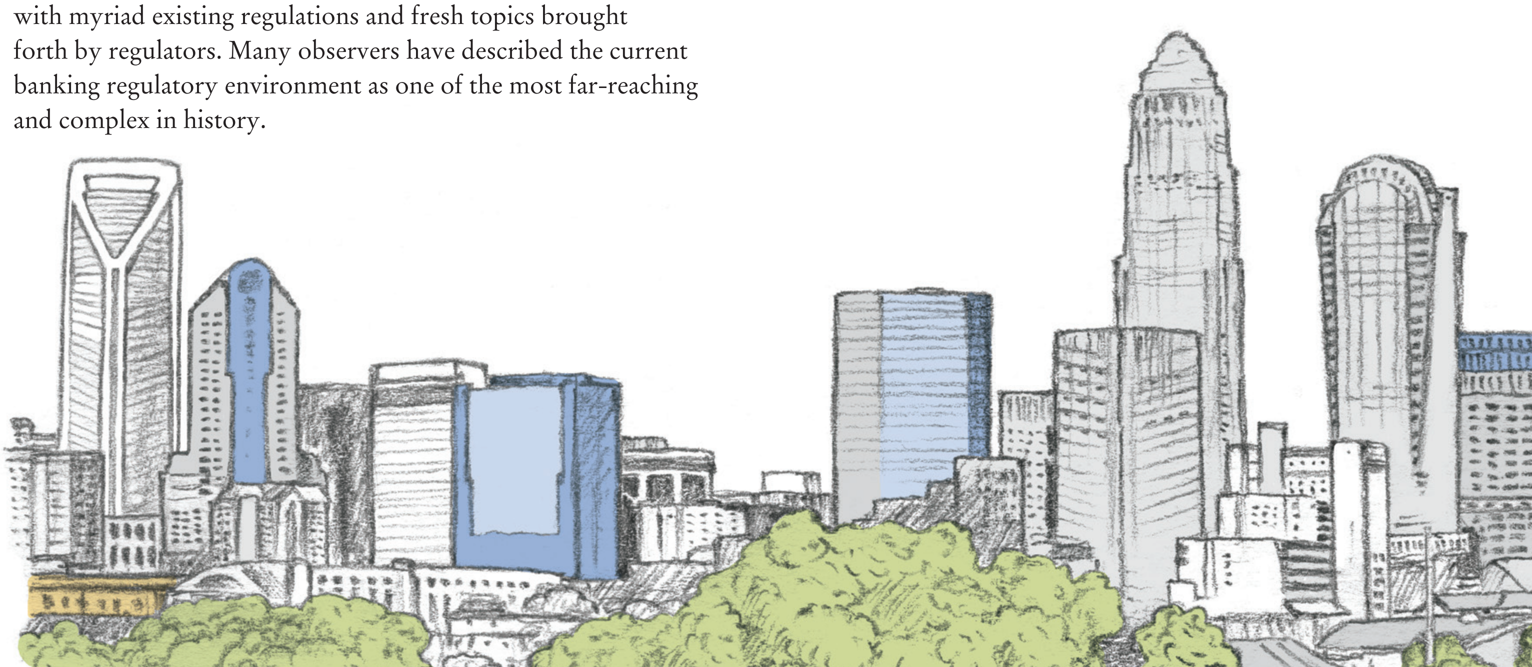
2013 banking outlook: Surviving and thriving in the "new normal" world of banking regulations

Introduction

The financial crisis that surfaced in 2007 and erupted in 2008 has continued to have lasting effects on the U.S. economy in early 2013, and has resulted in what is perhaps the most significant wave of regulatory changes for the banking industry in more than 70 years. Bank management and their boards of directors have had to deal with the Dodd-Frank Wall Street Reform and Consumer Protection Act of 2010 (the Dodd-Frank Act) — arguably the most significant financial regulation since the Securities Act of 1933, the Securities Exchange Act of 1934 and the Glass-Steagall Act of 1933 — along with its establishment of the Consumer Financial Protection Bureau (CFPB). Added to the complexity of these events is bank regulators' renewed focus on a number of key areas, such as compliance, risk management, strategic planning and operations, just to name a few.

While banking has always been a highly regulated industry in the United States, at least since the Great Depression, the current environment is nearly unprecedented, resulting in bankers spending much of their time implementing new regulations or ensuring that their banks continue to comply with myriad existing regulations and fresh topics brought forth by regulators. Many observers have described the current banking regulatory environment as one of the most far-reaching and complex in history.

Previously, many bankers adopted a wait-and-see attitude toward some of the new regulatory challenges, hoping for legislative relief or a more robust economy to provide some respite from the regulatory challenges. As we begin the new year, though, it should be clear that the results of the November 2012 election will result in accelerated rather than decelerated regulatory activity. Grant Thornton LLP views the current regulatory environment to be the "new normal" state of the banking industry. While the thrust of most bank managements and boards of directors since 2008 has been to weather challenges of the financial crisis concerning credit and capital, a new survival mode has taken hold in today's regulatory environment. This new normal provides opportunities for banks to not just survive but thrive in 2013 and beyond.



