AMERICAN BANKER.

COVER STORY

The Dodd-Frank Effect

By Glen Fest
NOV 1, 2011

Barney Frank was running late.

Bankers, lawyers, regulators and press milled around the Washington Marriott, waiting for him to deliver the keynote address to an American Banker regulatory symposium.

After a 15-minute delay, the Massachusetts Democratic congressman arrived, looking only slightly disheveled as he stepped up to the podium and flew into his presentation.

Using neither notes nor a net, the co-author of the Dodd-Frank Wall Street Reform and Consumer Protection Act provided an emphatic defense of the landmark, 2,300-page bill, including a lengthy critique of efforts to neuter its 5 percent risk-retention rule for lenders.

But the real highlight of the morning came during the audience Q&A, when Frank put his signature bulldog tenacity on display after an old foe of ramped-up regulatory efforts took the mike: retired Office of Thrift Supervision Director John Reich.

Reich, whose former agency was itself retired this year when the OTS was folded into the Office of the Comptroller of the Currency, asked Frank what he thought of consolidation in the industry, the accumulative impact of regulations on small banks and the "pervasive feeling that Washington doesn't really care about the future of community banking, whether it's 7,000 banks in the country or ..."

"Can I ask you a question?" Frank interrupted. "Why do you think we increased the deposit limits to $250,000? Do you think we did that for Bank of America?

"Why did we change the basis on which deposit insurance is calculated to make it risk based," Frank continued, "so that the percentage paid by the largest banks went up and the percentage paid by the smaller banks went down?"

"Well," Reich answered, "those are two steps in the right direction ..."

"But do we think we did that out of indifference to the community banks?" Frank said, taking over the conversation again. "Let me put it this way: There may be differences about policy, but the motives you're impugning to us are simply not there."

***

Terry Pruden has been in banking for more than 40 years, from his days in the Chicago region to his time in Texas, where he's now vice chairman of The Bank of River Oaks in Houston. He's well accustomed to the FDIC exam process, but at the bank's most recent assessment, it was the first time he needed a third hand to count the number of people sent by the Federal Deposit Insurance Corp. "We had 12 to 13 examiners at our last exam," he says.

In the past, the $254 million-asset River Oaks normally drew only four or five examiners at a time. And the exam team was only that big because of the six-year-old bank's extended de novo status.

Pruden doesn't question the efficiency of the super-team process—he saw no redundant exercises or unnecessary checklists—but "we've always had good ratings throughout the history of the bank," Pruden says. With only two branches and 38 employees, "12 to 13 sounds like a lot to me."

Welcome to the new FDIC. With Dodd-Frank on the books and the troubled-bank list growing more than 25 percent since 2009, the primary regulator for 62 percent of the nation's banks is branching out with deeper exams—and knocking on new doors.

Since Dodd-Frank assigned the agency resolution responsibilities for institutions of systematic significance, the FDIC has been sending examiners into new areas, such as large-bank capital markets operations, or into institutions where other primary bank regulators already have set up shop.

"We never had an FDIC person on premises, but they want to be here now," says Bill Demchak, senior vice chairman at PNC Financial Services Group, which is primarily overseen by the Federal Reserve at the holding company level and by the OCC at the national bank level.

The day-to-day changes in compliance procedures, exams and even the risk-management methodology forged by major bank regulators already have had a profound impact. In addition to being visited by larger exam teams, bankers say that as a result of Dodd-Frank, they are

being pressed further on Fair Lending compliance, and they complain that examiners are forcing them to classify too many salvageable loans.

What has many concerned is that despite all of the thorny issues that have arisen, this is just the first phase of a long-term regulatory makeover for which a plethora of rules is still on the drawing board.

In a Sept. 19 speech at the same conference in Washington where Frank and Reich had their exchange, FDIC Acting Chairman Martin J. Gruenberg noted that "economic inclusion and access to mainstream banking services" is one of the agency's major priorities, which echoes bankers' reports of a recent crackdown on compliance with Fair Lending rules.

In addition, with a surge of hires and transfers at the FDIC, the agency is assigning newcomers to ride sidesaddle into exams with experienced regulators to get a better understanding of what to look for and of the mechanics of a banker-regulator relationship.

