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Five Building Blocks for a Healthy Relationship With Regulators

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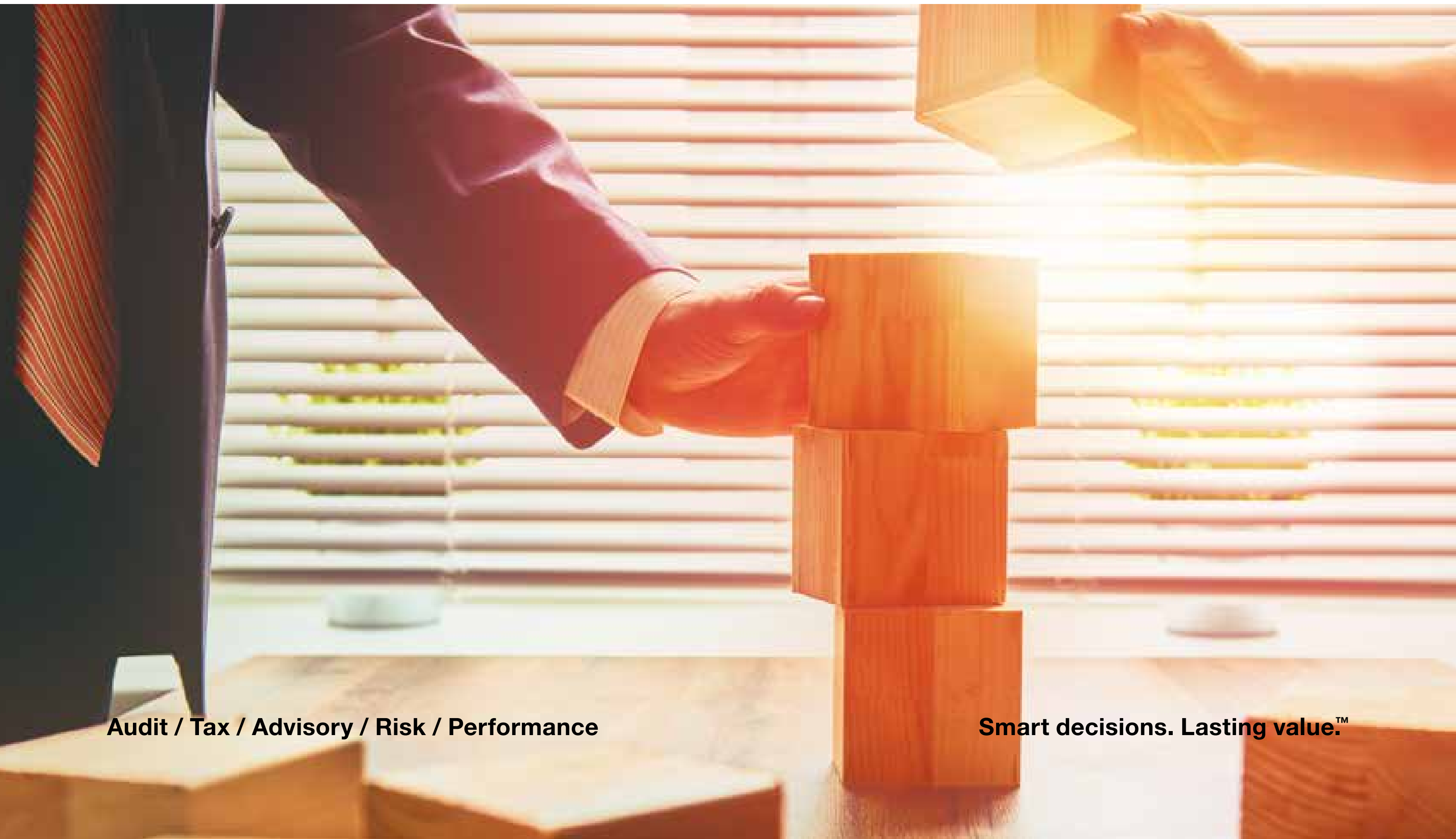

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Federal banking regulators can have a tremendous influence on a financial organization's activities and future.

Whether through the Office of the Comptroller of the Currency (OCC), the Federal Deposit Insurance Corp. (FDIC), the Reserve (Fed), the Consumer Financial Protection Bureau (Bureau), or the bank departments of various states, enforcement activity levels are high and likely to intensify even further. With regulators having such a constant presence – both during and between examinations – a bank's relationship with its regulators is critical.

