

September 29, 2020

To: Members of the Class of 2020-2021, VBA Management Development Program
Fr: Andy Davies

Re: 'Regulatory Actions' Affecting Banks

Context:

During the Post-Session One "Office Hours" session on Monday, September 21, Candice Hinson asked two very good inter-related questions.

#1: "What causes a bank to receive a Written Agreement with regulators?"

#2: "What happens if the bank fails to comply with the Written Agreement?"

Response to Candice's inter-related questions:

Part One: Setting the Stage to Answer the Questions:

A 'written agreement' is just one form of regulatory action. I'll define the other forms for you via some attached information, but let's set the stage on how best to answer Candice's questions.

Problems forcing regulatory action don't just happen without root causes. A key lesson from the mass of regulatory actions during and post-Great Recession was that many banks, especially those that failed, often lacked a basic *risk management (management) and risk oversight (board) process*.

An effective risk management framework begins with a board and management team defining the risk APPETITE they have for various risks. They must then have some way to watch for increasing risk trends in specific areas so they can take early/prompt corrective action to mitigate any growing risks.

So, going back to Candice's questions, there could be a 'single cause' or 'multiple causes' that would cause a bank to receive a 'written agreement'. But from the regulators' view, their PRIMARY focus is to take a big picture view and look for SYMPTOMS that lead to issues that lead to regulatory action.

Again, the entire 'regulatory action' topic goes back to a bank having a strong, effective RISK MANAGEMENT AND RISK OVERSIGHT PROCESS in place.

Part Two: Definitions of 'Regulatory Enforcement Actions':

Please see 2-page attachment

You'll see that the 'written agreement' Candice asked about is but one type of 'regulatory enforcement action'. There are INFORMAL and FORMAL enforcement action. A 'written agreement' is in the category of FORMAL enforcement actions.

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Part Two: Definitions of ‘Regulatory Enforcement Actions’, continued:

‘Written Agreements’ and ‘Consent Orders’ are public record and can be read on a respective regulatory agency’s external web site.

For example, the site for the Richmond Federal Reserve Bank (FRB) is:

www.federalreserve.gov/newsevents/pressreleases.htm

Part Three: “Matters Requiring Attention” (MRAs):

In today’s financial/economic environment, regulatory enforcement actions are RARE. These days, when regulators may have concern about a specific issue or issues, it is not uncommon for regulators to issue a “MRA” (Matter(s) Requiring Attention)...or... (more serious), a “MRIA” (Matter(s) Requiring IMMEDIATE Attention).

“MRAs” and “MRIAs” are NOT listed on the ‘regulatory enforcement actions’ list because they are essentially informal red flags that are less severe than enforcement actions and, in theory, serve as an early way to identify problems and escalate their resolution.

“MRAs” are communicated verbally and in writing to a bank’s BOARD and MANAGEMENT and are included in a bank’s examination report from regulators. These notices are NOT public, and regulators issue them in various forms.

The Federal Reserve, for example, describes MRIAs as matters arising from an exam, inspection or any other supervisory activity that are of significant importance and urgency that banks must address immediately.

Part Four: Examples of issues TODAY that *could* lead to “MRAs”, “MRIAs”, ‘Written Agreements’ and other regulatory enforcement actions:

- . insufficient CAPITAL
- . cybersecurity issues
- . growing/high level of ‘problem loans’, often referred to as ‘Non-Performing Assets’ (NPAs)
 - . evidenced by: increase in a bank’s Texas Ratio
 - . evidenced by: a bank’s Classified Assets (Coverage) Ratio
- . BSA/AML issues (examples: poor tracking/non-compliance)
- . concerns about board corporate governance
- . concerns about management
- . CRA issues
- . general compliance issues
- . specific issues surrounding various risk categories
 - (example: operational risk related to vendor management)
- . lack of ‘core’ earnings
- . insufficient liquidity
- . strategic risk: (example: engaging in activities outside expertise of management)

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Part Five: Answer to Candice's Second Question:

If a bank fails to comply with a 'Written Agreement', regulators will turn up the heat and go to a higher and more serious level of enforcement (as outlined on the attached list of 'Regulatory Enforcement Actions').

