LEGAL UPDATE

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WHY THE FDIC'S REVISED APPEAL GUIDELINES FAIL TO CURE KEY PROCESS DEFICIENCIES

On July 29, 2016, the Federal Deposit Insurance Corporation (FDIC) issued Financial Institution Letter 52-2016 (FIL-52-2016) seeking comment on updates to the FDIC's Guidelines for Appeals of Material Supervisory Determinations (the "Guidelines" and the "Proposed Amendments").[1] The Guidelines govern the intra-agency appeal process by which a financial institution can appeal certain material supervisory determinations contained, by way of example, in a report of examination. Material supervisory determinations that can be appealed through an intra-agency appeal process include CAMELS ratings and apparent violations of law and regulations, as well as many other determinations that are critical to the supervisory process and the prosperity of the institution.

Background

Section 309 of the Riegle Community Development and Regulatory Improvement Act of 1994 (the Riegle Act) requires the federal banking agencies to "establish an independent intra-agency appellate process" in order to "review material supervisory determinations made at insured depository institutions or at insured credit unions that the agency supervises." Section 309 of the Riegle Act defines "material supervisory determinations" to include determinations relating to "(i) examination ratings; (ii) the adequacy of loan loss reserve provisions; and (iii) loan classifications on loans that are significant to an institution." 12 U.S.C. 4806(f).

The Riegle Act defines the term "independent appellate process" as a "review by an agency official who does not directly or indirectly report to the agency official who made the material supervisory determination under review." The statute directs the agencies to ensure that "any appeal of a material supervisory determination…is heard and decided expeditiously." Further, agencies must ensure "appropriate safeguards exist for protecting the appellant from retaliation by agency examiners." Finally, Section 309 of the Riegle Act requires each agency to appoint an ombudsman to:

- act as liaison between the agency and any affected person with respect to any problem such party may have in dealing with the agency resulting from regulatory activities of the agency, and
- assure that safeguards exist to encourage complainants to come forward and preserve confidentiality.

The federal banking agencies interpret the functions of the ombudsman differently and, therefore, the relief obtainable through the ombudsman varies. The Office of the Comptroller of the Currency (OCC) permits the ombudsman to hear and decide appeals. In contrast, the FDIC and the Board of Governors of the Federal Reserve System (FRB) both limit the ombudsman's role and do not allow the ombudsman to engage directly in the appeal process.

Part I: The Intra-Agency Appeal Process As Implemented By the Existing FDIC Guidelines

The FDIC intra-agency appeals process is available to the institutions the FDIC supervises, including "insured State non-member banks, insured branches of foreign banks, and state associations," as well as "to other insured depositary institutions with respect to which the FDIC makes material supervisory determinations."[2]

[1] The Proposed Amendments were subsequently published in the Federal Register on August 4, 2016. *See* Federal Desposit Insurance Corporation, Guidelines for Appeals of Material Supervisory Determinations, 81 Fed. Reg. 51441 (Aug. 4, 2016).

[2] Federal Deposit Insurance Corporation, Intra-Agency Appeal Process: Guidelines for Appeals of Material

The Guidelines establish the Supervision Appeals Review Committee (the "SARC") to review appeals of material supervisory determinations. The SARC is composed of three voting members. The FDIC general counsel is a fourth non-voting member of the committee.

Under the Guidelines, the following determinations constitute material supervisory determinations that can be appealed through the intra-agency appeal process:

a) CAMELS ratings under the Uniform Financial Institutions Ratings System;
b) IT ratings under the Uniform Interagency Rating System for Data Processing Operations;
c) Trust ratings under the Uniform Interagency Trust Rating System;
d) CRA ratings under the revised Uniform Interagency Community Reinvestment Act Assessment Rating System;
e) Consumer compliance ratings under the Uniform Interagency Consumer Compliance Rating System;
f) Registered transfer agent examination ratings;
g) Government securities dealer examination ratings;
h) Municipal securities dealer examination ratings;
i) Determinations relating to the adequacy of loan loss reserve provisions;
j) Classifications of loans and other assets in dispute, the amount of which, individually or in the aggregate, exceeds 10 percent of an institution's total capital;
k) Determinations relating to violations of a statute or regulation that may affect the capital, earnings, or operating flexibility of an institution, or otherwise affect the nature and level of supervisory oversight accorded an institution;
l) Truth in Lending (Regulation Z) restitution;
m) Filings made pursuant to 12 C.F.R. § 303.11(f), for which a request for reconsideration has been granted, other than denials of a change in bank control, change in senior executive officer or board of directors, or denial of an application pursuant to section 19 of the Federal Deposit Insurance Act ("FDI Act"), 12 U.S.C. § 1829 (which are contained in 12 C.F.R. § 308, subparts D, L, and M, respectively), if the filing was originally denied by the Director, Deputy Director, or Associate Director of the Division of Depositor and Consumer Protection ("DCP"), the Division of Risk Management Supervision ("RMS"), or the Office of Complex Financial Institutions ("OCFI"); and
n) any other supervisory determination (unless not eligible for appeal) that may affect the capital, earnings, operating flexibility or capital category for prompt corrective action purposes of an institution, or otherwise affect the nature and level of supervisory oversight accorded an institution.

