L. REV. 1683, 1690 (2011).

[6] For example, during the 2008 financial crisis, Citibank, Bank of America, and JPMorgan Chase Bank sought to bolster their faltering broker-dealer affiliates by lending them billions of dollars. *See* Omarova, *supra* note 5, at 1730. Also during the 2008 crisis, Citigroup transferred the vast majority of its subprime mortgage assets into Citibank, and numerous conglomerates transferred risky asset-backed commercial paper from their affiliated money market mutual funds (MMMFs) to their banks. *See id.* at 1709-17, 1740-42. More recently, several financial conglomerates transferred assets from their MMMF and broker-dealer affiliates to their bank subsidiaries during the Covid-19 pandemic. *See* Kress, *supra* note 2, at 922-23. Outside of crisis times, financial conglomerates routinely use internal dividends from bank subsidiaries to fund both the parent's external dividends and nonbank expansion. *See* Jonathan

Recognizing a financial conglomerate's incentive to take advantage of its bank subsidiary, the federal banking agencies instruct a bank's directors to protect the bank from its affiliates. The OCC's bank directors' handbook, for example, states that a "*subsidiary bank's board* should ensure that relationships between the bank and its affiliates … do not pose safety and soundness issues for the bank…."[7] The OCC further asserts that the "*bank's board* should ensure the interests of the bank are not subordinate to the interests of the parent holding company…."[8] In addition, the Board requires a majority of a bank's board of directors to review and approve certain transactions with the bank's affiliates.[9]

In fact, the banking agencies presume that bank directors will go to great lengths to protect the bank from its holding company. The OCC states that "[i]f the *bank's board* is concerned that the holding company is engaging in practices that may harm the bank … *bank directors* should notify the holding company and obtain modifications."[10] If the holding company fails to address the bank directors' concerns, the OCC instructs the bank directors to "dissent on the record and consider actions to protect the bank's interests."[11] The OCC advises that, if necessary, the bank's board "should hire independent legal counsel" or "raise its concerns with its regulators."[12] The agencies, in sum, presume that bank directors will zealously safeguard the interests of the bank vis a vis its holding company.

The expectation that a bank's directors will shield the bank from exploitation, however, ignores a critical conflict of interest. When a bank's directors also sit on the board of the bank's holding company, the directors have an incentive to *allow* the holding company and its nonbank subsidiaries to take advantage of the bank and thereby benefit from federal safety net subsidies. Since bank holding company (BHC) directors are accountable to shareholders for maximizing the value of the financial conglomerate—not just the bank subsidiary—they may want the bank to engage in preferential loans, asset transfers, or other intracompany transactions that benefit its affiliates. In addition, BHC directors may be enriched financially when a bank extends federal safety net subsidies to its affiliates, since board members are often significant shareholders of the BHC. When a bank director serves simultaneously on the board of the parent holding company, therefore, the director is ill-suited to protect the bank from exploitation by its affiliates.

Pogach & Haluk Unal, *The Dark-Side of Banks' Nonbank Business: Internal Dividends in Bank Holding Companies* 3–4 (Fed. Deposit Ins. Corp., Working Paper No. 2018-01, 2018).

[7] OFF. OF THE COMPTROLLER OF THE CURRENCY, THE DIRECTOR'S BOOK: ROLE OF DIRECTORS FOR NATIONAL BANKS AND FEDERAL SAVINGS ASSOCIATIONS 34–35 (2020), https://www.occ.gov/publications-and-resources/publications/banker-education/files/pub-directors-book.pdf (emphasis added).

[8] *Id.* at 34 (emphasis added).

[9] 12 C.F.R. § 223.41(d)(5) (2021) (providing that a bank's purchase of assets from an affiliate in connection with an internal corporate reorganization is exempt from section 23A's quantitative limits only if, among other things, a majority of the bank's directors review and approve the transaction before consummation).

