

# Weathering the Storm:

## *A Guide to Banking in Uncertain Times*

Session 2: “The Regulatory Enforcement Process”

A Jones Walker Webinar Series  
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## Introduction and Overview

- Second of six sessions addressing issues for bankers navigating a difficult banking environment.
- First session covered the current regulatory environment and its implications for your next exam.
- This session will focus on the regulatory enforcement process and will cover the following:
  - ❖ issues giving rise to enforcement actions
  - ❖ types of enforcement actions and their implications
  - ❖ common provisions found in enforcement actions
  - ❖ understanding the enforcement-action process and negotiating enforcement actions
  - ❖ guidance on complying with enforcement actions

## Introduction and Overview

- Significant increase in number of enforcement actions
  - ❖ 2000–2007 – FDIC averaged 35 Cease & Desist Orders per year
  - ❖ 2008 – FDIC issued 94 Cease & Desist Orders
  - ❖ 2009 – FDIC issued 276 Cease & Desist Orders
- 1- and 2-rated banks are now finding themselves 3- and 4-rated.
- Usually, 3-rated banks will be subject to an MOU, and 4-rated banks will be subject to a Cease & Desist Order.
- In some cases, 2-rated banks are being subjected to enforcement actions where prior exam criticisms have not been properly addressed.
- Expected that more than 1/3 of banks in GA and AL will be problem banks (3, 4 or 5-rated) within the next 12 months.

## Issues Giving Rise to Enforcement Actions

- Material loss reviews (MLRs)
  - ❖ Conducted by the agency's inspector general on the heels of a bank failure.
  - ❖ Are regularly critical of the oversight work of the regulators.
  - ❖ Recurring theme is the failure of the regulator to take sufficiently aggressive approach in dealing with weaknesses.
  - ❖ MLRs are getting examiners' attention – no one likes being criticized or second-guessed.
- Proposed legislation to eliminate certain of the bank regulatory agencies or to take away responsibilities.

## Issues Giving Rise to Enforcement Actions

- Increasing number of new examiners who are new to the game and thus more conservative and less flexible.
  - ❖ FDIC plans to increase its exam staff by 25% in 2010, resulting in an increase of 69% in its safety and soundness staff since 2007.
  - ❖ OCC expects to increase its exam staff by 3% in 2010, which results in a 6% increase since 2007.
- No incentive for examiners to show flexibility. They aren't paid to be right; rather, they are paid not to be wrong.

## Issues Giving Rise to Enforcement Actions

### Areas of Examiner Focus

- *Asset Quality*—Will receive the most scrutiny, with ADC and non-owner occupied CRE receiving the most attention.
- *Loan-Loss Reserve*—Is the bank promptly identifying and recognizing losses and maintaining an adequate reserve; are assumptions realistic?
- *Loan Concentrations*—Do CRE and ADC loans exceed the thresholds set forth in 2006 Interagency Guidance?
- *Liquidity*—Examiners will be critical of overreliance on brokered deposits and FHLB advances; will also focus on contingency funding plans.
- *Interest Rate Risk*—Examiners concerned with banks funding long-term assets with short-term liabilities, when rates will likely rise as economy recovers.
- *Capital Levels*—CRE concentration and asset quality issues will result in higher capital requirements.
- *Risk-Management Practices*
- *Insider Abuse/Reg O Compliance*

# Types of Enforcement Actions & Their Implications

## Formal Action vs. Informal Action

### ■ Formal Action

- ❖ Order or agreement issued by a banking agency pursuant to specific statutory authority, such as Section 8 of the FDI Act.
- ❖ Includes (i) Cease & Desist Orders, Formal Agreements, Written Agreements, Consent Orders (Section 8(b)), (ii) Prohibition & Removal Orders with respect to institution-affiliated parties (Section 8(e)), and (iii) civil money penalty assessments (Section 8(i)).

