Mitigating Systemic Risk through Substantive Rules and Greater Individual Accountability: A Few Observations on Recalibrating Our Regulatory Approach

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The Financial Industry in a Post-Crisis World Symposium Dinner
Washington, D.C.
July 9, 2014

As prepared for delivery:

Good evening. Thank you all for being here. This informal setting is a terrific way to kick off our symposium, which will provide us an opportunity to assess the impact that the post-crisis regulatory landscape is having on banks and the banking system, and to review the progress we have made since the crisis.

I am confident that, on the whole, we will all be encouraged by what we learn tomorrow. We are in a much better position today to withstand the next shock to the system.

This improvement is due to the immense progress made by both regulators and the industry towards increasing our collective focus on identifying and mitigating systemic risks, including both risks that have manifested themselves in the past and new risks that may arise in the future like those posed by CCPs, which we will discuss tomorrow.

But there is always room for improvement, and tonight, I want to raise a word of caution and hopefully begin a conversation about two related and interconnected trends I am seeing: process-based regulation and institution-focused enforcement.

Before getting into specifics, it's also important to remember how we got here.

When we look back at the Dodd-Frank Act in ten or fifteen years, I suspect that the part of that law that will stand out to us the most is not the breadth or depth or even the scope of its regulatory reforms, but instead the mechanism it employs to implement those reforms: an enormous delegation of authority and discretion to rulemaking agencies – or

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in many cases a group of agencies – to set and shape the actual contours of new regulation. It is this congressional choice of approach – in my own humble opinion, an abdication of responsibility – that has set the stage for the process-based regulation and institution-focused enforcement that I want to talk about tonight.

Given the large discretion granted to the agencies and the significant challenge they face in implementing often ambiguous and inconsistent statutory mandates, neither of these trends should surprise us. And so as I continue my remarks tonight and highlight a number of concerns that I have about the direction of our existing regulatory framework, I want to make clear that I think we should all approach these problems with a healthy degree of empathy for the very difficult task that regulators currently face.

I. Introduction

The first trend I want to discuss this evening is the increasing incorporation within prudential rules of a process-based approach to regulation where prescriptive procedural mandates themselves – and not clear substantive behaviors – have become the end-state objective.

I worry that this increasing emphasis on process-based rules, especially when they become mere check-the-box exercises, will ultimately lead to misplaced attention and an inefficient allocation of compliance resources. There is real cause to worry that firms and regulators alike may be shifting to an approach to both macro and microprudential regulation that focuses on policies, procedures, and processes, while paying less attention to the difficult task of defining the underlying substantive risks.

The second trend that I'd like to highlight this evening is a developing imbalance in the enforcement of banking rules and regulations, where undue emphasis is placed on collective and institutional culpability, rather than individual accountability.

We have seen all too many headlines announcing enormous fines for bank after bank, but only rarely do we see enforcement actions against the specific individuals who perpetrated the wrongdoing. In a certain sense, this should not surprise us – in an environment where rules are increasingly taking the form of institutional procedural mandates, compliance with those rules itself becomes, by definition, an institutional and not individual exercise. But at the risk of joining the populist choir, I believe consumers and counterparties would be better served with a regulatory framework based on clear, substantive behavioral norms to which individuals can be and are held accountable on a much more frequent basis.

Once individuals understand that they can no longer hide behind the institutions they work for and know in advance precisely what standards their behavior must conform to, I am hopeful that we will start to see the cultural shift in banking that we all desire.

II. The Trend Towards Process-Based Rules

With that introductory context, let's focus on my first observation – the growing prevalence of process-based rules.

Let me be clear – in highlighting this concern, I am not trying to whine and complain about the costs or burdens that our nation's banks bear in implementing and complying with new rules.

But I do want to start a dialogue tonight on several important questions: Are we appropriately focusing our collective attention on substantive behavioral norms that restrict and prevent the excessive risk-taking or other activities that are outside the normative view of what banks should do? And is it possible that, by focusing too much on procedural rather than substantive standards, our current regulatory approach might not be best designed to produce the outcome we desire – a safer, sounder, and more accountable banking industry?

Many in this room will recall that before and during the crisis, one of the most hotly debated questions in Washington was whether we should have a "principles-based" or "bright line" rules environment.

