Bank Safety & Soundness Advisor

Executive intelligence on bank exams, enforcement and risk management.

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Don't Neglect Consumer Compliance, FDIC Warns

In case there was any doubt, the FDIC reemphasized its focus on consumer compliance and asserted a strong causal connection between it and risk management.

In fact, you can't have good risk management without good consumer compliance, asserted Sandra Thompson, FDIC director of risk management supervision, who spoke at the Wolters Kluwer CRA & Fair Lending colloquium in Baltimore last week.

"Well-informed customers, who feel that they are being treated fairly by mainstream financial institutions and who understand the banking products they use, make the best customers," said Thompson. "If there is any lesson to be learned from all the trouble we're having in the housing, mortgage and credit markets, it is that consumer protection matters. And it matters now more than ever."

Thompson urged bankers to "take a holistic view of banks' financial and consumer compliance performance" since both are "critical to maintaining public confidence in the banking system."

"It's quite simple: Consumer

See Page 6

Overdraft Legal Risk May Be Shifting to Community Banks

For big banks, the legal risk in overdraft fees and high-to-low posting is old news. Several of the country's largest banks have been battling overdraft fee lawsuits for several years now. Impacted banks include Wells Fargo, BB&T, SunTrust and Bank of America, which settled a lawsuit involving overdraft fees for $410 million just last week. For community banks, however, the legal battles may just be beginning.

"The big banks have been in the spotlight, but now, we're seeing community banks getting the same kind of attention to posting, attention to overdraft practice as the big banks," says Andrew Lorentz, a partner with Davis Wright Tremaine LLP in Washington, D.C. "Community banks should look at their overdraft programs now. It is an opportune time for them to take preventive action."

When it comes to lawsuits like this, they tend to follow a familiar pattern, he adds. "The big guys – the high profile banks – get sued, and

(continued on page 2)

Openness to Risk Discussion Key to Risk Management

Elements of Enterprise Risk Management (ERM) can be deviously technical, complicated or nebulous. Ask any bank working to tailor broad ERM concepts to their own institution. But there is one really basic element that can kill an enterprise-wide risk process if a bank fails to get it right, and that's talking about risk. You can draft up all the spreadsheets and form all the risk committees you want, but if your bank executives and managers aren't comfortable talking openly about risk in your institution, your risk program won't be worth a thing, experts say.

Having a risk forum – an openness to talking about and taking action on institutional risk – is a sure sign that a bank has "developed a mature risk culture," says Beth Mooney, CEO of Key Bank. The executive talked about risk culture and openness to talking about risk at the RMA's Annual Risk Conference last month

"The next step [after crafting a risk appetite and setting institutional risk limits] is to have a forum to discuss senior risk – how these risks might impact one another and the firm," she said.

(continued on page 4)

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Overdraft

(continued from p. 1)

then you start seeing people target the smaller ones."

Until relatively recently, financial regulators asserted that banks had the right to post daily debits in any order they chose. In recent years, a number of banks switched to high-to-low posting, a method guaranteed to increase if not maximize overdraft fees. Recent, high profile lawsuits against some of the country's largest banks argue, however, that the practice is unfair and deceptive. At the same time, several financial regulators, citing consumer protection concerns, suddenly reversed their opinions on debit postings and overdraft fees.

The FDIC's guidance on overdraft fees takes an unequivocal position: No on high-to-low posting (though, strangely enough, the guidance only applies to checks and not to debit cards). The OCC has issued its own guidance on overdraft and high-to-low posting. That agency also takes a dim view of high-to-low posting, though it has yet to issue a final draft of the guidance.

This situation, with prosecutors on the lookout for new targets and financial regulators coming out against high-to-low posting, could put banks in a double-bind, says Barkley Clark, a partner in the Washington, D.C. offices of Stinson Morrison Hecker LLP.

"There have been some suits [against smaller banks] filed," he says. "The reason for this is that legal action against the big banks – and the class action suit against multiple banks in Florida in particular – have set the tone and the template [for suits against smaller banks]."

At the same time, the FDIC has come out against high-to-low posting. And though this is only guidance, which only applies to FDIC-supervised banks, it is likely that prosecutors will treat the guidance as an industry standard and use it in suits against all banks, Clark adds.

"As so often happens, plaintiffs will try to use [the guidance] as a standard," he says. "The big banks are all in the process of settling. You have this and you have the FDIC guidance, and this makes a good landscape for plaintiffs."