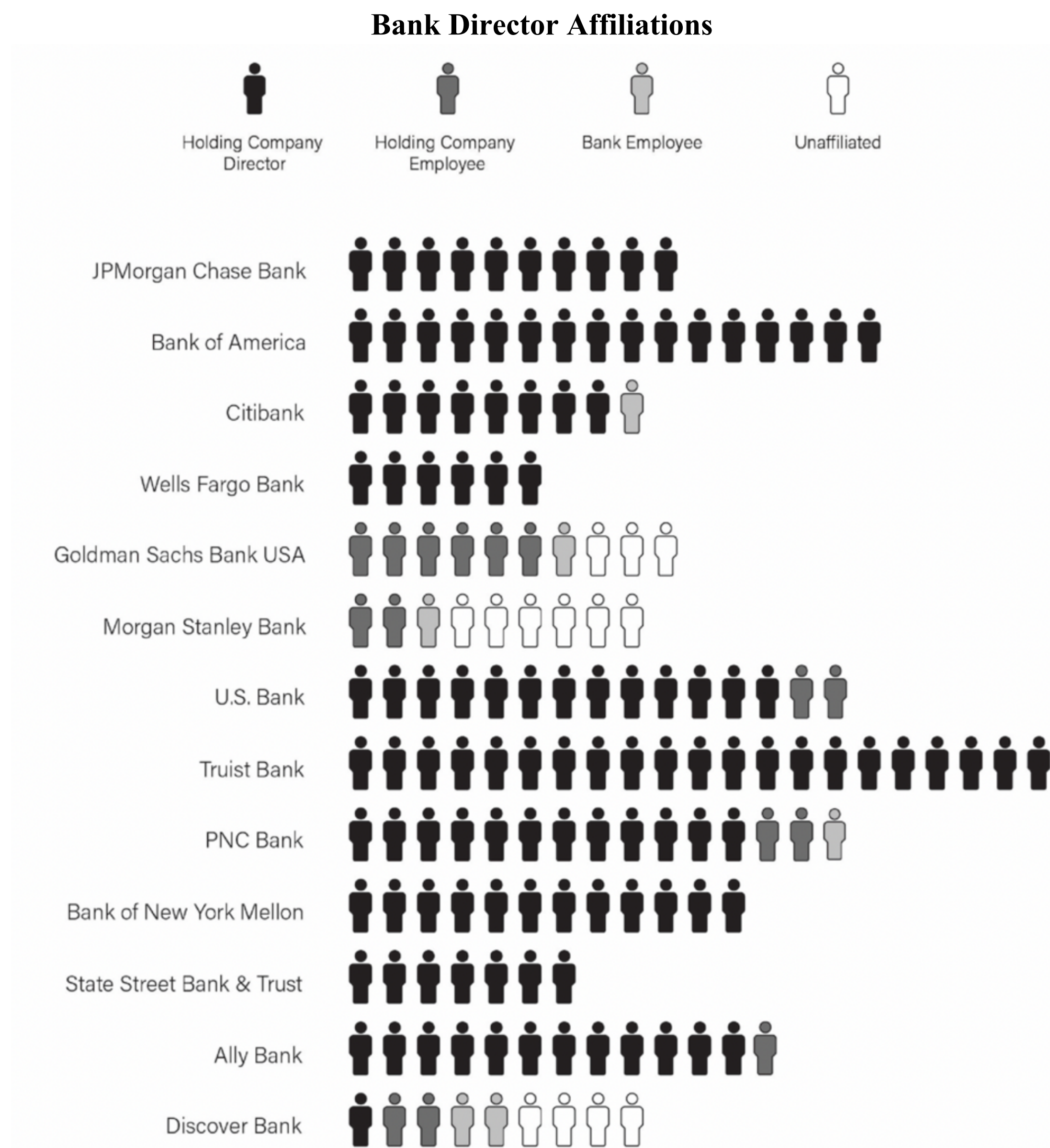
[10] OFFICE OF THE COMPTROLLER OF THE CURRENCY, *supra* note 7 at 35 (emphasis added).

[11] *Id.*

[12] *Id.*

This conflict of interest is far more widespread than commonly understood. BHCs do not routinely disclose the identities of their bank subsidiaries' directors. However, some bank board membership information is available in various state and international corporate registries, securities filings, and enforcement actions. Drawing on these resources, I compiled a near-complete dataset of the directors of the lead bank subsidiaries of BHCs with more than $100 billion in assets and more than one percent of their assets in nonbank legal entities.[13] This dataset reveals that the vast majority of big-bank directors simultaneously serve as directors of their parent holding companies, as depicted in the following figure.[14]

Bank Director Affiliations



[13] American Express Company was the only BHC that met the criteria for inclusion in the sample as of 2021 for which data were unavailable.

[14] The membership of each bank's board of directors as of 2021 is listed in the Appendix of my article. *See* Kress, *supra* note 2, at 947-60.

This figure shows the significant overlap between most large BHCs' boards and the boards of their bank subsidiaries. Nearly half of the banks in the sample do not have a single director who does not also serve on the board of its BHC. Of the four biggest banks by asset size—JPMorgan Chase Bank, Bank of America, Citibank, and Wells Fargo Bank—only Citibank has a director who does not also sit on its BHC's board. In total, 119 out of 153 bank directors in the sample—or 78 percent—simultaneously serve on the board of the bank's holding company.

These widespread overlaps call into question whether bank directors can be counted on to protect the banks they represent. Consider the United States' largest state nonmember bank, Truist, and its holding company, Truist Financial Corporation. In 2020, twenty-two individuals, including chief executive officer Kelly King, served on the company's board.[15] Those same twenty-two individuals comprised the board of the firm's bank subsidiary, with King also serving as CEO of the bank.[16] Thus, the twenty-two people who were responsible for safeguarding the bank's $500 billion in assets were, at the same time, in charge of maximizing the holding company's value, including its nonbank activities. Since extending the bank's federal safety net to its nonbank affiliates could improve the holding company's performance, Truist's directors faced an inherent conflict of interest. This is not to suggest that the directors of Truist—or any other financial conglomerate—have engaged in specific instances of misconduct. However, when a director serves on the board of both a bank and its holding company, there is at least the potential for the dual roles to skew the director's incentives or bias the director's judgment.

The FDIC ought to adopt its unaffiliated director guideline in light of these problematic conflicts of interest. The FDIC's proposal states that the board of a covered depository institution "should include a majority of outside and independent directors."[17] The FDIC defines an independent director as a director who, among other things, is "not a principal, member, director, officer, or employee of any affiliate or principal shareholder of the institution."[18] The proposal further states that a covered institution's audit committee should be composed entirely of outside and independent directors and that the risk committee should be chaired by an independent director.[19] Requiring large banks to appoint unaffiliated directors in this way will have several salutary effects.