Part Six: "Regulatory Speech":

Candice's good questions give me the opportunity to share another attachment with you by this title. When a bank undergoes a 'safety and soundness examination' or a separate 'compliance examination', I believe it's prudent for a management team and board to be cognizant of these three (3) different ways regulatory examiners communicate with management during an exam.

Opinion/experience: FOLLOW 'guidance' advice, even if non-enforceable

Opinion/experience: FOLLOW 'best practices'

Part Seven: Looking Back at the Regulatory Enforcement World:

For those of you who are trivia buffs:

- . 8,348 regulatory orders were levied against banks and thrifts between 1983 and 2017
- . 63% of banks that experienced a regulatory order between 1983 and 2017 are no longer in the industry
- . the avg time to resolve or terminate an order was 1.2 years during 2009-2017
- . 58% were 'Cease and Desist' OR formal 'Consent Orders'
- . actions against individual bank employees accounted for 25% of the regulatory activity

Sincerely,
Andy



From Andy Davies to

Members of 2021-2021 Management Development Program Class

Definitions of

Regulatory Enforcement Actions

From 2011 and

Still Applicable in 2020

Regulatory Enforcement Actions (Definitions)

November 28, 2011

From: "Banc Investment Daily", Steve Brown and PCBB

(confirmed by Andy Davies via discussions with regulators of FDIC, FRB, OCC)

INFORMAL ENFORCEMENT ACTIONS:

When regulators view a bank's overall condition as sound, but feel it is necessary to obtain written commitments from board to make sure identified problems will be promptly corrected;

These actions are explicit in nature and while not a legally binding document, the failure to honor the commitment most often leads to a formal action; information actions include the following:

- . **commitment letters** (document signed by board reflecting specific written commitments to take corrective actions);*
- . **memoranda of understanding (MOU)** (in form and content looks like a formal enforcement action);*
- . **safety and soundness plans** (a description of the steps bank will take to correct deficiencies and the time within which these steps are to be taken).*

FORMAL ENFORCEMENT ACTIONS:

Authorized by statute, are more severe, are publicly disclosed and include the following (ranked in terms of severity from most to least):

- . **consent orders** (an order to cease and desist that outlines restrictions and remedial measures the bank must take to correct deficiencies or violations);*
- . **cease & desist orders** (identical in form and legal effect to the consent order but imposed on an involuntary basis after issuance of charges and a hearing before a judge);*

(the first two examples above give regulators the power to restrict the growth of the bank, dispose of assets and prohibit payments on contracts the bank has with others)

*. **formal written agreement** (as with consent order and C&D) this document sets out and specifically indicates restrictions and measures the bank needs to take to correct deficiencies or violations; it is a legally recognized document but unlike the consent order and the C&D, it is not enforceable through federal court system; in addition, while willful violation of a consent order or C&D can be used to appoint a receiver, the formal agreement may not);*

*. **prompt corrective action (PCA)** subjects bank to mandatory restrictions based on bank's capital category and gives a time line to comply; has same force and effect as C&D, and when banks are undercapitalized or worse, are often used in anticipation of an early resolution;*

(violations of a consent or other order are used to provide the legal basis for assessing civil money penalties against directors and officers; in addition, formal enforcement actions can require a bank to raise capital, sell itself, merge, restrict asset growth, make restitution, dispose of assets, rescind contracts or agreements, employ qualified officers or even liquidate).



From Andy Davies to

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Definitions of

Regulatory Speech

**From 2014 and
Still Applicable in 2020**

Andy has found these to be good recommendations on how a bank's management team should consider responses to information conveyed by regulators.

“Regulatory Speech”

“Regulations”

- . banks are expected to comply, and noncompliance is *enforceable*.

“Guidance”

- . banks are expected to comply, but guidance is *not enforceable*.

“Best practices”

- . are procedures and approaches certain banks use
- . they may represent strong ways to meet a particular challenge
- . performing them is not a regulatory expectation (so say some regulators)
- . regulators are frequently asked about ‘best practices’ by bankers
- . regulators *state they don’t examine for best practices*

from: www.ababj.com (American Bankers Association Banking Journal), April 17, 2014

“FDIC Officials Tackle Bank Concerns” by Steve Cocheo