E-Memo

TO: INVESTORS/MEMBERS/PARTNERS AND FRIENDS
FROM: Jon Bruss and James Bruss
DATE: September 25, 2009
SUBJECT: Rex Regulator

In an era when bank executives are compelled to Washington for televised tongue lashings by lawmakers, and debt holders and pension funds are excoriated by the President as "speculators" for attempting to enforce their contracts, we should not be surprised that regulators might want to join in the fun of publicly kicking bankers around. And indeed, that is exactly what they have decided to do.

The FDIC now publishes the names of banks that challenge regulatory orders—thus revealing to the world those banks the FDIC deems guilty until proven innocent. The FDIC wants us all to know when a banks' dirty laundry, real or imagined, is publicly available. There is a certain lawlessness in this policy, ungoverned by any sense of process or fairness. Rex Regulator is above all that.

In the world of regulated industries, nothing is uncomplicated. Before the FDIC enters a regulatory order, setting out requirements a bank must meet, the bank must agree to the order. If the bank disputes the order and is unable to compromise with the FDIC, the FDIC will issue a notice of charges to the bank. The process concludes in a public hearing during which each side makes its case. In practice, however, few cases ever get to the public hearing stage. Instead, the banks that refuse to agree to the order will typically continue to negotiate in an attempt to reach a compromise before the hearing.

But overturning a 20-year practice of non-disclosure, the FDIC now believes it is important to disclose the charges, which are more detailed than the order ultimately imposed on the bank. Moreover, the charges will potentially disgrace the bank, even though not yet stipulated to or proven. So why did the FDIC change course after 20 years? FDIC spokesman David Barr doesn't know, except to say that "the notices are part of the enforcement process, [therefore] we decided to make them available when they are imposed." "FDIC Flags Dissenters, Raises Ire", *American Banker*, September 8, 2009. Well, that explains it.

Still, others are skeptical the FDIC is using this tactic to bully banks into obedience. While we would never want to accuse the FDIC—or any other regulatory agency—of untoward motives, facts get pretty stubborn sometimes. If this tactic, which the FDIC officially can't justify, is not meant to bully banks, it certainly raises the potential for mischief. Imagine a rogue regulator, newly emboldened by this tool, finds a bank in disagreement with the FDIC's conclusions about the health of the bank. The policy to disclose the charges gives the FDIC a big hammer and encourages the rogue regulator to make those charges as unsavory as possible to ensure the bank's compliance.

Previously, if a bank disagreed with its examiner, it could dispute the regulator's findings and orders. Nominally, this is still possible. But the risks for banks—to their reputation, for a run on deposits and other funding sources, etc.—that would bargain with the FDIC is now extraordinary. The new disclosure policy denudes the bargaining process, sets up the regulator and the regulated as de facto adversaries, and prejudges any dispute in favor of the regulator.

So what should banks do? Understand they have little power in the face of the regulators. This will encourage the proper tactfulness in their dealings with regulators. Bankers may bristle at being forced into friendly relations with their regulators—especially if they have to extract a knife from their backs—but it's good business not to rile your biggest "shareholder". (In case the current bullying by Rex Regulator is not enough to convince you, read *Dead Bank Walking: One Bank's Struggle for Survival and*

the Merger That Changed Banking Forever, a history of the 1992 merger of Security Pacific Bank and Bank of America written by Robert H. Smith, the bank's last CEO. It details in chilling fashion the role of roguish regulators in the merger, and we think a must read for bankers and investors. After reading *Dead Bank Walking*, recall Yogi Berra: "It's déjà vu, all over again.")

Among the many ill-conceived regulations coming down the pike, the FDIC's sacrifice of good policy on the altar of transparency may be the worst. It is not because the FDIC necessarily grossly overreaches whenever it discloses the names of banks that challenge its conclusions. Rather, it's because the new policy *encourages* the FDIC to grossly overreach, and in the process chills dissent and compels banks to buckle under pressure even when the regulators order bad business decisions. Banks are well-advised to commence as soon as possible with the buttering up they will be required to do. And learn how to duck.

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