> "These neat tricks generated colossal sums per year in additional overdraft fees, just as the internal bank memos had predicted."

What you can do

Community banks concerned about overdraft and legal risk can learn from recent, high profile cases against large banks, Lorentz says.

Lorentz points specifically to the recent case against Wells Fargo. The case didn't challenge the bank on overdraft fees, per se. Instead, it asserts that the bank purposefully devised a scheme to multiply overdraft fees stemming from a single bank account infraction.

"This action does not challenge the amount of a single overdraft fee (currently $35). That is accepted as a given. Rather, the essence of this case is that Wells Fargo has devised a bookkeeping device to turn what would ordinarily be one overdraft into as many as ten over-

drafts, thereby dramatically multiplying the number of fees the bank can extract from a single mistake," wrote U.S. District Judge, William Alsup. "The draconian impact of this bookkeeping device has then been exacerbated through closely allied practices specifically 'engineered' — as the bank put it — to multiply the adverse impact of this bookkeeping device. These neat tricks generated colossal sums per year in additional overdraft fees, just as the internal bank memos had predicted. The bank went to considerable effort to hide these manipulations while constructing a facade of phony disclosure."

The court found the process unfair and deceptive, a violation of California Business and Professions Code.

"The case considered the bank's internal paper trail that documented the bank's conscious efforts to engineer the process, to make it so that the fees they collected would be maximized," Lorentz says.

If community banks went through a similar, documented process – if they brought in a vendor package that changed the way they structured overcharge fees, for example – they should have some concern, he adds. Having a paper trail or detailed process that looks Wells Fargo's can be a liability in court.

"This is the kind of practice that brings big judgments," he adds. "It's a hard thing for juries to square customer expectations with processes like this. Bank customers expect that the bank isn't just interested in using them, in milking them for fees."

What can you do about it? For past decisions, processes and vendor arrangements, not much, Lorentz says. Those facts won't be protected by attorney/client privilege if they're in the files of the bank, he adds.

Follow through with your review

Where banks can positively impact their future legal risk is by how they handle changes in the overdraft process. In other words, if you review your program and conclude that you need to make some changes, make sure you make the changes.

Lorentz points to a parallel example, a bank that took note of all the enforcement action involving foreclosure procedures. That bank reviewed its processes for foreclosure and determined, in writing, that there were parts of the process that needed to be fixed, he says. But the bank didn't fix them.

"This is a worst-case scenario," he says. "It's worse than simply having a bad process to begin with. I'm not saying, 'Don't look into your programs.' But I am saying, if you look into these programs, be

(continued on page 4)

FDIC Overdraft Guidance Says No to High-to-Low Posting

Last year, the FDIC issued overdraft guidance heavy on consumer concern. One of the issues the guidance zeroed in on was overdraft processes that could multiply overdraft fees. The guidance looked askance at high-to-low posting, in particular.

"Overdraft fees can exceed the amount of the overdraft and can occur multiple times in a single banking day, depending on the type and amount of transactions and the transaction-clearing practices of the institution," the guidance states. "For example, batch processing checks and clearing them from largest to smallest likely increases the number of items triggering an overdraft …Extremely high costs in comparison to the overdraft benefit and/or permitting product overuse often result in customer dissatisfaction and complaints. Serious financial harm can result for customers with a low or fixed income."

In the guidance, the FDIC reiterates the notion that a lot of bank overdraft payment programs are heavy with safety and soundness as well as reputational risk. When it comes to high-to-low posting, the guidance doesn't mince words. The agency asks all FDIC-insured institutions to "[r]eview check-clearing procedures of the institution and any third-party vendor to ensure they operate in a manner that avoids maximizing customer overdrafts and related fees through the clearing order."

Those institutions that keep programs the agency considers suspect will be penalized. "Overdraft payment programs will be reviewed at each examination," the guidance concludes. "Overdraft payment programs that are found to pose unacceptable safety and soundness or compliance risks will be factored into examination ratings and corrective action will be taken where necessary."

"The language in the guidance says that you can't engineer the process – that's a no-no," says Andrew Lorentz, a partner with Davis Wright Tremaine LLP in Washington, D.C. "Regulators have tightened up on the supervisory side." ■

Overdraft

(continued from p. 3)

prepared to make the change. Don't conduct an internal review, decide you need to make the change and then do nothing. That will only compound your problems."