First, this guideline will mitigate conflicts of interest inherent in dual BHC-bank directorships. When an individual serves both a bank and its BHC simultaneously, he or she may have incentives to allow the holding company to exploit the federal safety net. By contrast, when a director serves only the bank—and has no formal ties to the holding company or its nonbank affiliates—he or she experiences no such conflict. Unaffiliated bank directors are therefore more likely to identify

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[15] TRUST, ANNUAL MEETING OF SHAREHOLDERS: PROXY STATEMENT 5 (2021), https://ir.truist.com/download/Truist+2021+Annual+Meeting+Notice+and+Proxy+Statement.pdf.

[16] TRUIST BANK, ANNUAL REPORT: THE COMMONWEALTH OF MASSACHUSETTS, SECRETARY OF THE COMMONWEALTH, CORPORATIONS DIVISION (2020) (on file with author).

[17] 88 Fed. Reg. at 70405.

[18] *Id.*

[19] *Id.* at 70406.

potential exploitation of the depository institution and resist predatory practices by the holding company.

Similarly, requiring large banks to appoint unaffiliated directors would rationalize the United States' regulatory framework for financial conglomerates. As noted above, the federal banking agencies presume that a bank's board zealously protects the depository institution from its nonbank affiliates. These safeguards, however, are effectively meaningless when a bank's board overlaps with its BHC's board. In that case, the bank's board is unlikely to push back against the holding company's board—since their members are one and the same. Requiring a bank to appoint unaffiliated directors, on the other hand, would help the existing regulatory framework function as intended.

In addition, unaffiliated bank directors could serve as valuable points of contact for bank supervisors. Bank directors who are independent of their holding companies could function as unbiased points of contact for supervisors focused on safeguarding depositors and preventing the inappropriate expansion of the federal safety net. For example, supervisors could interview a bank's unaffiliated directors as part of its annual examination and maintain consistent dialogue with the unaffiliated directors about any shortcomings. In return, unaffiliated directors might be more likely than dual BHC-bank directors to proactively seek out supervisors when the holding company jeopardizes the bank's safety and soundness.

Some foreign countries already mandate that banks maintain directors who are unaffiliated with their holding companies. The United Kingdom, for example, requires that no more than one-third of the members of a large bank's board of directors may be employees or directors of any of the bank's nonbank affiliates.[20] Along the same lines, France prohibits a systemically important bank from sharing any directors with an affiliate that engages in proprietary trading or similarly risky financial activities.[21] Thus, other developed countries acknowledge the vital role that independent boards can play in safeguarding depository institutions from exploitation by their financial conglomerates.

Moreover, the FDIC has already mandated unaffiliated directors for certain insured depository institutions. In 2021, the FDIC adopted a rule establishing conditions for newly licensed industrial loan companies (ILCs).[22] In the rule, the FDIC announced that it will require a new ILC to limit its parent company's board representation to less than 50 percent of the ILC's directors.[23] The FDIC explained that it adopted this safeguard "[i]n order to limit the extent of each [parent company's] influence over a subsidiary industrial bank."[24] This same logic could be applied to BHCs and their subsidiary banks. If such a rule is necessary to protect an ILC from exploitation

[20] PRUDENTIAL REGUL. AUTH., PRA RULEBOOK: CRR FIRMS AND NON-AUTHORIZED PERSONS: RING-FENCED BODIES INSTRUMENT § 4.4 (2019), https://www.prarulebook.co.uk/rulebook/Content/Part/320929/28-11-2023.

[21] Matthias Lehmann, *Volcker Rule, Ring-Fencing or Separation of Bank Activities – Comparison of Structural Reform Acts Around the World*, 17 J. BANKING REGUL. 176, 181 (2016).

[22] Parent Companies of Industrial Banks and Industrial Loan Companies, 86 Fed. Reg. 10,703 (Feb. 23, 2021) (to be codified at 12 C.F.R. pt. 354).

[23] *Id.* at 10,719.

[24] *Id.*

by its parent company, a similar rule is equally appropriate to prevent BHCs from taking advantage of their bank subsidiaries.

II. <u>The FDIC Should Adopt Modest Changes to Ensure that the Unaffiliated Director Guideline Is Effective</u>

Based on my research, I urge the FDIC to make the following modifications in the final unaffiliated director guideline. If implemented, these reforms would help ensure that the unaffiliated director guideline is effective at mitigating conflicts of interest and preventing the inappropriate expansion of the federal safety net.

A. Appointment and Removal of Unaffiliated Directors

The FDIC should enact safeguards around how a covered institution appoints and removes unaffiliated directors. Each of the largest U.S. banks is wholly owned by its holding company. As the sole shareholder, the BHC may select and remove the bank's directors at its discretion. This ownership structure therefore creates the risk that a bank's unaffiliated directors will remain responsive to the BHC's preference to expand the federal safety net. Knowing that they could be removed by the BHC at any time, the unaffiliated bank directors will not want to "bite the hand that feeds them," even if they are nominally independent of the BHC.

To address this concern, the FDIC should require a covered institution to provide notice to the FDIC before appointing or removing an unaffiliated director. The FDIC could disapprove an appointment or removal if supervisors believe the proposal represents an attempt by the BHC to exert inappropriate influence over the bank's board. There is precedent for this approach: the United Kingdom requires a bank to obtain prior approval from the Prudential Regulatory Authority before appointing certain directors.[25]

The United States, in fact, already has a prior notice framework for bank personnel changes that could easily be adapted for this purpose. The Federal Deposit Insurance Act requires a bank to provide notice to its primary federal regulator at least thirty days before replacing any member of its board or hiring a new senior executive officer if the bank is undercapitalized or considered to be in "troubled" supervisory condition.[26] The responsible agency may disapprove a proposed personnel change if the agency finds that "the competence, experience, character, or integrity of the individual . . . indicates that it would not be in the best interests of the depositors of the [bank] or in the best interests of the public to permit the individual to be employed by, or associated with" the bank.[27] To adapt this framework for unaffiliated directors, the FDIC could disapprove a notice if it finds that the appointment or removal of an unaffiliated director could create or exacerbate conflicts of interest or compromise the bank's independence. In this way, the FDIC could help

[25] The United Kingdom's prior approval requirement applies to a bank's chairman, lead independent director, and the chairs of the audit, nomination, compensation, and risk committees. *See* Thom Wetzer, *In Two Minds: The Governance of Ring-Fenced Banks*, 19 J. CORP. L. STUDS. 197, 221 n.171 (2019).

