

GOOD-FAITH EFFORTS MAY PAY OFF WHEN BANKS FALL SHORT OF REGULATORY ORDER

You've got nothing to lose by showing that you're doing your best, Jeff advises

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By last count, there were approximately 2,250 formal and informal enforcement actions of some type against financial institutions in the United States.* What does the board of directors do if the bank has agreed to a Board Resolution, a Memorandum of Understanding, a Consent Order, or something similar, yet the board discovers that the bank simply cannot comply.

As most of you know, virtually every enforcement action, informal or formal, contains fairly similar boilerplate provisions. The document will generally have a:

- Management provision,

- Reduction of classifications requirement

- Requirement that the allowance for loan lease losses be stated accurately

- Requirement that the bank engage in strategic planning and budgeting (the regulators often confuse these two)

- Number of other requirements, including the capital requirement paragraph. The capital paragraph generally requires the bank to reach a stated level of Tier 1 capital of typically 9%, and total risk-based capital of typically 12%, by a certain date.

For some of these Consent Orders may firm has negotiated a stair-step on the capital, but the bottom line is, there will be some point in time at which the bank's capital must reach a certain level.

Although there are a number of ways to increase the capital ratio, e.g. either add capital or shrink assets (sell branches, shrink the bank, etc.), the reality is that many banks are simply in a position where they cannot comply with the capital paragraph. The failure to comply with a Board Resolution or a Memorandum of Understanding capital paragraph results, as a practical matter, in no monetary consequences to the directors. This is because these enforcement actions are informal, nonpublic, and totally unenforceable by the regulators.

Covering the board when plan doesn't work

However, failure to comply with a Consent Order, or its predecessor, the Cease and Desist Order, is a different story. What does the board do to protect itself in that case?

The answer: Document that the bank has acted in "good faith" and attempted to comply with the capital paragraph.

Will this prevent the Board or individual members from receiving civil money penalties in connection with a failure to comply with a capital paragraph of a Consent Order? Who knows? But having negotiated literally hundreds of orders over the last several years, and having had the same discussion on the capital paragraph with the OCC and FDIC, I can tell you what their response will be. (FYI, the Federal Reserve generally does not include minimum capital requirements

in its Written Agreements.)

When you are negotiating the Order and indicate that it will be difficult, if not impossible, for the bank to raise the capital at all, or to comply within the time frame set forth, the typical regulatory response is that the bank must simply evidence "good faith." This is what they tell you when they are trying to get you to consent, anyway, i.e. "trust me." Of course when you try to put the "good faith" qualifier in the Order, that is a nonstarter. Why? Because the regulators have never done it that way before.

In any event, if your bank is subject to an enforceable Order that has a capital paragraph that you don't think the bank can meet, there is absolutely no downside to documenting the bank's good faith attempts to comply with the requirements of the enforcement action-and make sure that documentation is presented to the regulators.

Results of a recent "best efforts" meeting

I recently participated in a meeting with the CEO of a bank under a Consent Order, and the regulators. It was clear the bank was not going to meet the capital requirement, and so I proactively called the regulators and requested the meeting.

The CEO spent about an hour informing the regulators of the bank's inability thus far to meet the terms of the capital requirements of the Consent Order, notwithstanding herculean efforts to do so. This bank had previously passed the hat around the board table, looked to their own shareholders, and hired an investment banking firm knowledgeable in community banking to raise capital.

Notwithstanding all of these efforts, nothing worked.

The goal of meeting with the regulators was to let the regulator know that the bank had exhibited good faith in attempting to meet the capital requirements.

During the course of the meeting, I reminded the regulator with whom we had negotiated the Consent Order of his discussion with the board of directors regarding the "If you act in good faith, we won't come after you" scenario. He did acknowledge that that was the discussion. The regulatory reaction was because the bank had failed to meet its capital requirements, the regulators wanted more frequent reporting on the bank's attempts. This is easy to do.

The moral of the story: If you get in a situation where you do not think the bank will meet the requirements of the agreement with the regulatory agency, particularly with the capital requirements, then:

1. Document for the bank's own file every conversation, discussion and approach to meet the capital requirements.
2. Advise the regulators of the bank's efforts.
3. More frequently report on the capital issue and as required under the enforcement action.

Good luck!

* Don't worry, however, about trying to find enforcement actions against 18 of the 19 largest institutions. You won't find

any. Enforcement actions apparently are reserved for only the defenseless or the non-too-big-to-fail, or the too-small-to-care-about, or any other way you want to categorize that.

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About the Author

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