Capital

The banking industry suffered a significant reduction in capital as a result of historically high credit losses, particularly in home mortgages, mortgage-backed securities and commercial real estate lending. Furthermore, as a result of the recession and reduced investor confidence in the banking industry, sources of additional needed capital have been either unavailable or prohibitively expensive.

Regulators continue to push for more capital despite a slight improvement in overall industry capital ratios in recent years, given more profitable operations and, in some instances, shrinking balance sheets. With the additional capital requirements proposed under Basel III, the global banking regulatory standard, "more capital" will be the cry heard throughout many banking organizations.

A number of community banks were surprised that Basel III proposals included them in the proposed capital requirements. While some relief may be forthcoming in 2013 for community banks, all banks should prepare now for the new requirements. By starting now, not only will your bank have a better chance of surviving the new capital challenges, but it can thrive as you take advantage of the stronger capital position. Grant Thornton recommends that you consider some or all of these ideas:

- Plan to increase capital now, particularly common equity. Having a capital infusion in place prior to Basel III's full implementation date could lessen the stress on your bank management and allow them to focus on other areas, such as new products, additional markets and operational improvements.

- Model the new risk-weighting requirements now and begin preparing for any changes to products, balance sheet mix, markets, etc. A gradual approach to exiting certain types of loans or emphasizing growth in other loan areas will pay dividends during the potentially chaotic balance sheet restructuring that may be needed as the full implementation date for Basel III gets closer.

- Explore creative additions to capital. With the continued low-interest-rate environment, opportunities exist to add preferred stock or other non-common equity instruments at a lower cost than will be likely in the future. While Basel III has requirements for minimum levels of common equity, there are also new requirements for additional total equity, so the non-common additions will be important as well. While federal income tax rates on dividends beginning in 2013 have increased, at least for some taxpayers, the tax rate is still less than the tax rate on interest income.

- Enhance stress testing and evaluation of results. A more robust and meaningful stress-testing process and evaluation can improve access to capital by increasing investor confidence, and may also boost the regulators' attitudes toward a bank's management as they try to improve their capital position. Bank regulators will likely not approve a bank's capital plans if they have concerns with the bank's stress-testing results.

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Compliance

While bankers were preoccupied with credit and capital issues from 2008 through 2010, some believe banks lost focus on the many compliance issues that exist in all banking operations. Coupled with the increasing emphasis of bank regulators on the topic and the creation of the CFPB, a perfect storm of compliance challenges has surfaced in many banks. With ever-increasing frequency, regulators are finding major compliance shortfalls with the Bank Secrecy Act (BSA), and the Anti-Money Laundering (AML) and Suspicious Activity Report (SAR) programs. There have also been issues with a host of consumer compliance regulations such as the Truth in Lending Act (TILA); the Equal Credit Opportunity Act (ECOA); the Home Mortgage Disclosure Act (HMDA); the Real Estate Settlement Procedures Act (RESPA); Unfair or Deceptive Acts or Practices (UDAP); and Unfair, Deceptive or Abusive Acts or Practices (UDAAP) regulations; Servicemembers Civil Relief Act (SCRA); and others. A large number of severe enforcement actions issued by regulators are attributable to compliance issues, resulting in regulatory mandates for more training, enhanced monitoring and oversight, more auditing, and improved compliance management systems. These enforcement actions have resulted in significant fines, penalties and time spent on corrective actions.

At Grant Thornton, we have a few ideas to improve your compliance scores from regulators:

- Ensure that internal audit and/or third-party reviews of compliance activities are robust in scope and in the qualifications of the reviewers.
- Emphasize to all employees the importance of zero-defects compliance with BSA, AML, HMDA, TILA, ECOA, RESPA, UDAP/UDAAP, SCRA, flood insurance and the numerous other compliance requirements.
- Increase training of employees in compliance issues.
- Correct exceptions in a timely manner and monitor status of all open exceptions.
- Demonstrate to the regulators that your bank is in consistent compliance with all consumer lending and other lending requirements.
- Consider incentive programs to reward improvements. A few dollars spent now may save many more dollars in fines and penalties or other compliance mandates from regulators.

Mergers and acquisitions

Bank M&A activity has been hampered by capital restraints of potential acquirers and the overall depressed stock valuations of banking companies, along with the perceived risks of acquiring a bank with potential credit issues. It has also become pretty clear that banks rated worse than a 2 in CAMELS ratings will have a more difficult time obtaining regulatory approval of acquisitions. (Bank examiners use the CAMELS system to help measure the safety and soundness of a bank. Each letter stands for one of the six components of a bank’s condition: capital adequacy, asset quality, management, earnings, liquidity and sensitivity to market risk.)[1] Indeed, the regulators have even told the larger banks that approvals for any acquisitions other than for relatively minor deals will be very difficult.