[26] The relevant agency may also require prior notice any time the agency "determines . . . that such prior notice is appropriate." 12 U.S.C. § 1831i(a).

[27] *Id.* § 1831i(e).

ensure that a BHC does not exert inappropriate influence over its bank's board through the appointment and removal of unaffiliated directors.

B. Compensation of Unaffiliated Directors

In addition to monitoring how unaffiliated bank directors are appointed and removed, the FDIC should also oversee how such directors are paid. Financial conglomerates traditionally compensate senior officials, at least in part, with holding company stock or other equity-linked instruments. If a bank pays its unaffiliated directors with holding company stock, however, these equity awards could bias the board members' judgment. To the extent that a bank director owns a stake in the holding company, the director would have a financial incentive to allow the holding company to take advantage of the depository institution. The structure of bank directors' compensation, therefore, could undermine the efficacy of an unaffiliated director mandate.

In response to this challenge, the FDIC should establish standards for unaffiliated director compensation. The FDIC could adopt several potential approaches to ensure that unaffiliated director compensation does not create conflicts of interest. For example, the FDIC could require that banks pay their unaffiliated directors entirely in cash. Alternatively, the FDIC could mandate that a bank compensate its unaffiliated directors using the bank's debt, which would better align the directors' interests with the bank's creditors. The standards for bank director compensation need not be overly prescriptive—they simply need to ensure that the way in which banks pay their unaffiliated board members does not undermine their independence from the holding company.

C. Public Disclosure of Covered Institution Board Members

The FDIC should require covered institutions to publicly disclose the names of their board members. As discussed in Part I, I found it very challenging to identify the board members of the United States' largest banks when conducting my research. Publicly traded BHCs do not routinely disclose their bank subsidiaries' directors. In response to my inquiries, many BHCs declined to provide the membership of their bank subsidiaries' boards.[28] In addition, each of the federal banking agencies declined my requests under the Freedom of Information Act to disclose the identities of individuals who serve as directors of the largest U.S. commercial banks.[29] I had to resort to various state and international corporate registries, securities filings, enforcement actions, and other obscure sources to compile listings of bank board members.

[28] *See, e.g.*, E-mail from Emily Yang, Dir. of Inv. Rels., Discover Fin. Servs., to author (June 30, 2021) (on file with author) ("We do not publicly disclose the identity of the Bank directors."); E-mail from Janet L. Deringer, Assistant Corp. Sec'y, PNC Fin. Servs. Grp., Inc., to author (June 29, 2021) (on file with author) ("The Office of the Corporate Secretary does not provide non-public, confidential information including PNC Bank Directors [sic] names.").

[29] *See, e.g.*, Letter from Alisa Colgrove, Gov't. Info. Specialist, Fed. Deposit Ins. Corp., to author (July 21, 2021) (on file with author) ("During the normal course of business, the FDIC does not create a consolidated list of bank board of directors."); Letter from Michele Taylor Fennell, Deputy Assoc. Sec'y of the Bd., Bd. of Governors of the Fed. Rsrv. Sys., to author (June 11, 2021) (on file with author) ("[T]o the extent the Board maintains the board of director membership information you seek, it is contained within supervision files and accordingly would be subject to withholding pursuant to exemption 8 of the FOIA."); Letter from Frank D. Vance, Jr., Manager, Discloser Servs. & Freedom of Info. Act Officer, Off. of the Comptroller of the Currency, to author (June 29, 2021) ("National banks are not required to file a list of individuals who served as a director during a specific year or time period. Therefore, we do not have the lists you seet [sic].").

Transparency is a pillar of good governance. The American public deserves to know the directors who oversee the country's largest banks. This disclosure is important, among other reasons, so that the public can assess the extent to which a bank's directors suffer from conflicts of interest. Accordingly, the FDIC should require covered institutions to disclose annually the names of their directors and their affiliations (if any) with the institutions' parent company or affiliates.

D. Quantitative Threshold for Exemption from the Unaffiliated Director Standard

Finally, the FDIC should establish a quantitative trigger for when a covered institution is exempt from the unaffiliated director standard. The proposed guidelines state, in a footnote, that when a covered institution's "holding company conducts limited or no additional business operations outside of the institution, an independent director of the holding company may also be an independent director of the institution…."[30] Although I agree that the FDIC should permit an exemption from the unaffiliated director standard when a holding company conducts de minimis nonbanking business, the proposed exemption language is too indefinite and open to varying interpretations.