The Guidelines explicitly exclude from the list of material supervisory determinations the following items:

a) Decisions to appoint a conservator or receiver for an insured depository institution;
b) Decisions to take prompt corrective action pursuant to section 38 of the FDI Act, 12 U.S.C. 1831o;
c) Determinations for which other appeals procedures exist (such as determinations of deposit insurance assessment risk classifications and payment calculations);
d) Decisions to initiate informal enforcement actions (such as memoranda of understanding); and
e) Formal enforcement-related actions and decisions, including determinations and the underlying facts and circumstances that form the basis of a recommended or pending formal enforcement action, and FDIC determinations regarding compliance with an existing formal enforcement action.

As discussed below, the last two of these exceptions are notable because of their impact on an institution's ability to challenge inherently significant material supervisory determinations. These exceptions are among the subjects of the Proposed Amendments.

Part II: Longstanding Failings in the Guidelines, and Representative Case Studies

The Guidelines contain numerous deficiencies that

Supervisory Determinations, 77 Fed. Reg. 17055, 17057 (March 23, 2012).

significantly curtail an institution's access to the intra-agency appeal process. Many of these deficiencies are unique to the FDIC (that is, the OCC and/or the FRB take opposing views on the issue). As discussed more fully in Part III, the Proposed Amendments address some but not all of these issues, and with varying degrees of efficacy. This section explains the failings in the current Guidelines, and highlights their impact on institutions with two case studies.

Issue One: Determinations re: "Recommended or Pending Formal Enforcement Actions" Are Not Appealable.

The Guidelines have historically prohibited financial institutions from appealing "formal enforcement-related actions and decisions…" The Guidelines define that term – "formal enforcement-related actions"- in part to include "determinations and the underlying facts and circumstances that form the basis of a recommended or pending formal enforcement action…"

While neither the term "recommended" nor "pending" is defined, the Guidelines do give some indication of the FDIC's approach by stating that "[a] formal enforcement-related action or decision commences, and therefore becomes unappealable, when the FDIC initiates a formal investigation under 12 U.S.C. § 1820(c) or provides written notice to the bank indicating its intention to pursue available formal enforcement remedies[.]" (Emphasis added.)

The agency's longstanding position has been that it may, merely by indicating an "intent" to pursue a formal enforcement action, terminate an institution's ability to appeal any determination relating to that action, and instead subject the institution to the onerous and expensive formal administrative process available under 12 U.S.C. 1818. This position is indubitably problematic because the concept of an "intent to pursue" is vague and makes it easy for the FDIC to terminate access to the intra-agency appeal on a whim (under the current Guidelines, the agency does not need to pursue the action they claim to "intend," and thus needs no defensible basis for that "intended" action.)

Unsurprisingly, a March 2016 report issued by the FDIC Office of Inspector General (OIG) noted instances where "complaints from the banks languished and ultimately were not addressed or investigated independently. Ratings appeals that included these complaints were not considered because they were voided by the FDIC's filing of formal enforcement actions."[3]

The current Guidelines do not address the scenario under which the FDIC delays its "intended" enforcement action, or abandons its intent to pursue that action. In either case, institutions have been deprived of an avenue to appeal, in contravention of the Riegle Act ("The process shall be available to review material supervisory determinations...").

As discussed in Part III, the proposed Guidelines address this issue in part by establishing a time limit for initiating the intended action, but in the authors' opinion the Proposed Amendments do not go far enough.

Issue Two: Determinations re: Compliance with Existing Enforcement Actions Are Not Appealable.

The Guidelines currently prevent institutions from appealing "determinations regarding compliance with an existing formal enforcement action" on the basis that such determinations constitute "formal enforcement-related actions and decisions."

As discussed in Part III, the proposed Guidelines address this issue by permitting institutions to appeal determinations of compliance. This is a much needed amendment, as there currently exists no clear mechanism whereby an institution can appeal determinations regarding a lingering enforcement action.

Often, cease and desist orders can hang over an institution for years, even well after the institution has complied with the order's requirements. In such circumstances, the FDIC's practice has been to claim that the agency needs to see "sustained" compliance in order to lift the order, or to claim that the bank has failed to meet some vague and subjective standard established by a provision in the order. This approach can needlessly restrict the institution's business activities and bloat compliance costs for years.

