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PUBLIC INTEREST COMMENT

FDIC PROPOSED GUIDELINES ON STANDARDS OF CORPORATE GOVERNANCE AND RISK MANAGEMENT FOR COVERED INSTITUTIONS WITH TOTAL CONSOLIDATED ASSETS OF 10 BILLION DOLLARS OR MORE

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Proposed Rule on Guidelines Establishing Standards for Corporate Governance and Risk Management for Covered Institutions with Total Consolidated Assets of 10 Billion Dollars or More
Agency: Federal Deposit Insurance Corporation
Comment Period Opens: October 11, 2023
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I appreciate the opportunity to comment on the FDIC's proposed "Guidelines Establishing Standards for Corporate Governance and Risk Management for Covered Institutions with Total Consolidated Assets of $10 Billion or More."[1] The Mercatus Center at George Mason University is dedicated to bridging the gap between academic ideas and real-world problems and to advancing knowledge on the effects of regulation on society. This comment contains only my views as a scholar at Mercatus and does not represent the views of any other party or group. Rather, it is designed to help the FDIC as it considers whether to impose new requirements on the corporate governance of certain banks for the purpose of protecting their safety and soundness.[2]

The FDIC's current proposal appears to be premature and lack sufficient basis to assure the public that (1) its benefits will exceed its costs and (2) it will truly further the interest of bank safety and soundness. The FDIC should withdraw the proposal, solicit information, and perform a meaningful cost-benefit analysis. It should then present those findings, and how the FDIC reached them, to the public for comment and critique. Otherwise, neither the FDIC nor the public

[1] 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 (October 11, 2023).
[2] The FDIC bases its authority to promulgate these guidelines on 12 U.S.C. § 1831p–1, which allows the FDIC to prescribe certain standards for covered banks to protect their safety and soundness.

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can trust the guidelines will be an improvement, rather than a detriment, to safety and soundness.

The FDIC adopts an expansive definition of what constitutes an "unsafe or unsound" action. To be unsafe or unsound, an action must pose an "abnormal risk of loss or damage" to the bank, its shareholders, or the insurance fund.[3] To consider an action unsafe or unsound the FDIC historically has required not that the action pose an existential threat to the bank's soundness, but simply that it be "contrary to accepted standards of banking operations which might result in abnormal risk of loss to the institution or shareholder."[4] As such, by its own logic the FDIC should be concerned that any requirement it imposes on banks would cost more than it provides in benefits, since those costs will weaken a bank's financial position and increase the risk of distress or failure.

Given this, it is unfortunate that the FDIC appears to have not even attempted to quantify the potential benefits of its proposal for bank safety and soundness.[5] Without such information, or at least a reasonable estimate, it is impossible for the public and the agency to assess whether the likely costs of such a proposal would outweigh the benefits. This would defeat the purpose and justification for the requirement.

While the FDIC claims it lacks access to information to enable such an estimate, that seems unlikely. The effect of board size, structure, and composition on a firm's performance is an obviously challenging question. That does not mean, however, that there have not been considerable efforts to answer it. There is a large and growing literature that looks at the effects of corporate governance features at firms, including banks, both internationally and domestically, with varying results.

For example, Renata Karkowska and Jan Acedański find that independent boards may have limited bank risk-taking and larger boards may decrease stability.[6] Allen N. Berger et al. find that higher shareholding by outside directors implies a lower risk of failure.[7] Jens Hagendorff and Kevin Keasey find that while boards with members from diverse career backgrounds are associated with positive returns from the announcement of a merger, the opposite is true for age and tenure diversity, with no impact from gender diversity.[8] Gennaro Bernile et al. find that more diverse boards, with diversity encompassing both cognitive and demographic traits, lead to better

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[3] Federal Deposit Insurance Corporation, *Formal and Informal Enforcement Actions Manual*, P. 3-1, June 2022. https://www.fdic.gov/regulations/examinations/enforcement-actions/ch-03.pdf.
[4] Greene County Bank v. FDIC, 92 F.3d 633, 636 (8th Cir. 1996). It should be noted that this view is not universally supported. See e.g. Gulf Federal Sav. and Loan Ass'n of Jefferson Parish v. Federal Home Loan Bank Bd., 651 F.2d 259 (5th Cir. 1981); Frontier State Bank Okla. City v. Fed. Deposit Ins. Corp., 702 F.3d 588, 604 (10th Cir. 2012).
[5] 88 FR 70398.
[6] Renata Karkowska and Jan Acedański, "The Effect of Corporate Board Attributes on Bank Stability," *Portuguese Economic Journal* 19 (2020): 99–137.
[7] Allen N. Berger, Björn Imbierowicz, and Christian Rauch, "The Roles of Corporate Governance in Bank Failures during the Recent Financial Crisis," (European Banking Center Discussion Paper No. 2012-023, October 18, 2012).
[8] Jens Hagendorff and Kevin Keasey, "The Value of Board Diversity in Banking: Evidence from the Market for Corporate Control," *The European Journal of Finance* 18, no. 1 (June 2010): 41-58.

