"How to" Clinic

How do you prepare your board for a meeting with examiners?

Rule #1: Don't mouth off

For most banks, things have been so good for so long, and relations with regulators have been so smooth as a result, that it's hard to recall that it wasn't always like this.

Indeed, it has been almost a decade since we've seen confrontations at exit interviews and regulatory meetings regarding the quality of loan portfolios. The 1990s saw increased capital adequacy, improvements in loan portfolios, and significant increases in CAMELS ratings, hence less angst.

Many of the bankers and directors who saw the worst of the 1980s and early 1990s have retired since the days of heated confrontations. Now we are hearing more about deteriorating loan portfolios in an already-weak economy that now faces the additional uncertainties following the events of Sept. 11th. And while the agencies have publicly embraced a policy of examiner restraint in regard to the impact of the terror attacks, sooner or later things will change.

What should be done if a financial institution finds itself confronted by a very concerned examiner-in-charge? And what should the institution's board do if such a situation arises? If your bank anticipates some trouble in the times ahead, *now* is the time to prepare directors for the inevitable contact.

You know you're in trouble…

If you suspect the regulators are really concerned with the quality of your bank's loan portfolio, you'll know for sure when they demand an exit interview with the entire board—even more so if they require the board to visit the agency's district or regional office: *their* turf.

Such appearances are command performances and it must be impressed on your directors that they cannot miss them. Directors should also be told, however, that the true importance of such meetings is to serve as a red flag. To put it more bluntly, such warnings should indicate to all directors and senior managers that the examiners are on the warpath. (There *can* be other reasons behind a request for an exit interview or a visit to the regional office, but those are beyond the scope of this article.)

Moreover, if your directors don't all attend the meeting, how can they fully understand the problems, possible solutions, and eventual course the board must take?

What should make all the warnings more worrisome now is that some key factors have changed since the last round of trouble. In 1991, for instance, the FDIC Improvement Act gave extraordinary powers to regulatory agencies and eliminated many discretionary supervisory techniques that had been prevalent prior to the savings and loan debacle of the 1980s. If you are a relatively new Reg O-level management team member or a relatively new director, do not discount the severity of what's facing your institution if exit interviews or regional visits are requested. These are signs of serious trouble—and of the need for an appropriate response by board and management.

One key warning at the outset: If they have been doing their job, determining that there is a loan quality problem at your bank and that the regulators will not be pleased, it should not come as a surprise to the directors, nor should it come as a shock that the regulatory agencies require remedial action quickly. If directors are surprised, then they will have a difficult time with other aspects of your bank's relationship with the regulatory authorities.

Shut up and listen

A major job of the management and board of directors at an exit interview is to *listen* to regulators' criticisms. It is to be assumed that the criticism will be constructive.

Do not argue with the examiners. If you argue, you will lose! All loans criticized are to be managed in a remedial fashion and corrected. If necessary, the loans should be charged off immediately. Impress on your board that this discussion is not open to negotiation between the board and the examiners. At this stage of the process, examiners are the masters and the other players

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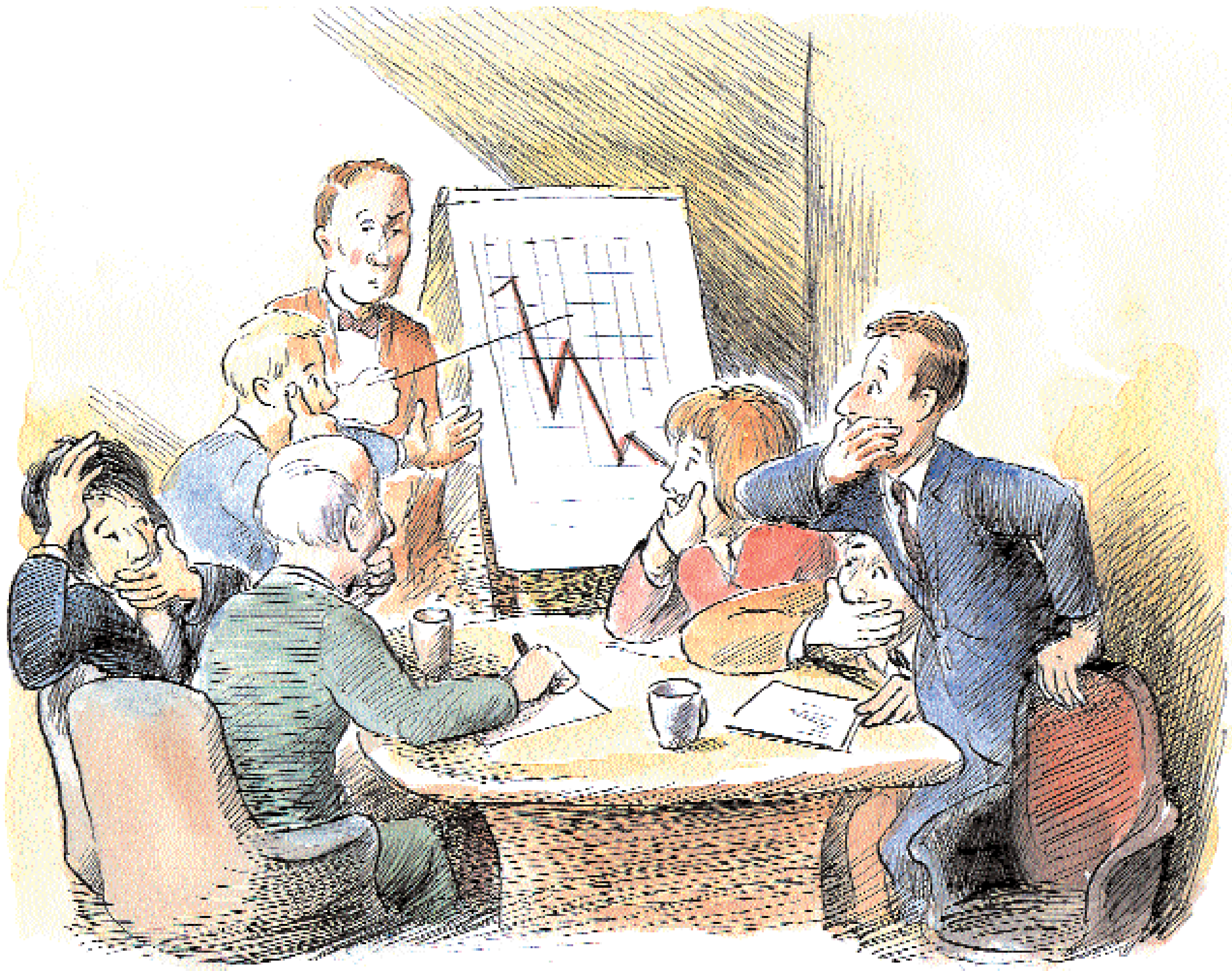

