Evaluating the Rating Significance of Regulatory Actions Against U.S. Banks

Moody’s continues to see a number of U.S. banks facing regulatory actions, most recently the cease and desist orders issued to Doral Financial Corporation and FirstBank Puerto Rico. The regulatory restriction on Citigroup Inc.’s ability to undertake major acquisitions was also removed recently. With these incidents in mind, we thought it would be useful to describe how Moody’s looks at supervisory actions against banks.

Typically, we base our analysis on three key issues:

1. **The differences among types of regulatory actions.** In other words, some actions are more alarming than others.
2. **The limitations imposed.** Although any restrictions imposed by regulators are not welcomed by a bank, we have to determine whether the restrictions actually have a significant impact on a bank’s financial or strategic flexibility.
3. **The implications of regulatory intent implied by the form of the actions taken.** The choice of regulatory action can reveal issues that can have implications for a bank’s rating.

This special comment provides some transparency about each of these issues.
**Differences Among Types of Regulatory Actions**

It is important to recognize that not all bank supervisory actions are the same. U.S. bank regulators have a variety of instruments at their disposal to encourage or to require a bank to make changes to its operations, risk management, or capital position. Because of the scope of their authority, moreover, U.S. bank regulators have more discretion in the type of supervisory actions they can employ compared with the leeway of most other U.S. regulators, including the Securities and Exchange Commission (SEC).

Typically, the greater the bank regulator’s concerns, the more severe the action it takes. At the lowest level of concern, a bank regulator might simply indicate areas requiring management’s attention in its annual report of examination. The regulator will typically prepare a separate document highlighting its concerns when it is more disturbed by what it found. This can be in the form of either an informal or formal agreement.

The principal difference between an informal agreement and a formal action is that a formal action is backed by the force of the law. If a bank fails to comply with an informal agreement, the typical response of the bank supervisor is to impose a formal agreement on the institution. But if a bank fails to comply with a formal agreement, the bank can be subject to civil monetary penalties (CMPs) or other administrative or legal actions.

Regulators are also required to disclose formal supervisory agreements publicly. In contrast, bank regulators typically do not disclose informal agreements. The decision to disclose the existence of an informal agreement is at the discretion of a bank’s board and management.

Even within each category, there are different types of actions that can be taken, depending upon the extent of the regulator’s concerns. We will outline the various actions available to banking regulators later in the comment. The mildest form of informal agreement is typically known as a supervisory letter or a board resolution. After that is the memorandum of understanding, commonly referred to as an MOU.

A written agreement is always a formal agreement. Such an agreement generally indicates a greater degree of regulatory concern than an MOU. A cease and desist order typically reflects the highest degree of regulatory concern. For example, the orders issued to Doral Financial Corporation and FirstBank Puerto Rico in March 2006 reflected regulatory concerns about these and other local banks and the banking system generally in Puerto Rico. Regulators can also impose civil monetary penalties on banks, or, which is more often the case, on specific individuals.

A major analytical challenge for Moody’s is the fact that the regulatory actions can be "sticky". That is, regulators are slow to remove regulatory restrictions. This creates a challenge because it is difficult to determine if the delay reflects the regulator’s concerns about slow or limited progress or simply the regulator’s modus operandi.

Even after demonstrating compliance with all items noted in the agreement, a regulatory body will typically wait for a period of time before removing a restriction. The reason for this is to provide for a period of monitoring. As an example, in August 2002, Capital One Financial Corporation entered into an informal MOU with the bank regulatory authorities with respect to certain issues. In its 2002 Annual Report, Capital One believed it had satisfied the terms of the MOU. However, the agreement was not removed until January 2004.
Types of Regulatory Actions

- **Bank examination findings.** These are confidential findings that are not disclosed externally.

- **Conditions or commitments in regulatory approval orders.** As a part of the normal regulatory approval process required for a wide variety of acquisitions or new activities, a regulator may condition the approval upon certain limitations or restrictions on related or future activity. These restrictions may be agreed to by the bank in the form of a commitment, or imposed by the regulator as a condition.