To ensure consistency over time and across institutions, the FDIC should establish a quantitative threshold for what constitutes "limited or no additional business operations outside of the institution." I recommend that the FDIC allow an independent director of a covered institution's holding company to qualify as an independent director of the institution only if the holding company has less than 1 percent of its total consolidated assets in nonbank legal entities.[31] In my research, I found that the 1 percent threshold identifies institutions that are meaningfully engaged in nonbanking activities that pose the greatest risk of improperly expanding the federal safety net. Accordingly, I urge the FDIC to adopt this standard (or a similar threshold) to ensure that the unaffiliated director guideline is applied to the appropriate population of covered institutions.

I am attaching for your reference a petition for rulemaking that I am filing with the Federal Reserve Board and OCC under section 553(e) of the Administrative Procedure Act. The petition urges the agencies to adopt an unaffiliated director requirement for large Board- and OCC-supervised depository institutions that is similar to the FDIC's proposed unaffiliated director guideline.

[30] 88 Fed. Reg. at 70405.

[31] For this purpose, the FDIC could define a nonbank legal entity as an entity that conducts, directly or indirectly, any activity that is not permissible under 12 C.F.R. § 225.28.

Thank you again for the opportunity to comment on the FDIC's proposal. Please do not hesitate to contact me if I can provide any additional information.

Sincerely,

Jeremy C. Kress

Attachment

Attachment:

Petition for Rulemaking Filed With the Federal Reserve Board of Governors and Office of the Comptroller of the Currency

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MICHIGAN
ROSS SCHOOL OF BUSINESS

February 8, 2024

Via Electronic Mail

Board of Governors of the Federal Reserve System
20th Street and Constitution Avenue N.W.
Washington, DC 20551
Attn: Ann Misback, Secretary

Office of the Comptroller of the Currency
400 7th Street SW
Washington, DC 20219
Attn: Benjamin McDonough, Chief Counsel

Re: Petition for Rulemaking on Unaffiliated Insured Depository Institution Directors

Dear Ms. Misback and Mr. McDonough:

I am writing to petition the Board of Governors of the Federal Reserve System (the Board) and the Office of the Comptroller of the Currency (OCC) under section 553(e) of the Administrative Procedure Act (APA) to issue a rule requiring members of a large insured depository institution's board of directors to be unaffiliated with the institution's holding company and its affiliates.[1] The Federal Deposit Insurance Corporation (FDIC) proposed an unaffiliated director standard for large state nonmember banks in October 2023.[2] I encourage the Board and the OCC to adopt a similar standard to prevent conflicts of interest in bank governance and to better align corporate governance policies among the three federal banking agencies.

[1] By way of background, I am an Assistant Professor of Business Law at the University of Michigan's Stephen M. Ross School of Business and Co-Faculty Director of the University of Michigan's Center on Finance, Law & Policy. My research focuses on bank regulation, systemic risk, and financial stability. I am an "interested person" afforded the right to petition an agency under section 553(e) of the APA. As Professors Jason Schwartz and Richard Revesz concluded in a report for the Administrative Conference of the United States, the APA's use of the phrase "interested person" "does not seem to impose any substantial restrictions on the right to petition," and the "plain text strongly suggests that any requirement of 'interest' should be a low bar." JASON A. SCHWARTZ & RICHARD L. REVESZ, PETITIONS FOR RULEMAKING: FINAL REPORT TO THE ADMINISTRATIVE CONFERENCE OF THE UNITED STATES 11 (Nov. 2014).

[2] Guidelines Establishing Standards for Corporate Governance and Risk Management for Covered Institutions with Total Consolidated Assets of $10 Billion or More, 88 Fed. Reg. 70391, 70405 (proposed Oct. 11, 2023) (to be codified at 12 CFR pt. 364, App. C § II.B).

This petition for rulemaking is based on my law review article, *Who's Looking Out for the Banks?*.[3] My article exposes a troublesome conflict of interest in the governance of the United States' largest banking organizations. Specifically, the vast majority of large-bank directors also serve as board members of their parent holding companies. These dual directors are poorly situated to exercise the independent judgment necessary to protect a bank from exploitation by its nonbank affiliates. This problem is most pronounced at the largest and most diversified financial conglomerates whose depository institution subsidiaries are supervised by the Board or the OCC.[4] Accordingly, the Board and the OCC should strengthen bank governance—and better insulate banks from their nonbank affiliates—by mandating that at least some of a bank's directors be unaffiliated with its holding company. I respectfully petition the Board and the OCC to adopt such a requirement, consistent with the FDIC's proposed guidelines.

Background

It is well understood that banks benefit from a "federal safety net." In recognition of banks' essential role in the U.S. economy, policymakers support the banking system in several ways. For example, banks receive FDIC deposit insurance, access to the Federal Reserve's discount window, guaranteed overdraft payments made via Fedwire, and low-cost advances and generous dividends from the government-sponsored Federal Home Loan Banks.[5] Collectively, these safety net policies serve as valuable subsidies to the banking system.[6]

When a bank operates as part of a diversified financial conglomerate, the conglomerate may try to exploit the bank's federal safety net by transferring government subsidies to its nonbank affiliates. For instance, a bank's affiliate may seek to avail itself of federal subsidies through preferential loans, asset sales, or other intracompany transactions.[7] This type of exploitation is problematic because it expands the scope of government subsidies, encourages nonbank affiliates to take excessive risks, and may impair a bank's financial condition. Nonetheless, financial conglomerates have repeatedly exploited their bank subsidiaries in these ways.[8]

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[3] Jeremy C. Kress, *Who's Looking Out for the Banks?*, 93 U. COLO. L. REV. 897 (2022).

[4] *See infra* note 20 and accompanying text.