It is worth nothing that it has been the OCC's longstanding practice to allow institutions to appeal compliance with an existing formal enforcement

[3] Federal Deposit Insurance Corporation Office of Inspector General, *Report of Inquiry into the FDIC's Supervisory Approach to Refund Anticipation Loans and the Involvement of FDIC Leadership and Personnel*, OIG-16-001, at 4 (Feb. 19, 2016).

action. The OCC's guidelines state flatly that determinations regarding compliance constitute appealable material supervisory determinations.[4] The FRB states generally that "[w]hether an appealed action constitutes a 'material supervisory determination' eligible for the appeals process shall be decided by the person or persons hearing the appeal…"[5] leaving open the possibility for appeal of compliance determinations. This opportunity is essential, for the reasons noted above.

Issue Three: Determinations re: Informal Enforcement Actions Are Not Appealable.

The Guidelines do not currently permit appeal of informal enforcement actions such as memoranda of understanding ("MOUs"). This policy is unique among the banking agencies and is significant because banks often wish to appeal conclusions that form the basis for the proposed or threatened informal enforcement action. It is significant because there exists no other administrative avenue to appeal informal enforcement actions. They are not subject to the statutory notice and hearing procedures which apply to formal enforcement actions initiated under 12 U.S.C. 1818.

As further discussed in Part III, the FDIC has proposed to amend the Guidelines to allow institutions to appeal such actions. This is a much needed amendment.

Case Studies: Examples of the Guidelines in Action.

Bank A

In 2011, Pinchus D. Raice, Head of Pryor Cashman's Financial Institutions Group ("FIG"), represented a state chartered bank supervised by the FDIC (hereinafter referred to as "Bank A") in an intra-agency appeal of certain material supervisory determinations, including CAMELS ratings. In 2009, Bank A had received preliminary examination conclusions from its examiners (with which it disagreed) in an exit meeting, along with a letter stating that a formal enforcement action would be recommended to the FDIC regional director.

After several unsuccessful attempts by Bank A to achieve informal resolution of both issues, the institution found itself in a holding pattern. Because the Report of Examination ("ROE") had not yet been finalized, the examiner's conclusions were only preliminary, and therefore, they were not material supervisory determinations eligible for appeal through the intra-agency process. Because the letter stating a formal enforcement action would be recommended did not constitute a formal notice under 12 U.S.C. 1818, the bank was unable to request an administrative hearing to challenge the potential order.

Four months later, Bank A received its report of examination. As had been indicated by the examiners, Bank A's CAMELS ratings had been downgraded to unsatisfactory. Shortly thereafter, Bank A received a letter from the agency indicating its intent to issue a cease and desist order based on the CAMELS ratings. (A cease and desist order constitutes a formal enforcement action).

Bank A submitted a comprehensive "request for review of a material supervisory determination" to the director of the Division of Supervision and Consumer Protection (pursuant to the guidelines which were operative at the time). The director responded that the assigned ratings are not eligible for review via the intra-agency appeals process under Part D of the Guidelines, and that "written notification of the FDIC's intent to pursue a formal enforcement action terminates a bank's right to appeal the determinations and underlying facts and circumstances that form the basis for the recommended or pending formal enforcement action."

In the six months since its exit meeting where examiners presented the bank with its proposed ratings and the letter indicating their intent to recommend a formal enforcement action, Bank A had been deprived of its ability to appeal the faulty examination conclusions because the FDIC immediately extinguished the bank's right to an expeditious appeal by declaring its intent to recommend a formal enforcement action. The denial of an avenue to appeal these MSDs – and the delay alone – severely prejudiced Bank A. The FDIC's approach fell far short of the intention of the intra-agency appeal process established by the Riegle Act, which was "designed to provide institutions with a procedure by which to voice objections to supervisory determinations for which no other

[4] OCC Bulletin No. 2013-15, Bank Appeals Process (June 7, 2013).

[5] Board of Governors of the Federal Reserve System, *Section 309 of the Riegle Community Development and Regulatory Improvement Act of 1994, Intra-Agency Appeals Process*, Supervision and Regulation Letter SR 95-18 (March 28, 1995).

formal appeals procedures exist."[6] Bank A had been deprived of every avenue of appeal. At no time since its receipt of the ROE was Bank A able to avail itself of the intra-agency appeal process or any other manner of appellate review. Bank A subsequently filed an appeal with the SARC, which responded that the Bank's right to appeal material supervisory determinations had been "cut-off" by an enforcement-related action, and therefore the CAMELs ratings were not appealable.