My own view is that the ideal regulatory approach is indeed principles-based, with firms independently customizing and developing their own compliance processes in ways that reflect their own idiosyncratic business models, needs, and risk tolerances. As a practical matter, however, that ideal is simply not currently possible. Why? Because principles-based rules require that both supervisors and firms have a thoughtful, constructive, apolitical dialogue about what those principles mean in practice. Unfortunately, in the current political environment, those kinds of meaningful, productive *ex-ante* conversations about what those principles mean in practice are increasingly difficult, and in many cases not possible. For these reasons, at least for the foreseeable future, it is in everyone's interest that we recalibrate our thinking more towards a "bright line" regulatory environment, where there is transparent symmetry between *ex ante* understandings and *ex-post* enforcement of what the prohibited behavior is.

Unfortunately, I am worried that we may be increasingly moving to an asymmetry in important areas, with opacity at the front end and highly politicized discretionary enforcement at the back end.

My concern around this asymmetry is most pronounced in the recent embrace of "supervision by horizontal review," where firms may be simply "marked to the median" rather than held to a clear, normative, objective benchmark designed to ensure safety, soundness, and financial stability. Whether through the Fed's creation of the Large Institution Supervision Coordinating Committee (LISCC)[2] and its horizontal review

[2] *See* Board of Governors of the Federal Reserve System, *Large Institution Supervision Coordinating Committee*, *available at* http://www.federalreserve.gov/bankinforeg/large-institution-supervision.htm.

exercises, or the OCC's recently-announced intention to rely more on centralized, horizontal-based supervision[3], I worry that supervisors may be increasingly dealing with substantive concerns by "grading on a curve" where a number of firms by definition are always inadequate.

Although I by no means intend to criticize horizontal supervision exercises per se – which, where done appropriately, can and should provide important supervisory and prudential benefits – they have the potential to devolve in practice into exercises that simply identify and proscribe outlier practices on a relative basis, without regard to whether those outlier practices (i) are sufficient to address the real underlying risks or (ii) appropriately reflect the idiosyncratic business and risk profile of the firm that employs them. Moreover, marking on a curve creates embedded disincentives to improve, as getting "better grades" simply moves the curve. This shift toward horizontal review and supervisory discretion reminds me of Warren Buffett's admonition: "The five most dangerous words in business may be 'everybody else is doing it.'"[4] I believe we can and should worry that, if not done right, these kind of horizontal practices might themselves give rise to a new kind of concentration risk, stifling innovation and diversity and herding banks into a single set of supervisor-mandated practices.

Fortunately, my concerns may be unwarranted; there may be reason for optimism. I was encouraged to see Governor Tarullo's recent Boston speech where he stated, in the context of CCAR, "the horizontal nature of the qualitative assessment does not mean that every year one or more firms must receive an objection on qualitative grounds…[T]his is not a PGA tournament – there is no foreordained cut that some participants will miss."[5] These are encouraging words that I hope will be embraced in practice.

Let me take just a few minutes and provide you with some specific illustrative examples of the trend I am noting.

As a first example, there is no better place to begin than with the Volcker Rule.[6] At the center of this controversial rule is an enormous compliance program and reporting mandate. As the press has widely reported, this process-based approach has quickly become a boon to outside lawyers and consultants, requiring thousands of hours of

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[3] *See* Office of the Comptroller of the Currency, *An International Review of OCC's Supervision of Large and Midsize Institutions*, *available at* http://occ.gov/news-issuances/news-releases/2013/nr-occ-2013-184a.pdf.

[4] *See* Memorandum from Warren E. Buffett to Berkshire Hathaway Managers ("The All-Stars") (Sept. 27, 2006), Full text of Warren Buffett's memorandum (Oct. 9, 2006), *available at* http://www.ft.com/intl/cms/s/0/48312832-57d4-11db-be9f-0000779e2340.html#axzz37dzFutVK.

[5] *See* Gov. Daniel K. Tarullo, *Address at the Federal Reserve Third Annual Stress Test Modeling Symposium* (June 25, 2014), *available at* http://www.federalreserve.gov/newsevents/speech/tarullo20140625a.htm.