There are a few other strategies banks can look to for protection against overdraft lawsuits.

1. Class action waivers. A number of banks have arbitration clauses with class action waivers in them, Clark says. In the recent Supreme Court case, *AT&T Mobility, LLC v. Concepcion*, the Court struck down a California rule that attempted to invalidate the waivers. If a bank faces a class action lawsuit, it will want to see if it included a class action waiver provision in its contract. If it did, it can force individuals to bring suits as individuals, which significantly lowers the legal risk for the bank.

2. Past regulatory pronouncements. "The OCC has regulation in place that gives banks great leeway in deciding how to handle fees regarding deposit transactions," Clark says. "You could argue that these regulations apply to the order in which debits are posted." Clark points to filed amicus briefs and interpretation letters from the OCC upholding a bank's right to make its own decisions on deposit transactions. Also, he adds, the Uniform Commercial Code also allows for high-to-low posting.

3. Disclosures. If your bank switched to high-to-low posting and it disclosed that practice all along and the customer signed off on it, you may have eliminated your liability, Clark says. "Leading cases from the third circuit court hold exactly this," he says. "If you've ordered your posting from high to low and explained to the consumer that you're doing it, it may increase fee income, but the bank is also off the hook." ■

FDIC Overdraft Guidance Now the Industry Default

Is it still okay for any bank to continue to use high-to-low posting with overdraft fees? After all, of all the financial regulators, only the FDIC has issued final guidance that says no to high-to-low posting. OCC-regulated banks are still waiting on final overdraft fee guidance and the Federal Reserve hasn't issued any opinion at all on the practice.

The smart move is to follow the FDIC guidance, even if the FDIC isn't your primary regulator, says Barkley Clark, a partner in the Washington, D.C. office of Stinson Morrison Hecker LLP. Prosecutors will try to use the guidance as an industry standard in court, which means that all banks may have to treat it that way, too, if they want to minimize legal risk. And besides, it's only a matter of time until the OCC weighs in against high-to-low posting.

"The message is, you can't go by what's in the OCC examiners' handbook right now," adds Andrew Lorentz, a partner with Davis Wright Tremaine LLP in Washington, D.C. "You want to stay within FDIC guidance when managing an overdraft program. You need to look at other sources of guidance [beyond your primary regulator] if you want to stay out of the gray areas." ■

Risk Discussion

(continued from p.1)

Banks need to be comfortable talking about risk openly, says Eric Holmquist, president of Holmquist Advisory, LLC in Spring House, Pa. If banks want to manage risk well, they need to have a banking culture that permits these kinds of conversations.

"I've seen banking environments where there was a hesitation to bring up risk," he says. "It was part of the culture. Executives wouldn't bring up risk for fear of seeming alarmist or impugning a coworker who owned that risk. The system was flawed. Risk wasn't pursued because doing so would make certain people feel criticized."

A bank with a culture like this won't be able to manage its own risk, no matter what programs and processes it puts in place, Holmquist adds.

Without a good risk forum, you probably won't have a good risk program, he says. In cultures like that, managers will find little personal incentive and plenty of disincentive to point to risk they've noticed.

"Where it's not culturally acceptable to report problems, it's

absolutely an inhibitor to effective risk management," he says. "If someone observes something happening, they'll be afraid to raise their hand. They won't because they're worried that they'll be hurt if they do."

But, "companies that have matured to the point where they can put risk out in the open will have better programs, because they'll have a better view of risk and that risk will get addressed more quickly," Holmquist says.

Moving to Openness

A bank culture that won't permit open discussions about risk is asking for trouble, says Tony Ferris, a partner and ERM consultant with the Rochdale Group, Overland Park, Kan.

"It comes down to taking actions and providing education," says Ferris. "Everyone should see that risk discussions result in solid organizational decisions and actions without repercussions. Second, education of the program and its process is invaluable. A strong link needs to be drawn to the fact that the worst kind of risk is created only when an organization seeks to hide, ignore, or discourage risk discussions."

The good news is, making this transition – from a banking culture intolerant of risk discussion to one that accepts it – may not be as hard as you think. The key, says Holmquist, is in management committing to talking openly about risk and letting everyone simply get used to the idea. Once management sees that risk can be talked about openly and without negative consequences, the culture will begin to shift.