[5] In addition to these explicit government subsidies, some banks benefit from implicit government support when they are perceived to be "too big to fail." *See, e.g.*, Stefan Jacewitz & Jonathan Pogach, *Deposit Rate Advantages at the Largest Banks* 2–3 (Fed. Deposit Ins. Corp., Working Paper No. 2014-02, 2014), https://www.fdic.gov/analysis/cfr/2014/wp2014/2014-02.pdf.

[6] *See, e.g.*, Myron L. Kwast & S. Wayne Passmore, *The Subsidy Provided by the Federal Safety Net: Theory, Measurement, and Containment* (Fed. Rsrv. Bd., Fin. & Econ. Discussion Series No. 1997-58, 1998), https://www.federalreserve.gov/pubs/feds/1997/199758/199758pap.pdf.

[7] Although Sections 23A and 23B of the Federal Reserve Act ostensibly restrict a bank's transactions with its affiliates, these rules are generally inadequate to prevent exploitation in the modern financial system. As Professor Saule Omarova has noted, Sections 23A and 23B were adopted decades before the Gramm-Leach-Bliley Act authorized depository institutions to affiliate with other financial companies, and the rules are "not well-suited to serve as the principal guarantee of the safety and soundness of the depository system in today's increasingly complex and dynamic financial marketplace." Saule Omarova, *From Gramm-Leach-Bliley to Dodd-Frank: The Unfulfilled Promise of Section 23A of the Federal Reserve Act*, 89 N.C. L. REV. 1683, 1690 (2011).

[8] For example, during the 2008 financial crisis, Citibank, Bank of America, and JPMorgan Chase Bank sought to bolster their faltering broker-dealer affiliates by lending them billions of dollars. *See* Omarova, *supra* note 7, at 1730.

Recognizing a financial conglomerate's incentive to take advantage of its bank subsidiary, the federal banking agencies instruct a bank's directors to protect the bank from its affiliates. The OCC's bank directors' handbook, for example, states that a "subsidiary *bank's board* should ensure that relationships between the bank and its affiliates … do not pose safety and soundness issues for the bank…."[9] The OCC further asserts that the "*bank's board* should ensure the interests of the bank are not subordinate to the interests of the parent holding company…."[10] In addition, the Board requires a majority of a bank's board of directors to review and approve certain transactions with the bank's affiliates.[11]

In fact, the banking agencies presume that bank directors will go to great lengths to protect the bank from its holding company. The OCC states that "[i]f the *bank's board* is concerned that the holding company is engaging in practices that may harm the bank … *bank directors* should notify the holding company and obtain modifications."[12] If the holding company fails to address the bank directors' concerns, the OCC instructs the bank directors to "dissent on the record and consider actions to protect the bank's interests."[13] The OCC advises that, if necessary, the bank's board "should hire independent legal counsel" or "raise its concerns with its regulators."[14] The agencies, in sum, presume that bank directors will zealously safeguard the interests of the bank vis a vis its holding company.

The expectation that a bank's directors will shield the bank from exploitation, however, ignores a critical conflict of interest. When a bank's directors also sit on the board of the bank's holding company, the directors have an incentive to *allow* the holding company and its nonbank subsidiaries to take advantage of the bank and thereby benefit from federal safety net subsidies. Since bank holding company (BHC) directors are accountable to shareholders for maximizing the value of the financial conglomerate—not just the bank subsidiary—they may want the bank to engage in preferential loans, asset transfers, or other intracompany transactions that benefit its

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Also during the 2008 crisis, Citigroup transferred the vast majority of its subprime mortgage assets into Citibank, and numerous conglomerates transferred risky asset-backed commercial paper from their affiliated money market mutual funds (MMMFs) to their banks. *See id.* at 1709-17, 1740-42. More recently, several financial conglomerates transferred assets from their MMMF and broker-dealer affiliates to their bank subsidiaries during the Covid-19 pandemic. *See* Kress, *supra* note 3, at 922-23. Outside of crisis times, financial conglomerates routinely use internal dividends from bank subsidiaries to fund both the parent's external dividends and nonbank expansion. *See* Jonathan Pogach & Haluk Unal, *The Dark-Side of Banks' Nonbank Business: Internal Dividends in Bank Holding Companies* 3–4 (Fed. Deposit Ins. Corp., Working Paper No. 2018-01, 2018).

[9] OFF. OF THE COMPTROLLER OF THE CURRENCY, THE DIRECTOR'S BOOK: ROLE OF DIRECTORS FOR NATIONAL BANKS AND FEDERAL SAVINGS ASSOCIATIONS 34–35 (2020), https://www.occ.gov/publications-and-resources/publications/banker-education/files/pub-directors-book.pdf (emphasis added).

[10] *Id.* at 34 (emphasis added).

[11] 12 C.F.R. § 223.41(d)(5) (2021) (providing that a bank's purchase of assets from an affiliate in connection with an internal corporate reorganization is exempt from section 23A's quantitative limits only if, among other things, a majority of the bank's directors review and approve the transaction before consummation).

[12] OFFICE OF THE COMPTROLLER OF THE CURRENCY, *supra* note 9 at 35 (emphasis added).

[13] *Id.*

[14] *Id.*

affiliates. In addition, BHC directors may be enriched financially when a bank extends federal safety net subsidies to its affiliates, since board members are often significant shareholders of the BHC. When a bank director serves simultaneously on the board of the parent holding company, therefore, the director is ill-suited to protect the bank from exploitation by its affiliates.