Given this backdrop, banks looking to pursue M&A activity should take into account the following considerations:

- The shortage of acquirers has resulted in a buyer’s market, which we expect to persist for the foreseeable future. With many banks shut out of the M&A market, buyers may see more favorable terms and potentially easier negotiations.
- Some boards of directors are much more interested in selling than they were in prior years, given increasing capital and compliance requirements and the cost and stress of additional regulatory burdens. Many boards of directors have resigned themselves to the fact that their bank stock valuation will never recover to pre-2008 levels and are more willing to accept a lower price for their banks.
- As the U.S. Treasury auctions its Troubled Asset Relief Program (TARP) preferred stock holdings in hundreds of banks and receives repayments from other banks, many bank senior executives are more willing to consider being acquired, given that the “golden parachute” provisions that were specifically prohibited by all TARP preferred stock issuances are eliminated with the auction sales to private investors or by the repayments by the banks.

[1] Banking Supervision & Regulation, www.federalreserveeducation.org/about-the-fed/structure-and-functions/banking-supervision.

The Dodd-Frank Act

In July 2013, the Dodd-Frank Act will be three years old, yet as of this writing many of the regulations needed to implement the act are not final. Despite an early flurry of activity shortly after its passage, we witnessed a slowdown in Dodd-Frank Act implementation in 2012 by the various regulatory agencies. In fact, nearly two-thirds of the implementing rules for the act have yet to be finalized. However, many experts predict that many of the remaining rules will be developed and proposed in 2013. Banks should prepare now for implementation, as the Dodd-Frank Act is here to stay.

Grant Thornton suggests that banks devote time and resources in 2013 to ensure they are ready for full implementation and avoid the stress and challenges of having to rapidly adapt to the new regulations. Here are some items to consider that may help you survive the Dodd-Frank Act:

- While the industry continues to push for at least some relief from the Volcker rule, it seems likely that there will at least be some restrictions on banks' proprietary trading activities. If applicable to your bank, prepare now by developing contingency plans and alternative strategies to your current proprietary trading activities. These could include exit strategies, personnel adjustments or alternative revenue sources, among others.

- The CFPB is still in its early stages, but has already received a lot of attention with the depth and breadth of its reach. The CFPB has particularly been focused on home mortgage origination, servicing, credit cards and other consumer lending activities, fair lending, and third-party oversight. Banks should stay on top of the activities and pronouncements and think ahead for areas of exposure.

- The CFPB recently issued the Ability-to-Repay and Qualified Mortgage Standards under TILA. TILA prohibits many types of risky mortgage lending practices such as no-doc and interest-only loans, which were prevalent prior to the recent financial crisis.

- In addition, the CFPB also issued broad and comprehensive rules involving mortgage servicing. The rules address topics such as billing statements, interest rate adjustments, error resolution, force-placed insurance, intervention and contact with delinquent borrowers, and loss mitigation. These rules become effective in January 2014.

- The regulators are increasingly scrutinizing banks' stress testing. Focusing on this area now will pay dividends in the future with regulators as well as with shareholders. Engage qualified help or staff and implement a robust testing process to avoid surprises.

- As with stress testing, regulators are paying a lot more attention to banks' risk management processes at the senior management and board of directors level. It seems clear that all banks will have to establish a substantive enterprise risk management process and also provide evidence that it is not only comprehensive, but also effective.

Operations

While banks dealt with credit issues over the past four years and searched for ways to increase profitability and capital, some of them turned to staff cutbacks and other efforts to reduce expenses. Although improving efficiency ratios is important and encouraged by regulators, they have focused their attention on ensuring that these improvements are not made at the expense of internal control or other operating concerns. Here are some areas where management should focus attention:

- Review all third-party vendor contracts to ensure that they are current and are being implemented correctly.
- Implement contingency plans for potential loss of key third-party vendors.
- Ensure that bank management has processes in place for dealing with third-party vendors. Outsourcing an activity does not relieve bank management of its internal controls and fiduciary responsibilities, and these vendors must meet the same standards as if the activities were being performed internally. Particular attention should be paid to higher-risk areas such as credit card and marketing vendors, because significant penalties and settlements have already been made in these areas.
- Conduct thorough reviews of loan origination, modification, servicing and foreclosure activities. The numerous large servicing settlements and the remediation of alleged violations provide roadmaps of where problems have occurred in the past and serve as guides for tightening up your own activities in these areas.
- Evaluate all of your data security issues and begin now to implement changes in processes, hardware, software and risk analyses. Making sure that your data and your customers' data are private and secure is a key to any bank's success.

Conclusion

Banks and their boards of directors must recognize that the current regulatory environment is the new normal and take steps to ensure compliance and improvements. Planning ahead uses a lot less energy and capital than fighting the system and making changes on the fly. With the support of your senior management and board of directors, staying on top of the regulatory environment will allow both your bank and your customers to not only survive, but thrive. •

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