Scott Polakoff, who spent 22 years at the FDIC and four with the OTS before becoming executive managing director at FinPro, an advisory firm to banks, says the FDIC and other agencies "have a barbell effect at the examiner level. They have a group of very seasoned, capable, talented examiners with 25 to 30 years of experience who are contemplating retirement in the next year or two; then they have this group of examiners that have been brought on in the last five years, who are remarkably educated and talented but are cutting their teeth in the most problem times."

The FDIC conducted 2,720 risk management exams last year, up slightly from 2,604 such exams in 2009, according to last year's annual report from the agency. Figures for 2011 are not yet available.

But observers say the FDIC has been widening and deepening its activity ever since a scathing 2010 FDIC inspector general report on the failure of Washington Mutual. The report laid the blame for the thrift's collapse in 2008 on feuding by FDIC and OTS regulators who could not agree on safety and soundness issues until shortly before the institution imploded.

Dallas banking attorney John Podvin attributes the heightened FDIC exam activity partly to the agency's desire to draw its own conclusions about a bank, rather than defer to the primary regulator. "The FDIC thought it should have had autonomy, issuing its own exam reports rather than participate in exams [where the] OTS would issue reports," says Podvin, who advises clients on Dodd-Frank compliance issues for the law firm Haynes and Boone.

It's unclear yet what the Dodd-Frank hirings will mean for the frequency of safety and soundness exams. But according to the Government Accountability Office, the FDIC will have a lot more bodies that need something to do. It added nearly 1,000 employees the last two years, including 444 in 2011. More than 10 percent of those were brought on specifically for duties related to Dodd-Frank, and the agency allocated more than $40 million, or about 1.1 percent of its $3.9 billion budget for 2011, toward Dodd-Frank initiatives.

At the OCC, Dodd-Frank has turned into a $235 million exercise, including its 2012 fiscal year budget request, according to the GAO's report. Not only have there been 133 hires for Dodd-Frank duties, but the agency has absorbed 619 new examiners from the OTS.

The Federal Reserve, meanwhile, has added 397 new or transferred employees this year to handle Dodd-Frank duties, on top of the 69 people brought on in 2010. The overall cost is pegged at $77.5 million.

***

There's an adage about people and their pets: Over the years, they come to resemble each other. After 18 months, Dodd-Frank has certainly come to share the hallmarks of its principal U.S. House author.

The act is widely panned in banking circles and in the Republican-led House, but like Frank himself it carries forth despite the arrows in its back. Dodd-Frank contains provisions that are loud, clear and direct—there will be new consumer-protection and systemic-oversight powers for banking regulators—but it has nurtured little subsequent consensus on how to put such ideals into action.

And like Frank's belated entrance to the banking conference in September, the law has got everybody waiting.

Waiting for ways to wind down large, complex financial companies. Waiting for the formalization of limits on derivatives, proprietary trading and reliance on credit ratings agencies, all of which is mandated in Dodd-Frank. And mostly waiting to see how the new rules will reshape banking regulatory authority.

More than a year since the bill's passage, the industry is counting down the time it will take for all 11 banking regulatory agencies to finish restructuring (or in some cases to start up) their organizations. Writing all of the rules that the legislation calls for is a process that could take years, given slower-than-expected progress. According to a report from the law firm Davis Polk,

regulators have already missed the deadlines on 163 rules that the act required them to undertake by a certain date, including 122 in the third quarter.

Some of the delay in implementing the 2010 legislation is, of course, by design. Both the launch of the Consumer Financial Protection Bureau and the merger of the OTS and OCC were not official until July of this year. All of the agencies have been steadily filing reports to Congress over the past year-such as a joint study completed in July by the Securities and Exchange Commission and the Commodity Futures Trading Commission, examining swaps and clearinghouse trading regulations in the U.S., Europe and Asia.

But there is a rising level of frustration about issues that many thought might have been settled by now. Besides the lagging rulemaking process, at press time three of the agencies lacked permanent directors. Meanwhile, the FDIC's long-awaited rules on "living wills" for systemically important banks came out in September, still needing approval from the Federal Reserve Board of Governors as the 18-month deadline approached. And it's been more than a year since the new Financial Stability Oversight Council submitted reports on implementing the Volcker rule and approaching the task of identifying systemically important institutions—the latter of which still has observers shrugging over what to expect.

The FSOC "in my opinion is making very scanty process—critical things, like even how you know what systemic means," says Karen Shaw Petrou, a managing partner with Federal Financial Analytics in Washington. "They're planning yet again to put out a third proposal."

