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Viewpoint: Give Examiners More Discretion with Regulations

By: *Peter G. Weinstock*¹

The regulatory response to problem financial institutions now has approached the point that, for many, the cure is worse than the disease. If a financial institution is a “troubled bank” (Camels 4 or 5 rated), then almost invariably it will receive formal administrative action. To be sure, a Camels 3-rated institution has problems, but a formal administrative action triggers a cascade of limitations and costs that may cripple banks that would otherwise have survived.

Regulators say formal action is required to: ensure a troubled bank’s board takes the situation seriously; create a road map for corrective action; and give regulators the authority to act.

But, do these justifications past muster?

For most boards and management teams, a memorandum of understanding or other informal administrative action would certainly get their attention. Last year, certain money-center banks may have signed MOUs. I am not lamenting a possible double standard for such large institutions. The point is to ask the question: Do the regulators get it right when they use MOUs?

Boards of directors that have entered into MOUs are generally very willing to ask the examiners whether they have the wrong people at the helm. If boards are willing to take dramatic action with management in response to regulatory input, then it is doubtful that formal administrative action is needed to get their attention.

The second justification, that formal action provides a concrete plan for restoring the bank to health, also fails to provide an adequate explanation. Boards of directors are extremely willing to include in an MOU every single requirement that would appear in a formal administrative action. In fact, the MOU and the formal administrative action may not differ in content, only tone. Banking agencies value consistent treatment and that extends to administrative actions. The regulators act as if these documents are “forms.”

The third possible policy reason is that a formal administrative action gives regulators more enforcement tools. This justification does have more merit. Regulatory authorities arguably have the ability to impose civil money penalties on institution-affiliated parties who fail to comply with formal administrative action.

In addition, an agency can seek injunctive action. In practice, however, regulators rarely use this authority. Even CMPs, while not rare, are

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still unusual and typically associated with matters other than the failure of a financial institution to meet its administrative action.

Regulators simply do not need these additional enforcement tools, in most cases. The mere threat of formal administrative action is enough to compel most financial institutions to act decisively.

So, if these three policy reasons do not explain the uniform use of formal administrative action, what does? The answer, as it is with much of what is wrong with our system, starts with Congress.

Invariably, at the start of a down economic cycle, regulators are called before Congress to explain why they are not using all of the sanctions available to them. In other words, why are they not tough enough? If a financial institution fails without a formal administrative action in place, there is criticism leveled on the regulatory agencies. In the case of every single bank failure, the Office of Inspector General will perform a review of the causes of the failure. Such reports

often will criticize the regulators for being slow to act. Such institutionalized feedback furthers the pre-existing regulatory tendency toward overkill. After all, regulators do not lose their jobs for being too tough. What previously may have been an institutional bias has now become mandated within the regulatory agencies.

What makes such an approach unreasonable is that it results in every other branch of the federal government piling on. Seemingly, every federal agency that touches upon banking has developed restrictions triggered by formal administrative action. Moreover, the enforcement action forces financial institutions to incur significant costs, not the least of which is the higher FDIC assessments. The cumulative effect of such automatic sanctions is that it is very difficult for a financial institution that is seeking to hunker down and work through its problems to do so. Equally as important, it diminishes prospects for a recapitalization.

Banking policy has become D.C.-centric. The regulatory authorities have taken away much of the discretion

from the people closest to the financial institutions. As a result, examiners and regional offices are not designing remedial action to the specific issues of a financial institution. Instead, these documents have become forms. Regulatory higher-ups seem much more concerned with consistency than with whether the administrative action and its terms are really appropriate. On the ground, however, examiners often can tell the difference between a quality board and management team, and teams that are subpar. Certainly, such determinations can be made in the regional offices.

There is an alternative to the current broad-brush enforcement approach to regulation. Regulatory authorities in D.C. should be willing to delegate more. This will allow examiners to treat the quality teams more leniently. Freed from some of the one-size-fits-all shackles, such bankers will be better able to turn their ships around. Otherwise, the impact will be unneeded bank failures.