Banking has long been about relationships, but it's not only relationships with customers that are vital to a bank's long-term success. After all, customers will come and go, but regulatory relationships are forever, even if a bank's primary regulator changes. An institution's regulators will be with it throughout its existence, and those regulators have the power to make that time feel like smooth sailing, rough waters, or a capsized vessel.

Thus, as the Fed has observed: "A positive relationship between a bank and its regulator is a valuable asset. A bank will have close interaction with regulators in every stage of its development and will be subject to the regulator's scrutiny in examinations and certain applications for consent or approval."[1] A bank that has a strong relationship with its regulators is likely to benefit from the enhanced credibility that comes from such a relationship, even if the bank occasionally stumbles or falls short. Regulators also can be an invaluable source of insight to the organizations they examine.

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Banks, therefore, must think beyond their exams to how they can cultivate healthy, ongoing relationships with regulators that are not only about compliance but also creating opportunities. Following are the building blocks that are essential to promoting productive working relationships with regulators. Some of the blocks have overlapping elements, but combined, the blocks can form a powerful structure.

1. Transparency

Bank regulators have put an enormous emphasis on transparency in the years following the financial crisis, from customer due diligence and stress-testing requirements to deceptive practices. Financial services companies should bring that same principle of transparency to their dealings with regulators by being forthcoming with detailed information on their banking activities that will help examiners better evaluate the effectiveness of the compliance program and the safety and soundness of the organization.

From a regulator's perspective, the Fed has explained that the relationship with a bank should be free-flowing and involve two-way communications.[2] Bank representatives are encouraged to share their views and opinions. And when regulators request information, banks are expected to provide prompt and accurate responses. In addition, according to the Fed, regulators should expect early communication from banks on issues or areas of emerging risk.

Providing detailed information on a proactive basis can seem counterintuitive to bank executives, particularly when a potential issue might not even develop into a serious problem. But by being transparent early on, a bank can communicate a clear and complete picture and receive real-time perspective and questions. Withholding information usually deprives a bank of the ability to have a forthright discussion with regulators later.

With this in mind, it becomes apparent why it sometimes can be a misstep to use general counsel to engage an external consultant to conduct an independent third-party review of, for example, fair lending concerns. The results are reported only to counsel, and attorney-client privilege will apply to the report. The approach can lead to a dilemma – should the bank share with its regulator the results of the review (negative or positive) and potentially bring further scrutiny, or should it wait to see if the regulator discovers the concerns on its own?

The banks with the best regulator relationships likely would opt to disclose the information. In fact, many financial services companies increasingly are retaining independent third parties directly, rather than going through counsel, with the intent of demonstrating to regulators that they are on top of the issues and choosing transparency over the protections of attorney-client privilege.

Still, the proper timing of the disclosure can pose difficulties. Timing a disclosure appropriately is an art, not a science. Financial services companies must find the sweet spot to provide the right level of information at the right time in order to allow regulators to evaluate certain types of activities. Not surprisingly, those banks with greater credibility with regulators generally lean toward having earlier conversations. They recognize, though, that the mere appearance of a single red flag does not necessarily merit a conversation.

It's important, too, that transparency is not limited to examinations. Financial services companies should be open to having unscheduled conversations with their regulators when potential issues arise, making transparency routine. Transparency should not solely be examination- or event-driven; instead it should be a part of the ongoing relationship.

2. Clarity

Once a bank commits to being transparent with regulators, it also must consider the clarity of its communications with them. The banks that have the best relationships with regulators articulate clear messages to their regulators, whether those messages are sharing good or bad news. Among other things, that means thinking about messages before conversations occur.

A bank's entire management team must be familiar with the key messages it shares. If bank representatives simply talk off the top of their head, the bank runs the risk of sending disparate, incomplete, or even inaccurate messages. In the context of an examination, it might be wise to hold prep sessions for the team. Clarity also is valuable in ongoing updates with regulators. Many banks – even small ones – have standing check-ins with regulatory personnel throughout the year.

Members of management must see and understand the broad organizational perspective, not just a narrow view of their specific domain. They need to understand where their area of expertise (for example, earnings or liquidity) fits into the bigger picture and be comfortable knowing when another person is better suited to provide details.