This conflict of interest is far more widespread than commonly understood. BHCs do not routinely disclose the identities of their bank subsidiaries' directors. However, some bank board membership information is available in various state and international corporate registries, securities filings, and enforcement actions. Drawing on these resources, I compiled a near-complete dataset of the directors of the lead bank subsidiaries of BHCs with more than $100 billion in assets and more than one percent of their assets in nonbank legal entities.[15] This dataset reveals that the vast majority of big-bank directors simultaneously serve as directors of their parent holding companies, as depicted in the following figure.[16]

Bank Director Affiliations

[15] American Express Company was the only BHC that met the criteria for inclusion in the sample as of 2021 for which data were unavailable.

[16] The membership of each bank's board of directors as of 2021 is listed in the Appendix of my article. *See* Kress, *supra* note 3, at 947-60.

This figure shows the significant overlap between most large BHCs' boards and the boards of their bank subsidiaries. Nearly half of the banks in the sample do not have a single director who does not also serve on the board of its BHC. Of the four biggest banks by asset size—JPMorgan Chase Bank, Bank of America, Citibank, and Wells Fargo Bank—only Citibank has a director who does not also sit on its BHC's board. In total, 119 out of 153 bank directors in the sample—or 78 percent—simultaneously serve on the board of the bank's holding company.

These widespread overlaps call into question whether bank directors can be counted on to protect the banks they represent. Consider the United States' largest financial conglomerate, JPMorgan Chase & Co. In 2020, ten individuals, including chief executive officer Jamie Dimon, served on the company's board.[17] Those same ten individuals comprised the board of the firm's lead bank subsidiary, JPMorgan Chase Bank, N.A., with Dimon also serving as CEO of the bank.[18] Thus, the ten people who were responsible for safeguarding the bank's $3 trillion in assets were, at the same time, in charge of maximizing the holding company's value, including its substantial nonbank activities. Since extending the bank's federal safety net to its nonbank affiliates could improve the holding company's performance, JPMorgan's directors faced an inherent conflict of interest. This is not to suggest that the directors of JPMorgan Chase—or any other financial conglomerate—have engaged in specific instances of misconduct. However, when a director serves on the board of both a bank and its holding company, there is at least the potential for the dual roles to skew the director's incentives or bias the director's judgment.

In sum, policies that rely on bank directors to shield a bank from its nonbank affiliates ignore critical conflicts of interest. Overlaps between bank and BHC boards may bias directors' incentives toward expanding federal safety net subsidies. Policy changes are therefore necessary to ensure that bank directors protect banks from exploitation by their holding companies.

Recommended Reforms and Rationale

To prevent financial conglomerates from taking advantage of their bank subsidiaries, the Board and the OCC should require large banks to appoint at least some directors who are unaffiliated with their holding companies. The FDIC's proposed corporate governance guidelines for banks with more than $10 billion in assets state that a bank's board "should include a majority of outside and independent directors."[19] This standard will mitigate conflicts of interest that currently plague bank governance, and it will empower banks to resist exploitation by their affiliates. The Board and the OCC should adopt a similar requirement to alleviate conflicts of interest that facilitate the inappropriate expansion of the federal safety net.

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[17] JPMORGAN CHASE & CO., ANNUAL MEETING OF SHAREHOLDERS: PROXY STATEMENT 26 (2021), https://www.jpmorganchase.com/content/dam/jpmc/jpmorgan-chase-and-co/investor-relations/documents/proxy-statement2021.pdf.

[18] *Id.*

[19] 88 Fed. Reg. at 70405. Under the FDIC's proposed guidelines, an independent director is a director who, among other things, is "not a principal, member, director, officer, or employee of any affiliate or principal shareholder of the institution." *Id.*

It is crucial that the Board and the OCC join the FDIC in implementing an unaffiliated director standard because state member and national banks are at the highest risk of exploitation by their parent holding companies. The FDIC's corporate governance guidelines apply only to state nonmember banks. However, the bank subsidiaries of the largest diversified financial conglomerates tend to be state member and national banks.[20] Accordingly, an unaffiliated director standard is especially imperative for these Board- and OCC-supervised firms.

Requiring large state member and national banks to appoint unaffiliated directors would have several salutary effects. First, this reform would mitigate conflicts of interest inherent in dual BHC-bank directorships. When an individual serves both a bank and its BHC simultaneously, he or she may have incentives to allow the holding company to exploit the federal safety net. By contrast, when a director serves only the bank—and has no formal ties to the holding company or its nonbank affiliates—he or she experiences no such conflict. Unaffiliated bank directors are therefore more likely to identify potential exploitation of the depository institution and resist predatory practices by the holding company.

Similarly, requiring large banks to appoint unaffiliated directors would rationalize the United States' regulatory framework for financial conglomerates. As noted above, the federal banking agencies presume that a bank's board zealously protects the depository institution from its nonbank affiliates.[21] These safeguards, however, are effectively meaningless when a bank's board overlaps with its BHC's board. In that case, the bank's board is unlikely to push back against the holding company's board—since their members are one and the same. Requiring a bank to appoint unaffiliated directors, on the other hand, would help the existing regulatory framework function as intended.

In addition, unaffiliated bank directors could serve as valuable points of contact for bank supervisors. Bank directors who are independent of their holding companies could function as unbiased points of contact for supervisors focused on safeguarding depositors and preventing the inappropriate expansion of the federal safety net. For example, supervisors could interview a bank's unaffiliated directors as part of its annual examination and maintain consistent dialogue with the unaffiliated directors about any shortcomings. In return, unaffiliated directors might be more likely than dual BHC-bank directors to proactively seek out supervisors when the holding company jeopardizes the bank's safety and soundness.

