Set in Stone: Does Current Regulation Limit Flexibility?

THE OCC'S GUIDELINES ON INFORMAL RECOMMENDATIONS AND MRAS, ISSUED ONE YEAR AGO, LIMIT FLEXIBILITY AND INCREASE THE USE OF LENGTHY AND COSTLY FORMAL PROCESSES.

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Effective understanding and management of risk requires the exercise of expert analysis and experienced intuition. It is an art and a science. Understanding the impact of multiple risks across time requires a deep understanding of hard data as well as human behavior. For bank regulators, gathering the necessary information to apply professional analysis and intuition requires a balance of formal and informal engagement between the supervisors and the supervised.

Often the greatest insights develop over informal conversation, the most natural human interaction. While informal engagement continues, the clear trend since the beginning of the financial crisis has been to increase supervision and influence bankers' behavior through lengthy, fixed, and formal arrangements. For example, since 2008, more than 100 enforcement actions involving financial institutions have been brought and resolved through consent orders and deferred prosecution agreements. The outcomes are understandable in light of current regulatory and prosecutorial desires to demonstrate strong governance, supervision, and enforcement. The dynamics of a highly competitive and rapidly evolving world suggest, however, that emphasizing formal, public outcomes risks developing an inflexible system less able to meet change. In an appropriate desire to create transparency, the system has increased rigidity and reduced the ability to manage change.

In effect, the system may be more transparent, but it has come to resemble a glass spiderweb of interlocking but inflexible obligations, which may be less than optimally resilient in periods of rapid change.

Regulatory Changes Drive Formality

Regulators have a wide array of tools to address banking practices. These range from simple, informal interaction through highly formal agreements and orders, complete with publicly measured standards and outcomes *(See Office of the Comptroller of the Currency, PPM 5310-3, "Enforcement Action Policy" (2011); Federal Reserve Board, "Commercial Bank Examination Manual, Section 5040.1: Formal and Informal Corrective Actions" (2013); Federal Deposit Insurance Corporation, "Risk Management Manual of Examination*

Policies, Part IV: Administrative and Enforcement Actions" (2015). Informal enforcement actions include nonpublic commitment letters and memoranda of understanding. Formal enforcement actions include public cease-and-desist orders and civil money penalties). Of their many tools, from the inception of bank supervision, regulators have had one of their most effective: regular, informed dialogue about bank operations and practices, the bedrock of effective supervision. Deep power and flexibility lie in communicating expectations through conversation and written recommendations.

Consistent with the trend toward greater formality, however, within the last two years, both the Office of the Comptroller of the Currency (OCC) and the Federal Reserve Board (FRB) restricted the use of informal recommendations by examiners in examination reports. On October 30, 2014, the OCC updated its policy and procedures regarding Matters Requiring Attention (MRAs), which are the means by which the OCC communicates supervisory concerns in writing to bank boards and management teams and tracks remedial efforts to address such concerns. The OCC's policy and procedure revisions with respect to MRAs instructed: "[Examiners] must not employ a graduated process by first listing a practice meeting the MRA criteria as a recommendation, then, if it is not addressed communicating it in writing in an MRA." As a means of prohibiting such a graduated process, the OCC further indicated that "[r]ecommendations must not be included in the ROE [Report of Examination] or other formal written communication to the Bank." The OCC's action followed a similar instruction by the FRB to its examiners a year earlier, when it eliminated observations, stating, "When examiners expect the banking organization to take action to address practices in a particular area or business function, examiners should treat these matters as [Matters Requiring Immediate Attention] or MRAs."

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Although neither regulator bans informal communications, the elimination of recommendations and observations from the supervisory findings of ROEs increases formality and raises the risk of rigidity. The new guidance in effect encourages issues to be addressed formally through the lengthy and fixed MRA/MRIA process. The change may have the desired effect of driving formal issue identification and remediation, but once an MRA or MRIA is identified, it must be classified, tracked, and remediated, whether or not the issue has been eclipsed by competitive pressures or later events.

Consent orders and nonprosecution agreements create similar rigidity. Many of these settlements, which generally last for years, not only contain specific requirements for change but also broadly prohibit and anticipate punishing any form of later legal or regulatory violation, whether or not the violation occurred at a time before that settlement. In addition, multiple jurisdictions often demand similar highly structured settlements based on the same conduct. The result: not only fines paid to multiple government entities for the same conduct as well as draconian consequences for any new or newly discovered problem, but also rigidly enforced specific processes and outcomes. The enforcement resolutions' systemic rigidity is compounded by regulators' natural expectation of flawless execution, leading to intense focus by bank management on remediating prior problems, possibly to the detriment of currently needed innovation. In sum, the settlements create intense formality while multiplying the risk of future enforcement actions, including claims of recidivism even if the alleged violations are completely unrelated or in an unrelated business.

We can expect more such detailed, obligatory agreements. In the current environment, multiple state and federal regulators as well as criminal enforcement authorities are competing to be the strictest in enforcing statutory and regulatory mandates.

With the passage of Dodd-Frank, more regulators are enforcing more regulations. Many such regulations have been recently promulgated and are not fully developed through regulatory guidance and court rulings. Yet regulators and other enforcement authorities are using consent orders and various forms of nonprosecution agreements as a means to guide the behavior and practice of bankers under Dodd-Frank. Regulation through enforcement may seem more efficient than the regulatory proposal and comment process, but it adds to the current growing inflexibility. Vocal lawmakers are actively supporting both strict interpretation and rigid enforcement, spurring enforcers to yet more action. Under the prior well-defined regulatory structure, regulators had the opportunity to seek and obtain structured settlement agreements; with the addition of still-developing Dodd-Frank regulations, the opportunities for more rigid solutions became exponential.

Formal solutions clearly have their place, but they must be balanced with flexibility and informal engagement to permit necessary development and focus on emerging risks and opportunities.

Such a highly formalized system means that operations might not evolve as rapidly to meet changing societal needs and technology as they otherwise could because the banking industry is forced to focus on past or existing operations. Formal solutions clearly have their place, but they must be balanced with flexibility and informal engagement to permit necessary development and focus on emerging risks and opportunities.

There are signs that the current focus on formality may be moderating. By recently closing agreements upon completion of assigned actions, the OCC recently reduced complexity and created more flexibility in the system while recognizing that certain conduct merits intense oversight and formality *(On June 17, 2015, the OCC terminated consent orders against Bank of America, N.A., Citibank, N.A., and PNC Bank, N.A. that were issued in April 2011 and amended in February 2013 related to mortgage servicing and foreclosure practices at those institutions. See OCC NR 2015-85, "OCC to Escheat Funds from the Foreclosure Review, Terminates Orders Against Three Mortgage Servicers, Imposes Restrictions on Six Others" (June 17, 2015).* Other regulatory and enforcement resolutions will need to be similarly closed not only to recognize remediation, but also to reduce complexity and increase innovation.

Over the coming years, regulators and banks will need to reach a reasoned understanding to rationalize the continuing impact of the highly formal system. The trend of closing consent agreements as a way to complete issues is a hopeful sign. In the meantime, bank advisers need to know the current spiderwebs and their inflexibility, while seeking to eliminate them through compliance and closure and creating more flexible solutions going forward.