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One approach is to have a uniform message that is shared throughout the organization – a so-called state of the union. Having a broad shared message like this will help everyone who is a primary contact with regulators to be aware of the main points the bank wants to get across and to know to whom within the bank to direct questions. For example:

- Here's what we have accomplished since our last update. We have:
  - Strengthened our *Bank Secrecy Act*/anti-money laundering (BSA/AML) program significantly
  - Automated our general ledger account reconciliation process, which in turn has strengthened our financial reporting internal controls
  - Opened three new branches

- Here's what we are working on. We are in the process of:
  - Streamlining our new employee onboarding process
  - Migrating to a new budgeting system
  - Implementing beneficial ownership elements within our customer identification program and AML transaction monitoring system
  - Evaluating a process of analyzing our complete consumer loan portfolio for any disparities using proxy methodologies

- Here's what we are going after (which can include some areas of weakness). We want to:
  - Increase our training activities for credit analysts so they can better stay on top of changes in the market
  - Upgrade our mobile banking platform

Smaller banks could use this broad message in a single update. Larger banks, however, have many connections to examiners across the bank and the scope of any message likely is too broad for one single update to suffice. But the important concepts still apply: Understand your landscape and be able to articulate a clear, concise message.

3. Reliability

Like most people, regulators appreciate reliability. Banks that deliver on their promises and commitments – whether spelled out in an examination report or discussed verbally in the exit meeting or at some other time – tend to have better regulator relationships. It might seem like regulators generally take a backward perspective, reviewing what a bank already has done (or failed to do), but they often also are forward-looking. A less significant risk that doesn't warrant inclusion in today's report could grow over the coming year. If the regulator brings it up in conversation and finds a year later that the bank did not take any action on his or her suggestions, the bank will not engender positive feelings. Regulators need to see over time that when a bank says it's going to do something, the bank follows through and performs the corrective action.

Reliability also encompasses being the kind of bank that makes regulators' jobs easier. A bank should respond to a regulator's requests promptly and helpfully. For example, instead of sending a regulator a 25-page desktop procedures manual and leaving it to the regulator to sift through the entire manual to find the specific information requested, include a note stating the page number and paragraph where the requested information can be found. Regulators work with numerous banks, and they will note those that make information sharing easier or harder.

4. Proactivity

Some banks take a reactive approach to the regulatory environment, waiting to deal with issues until regulators bring them up. That might be understandable, and less burdensome in the short term, but it surely will not facilitate good relations with regulators. It probably isn't the best strategic answer, either.

Just as regulators can be forward-thinking about a bank's potential problem areas, so should the bank. That requires looking ahead to potential business issues or regulatory changes on the horizon and trying to understand the steps that should be taken today to stay on the right side of the relevant laws, regulations, or regulatory guidance. Discussions on these matters should be held both internally and with regulators, who can be an invaluable source of experience, insight, and advice.

A bank that is exploring the possibility of opening new customer accounts online, for example, could plunge ahead and see what happens on the regulatory front once the new program is up and running. Or it first could perform due diligence by reviewing all of the relevant regulatory guidance and seeking other industry insights, such as peer experience. After crafting preliminary plans, then it could seek input from its regulator and take that input into account as it finalizes its plans. Not only can such an approach demonstrate good due diligence and being proactive, it also can help avert issues that examiners might have seen elsewhere.

5. Collegiality

Collegiality can be summed up as mutual respect. Bank representatives might need to exercise restraint at times because it's vital that conversations do not become antagonistic. Adversarial stances certainly can come up during the exam process (for example, when the parties disagree about the severity of an issue), but they also can arise over the course of the year. Either way, the difference of opinion should be addressed professionally and respectfully.

The mission of regulators is to ensure safe and sound banking practices and compliance with banking laws and regulations. Examiners take that mission seriously. Keeping that in mind might help banks maintain a strong level of respect in their relationships, even when tough conversations are taking place. Things will

go more smoothly for everyone if banks appreciate the amount of experience regulators have and the incredible resource they can be when banks approach conversations constructively. Even if the parties never ultimately find common ground on an issue, mutual respect can carry them through the disagreement and safeguard an otherwise positive and productive relationship.

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A Foundation of Trust

Together, the components described here can help build strong regulatory relationships with a solid foundation of trust. When regulators regard a bank as being honest and straightforward, thinking ahead, and trying to do the right thing, the resulting relationship will be beneficial for the bank. The bank might occasionally receive the benefit of the doubt given past performance and can benefit richly from the experience and insights of its regulators. As with any relationship, though, relationships with regulators require nurturing.

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[1] https://www.fedpartnership.gov/bank-life-cycle/start-a-bank/supervisory-process-and-regulatory-relations
[2] Ibid.

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