The delays and indecision on the part of regulators have many bankers questioning the capacity that the agencies will have to oversee entirely new areas of responsibility. There also is a strong feeling that the policy edicts contained in Dodd-Frank will generally undermine the business of banking.

"What do we want the banking industry to be?" asks Albert "Kell" Kelly, the president and CEO of SpiritBank in Tulsa, Okla. "What we've seen is an assault on the profitability of banks" with Dodd-Frank, which he derisively describes as the "Main Street destruction bill."

"Do we want banking to be the economic giant that's been the underpinning of the world's greatest economy," Kelly asks, "or a utility?"

Bankers have been complaining about the stricter regulatory views on capital and classified loans since the start of the financial crisis, and some worry Dodd-Frank will further constrain the flexibility of examiners to deviate from their checklists when it would seem appropriate to do so.

Robert Catanzaro, president of $74 million-asset Independence Bank in East Greenwich, R.I., said that examiners used to be more willing to get into "loan talk," discussing the nuts and bolts of individual loans and considering whether lagging performance on a particular loan might only be temporary. That's not happening as much these days, Catanzaro says. "It's now, 'Downgrade the loan. And by the way, reserve more against it.'"

Many bankers say that regulators have undertaken more of a quantitative, one-size-fits-all approach to exams, with an adherence to formulas that is getting in the way of common sense risk-profiling.

SpiritBank's Kelly argues that the regulators' hardened positions on classifying business loans as troubled—a step which can be tripped by any number of performance standards in loan covenants besides default—impede business lending and discount bankers' judgment.

"In the 1980s when oil went to eight bucks, we called all our oil customers and said, 'We're going to reduce your interest rate temporarily and we're going to put you on interest-only [payments]," says Kelly, who also is the chairman-elect of the American Bankers Association. "Every one of those guys made it. We were the good guys. If we did that today, they would all be TDR [troubled debt restructuring]."

A House financial subcommittee hearing on Aug. 16 addressed the so-called "mixed messages" that have arisen between banks and regulators regarding the encouragement to lend versus the demands of a heightened risk-management atmosphere. Two FDIC officials defended the agency's "balanced approach" to supervision, which they say relies on a process, rather than colorblind bureaucratic edicts, to validate a bank's own risk management processes. And with supervisors and an ombudsman on hand to weigh in on any conclusions about a bank's risk or capital standings, they argue that institutions are protected from being subject to the whims or mistaken calls of an individual examiner.

In analyzing business-loan quality, examiners will consider collateral or personal guarantees as opposed to just income, according to written testimony from Bret Edwards, FDIC's director for the division of resolutions and receiverships, and Christopher Spoth, the senior deputy director of risk supervision. They also testified that "our examiners do not focus on the price of properties from distressed sales. Instead, we evaluate the borrower's cash flow, financial position, and overall ability to repay the debt."

Since the crisis, regulators have trained examiners to better understand the risk parameters of portfolios. After Dodd-Frank, those practices have become even more formalized. Banks,

meanwhile, are being asked to instill some formalization of their own, particularly at the director level.

"One thing we have seen is this call for more and more board involvement," says Bill Perotti, chief risk officer and chief credit officer for $18.5 billion-asset Frost Bank in San Antonio. The bank's OCC examiners "want to make sure we're taking more and more things to the board ... whether new processes or procedures. There's nothing wrong with keeping the board informed, but with a lot of these things, they're saying the board must approve it."

Anxiety over new regulatory demands is perhaps strongest for thrifts, and especially mutuals, which have to adjust not only to the new regulatory mindset but to an entirely new regulator now that the OTS has been put out of commission.

For many institutions formerly overseen by the OTS, the changeover to OCC examination has been too recent to judge the ramifications. So questions remain: Will OCC examiners take a particularly harsh view of thrift portfolios, which are likely to have a heavier mortgage concentration than a commercial bank portfolio? Will the necessary systems for handling a new call-report process be very costly to install?

While his initial meetings with the OCC have gone well, Thomas Kemly, the chief operating officer of Columbia Bank in Fair Lawn, N.J., says compliance issues remain a major concern at his $4.5 billion-asset thrift. "There's the whole credit-review function and how they might look at that, and a little bit of concern whether ... there was going to be a good understanding of how we managed our real estate portfolios," says Kemly, who is slated to become Columbia's CEO in January.