Some foreign countries already mandate that banks maintain directors who are unaffiliated with their holding companies. The United Kingdom, for example, requires that no more than one-third of the members of a large bank's board of directors may be employees or directors of any of the bank's nonbank affiliates.[22] Along the same lines, France prohibits a systemically important bank

[20] Of the 13 BHCs in my study with more than $100 billion in assets and more than one percent of their assets in nonbanks, only two of the lead bank subsidiaries—Truist Bank and Discover Bank—are state nonmember banks.

[21] For example, the banking agencies entrust a bank's directors to review and approve certain transactions with its affiliates, and they expect a bank's board to dissent on the record—and even hire legal counsel—if its BHC takes advantage of the depository institution.

[22] PRUDENTIAL REGUL. AUTH., PRA RULEBOOK: CRR FIRMS AND NON-AUTHORIZED PERSONS: RING-FENCED BODIES INSTRUMENT § 4.4 (2019), https://www.prarulebook.co.uk/rulebook/Content/Part/320929/28-11-2023.

from sharing any directors with an affiliate that engages in proprietary trading or similarly risky financial activities.[23] Thus, other developed countries acknowledge the vital role that independent boards can play in safeguarding depository institutions from exploitation by their financial conglomerates.

Moreover, U.S. regulators have already mandated unaffiliated directors for certain insured depository institutions. In 2021, the FDIC adopted a rule establishing conditions for newly licensed industrial loan companies (ILCs).[24] In the rule, the FDIC announced that it will require a new ILC to limit its parent company's board representation to less than 50 percent of the ILC's directors.[25] The FDIC explained that it adopted this safeguard "[i]n order to limit the extent of each [parent company's] influence over a subsidiary industrial bank."[26] This same logic could be applied to BHCs and their subsidiary banks. If such a rule is necessary to protect an ILC from exploitation by its parent company, a similar rule would be equally appropriate to prevent BHCs from taking advantage of their bank subsidiaries.

Petition for Rulemaking

For the reasons discussed above, I respectfully petition the Board and the OCC to issue a rule requiring a large bank to appoint directors who are unaffiliated with the bank's holding company and affiliates. The Board and the OCC could structure this rule in several ways. For example, in keeping with the FDIC's proposal, the Board and the OCC could mandate that the board of any bank with more than $10 billion in assets must include a majority of unaffiliated directors.[27] This option would have the advantage of increasing uniformity among the three banking agencies.

Alternatively, the Board and the OCC could establish a sliding scale to determine how many of a bank's directors must be unaffiliated based on the extent of the holding company's nonbank activities, as I proposed in my article.[28] This approach would allow the agencies to tailor corporate governance standards for banking organizations with different business models. Regardless of

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[23] Matthias Lehmann, *Volcker Rule, Ring-Fencing or Separation of Bank Activities – Comparison of Structural Reform Acts Around the World*, 17 J. BANKING REGUL. 176, 181 (2016).

[24] Parent Companies of Industrial Banks and Industrial Loan Companies, 86 Fed. Reg. 10,703 (Feb. 23, 2021) (to be codified at 12 C.F.R. pt. 354).

[25] *Id.* at 10,719.

[26] *Id.*

[27] Similar to the FDIC's proposed guidelines, the Board and the OCC could exempt a bank whose holding company "conducts limited or no additional business operations outside the [bank]." *See* 88 Fed. Reg. at 70405 n.45.

[28] In my article, I recommended that BHCs with a majority of their assets in nonbank legal entities should be required to appoint unaffiliated directors to every seat on their bank subsidiary boards. Because of their heavy focus on nonbank activities, these conglomerates pose the biggest risk of exploiting the federal safety net, and their bank subsidiaries would therefore benefit the most from unaffiliated directors. BHCs with significant nonbank operations—for example, between 10 and 50 percent of their assets in nonbank legal entities—could be required to maintain a majority of unaffiliated directors on their bank subsidiary boards. By contrast, BHCs in which nonbank activities constitute a smaller focus—for example, between 1 and 10 percent of assets—could appoint unaffiliated directors to at least one-third of their bank board seats. In the interests of efficiency, the agencies could exempt large BHCs with de minimis nonbank operations from the requirement to appoint unaffiliated bank directors, as bank-focused conglomerates likely pose the least risk of exploitation. *See* Kress, *supra* note 3, at 935-36.

which approach the agencies select, it is imperative that they establish an unaffiliated director standard to alleviate conflicts of interest in bank governance, prevent financial conglomerates from taking advantage of the federal safety net, and safeguard the stability of the banking system.

For your reference, I am attaching the comment letter I filed with the FDIC about its corporate governance proposal. My comment letter supports the FDIC's unaffiliated director standard and suggests enhancements to strengthen the guidelines. Specifically, I urge the FDIC to (1) enact safeguards around how a covered institution appoints and removes unaffiliated directors, (2) oversee how a covered institution compensates its unaffiliated directors, (3) require covered institutions to publicly disclose the names of their board members, and (4) provide clarity around the FDIC's proposed de minimis exemption from the unaffiliated director guideline. Should the Board and the OCC adopt a standard similar to the FDIC's proposal, I encourage the Board and OCC to incorporate these reforms, as well.

This petition is made pursuant to section 553(e) of the Administrative Procedure Act. I respectfully request a response, as required by law.

Sincerely,

Jeremy C. Kress

Attachment