[6] Dodd–Frank Wall Street Reform and Consumer Protection Act § 619 (12 U.S.C. § 1851) (2010); 79 Fed. Reg. 5535 (Jan. 31, 2014) (final rule).

billable time to design, implement, and run.[7] I think that we should legitimately worry that instead of dedicating their undivided attention to the perceived risks involved – managing the market, credit, and other risks of trading, hedge fund and private equity fund activities – a number of firms will instead have to deploy tremendous resources to build and then check, over and over, a long series of regulatory boxes.[8] For example, for each trading desk at a covered firm, the compliance program mandate within Volcker provides pages and pages worth of details that every desk must include in its processes, policies and procedures.[9] And for some firms that don't even engage in the activities the Volcker Rule targets, this process-driven approach will nonetheless require them to build large programs and systems that in the end will simply produce compliance reports filled with pages and pages of zeros.[10]

The operational risk capital framework is another example. Few rules have become more proceduralized than the existing U.S. approach to operational risk capital, where observers from a wide range of perspectives are concerned that banks are being required to develop and implement complex operational risk modeling processes that may simply be overridden in practice by supervisory judgment and discretion as to what constitutes an appropriate level of operational risk capital.[11] The result may be an operational risk capital framework that bears little relationship to actual loss experiences and real risks, with some financial institutions required to hold capital that is a multiple of their actual loss experiences.

We at The Clearing House are doing extensive work in this area, including a survey of banks' operational risk management and measurement practices, in order to assess the extent of the apparent disconnect between the regulatory framework and the underlying risks, and provide constructive suggestions for substantive improvement.

BSA/AML is another example where I worry that we are moving away from a risk-based approach to preventing financial crime. Are we really comfortable that the current regulatory compliance architecture, with its heavy emphasis on policies, procedures, and process, is the best way to pinpoint the real risks and catch the bad guys? For example, the SAR process can be an important tool, but we should not equate the number of SARS a firm files with its commitment to compliance in the AML/BSA space, or the

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[7] *See* Peter Eavis, *Wall Street's Latest Must Have? A Volcker* Helper, N.Y. Times (June 20, 2014) *available at* http://dealbook.nytimes.com/2014/06/20/wall-streets-latest-must-have-a-volcker-helper/.

[8] *Id*.

[9] *Supra,* note 5.

[10] *Id.*

[11] *See* Board of Governors of the Federal Reserve System, Federal Deposit Insurance Corporation, Office of the Comptroller of the Currency, Office of Thrift Supervision, *Interagency Guidance On The Advanced Measurement Approaches For Operational Risk* (June 2011) *available at* http://www.occ.gov/news-issuances/bulletins/2011/bulletin-2011-21a.pdf.

effectiveness of its program.[12] Here, too, The Clearing House has undertaken extensive work to explore both public/private partnerships and private sector solutions aimed at facilitating a more risk-based, efficient approach to preventing financial crime.

The last example I will offer is the emerging regulatory approach to corporate governance – here again, many have noted that regulation in this area seems to be headed too far in the direction of a laundry list of process and procedural mandates that directors must ensure compliance with.

This is an issue that will be raised in the next issue of our quarterly journal *Banking Perspective*, to be published next week, in which KeyCorp Secretary and General Counsel Paul Harris wrote a thoughtful and informative piece that addresses the proceduralization that appears to be creeping into bank governance standards.[13] He succinctly captures the issue and the risks involved:

> [A]s the list of director responsibilities for [bank] boards continues to grow, it is important for management and directors of banking organizations, as well as regulators and supervisors, to keep in mind that effective board oversight should not be hampered by a 'checklist' or compliance mentality to carrying out these responsibilities.[14]

If we truly recognize that different banks have different business models and risk profiles – which, let's not forget, is what we want, a banking system of all shapes and sizes – we ought to be wary of this trend towards process-based regulation. Flexibility that recognizes the unique characteristics of different-sized banks and different business models is crucial.

And so this trend worries me not just because it raises significant due process concerns but because, at the end of the day, it makes it harder to achieve the real desired outcome here: a safer, sounder banking environment.

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[12] For example, as Robert Axelrod has questioned, "[i]s a program just turning out large numbers of SARs that end up as statistics independent of any demonstrated link to real criminal activity? If so, the program might pass with flying colors the current regimen of quality and quantity checks, but it might nonetheless be a prime candidate for improvement." Robert M. Axelrod, *Making SARs More Effective: Broader Based Feedback From Law Enforcement Needed by Financial Institutions*, BLOOMBERG BNA BANKING REPORT (Feb. 5, 2013) *available at* https://www.deloitte.com/assets/Dcom-UnitedStates/Local%20Assets/Documents/FinancialAdvisoryServices_FAS/us_fas_SAR_Feedback_Bloomberg_032113.pdf.

[13] *See* Paul N. Harris, *Effective Bank Governance in the Age of Heightened Expectations*, BANKING PERSPECTIVE, 2nd Quarter 2014, Vol.2, Issue 2, at 46, *available at* https://www.theclearinghouse.org/~/media/Files/Banking%20Perspective/Q2_2014/TCH-Journal%20Vol%202-2%20Rev8%20v30.pdf.