- **Informal actions.** The bank decides if these are disclosed to the public.
  - **Supervisory letter, commitment letter, or board resolution.** Generally used when the problems do not pose a serious threat to the bank and when the regulator expects the bank to comply fully.
  - **Memorandum of understanding (MOU).** Somewhat more formal than letters or resolution, but still not administratively or judicially enforceable.
  - **Safety and soundness plan.** Requires the bank to produce and implement a plan to comply with safety and soundness guidelines, which include issues such as internal controls, internal audits, loan documentation, underwriting standards, interest rate exposure, compensation, and asset growth.

- **Formal actions.** These are required to be made public by the regulatory body.
  - **Safety and soundness order/directive.** When a bank fails to submit or implement a safety and soundness plan, the regulator can issue an order or directive to require compliance.
  - **Prompt corrective action directive.** This imposes restrictions on banks failing to maintain adequate capital.
  - **Capital directive.** This allows the regulator to set higher capital requirements that are generally expected of the bank.
  - **Written or formal agreement.** These agreements are used by regulators to remediate violations of the law or unsafe or unsound practices. The agreement requires a bank to cease certain practices and to take affirmative actions to correct practices. However, unlike an MOU, the agreement is made public and the regulator can assess civil monetary penalties (CMPs) for violations of the agreement. Such an agreement can be issued in combination with a consent order (see below).
  - **Consent order.** These orders are used by regulators to remediate violations of the law or unsafe or unsound practices. The order requires a bank to cease certain practices and to take affirmative actions to correct practices. Such orders are issued when the regulator is not confident that management will take the necessary steps voluntarily and/or where the problems are so severe that a lesser action is not justified. As their name suggests, these orders are issued with the bank’s consent. Failure to comply with the order can lead to CMPs against the bank or specific individuals and, in the extreme, the regulator can seek an injunction against the bank requiring compliance.
  - **Cease and desist order.** These are effectively identical to consent orders in terms of potential scope and effect. However, these orders are typically issued to a bank without its consent if the regulator takes the necessary administrative steps.

- **Other actions.** These are sometimes taken in conjunction with one of the above, not alone.
  - **Civil money penalties.** Regulators can and do issue a CMP on a bank. More often, however, the penalty is directed at specific individuals.
  - **Removal/prohibition.** In addition to CMPs, regulators can take actions against individuals, including a formal agreement (to take actions), a cease and desist order or prohibition action (to cease an action), or removal from office (for serious misconduct).
Limitations Imposed by the Regulatory Action

Regulators can take actions that to impose limitations upon the bank’s financial or strategic flexibility. This typically takes the form of limitations on dividends, but it can also include growth restrictions and even deposit restrictions. Other limitations are also available (see “Types of restrictions”).

The extent of the limitations or restrictions imposed generally varies with the form of agreement. Often, these restrictions are designed to conserve resources at the bank level. Although this may support a bank’s credit profile, it can weaken the credit profile of the parent holding company.

The restrictions can have a significant affect on the bank’s ability to execute its strategy. For example, the Federal Reserve Board stated, as part of its March 2005 order approving Citigroup’s acquisition of First American Bank, that it expected Citigroup would not undertake significant expansion during the implementation period of its plan to improve oversight, compliance, and controls. This restriction was not lifted until April 2006. Similarly, AmSouth Corporation has been operating under a cease and desist order, issued jointly by The Federal Reserve and the Alabama Superintendent of Banks, since October 2004. This order precluded the company from opening any new branches for some time. The bank recently announced that the regulators have agreed to the bank opening over 60 new branches in 2006; however, the order remains in place.

Implications of the Form of Action

Moody’s takes a case-by-case approach to determining how we react to news that a bank is subject to a regulatory action. The extent to which we believe any rating action is required depends (a) on the nature of the problems identified and (b) on the extent to which views on these issues have already been factored into the bank’s and parent company’s current ratings.