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carry out the masters' wishes.

The more the board and management object and become confrontational, both at the meeting and subsequently, the more problems your bank will have with remedial actions. When the examiners crack down, the job of director and manager is to solve the problems immediately and fully.

Even if the examiners are wrong, if the board and management fix the problems, your bank will reap the rewards and benefits. Unfortunately, while it may be difficult to believe, the examiners are usually right. They visit hundreds of institutions and see quality problems everywhere. As an officer or director of only a single institution with perhaps not a lot of loan expertise, you can defend only what you believe is correct for your particular market. The more cooperative you are, the more the regulatory authorities will consider your expertise and competence, and the sooner the bank will solve the situation.

Don't get CAMEL-stomped

At this juncture, the "M" in CAMELS should be brought up. As you know, the "M" stands for Management, and directors should already be aware that this means management *broadly*—not solely management and staff. That is, the "M" stands for the overall supervision and monitoring of the organization by directors as well as overall administrative competence demonstrated by management.

Objecting to "recommended" (as in, "do it") chargeoffs and related actions by the regulatory agencies, or becoming recalcitrant and arguing with examiners will have a direct impact upon your bank's "M" rating. You can almost count on one downgrade in the "M" if the bank does not react appropriately. Banks whose directors and managers quickly undertake remedial actions, even though success may take longer than anticipated, will, by contrast, have their "M"s enhanced.

A whisper to board members

Psst: Directors should not believe their president.

There, I said it.

I always get in trouble with management over this statement. But it is invariably true when the quality of the loan portfolio has deteriorated significantly and the regulators have become a regular presence. Generally it is the president and other senior managers who created the situation. There are loans that should not have been granted on terms that should not have been offered. The president and other senior managers are responsible for poor loan payments and significant past dues and substandard assets. Moreover, when the president and/or senior man-

agement are criticized regarding those loans, the response is often that the loan will be paid within 30 days, 60 days, or 90 days—because they know good ole' Harry and they vouch for him.

If directors fall into this trap, they will pay the consequences with the regulators.

Banks have to write off or write down such problem loans. If the president or senior loan officer turns out to be right after all, then they can gloat afterwards and the loans can be recovered at that time.

I understand the tendency of many a board to want to stand by its CEO. But, based on my experience, the regulators are far more likely to be right than the president and senior lending officer. If the full board takes a position that officers are right, your bank and your board are headed in the direction of administrative orders—i.e., letter agreements, memorandums of understanding, or even cease-and-desist orders. (*See "A primer of regulatory penalties."*) You might even end up with civil money penalties if you are so recalcitrant as to really tick off the agencies.

In essence, if you don't schmooze, you lose.

Organizing for response

Don't take anything I have written thus far as a suggestion that the board and management should put its collective brain into "park." A mechanism must be established to direct and supervise the corrective actions. If your bank finds itself in this predicament, establish a specific board committee consisting only of outside board members, or utilize your established standing audit/compliance committee.

Under the mildest of circumstances, the regulators may simply want your institution to add to the loan-loss provision, directly affecting the bank's current earnings, and stop certain practices on a voluntary basis. They may want the bank to cut down on its past dues and substandard loans within three to six months. They will check on your progress after

A primer on regulatory penalties

As a consultant for over 30 years, such terms as "memorandum of understanding," "cease and desist order," and "civil money penalties" roll off my tongue easily. However, I realize that there are many directors or management members who have never (fortunately) seen one of those orders during their banking lifetime. A short definition of those terms is in order.

