BIG BAD BANKS AND WHAT TO DO ABOUT THEM

Karen Shaw Petrou
Managing Partner
Federal Financial Analytics, Inc.

Remarks Prepared for the
Office of the Comptroller of the Currency
Bank Supervision Managers' Conference
Washington, D. C.
April 23, 2003

It is a pleasure to talk with you this morning about emerging issues in bank supervision – at least those issues that appear to be emerging from the private-sector side of the banking fence. As an "institution-affiliated person" – that is, a consultant – I share in these risks along with the banks you examine, albeit from a distance I occasionally find comforting. However, in these post Sarbanes-Oxley days, anyone in the corporate corral is a risk-taker. In fact, that's what I'd like to discuss today: how the new legal environment for bank boards and senior management affects reputational risk and, in turn, how this could result in serious safety-and-soundness problems. The strong hand agencies are taking with regard to problems at mid-sized banks while big ones appear still to be invulnerable from public sanction particularly troubles me.

Big bad banks that go unsanctioned will, like big bad boys, get bigger and badder. I do not mean to suggest that every public accusation made in recent months against virtually all of the biggest banks is right. But, some of the accusations will stick. At a time when the agencies are pressing hard and publicly on smaller banks that tread too hard on the regulators' toes, disparate treatment between big and mid-sized banks raises questions. Certainly, the agencies are right to fear systemic risk if they whack the biggest banks too hard in public. But, we're all fans of market discipline now and that means sunshine not only in bank disclosures, but also in agency actions.

In this talk, I'd like to suggest a model for supervision that may promote more even-handed policy without undue risk. A little toughness now could well insulate the financial system from shock later, even at the cost of some testy meetings with bank boards accompanied by threats of charter change. Problems identified by regulators that go public in tandem with approved corrective plans are less likely to be serious market concerns than any that come to light through the new corporate disclosures or – worse – subsequent scandals. A small deal undone because of compliance problems now leaves open the larger deals necessary for the overall market later on; a consent agreement now can obviate a C&D later that threatens a bank's rating with far-reaching consequences; in short, a slap now may obviate the need for a damaging whack later on.

Top-Down Supervision

In connection with a project, we recently counted more than one hundred specific requirements for board of directors and/or senior management action. Having served on bank boards, I can testify to the number of sections in my loose-leaf binders covering these requirements. I have, for example, personally attested to the quality of a large bank's security system even though I wouldn't know a die-pack from a ding-dong if both were presented to me for inspection. With each year, the number of cases in which some bank has done something egregious its board should have caught grows and, with it, the number of sections in each board binder. It's hard for board members – most of whom have other demanding responsibilities – to know which policy the regulators think truly warrant in-depth review and, if necessary, change undertaken promptly by senior management.

If the answer to this question is that regulators think every item for which board review is now mandated is equally important, then a hard look at real-world corporate governance is in order. I think on review you will agree that a trim of the board reviews is in order. Top-priority items should go to the board as a whole, but these should be few and truly top-priority regulatory concerns that also affect shareholder interests. Other issues – important, but not necessarily headline-making – should go to specific board committees (on which more in a moment) or to senior management. You can and should hold senior management responsible for many issues now put on the board's list, and I think you'll often get a good deal more from them than from the board as a whole.

Which Board Does What

Comptroller Hawke has recently and rightly drawn attention to the important problem of effective corporate governance in companies that are both publicly-traded at the parent level and insured depositories – problems exacerbated when the bank is the majority business of the firm. In these cases, the insured depository's board and that of the parent holding company are often virtually identical, with both meetings held at the same time and covering largely the same agenda to facilitate everyone's work.

However, this overlap may create serious conflicts of interest. The bank's board has a responsibility for all of the compliance issues on which all of the directives noted above are aimed. The parent company's board, in contrast, is responsible principally for acting in the fiduciary interest of shareholders in compliance with the SEC's mandates. Sometimes, protecting the FDIC or the payment system isn't the same as protecting shareholders – look at the difference of views on loan loss reserves, for example, and then take it from there.