firm performance and less risk.[9] Mariassunta Giannetti and Mengxin Zhao find evidence that greater ethnic diversity on a board may lead firms to be more innovative but also less predictable and potentially more conflict prone.[10] W. Gary Simpson et al. find that the potential added value of women on a corporate board is likely case specific.[11] C. José García Martin finds that higher board independence correlates with lower firm performance, and he finds limited evidence that more board diversity increases firm performance.[12] Harald Dale-Olsen finds evidence that a quota for women on corporate boards in Norway failed to improve performance, as opposed to firms not subject to the quota.[13] David A. Carter et al. (2010) do not find a significant relationship between board gender or ethnic diversity and financial performance,[14] while Carter et al. (2003) find a positive relationship between board diversity and improved financial value.[15]

This limited sample shows that the question of corporate-governance features is incredibly complex and the academy is actively engaged in studying it. The copious literature in the field indicates that there are methods the FDIC could use to perform an analysis that would generate at least an informed opinion on the likely quantifiable potential benefits to banks. Meanwhile, the diversity of outcomes shows that the FDIC should not blithely assume the effect of the proposed guidelines.

Instead of rushing, the FDIC should solicit information from banks, consider the academic literature, and perform its own quantitative assessment of potential benefits. This assessment should then be presented for public critique as part of rulemaking.

Additionally, it is possible that the FDIC's estimates of compliance costs are incomplete. For example, the FDIC uses an estimated wage rate of $139.33 per hour based on a set of assumptions. However, the FDIC does not discuss why it came to those assumptions or whether it has inquired about the soundness of those assumptions by asking the very banks that would be required to implement this proposal. The FDIC fails to explain why it chose the metric it did. To be sure, banks can and should provide comments now, but they should have had the opportunity to do so without facing an imminent rulemaking. It again looks like the FDIC has failed to make

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[9] Gennaro Bernile, Vineet Bhagwat, and Scott E. Yonker, "Board Diversity, Firm Risk, and Corporate Policies," (March 6, 2017).

[10] Mariassunta Giannetti and Mengxin Zhao, "Board Ancestral Diversity and Firm Performance Volatility" (European Corporate Governance Institute (ECGI) – Finance Working Paper No. 462/2016, May 11, 2018).

[11] W. Gary Simpson, David A. Carter, and Frank P. D'Souza, "What Do We Know About Women on Boards?" *Journal of Applied Finance* (Formerly *Financial Practice and Education*) 20, no. 2, 2010 (November 2015), https://ssrn.com/abstract=2693058.

[12] C. José García Martín and Begoña Herrero, "Boards of Directors: Composition and Effects on the Performance of the Firm," *Economic Research-Ekonomska Istraživanja* 31, no. 1, (July 2017): 1015–41.

[13] Harald Dale-Olsen, Pål Schøne, and Mette Verner, "Diversity Among Norwegian Boards of Directors: Does a Quota for Women Improve Firm Performance?" *Feminist Economics* 19, no. 4, (September 2013): 110–35.

[14] David A. Carter, Frank D'Souza, Betty J. Simkins, and W. Gary Simpson, "The Gender and Ethnic Diversity of US Boards and Board Committees and Firm Financial Performance," *Corporate Governance: An International Review* 18, no. 5, (September 2010): 396-414, https://onlinelibrary.wiley.com/doi/abs/10.1111/j.1467-8683.2010.00809.x.

[15] David A. Carter, Betty J. Simkins, and W. Gary Simpson, "Corporate Governance, Board Diversity, and Firm Value," *The Financial Review* 38, no. 1 (February 2003): 33-53, https://onlinelibrary.wiley.com/doi/abs/10.1111/1540-6288.00034.

reasonable efforts to obtain information and present its assumptions to the public before embarking on rulemaking.

Given that the exact risk the FDIC is trying to prevent is economic loss to banks, it is essential for the FDIC to be able to make an informed, quantified assessment of the costs and benefits of the proposal. Otherwise, it risks frustrating the very statutory purpose it claims to serve. An agency action grounded in supporting safety and soundness but blind to its likely impact on that very question may also present legal risk, to the extent it would make the FDIC's actions arbitrary and capricious.[16] Even if the FDIC's actions would not be legally defective, they would certainly not be consistent with best practices or the suggestions of the FDIC's own inspector general, who has chided the FDIC before for failing to engage in meaningful cost-benefit analysis in rulemakings.[17]

In addition to performing a meaningful cost-benefit analysis, it is also essential that the FDIC present commenters with those results and how the conclusions were reached, so commenters can inform and critique the FDIC's assumptions as part of the rulemaking process.[18] The failure of the FDIC to take these actions here hampers the public's ability to serve its role and risks suboptimal results.

As such, the FDIC should withdraw this proposal and instead request information from banks and the public that can allow the FDIC to make a reasoned assessment after due consideration.

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[16] See e.g. Chamber of Commerce of U.S. v. SEC, 412 F.3d 133 (DC. Cir. 2011) (finding that an agency acted arbitrarily and capriciously by failing to consider costs when it had a statutory obligation to consider whether a rulemaking would promote "efficiency, competition, and capital formation").
[17] Federal Deposit Insurance Corporation, Office of Inspector General, *Eval-20-003: Cost Benefit Analysis for Rulemaking*, February 2020.
[18] See e.g. Owner-Operator Independent Drivers Association v. FMCSA, 494 F.3d 188 (D.C. Cir. 2007).