Clearly, not all supervisory actions result in negative ratings actions. Our ratings are forward-looking, and the existence of a regulatory agreement usually means that, in the future, a bank will have better risk management, tighter controls, improved underwriting, and stronger financials. This is, indeed, the regulator’s intention, and the regulator will be applying extra scrutiny to make sure the bank gets there.

Moody’s analyzes the regulatory actions to discern whether the issues highlight weaknesses in the bank which are inconsistent with the current rating levels. Key questions include the following:

- What does the choice of regulatory action reveal about the seriousness of the regulator’s concerns?
- Does the action reveal some significant deficiencies in the bank’s underwriting standards, management, or financial condition of which we were previously unaware?
- What impact will such an action have on the bank’s reputation and on the confidence of its customers and creditors? Banks, and particularly bank holding companies, are confidence-sensitive institutions, and reputational damage can significantly hinder their future earnings performance and credit profile. This is particularly true of banks that depend more heavily upon wholesale businesses and on institutional customers.
- What limitations are placed on financial or strategic flexibility, both at the bank and especially at the holding company?
- Is there uncertainty about the bank’s ability to comply with the terms of the action?

Types of Restrictions

- Restrictions on
  - dividends, capital distributions, etc.
  - management fees paid to holding company
  - brokered deposits, interest rates on deposits
  - acquisitions or new lines of business
  - interaffiliate transactions
  - senior executive compensation
  - asset growth
- Submission of one or more implementation plans (capital, asset growth, liquidity, management, risk management, etc.)
- Submission of periodic reports (daily, weekly, monthly, quarterly)
- Required divestitures
Once we have evaluated the issues, Moody’s determines whether the issues:

- **Are not significant or are already incorporated in the current ratings, thus supporting a ratings affirmations:** Moody’s has tended to affirm ratings when the problems are limited in nature and when the fines or penalties involved, if any, are relatively small. This happened over the last few years, for example, when a number of banks entered into regulatory agreements due to non-compliance with Bank Secrecy Act requirements (see, First Midwest Bancorp, Inc., Hudson United Bancorp and Popular Inc.).

- **Are difficult to evaluate immediately, so we have to gather more facts before determining the potential rating implications:** Sometimes, the extent of the issues is difficult to determine immediately, even when the nature of the problems appears significant. For example, PNC Financial Services experienced significant control and governance issues in 2002, however, the facts unfolded over the course of over a year. Moody’s, as a result, placed the ratings under review for downgrade twice, in April 2002 and October 2003, and both times confirmed the ratings, based on (1) the additional facts we were able gather, and (2) the extent of the control, risk and governance improvements that took place in the interim.

- **Are significant enough to necessitate an immediate negative rating action.** Moody’s has taken negative actions quickly when the problems identified are broad in nature and will take time to resolve fully. For example, when Fifth Third Bancorp announced it had entered into an agreement with its regulators in April 2003, Moody’s changed the bank’s outlook, to stable from positive.
Related Research

Methodology:
Rating Methodology: U.S. and Canadian Corporate Governance Assessment, July 2003 (78666)

Special Comments - General:
Lessons Learned in Moody’s Experience in Evaluating Corporate Governance at Major North American Issuers, April 2006 (97104)
Moody’s Response to Rated Companies Receiving SEC Wells Notices, October 2005 (94627)
CEO Compensation and Credit Risk, July 2005 (93592)
Takeover Defenses and Credit Risk, December 2004 (89713)
Moody’s Findings on Corporate Governance in the United States and Canada, October 2004 (89113)

Special Comments - Sectors:
No Assurance of Good Governance: Observations on Corporate Governance in the U.S. Insurance Sector, October 2004 (94705)
Observations of governance in U.S. REITs - some weaknesses but getting better, September 2005 (94031)
Don’t Bank on Strong Governance: Observations on Corporate Governance in US Banks, August 2005 (93743)

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Report Number: 97230

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