"Building a risk forum is best managed from the bottom up," he says. "Executive management can't just insist that everyone talk about risk. That won't change a thing. But, the more you talk about risk, the more people around the bank will begin to notice that risk is being discussed and nobody got killed."

Holmquist also recommends depersonalizing the risk discussion. Talk about risk, yes, but don't tie that risk back to individuals, he advises.

"The discussion can't be threatening," he says. "It always has to be within a framework of risk and it has to be depersonalized. In other words, don't say: 'Some of the stuff Sally is doing is really risky.' Instead, talk about process, third parties and the general risk profile. If the discussion is depersonalized – if no one feels personally implicated – people will get engaged in the discussion."

> "Where it's not culturally acceptable to report problems, it's absolutely an inhibitor to effective risk management."

Management can move the process along quickly, simply by refraining from punishing the first few executives who do have the guts to talk risk.

"It's more about what management doesn't do than what they do do," Holmquist adds. "They probably shoudn't praise people for raising their hands, but it will mean a lot if they don't berate or punish anyone for doing it."

Banks that make a concerted effort to talk through risk and demonstrate a tolerance for the practice can shift from a risk-discussion averse culture to a open one in less than a year, Holmquist suggests.

Here, according to Rochdale's Ferris, are some other elements banks can use to create and nurture an open risk forum:

- Ensure accountability for the process at both the senior management and board levels.

- Use a measurable program. This can force the bank's managers into an actual discussion and compel them to correct measurements. It also minimizes generalizations and sandbagging, Ferris says. Banks should make the effort to track this over time.

- Add some element of comparability. Pick a benchmark you can use to compare your bank with the rest of the industry. You could, for example, measure economic capital from within the organization as defined by the organization and compare that to an outside calculation reflected in COSO and Basel. If a large deviation exists, you've missed a risk and that reflects back on your risk forum, Ferris says.

"The keys are built within the process a bank creates," he says. "If an organization is concerned or wants to ensure it gets a true risk discussion, it should try to incorporate some of these elements." ■

Consumer Compliance

(continued from p. 1)

compliance plus safe and sound risk management equals good business and prudent banking," she says. "Safe and sound lending practices help banks keep their problem loans manageable when a downturn comes. The fundamentals for compliance with consumer protection laws require the same comprehensive, programmatic approach that emphasizes strong policies and internal controls, appropriate staffing and resources and a proactive independent review process."

And what's more, banks tend to drop consumer compliance quality in tough times and neglect to improve it when circumstances improve, Thompson says.

"What we've found to be true is when institutions get in trouble, and I'll define trouble as being in poor financial condition – they usually redirect their attention to other parts of the organization," she says. "They start cutting in the compliance area and when things get better and they start lending again – they usually forget to add back some of the important policies and processes that were cut. Aside from the hefty price-tag of penalties and making customers whole for violations of consumer laws, the reputational risks can flow straight to the bottom line and drag down earnings."

Bankers can't assume that they can neglect consumer compliance without catching the FDIC's attention, she adds. "As bank supervisors, we try to fully understand an institutions financial and qualitative performance and [try] to make sure that management recognizes the gravity of examination findings across the spectrum."

> "As bank supervisors, we try to . . . make sure that management recognizes the gravity of examination findings across the spectrum."

FDIC on Community Banks

Thompson also expanded on FDIC Acting Chairman Martin Gruenberg's plans to give extra attention to community banking next year. "Throughout the crisis, we've seen community banks maintain and even modestly grow their loan balances," she said. "This is why our Acting Chairman has launched a number of initiatives to help us get a better handle on where community banks stand today, post-crisis. What are the new realities? What are the challenges and the opportunities going forward?"

Here, according to Thompson, are the agency plans for community banks. The agency will:

• Hold a National Conference early next year on the future of community banking;

• Produce a study that traces the evolution of community banks over the past 20 years, including changes in business models and cost structures, and lessons learned;

• Review key challenges, such as raising capital, keeping up with technology, attracting and retaining qualified personnel, and meeting regulatory obligations;

• Review our own risk-management and compliance supervision practices to see if there are ways to make the process more efficient;

• Continue to have direct outreach and open dialogue with community bankers; and

• Host a series of regional roundtables with community bankers across the country to get their input. "These roundtables will supplement the work of our Advisory Committee on Community Banking where we hear first-hand from a broad cross-section of community bank CEOs," she added. ■

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