### ■ Informal Action

- ❖ Used when circumstances warrant a less severe form of corrective action. Not issued pursuant to statutory authority, but rather is an agreement by a bank to take action to address noted deficiencies.
- ❖ Includes Commitment Letters, Board Resolutions, MOUs and Safety and Soundness Compliance Plans.

# Types of Enforcement Actions & Their Implications

## Implications of Formal Actions

- Formal actions are made public by the agencies.
  - ❖ FDIC publishes its formal enforcement actions from the previous month on the last Friday of the following month.
  - ❖ OCC publishes its formal enforcement actions from the previous month on the 3<sup>rd</sup> Friday of the following month.
  - ❖ Fed publishes its formal enforcement actions individually, and timing is sporadic but usually sooner than FDIC & OCC.
  - ❖ OTS actions show up on the agency's website soon after they are signed.
  - ❖ Public companies must disclose any formal action in a securities filing.
  - ❖ Some orders now require banks to provide notice of the order to their shareholders.



# Types of Enforcement Actions & Their Implications

## Implications of Formal Actions (cont'd)

- How to Handle Public Relations Aspect
  - ❖ Public nature of formal action can create public relations issues with customers and shareholders. Be prepared to effectively field questions.
  - ❖ Identify spokesperson to respond to inquiries.
  - ❖ Develop talking points.
  - ❖ Educate employees, particularly those that interact with customers, and provide talking points.
  - ❖ Consider meeting with local media to ensure accuracy of news reports.
- Brokered-Deposit Restrictions & Interest-Rate Restrictions
  - ❖ If a formal action contains a capital maintenance requirement, bank will be required to obtain a waiver from FDIC to accept, renew, or roll over brokered deposits. Also will become subject to interest-rate restrictions on all deposits (generally may not exceed 75 bp over national rate).

## Types of Enforcement Actions & Their Implications

### Implications of Formal Actions (cont'd)

- Violation of formal action constitutes statutory basis for assessing civil money penalties against the bank and its officers and directors. D&O policies will not cover payment of the penalty but can provide for payment of defense costs.
- Violation of formal action may also constitute statutory basis for issuance of removal order against officers and directors if certain additional factors are present.
- Issuance of formal action will cause the bank to be deemed in a “troubled condition,” resulting in additional restrictions such as prohibition on golden parachute payments and being required to obtain regulator approval to add an executive officer or director.

# Types of Enforcement Actions & Their Implications

## Implications of Informal Actions

- Agencies do not make informal actions public.
  - ❖ If bank is a public company or is raising capital, disclosure may be required under securities laws (materiality standard).
  - ❖ If an insider is selling stock to a non-insider, disclosure to the buyer may be required under securities laws (materiality standard).
  - ❖ Need to consult and obtain approval of regulators before disclosing.
- Violating informal action does not constitute statutory basis for assessing civil money penalties.
- Violation could lead to imposition of formal enforcement action.
- A capital maintenance provision in an informal action will not trigger brokered-deposit and interest-rate restrictions.

## Common Provisions Found in Enforcement Actions

- Formal and informal actions can be substantially similar in content.
- Ordinarily, provisions are directly related to (i) exam results and criticisms noted in exam report, and (ii) areas of heightened regulatory concern (e.g., CRE concentrations, interest-rate risk).
- In the current environment, the following provisions are typically included:
  - ❖ Reductions in classified assets
  - ❖ Capital maintenance requirements
  - ❖ Reductions in asset concentrations
  - ❖ Management study
  - ❖ Restrictions on dividends
  - ❖ Disclosure to shareholders
  - ❖ Liquidity policy

## Understanding the Enforcement Action Process

### Process for Issuing Informal Action

- During the exam or exit interview, examiner will indicate that informal corrective program is warranted by exam findings.
- The Report of Examination will reflect the regulators' intention to require an informal action.
- Within a few weeks of delivery of the Report of Examination, regulators will provide a draft MOU to the Board.
- Terms of the MOU may or may not be negotiated.
- Board will execute MOU and submit to regulators.
- MOU becomes effective when executed by regulators.

