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VIEWPOINT

Answering Regulators: 5 Steps to Get It Right

BY DAVID D. GIBBONS

The surge in supervisory enforcement actions is a painful reality for bankers today, and CEOs and boards of directors cannot afford to ignore it.

Since the beginning of 2008, about 1,200 U.S. banks have come under formal — and thus public — enforcement actions, and their ranks are growing steadily, as this newspaper recently reported.

Furthermore, that total did not reflect the rise in informal — and thus undisclosed — enforcement actions such as memorandums of understanding.

The reason for the acceleration of enforcement actions is no surprise. Our economic recovery remains fragile.

Bank balance sheets and income statements are vulnerable to the cross-currents of high unemployment, weak spending and imbalanced housing markets. Supervisors, still extracting lessons from the financial crisis, are seeking to correct failed governance and risk management practices in institutions and are raising the bar on risk management expectations in general.

When supervisors present an enforcement action to a financial institution, they are saying they see financial or managerial weaknesses, or both, that threaten the bank's safety and soundness.

Their tolerance for further risk is low, and their expectations for corrective action are high. They press banks to reduce their risk profiles, improve their condition and improve risk management and governance by identifying problems' root causes and fixing them.

What should a CEO and board of directors do when confronting an enforcement action? Five steps are essential:

- Take it seriously and mobilize your team. Don't deny the problems, ignore their severity or fight city hall."

Doing so wastes precious time and sets the wrong tone with regulators and employees. Arguing that enforcement actions, or their provisions, are counterproductive is particularly poorly received. Supervisors want the problems fixed, and they will question the resolve and the competency of those that resist. Of course, some discussion is appropriate, but tone matters.

Bankers and directors should ensure they understand what supervisors are asking of them. Modest language changes can be sought, as well as deadline extensions to improve the clarity of expectations or ensure sufficient time to do a quality compliance job. But it is crucial to maintain a tone of respect, deference and cooperation.

The supervisors should be left with the clear impression that you are serious about improving the bank's condition and complying with the enforcement action.

- Plan for contingencies and communications. Carefully and honestly evaluate your ability to fund the bank, and raise capital as needed. Assess your funding and deposit flight-risk and identify the conditions that may give rise to outflows.

Make plans to fund and capitalize the bank under stressed conditions, one of which will be publicity around the enforcement action itself.

Be prepared for how you will communicate about your condition and regulatory issues with internal constituencies (board, management and staff), as well as external ones (depositors, significant customers, investors, debtholders and regulators).

Say nothing publicly or privately that could appear to disparage your supervisors, give them reason to believe you "don't get it" or question your resolve, and similarly, make no statement that would cause your employees to doubt your seriousness about compliance.

- Establish appropriate governance. Don't wait for the enforcement action to be executed to establish appropriate board and management governance and oversight. Though regulatory action will force this issue to a certain extent (enforcement actions always require a committee of the board to oversee compliance), start pulling together the committees you will need as soon as practical.

Select board members with banking and financial expertise and the ability to ask hard, informed, questions, push back and hold management's feet to the fire. Remember, the board is executing the action with the supervisor, and individual directors are on the hook to comply or face significant liability.

- Get a plan in place to comply with the action and its provisions. Review the enforcement action carefully with those who will address its requirements and the bank's underlying weaknesses. Lay out what needs to be done to correct conditions that gave rise to the enforcement action. Plans should inspire actions and include clearly assigned — and verifiable — steps, due dates and responsibilities.

Do not just say that you will achieve your goals — detail how and when. Progress should be formally and regularly monitored and reported so that roadblocks are identified and removed quickly.

- Ensure that your balance sheet risks are measured and reported accurately and in timely fashion. In particular, credit risk ratings and loan accounting requirements must be accurate.

The supervisors' tolerance for error here is low, and for good reason.

If risk is not accurately understood and reported, the size of the problem remains a guess for both management and the regulators, and the regulators will not trust the sufficiency of reserves (allowances for loan and lease losses) or earnings and capital adequacy and quality.

They will also question the resolve and competence of the board, management and staff. As a CFO friend of mine used to say, "Get the balance sheet right, it drives everything else."

Enforcement actions are painful, can be disruptive and may feel counterproductive.

That said, they should be taken seriously and addressed with resolve. In initiating an enforcement action, your supervisor is telling you your risks are too high, or your risk management and controls too weak. Remember, your risk is their risk, but the job of managing that risk is all yours.

David D. Gibbons is a managing director at Promontory Financial Group and a former deputy comptroller of the currency for special supervision.