Must the bank board be wholly separate from the corporate one? I don't think so. There are numerous areas where shareholder and regulator interest are in sync – audit integrity and quality of internal controls, for example. The parent independent audit committee thus can serve for the insured depository – assuming directors have any energy left. Other issues – compliance with bank capital, reserve and similar requirements, for example – not only bear principally on the bank, but can often conflict with the parent company's profit push. Decisions made at the bank board level can and sometimes should be overturned by the parent board – which is ultimately responsible for it – but a clear differentiation in responsibilities will not only avert many conflicts of interest, but also ensure top-level attention to the highest-profile regulatory concerns.

What’s a Regulator to Do?

Of course, better definition of board responsibility and a better-honed set of regulatory demands won’t eliminate all of the conflicts between supervisors and bankers. Here, I’m getting to my main concern: bad things should happen when bankers do ill, even if the bank is big. Ongoing discussions, disputations, dispensations and even disclosures aren’t enough when ongoing problems signal to examiners that a bank’s board and senior management – its own or that of the parent – have decided to take undue credit, operational and compliance chances to maximize profit. This choice may well be a rational, competitive one rewarded by the market, but it’s not one examiners should tolerate, nor do systemic risk concerns force them to buckle under and do so.

The Gramm-Leach-Bliley Act (GLBA) points to a way out both for parent companies that want to take undue risks and the examiners who love them. It’s simple: take risky activities out of the bank and put them elsewhere in the holding company. The old days in which a bank couldn’t associate with a range of non-banking activities are over and gone. Thus, charter barriers no longer block enterprises in which a bank hews to the straight and narrow warranted by deposit insurance, the Fed’s safety net and other benefits while affiliates walk on the wilder side. Inter-affiliate transaction restrictions, especially as beefed up by GLBA, provide ample protection for the bank, as does the Fed’s not-so-light hand at the top of the holding company structure.

Would moving some activities out of a bank be costly? Of course, but then that’s the point. If a big bank wants to take compliance risks with its private banking operation, then it should do so outside the benefits of deposit insurance that provide funding advantages. If it wants to link investment and commercial banking in ways that may tread on tying, then it – like securities firms – can do so by providing funds outside the bank, and absorbing the funding, accounting and other costs associated with so doing. A financial holding company can and should stay well-managed if its risky businesses are held outside the bank – indeed, this should be one criterion for this regulatory benediction.

Tough Embedded Examiners

The approach outlined above is, in a sense, levelling the competitive landscape between banks and non-banks with a bull-dozer. Doing so will put a toll on all of you that serve as resident examiners, particularly as your charges start to suggest that, if you push too hard, they can walk across the street to the tender embrace of the Federal Reserve. That is always a challenge in our multi-charter environment, but it’s no reason to relax the pressure under which big banks with a tendency to go bad are put.

What do I specifically suggest as you wrestle with your sometimes unruly charges?

First, working with senior OCC staff, take a hard look at what you demand of boards and senior management. Cut through the hundreds of requirements to those really essential to control risk and then cut back still further to those that are simple enough for an astute board of outside directors to be held accountable for. Key here are ensuring appropriate independence for effective risk management – including reputational risk management, compensation structures that reward risk management and effective exception reporting and control procedures. When bad things happen in a big bank, the big bank should do something about it and the board should make sure it does even if it isn't always sure why the thing is all that bad because of the complexity of the financial transactions involved.

Second, consider the overall corporate governance structure. If bank boards and parent ones are virtually identical, discuss a reconfiguration that reduces conflicts of interest and ensures appropriate expertise at the bank level for the complex issues you must discuss with the board and senior management. Some large banks are restructuring to have their bank board largely consist of insiders, and this is an approach worthy of careful consideration.

Finally, if the bank is running undue risk on a regular basis without effective and ongoing management, move the risk outside the bank charter. This provides the meaningful discipline to which the market will respond. First, other banks will get the message and either curtail their risk or restructure on their own. Secondly, a new, more appropriate structure for risk-taking is established that will reduce systemic risk without danger during the transition period. This structure will actually strengthen financial markets, not weaken them, as well as advance the goal of true financial services competitive equity. Maybe a few non-banks will even find the national bank charter looks a bit better when the overall holding company structure is made more rational.