Supervision of mutuals has been spread across four districts in the OCC's community banking division, and a senior thrift advisor has been appointed to each district. Some semblance of the OTS' former hierarchy remains intact as well. For example, Tim Ward, a former examination managing director at the OTS, has come over to the OCC as deputy comptroller for thrift supervision.

In addition to having to make technology investments to handle the conversion to a new call report structure, thrifts must prepare their holding companies for separate exams by the Fed, which could involve its own set of adjustments.

Molly Curl, the bank regulatory national advisory partner at Grant Thornton, says thrifts will not be used to the type of scrutiny that the Fed applies to capital standards for holding companies. "That's new to them," she says.

Recent changes at the Federal Reserve Bank of New York include the formation of a Financial Institution Supervision Group, a nod to the Fed's expanding role in overseeing potentially systemic nonbank firms (such as GE Capital) in addition to the major names on Wall Street that have come into the bank holding company fold.

The new group is expected to probe deep into the DNA of big institutions.

"We had always focused on risk controls and risk management. Where we had not had as deep a focus was at the business line level, the front office," says Sarah Dahlgren, head of supervision at the New York Fed. "Where is a firm's particular strategic advantage, where are they trying to make money, where are they actually making money and how-and what does that imply about the risks they are taking?"

For the Fed as a whole, new duties involving the monitoring of systemic risks add to the huge task of writing hundreds of new Dodd-Frank rules. The Fed's rulemaking process has been among the most deliberate of all the regulatory bodies, which makes sense given the tumult over specific duties it has, like setting rates on debit interchange fees, per the Durbin Amendment.

Guesstimates put the Fed's rulemaking backlog well into 2012 and perhaps beyond. At an ABA risk management conference in April, Fed management staff director Stephen Malphrus said he could "imagine sitting here a year from now talking about the additional work that needs to be done before we implement Dodd-Frank ... This is a multiyear project."

The Fed has been creating new offices for financial stability policy and research, financial market risk analytics and financial market infrastructure oversight. In addition, it has been helping to shape new liquidity and leverage requirements under Basel III international standards, which are still being hammered out.

One of the big differences in the Fed's strategy for supervising larger firms is the inclusion of "macroprudential" judgement, in which the systemic risk of an institution's portfolio becomes part of the risk assessment. This will require a deeper understanding of the management strategy behind the portfolios.

"One of the lessons going forward from the crisis is that our engagement was not at the right level and not intense enough at the highest levels in an organization," says Dahlgren, an examiner at the Fed since 1990. "We learned that we need to be more circumspect and we need to have a much higher level of healthy skepticism."

But does the Fed have the right resources and procedures in place for this? Count Chris Whalen, founder and CEO of Institutional Risk Analytics, among the doubters.

To judge the efficacy of the big banks' internal credit-risk measurements, Whalen says, the Fed—in developing stress portfolios and systemic risk calculations—has turned to risk-based modeling, an exercise in quantifiable analytics that didn't perform so well during the crisis.

Beyond creating a significant amount of new compliance work for the large institutions, the idea of checking one model against another could create a false sense of security, with everyone taking comfort in formulas that still could be proven wrong in the end.

"The quants," Whalen says, "have taken over the asylum."

Bankers might draw a similar conclusion about many of the bank regulation agencies. One senior executive at a major regional bank says that federal bank examiners seem to have been so prodded into using quantitative analysis over comparative risk judgment that they aren't even interested in studying individual loans in his company's small-business lending portfolio, which is something he has invited examiners to do alongside his credit team.

"I told one examiner ... if I were in your shoes and really wanting to understand the risk in an entity you're charged with supervising, I'd come in and sit in on this," says the executive, who requested anonymity so as not to damage his relationship with regulators. "Actually hear what's going on, and hear from individual borrowers. I issued that invitation at least twice, and was never taken up on it. I know they're busy, but it was striking to me."

Expect more instances of banks not understanding regulators, and vice versa, as more rules stemming from Dodd-Frank get written and enforced.

"The current situation is the bankers are about where the regulators are, in early stages," says Wayne Abernathy, the ABA's executive vice president of financial institutions policy and regulatory affairs. "We're all trying to figure out where all this is going to go."

Glen Fest is the executive editor of American Banker Magazine.

© 2011 American Banker and SourceMedia, Inc. All Rights Reserved. SourceMedia is an Investcorp company. Use, duplication, or sale of this service, or data contained herein, except as described in the Subscription Agreement, is strictly prohibited.