5 TRUTHS ABOUT BANK REGULATORS YOU NEED TO KNOW

Third in a series: Now ratings tools include a crystal ball

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In the current community banking environment, it is time to reveal some "truths" about directors, shareholders, and regulators. As the Good Book says, "The truth will set you free," or in the alternative, it may at least help you make a profit, enhance value for your shareholders, and run a good bank. The previous two blogs included the truths about directors and the truths about shareholders. No discussion about the new environment would be complete without addressing some truths about regulators.--Jeff Gerrish

1. Now that the regulators have gotten your attention, they may be nicer to you.

By last count, somewhere in the neighborhood of a third of the banks in the country, if not more, are subject to some type of formal or informal enforcement action.

Some of those actions were designed to protect the regulators from 20/20 hindsight criticism if the bank fails. Some were designed to correct the bank's problems. And some were designed simply to get the board's attention.

Now that the regulators have your attention, they may be nicer to you. In fact, even with seriously problem banks, I am beginning to see some changes in regulatory enthusiasm for failures, pounding the table, screaming at the board, and the like.

I do not know if the regulators are getting kinder and gentler--or if they are just fatigued like everybody else.

2. The regulators tout their appeals process--but do not hang your hat on it.

Each of the regulatory agencies in the last year has "reminded" community banks of their ability to appeal exam results they disagree with.

For example, any Material Supervisory Determination can be appealed. A Material Supervisory Determination is anything from a legal lending limit violation to a CAMELS rating, to a composite rating within the CAMELS rating.

Each of the agencies has a different appeals process. Each of them ends up with some internal agency, committee, or group who makes the final determination, i.e. the policeman policing the police force.

If you have a bad exam or some portion of an exam that impacts your CAMELS rating from a 2 to a 3, for example, then consider an appeal. But do it for the right reasons. Appeal due to the adverse financial impact that the lower CAMELS rating has as it relates to deposit insurance premiums, not the emotion that the board or management feels about the downgrade.

Although there have been more failures than successes at appeals, if enough money is at stake, it is probably worth a shot.

3. The regulators really do not understand strategic planning.

If you look at the enforcement actions that have been issued in the last three years, most require some type of "strategic planning."

Reviewing the regulatory enforcement action provision requirements, it is obvious what they are really talking about is business, operational, and tactical planning.

This is really a kind of a plan of plans--a profit plan, a capital plan, etc. But it isn't strategic planning.

Long-term strategic planning is really a board-level issue where the board establishes, at a 30,000 foot level, strategies for the company going forward, including risk profiles and the like.

I am not sure the regulators ever really understood that.

4. The regulators really have no idea how the Consumer Financial Protection Bureau and its activities are going to impact community banks.

All of us must acknowledge that compliance risks are enormous, particularly in fair lending, unfair and deceptive practices, and now, as added by Dodd-Frank, abusive practices.

The problem with these compliance issues is that they are enormously expensive to research, defend, and settle. (Usually they involve some reimbursement to the affected class, a civil penalty, and possibly a contribution to a financial literacy fund.)

Although neither the regulators nor the banks understand what is going to happen with the Consumer Financial Protection Bureau and its impact on community banks, all of us recognize compliance is here to stay. It is no longer a cyclical issue.

If you want to keep your bank out of the penalty box, make sure your compliance officer is on his or her "A" game.

5. The regulators are trying to further establish forward-looking supervision.

As virtually all of you know, the examination report over the last 30 years has basically reflected a "snapshot in time" of your bank.

The date is picked for the examination date and the examiners come in after that date.

- • Everything that occurs before that date is included in the examination report.

- • If anything bad occurs after that date, it is included in the examination report.

- • If anything good happens after that date, it is not included in the examination report.

Now, in addition to the snapshot in time, the examiners are attempting to establish forward-looking supervision, i.e. they are not just going to look at a snapshot in time, they are also going to look and see where they think the bank will be in three years.

My firm has had at least one situation where, based on a snapshot in time, the bank would clearly be a 1- or 2-rated bank. It was rated a 3 because "although it looks good today, we (the "regulators") think it may be in trouble three years from today."

Such is forward-looking supervision.

These are "inconvenient" truths about the new environment.

As Sir Winston Churchill said, "Men occasionally stumble over the truth . . . but most of them pick themselves up and hurry off as if nothing ever happened."

Do not let that be your bank.

About the Author

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Gerrish formerly served as Regional Counsel for the Memphis Regional Office of the FDIC, with responsibility for all legal matters, including cease-and-desist and other enforcement actions. Before coming to Memphis, Gerrish was with the FDIC Liquidation Division in Washington, D.C. where he had nationwide responsibility for litigation against directors of failed banks.

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