# Understanding the Enforcement Action Process

## Process for Issuing Formal Action

### ■ Consent-Order Process

- ❖ Substantially similar to process for issuing informal action.
- ❖ It's called a Consent Order because the bank consents to the issuance of the order and waives its right to a hearing.

### ■ Contested-Order Process

- ❖ Notice of Charges served, on the bank which sets out the basis for the order and sets a hearing date.
- ❖ Hearing is held before an ALJ 30–60 days from date of notice.
- ❖ Order is issued within 90 days following hearing.
- ❖ Order is effective 30 days following its service.
- ❖ Appeal of order can be taken to the Court of Appeals for the Circuit where the main office is located, or to the D.C. Circuit, if filed within 30 days of service of the order.

## Understanding the Enforcement Action Process

### Process for Issuing Formal Action (cont'd)

- Great deference is applied to decisions made by regulators and success in contesting an order is infrequent. Risks associated with contesting an order include negative publicity and an angry regulator.
- FDIC recently softened the language in its Consent Cease & Desist Orders. The softened version applies only if the bank consents to the issuance of the order.
  - ❖ Changed name of the order from Cease & Desist Order to Consent Order.
  - ❖ Some of the harsher language found at the beginning of such orders, ordering bank to cease and desist from certain unsafe and unsound practices, has been removed.

## Understanding the Enforcement Action Process

### Negotiation of Enforcement Actions

- Resist the temptation to bow up to the examiners. Adversarial approach is likely to be counterproductive and expensive.
- Focus on specific actions that need to be taken to correct identified problems. Convey message that problems are being taken seriously and that management will be proactive.
- Focus on the opportunity to solve the identified problems and develop heightened respect from regulators in the process.
- Get advisors in the mix for the right reasons—to assist with working through the process, not to play hardball.



# Understanding the Enforcement Action Process

## Possible Subjects of Negotiation

- Existence or Type of Enforcement Action
  - ❖ Success in negotiating whether an enforcement action will be issued, or the type of action issued, can be achieved only through success in changing conclusions reached in the report of examination.
  - ❖ This means bankers will have to make their case to examiners during the examination. Once the report is issued, it will be extremely difficult to change their minds.
  - ❖ Potential courses of action if fundamental disagreements arise: (i) seek intervention by the ombudsman for the agency, or (ii) utilize appeals process for material supervisory determinations. Should be considered only if bank has a very strong case.

## Understanding the Enforcement Action Process

### Possible Subjects of Negotiation (cont'd)

- Terms of Enforcement Action

- ❖ Avoid agreeing to terms that you believe are unachievable.
- ❖ Greatest chance of obtaining relief is with respect to timing associated with compliance with specific requirements.
- ❖ Must establish a reasonable basis for requesting a proposed change—make clear to regulators that your request is not to avoid compliance but rather to modify the order in a manner that is reasonable and will make compliance achievable.

## Complying With an Enforcement Action

- Start formulating the action plan early, preferably before the examiners leave the bank. This will show that management is proactive and should help in negotiations.
- Board and senior management must place highest priority on compliance. This will lead to the order being lifted sooner and bank can get back to business.
- Establish compliance committee and charge it with responsibility for ensuring compliance. Establish and maintain a schedule of frequent committee meetings.
- Create an action plan that identifies each specific requirement of the order, the date by which it must be satisfied, the responsible party and status.
- Stay in close communication with the regulators and update them on progress. Regulators will be more flexible with respect to bankers who are proactive.

## Bringing About Termination of Enforcement Action

- Key is addressing deficiencies which gave rise to the action.
- Full compliance with the terms of the action, and an evident commitment to addressing the issues contained in it, will create an environment in which regulators will be more inclined to consider termination sooner.
- At the earliest, termination will be attainable at the second examination following the exam that resulted in the enforcement action.

## Question & Answer Session

## Contact Information



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