The least offensive administrative order is a **voluntary board resolution**. When the regulatory agencies want something corrected, then the board, through a resolution approved at a regular or special board meeting, simply resolves to solve the problem in accordance with what the regulatory agencies want. Then the voluntary board resolution is sent to the regulatory agencies.

A **memorandum of understanding** is equivalent to a **letter agreement**. The term "memorandum of understanding" is used by the Federal Reserve, the Office of Thrift Supervision, and FDIC, while the term "letter agreement" is used by the Comptroller's Office. However, they are the same. They are still *informal* administrative orders that do not have to be disclosed to shareholders and/or the public, but they *do* set deadlines and specific remedial actions that must take place, so that the board of directors and management must comply completely and on time with these administrative orders.

The board of directors, through its legal counsel, may negotiate the terms of a memorandum of understanding or letter agreement with the appropriate agency. However, my experience indicates that most of the negotiations take place around the time necessary for remedial action, rather than what must be done. In essence, the bank is still going to have to charge off the loans, but it might get six months to add additional capital into the bank, rather than three months.

I have yet to see where a bank has actually talked a state or federal regulatory agency out of one of the clauses of the administrative order because it was not correct or was irrelevant or not important enough to comply with. I have, however, seen regular changes in the amount of time necessary to comply since often the bankers and the directors know more fully what amount of time it will take to correct the situation than do the regulators—and the regulators can be flexible to a certain degree.

Finally, the **cease-and-desist order** is a formal administrative order that forces disclosure to the public including the financial markets, and disclosure through either 8Ks (if the financial institution is a reporting corporation) or footnoted in annual reports. Cease-and-desist orders, if not complied with, often result in civil money penalties. Often C&Ds force directors to eliminate certain management members, or even directors, and often force the directors to hire outside professional consultants or legal counsel to develop corrective actions to comply with the order.

Cease-and-desist orders are extremely expensive and the cost of compliance can run into the hundreds of thousands of dollars, since the management and the board are incapable of corrective actions without the assistance of outside expertise. Moreover, civil money penalties are built into cease-and-desist orders and generally are not the ultimate result of a voluntary board resolution, memorandum of understanding, or a letter agreement.

Civil money penalties are assessed against directors individually, as well as management individually, and *are not subject to indemnification*. As a director, you do not want to get into a situation where civil money penalties are imposed because you forgot to comply with administrative orders from the federal and state regulatory agencies or because you forgot to comply with what they "required" at the exit interviews or at the regional visitations.

— Doug Austin

that time. However, if the situation is worse, your bank may be issued a memorandum of understanding that informs you precisely what remedies to take, when to take them, and what must be reported to the agencies.

Finally, if the regulatory agency issues a cease-and-desist order, your bank is in deep trouble and the agency will notify you as to exactly what you can and cannot do. If the recommended remedial actions are not performed according to the schedule and quality required, managers and directors could suffer civil money penalties.

The purpose of the standing audit/compliance committee or the ad hoc board committee is to make sure that all corrective remedial actions are done on time and to the specifications of the agencies. The board must be seen to be more obviously hands-on when this kind of a problem arises.

The board committee acts on behalf of the total board, but does not supercede the total authority of the board. The board committee becomes the working task force, if you will, to ensure remedial action.

The board committee supervises the compliance reports from the financial institution to the regulatory agencies. Normally these are quarterly reports required by the administrative order or examination report. The board committee makes sure the reports meet the standards of what the regulatory agencies demand, that they are submitted on time, and, if compliance is not achieved, the reasons why. Then the board committee informs the total board of what is going on and makes recommendations on management's compliance with the directives of the examiners and on whether managerial and/or staff changes are required, whether additional staff is needed, and whatever other changes might be in the offing due to required compliance with regulatory scrutiny.

A practical note for directors at banks that get called on the carpet: The time devoted to being a bank director may triple or quadruple over normal time commitments. Directors may be required to attend meetings on a weekly basis. Committee meetings may become monthly, rather than quarterly.

A warning: Do not attempt to increase compensation now that commitment has increased! The regulatory agencies take a dim view of directors lining their pockets when they (the regulators) are absolutely persuaded that the directors were the problem that caused the situation that required more frequent meetings. In essence, they reason, if directors had been doing their jobs in the first place, the bank would not have gotten into danger.

Both board and management will have to face up to the fact that, in the pecking order of corporate life, the directors control the management.

Needless to say, the regulatory agencies own your banks in these circumstances. If any director or board thinks they can control the regulators, and do not follow their recommendations, they will be in a whole lot more trouble than management ever thought of!

Without making this article sound like a commercial, if the board of directors runs into regulatory scrutiny they should utilize appropriate legal counsel or financial institution consultants as necessary to comply with remedial actions. There is a tendency to try to save money in these circumstances, yet an objective, third-party viewpoint of the problem is extremely helpful, even critical.

No party concerned should forget, that it is the board that is responsible, in the long run, for the safety and solvency of the financial institution. ***BJ***

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