[14] *Id*. at 47.

III. Balance in Enforcement – Institutional v. Individual Accountability

There is no question that the growing prevalence of process-based rules is also perpetuating the imbalance of enforcement actions that solely target firms, and not bad individual actors. Without clear rules, we will not be able to address the second issue that concerns me – individual accountability.

If we establish brighter lines between right and wrong and focus our attention on defining behavioral norms, it will also be easier to hold individuals accountable. This is critical to achieving the substantive outcomes we all support because individual accountability is a better deterrent to wrongdoing than assessing major fines on banks. Who feels the pain when banks are fined? At the moment, it is mostly shareholders, who have no involvement in the infraction. How is that preventive?

Ben Lawsky, New York State's Superintendent of Financial Services – with whom I do not always agree – got this point exactly right in a recent speech he gave at the Exchequer Club.[15] He said "[a] greater focus on individual accountability may also play a role in incentivizing more ethical behavior and addressing some of the cultural problems on Wall Street others have highlighted. Granted, focusing on individual accountability may make it more challenging for regulators to resolve these cases. It certainly takes regulators out of their comfort zone, which is maybe where we need to be in order to improve."[16]

So what is the better alternative? Clear substantive rules that prescribe behavioral norms that make it easier for authorities to hold individuals accountable. Instead of focusing on mandating processes and procedures, we should be focused on more directly addressing the underlying risks through (i) clear substantive rules that define and restrict bad behavior and (ii) aggressive pursuit of the culpable individuals who directly engage in that bad behavior.[17]

I suspect everyone here would agree with me that wrongdoers should be prosecuted to the fullest extent of the law.

But do we have a set of rules where right and wrong is black and white enough to empower regulators and prosecutors to go after bad actors?

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[15] *See* Benjamin M. Lawsky, Superintendent, Dept. of Fin. Serv., Remarks on Financial Regulatory Enforcement at the Exchequer Club (March 19, 2014), *available at* http://www.dfs.ny.gov/about/speeches_testimony/sp140319.pdf.

[16] *Id*.

[17] For example, enforcement under the Bank Secrecy Act and sanctions laws has been largely marked by fines against institutions rather than charges against individuals. In the case of BSA, it may well be that this result is driven in part by the existing statutory framework, which penalizes a failure to maintain an adequate compliance program – i.e., it proscribes institutional acts of omission, rather than individual acts of commission. Similar challenges may exist under the sanctions regimes in attributing to one or more specific individuals conduct that is more collective in nature.

Might we need better and clearer rules that restrict bad behaviors and serve as the foundation for a system that emphasizes aggressive pursuit of the actual individuals who violate them? I think we do.

Now, I certainly don't mean to suggest that we should discount the harm caused to those involved in some of these enforcement actions. But what I am suggesting is that although massive fines levied on banks might make for good headlines, they are unlikely to be the best way to get what we all really want: the deterrence of pernicious behavior. Sanctioning an institution creates almost no disincentive for individuals to cheat. My focus here is not whether we take an enforcement action; it is how we take that action.

Penalties that are institutional in nature inappropriately cast either the industry as a whole or entire firms as wrongdoers, but that's simply not the case in an overwhelming majority of the recent enforcement actions.

It cannot always be the case that simply because an individual or group of individuals acts illegally, a firm must be held liable because it didn't have a policy in place that prevented them from doing so. A zero-tolerance threshold for institutions is unrealistic and unattainable. Institutions should not be the primary target unless the problem is so pervasive as to suggest an enterprise-wide or institutional disregard for the underlying substantive rules.

Similarly, we must also ensure that we are holding accountable the right individuals – those that are actually culpable – and must resist the populist temptation to create artificial definitions of accountability that include those people whose only relationship to the underlying problem is that they are in positions of authority. Building a Sarbanes-Oxley-like architecture of managerial certifications would only lead to undue focus on process and procedures, and a much smaller talent pool of people able and willing to serve in senior management positions. Such results, again, are not in our collective best interest.

In the end, seeking better outcomes and mitigating the risk of unintended consequences is what really matters here. I hope I have begun a conversation tonight around whether or not we need to recalibrate certain aspects of our regulatory approach to better achieve those goals. Clearly, I think that conversation is one worth having, with real implications for how we identify and mitigate risks to our financial system.

With that, I want to thank everyone again for being here tonight and participating in what I expect to be an informative, thought-provoking, and educational day tomorrow.