Fortuitously, however, the FRB's approach with regard to the Bank A holding company was different. Based entirely upon the FDIC's examination findings, the FRB had assigned the Bank A holding company the same CAMELS ratings as those assigned to Bank A.

Mr. Raice recommended to Bank A that its holding company file a request for review of MSDs with the FRB. The holding company's appeal was subsequently filed and the FRB unsurprisingly promptly and properly granted a review and assigned a panel to hear Bank A's case.

Now armed with a contrary view taken by the FDIC's sister agency, Bank A again approached the FDIC seeking a resolution. Faced with the prospect of a hearing in which the FRB would take a position directly contrary to the FDIC's preferred interpretation of the Riegle Act, the FDIC immediately upgraded Bank A's CAMELS ratings.

As evidenced by the case of Bank A, the Guidelines have historically allowed the FDIC to so severely circumscribe the availability of the appeal process mandated by Section 309 of the Riegle Act as to functionally eliminate it. By merely announcing an intent to possibly pursue a formal enforcement action at some undisclosed time in the future, the FDIC has been able to deny institutions' access to the intra-agency appeal process – for years. With the more expeditious intra-agency appellate process unavailable to them, institutions that have been presented with flawed examination findings have been forced to wait (at times, for years) for presentation of a notice of charges before the institution can challenge the formal enforcement action in a trial-like administrative hearing. This approach has been unique to the FDIC and has not been pursued by the FDIC's sister agencies.

[6] Federal Reserve System, Internal Appeals Process, 60 Fed. Reg. 16470, 16472 (March 30, 1995).

Bank B

In June 2016, Mr. Raice challenged the Guidelines again in connection with the intra-agency appeal of another state chartered financial institution (hereinafter referred to as "Bank B").

In Bank B's Report of Examination, the factual and legal support for CAMELS ratings and the agency's conclusions regarding compliance with an existing consent order overlapped in no small measure. The bank decided to appeal the CAMELS ratings and the twenty material supervisory determinations underpinning those ratings to the director of the Division of Risk Management.

Predictably, the FDIC responded to Bank B's appeal by refusing to consider much of the appeal (sixteen of the twenty material supervisory determinations). The FDIC declined to consider the bank's appeal of its CAMELS ratings – and the inaccurate factual determinations and unsupported legal conclusions that formed the basis of those ratings – solely because those matters also related to the FDIC's assessment regarding the Bank's compliance with the consent order. The agency concluded that only determinations not relating to matters addressed by the consent order were appealable.

Bank B subsequently filed an appeal with the SARC, and received a request to appear for an oral hearing.

On June 9, 2016, seven weeks prior to the issuance by the FDIC of FIL-52-2016 proposing to amend the Guidelines, Mr. Raice appeared at the SARC oral hearing on behalf of Bank B and successfully argued that the FDIC should have considered each of the twenty material supervisory determinations in the Bank's appeal, even those challenging facts that served the dual purpose of supporting the bank's CAMELS rating and the FDIC's determinations regarding compliance with the consent order. The bank, after all, was not appealing its level of compliance with the order but rather the CAMELs ratings themselves. The SARC agreed with Mr. Raice, and permitted consideration of all of the Bank's arguments as well as RMS's responses to them.

Part III: Summary of Proposed Amendments to the Guidelines Contemplated By FIL-52-2016

The Proposed Amendments indicate that the FDIC at least partially appreciates the indefensibility of the

existing Guidelines and their longstanding effect on institutions desiring to expeditiously appeal examination conclusions.

However, the proposed Guidelines have significant shortfalls. They still permit the FDIC to foreclose access to the intra-agency appeal process by claiming that a MSD is a "formal enforcement-related decision." That term is still not clearly defined in the Proposed Amendments, and offers a continuing opportunity for the FDIC to claim that a particular MSD is somehow "related" to an enforcement action.

The significant amendments include:

Compliance with Existing Actions:

As previously noted, the Guidelines provide that MSDs subject to appeal do not include determinations regarding compliance with an existing formal enforcement action. The proposed amendment would permit appeals of an institution's level of compliance with an existing formal enforcement action; *provided*, however, that if the FDIC determines that lack of compliance with an existing enforcement action requires additional enforcement action, the proposed new enforcement action would not be appealable. The proposed amendment would mirror the OCC's historic position on this issue.

Commencement of Formal Enforcement Actions:

The Guidelines currently provide that a formal enforcement-related action or decision commences, and therefore becomes unappealable, when the FDIC initiates a formal investigation or provides written notice to the bank of its *intention to pursue* available formal enforcement remedies. The proposed amendments would provide that a formal enforcement-related action or decision commences and becomes unappealable when the FDIC initiates a formal investigation or provides written notice to the bank of a *recommended or proposed* formal enforcement action.

It is doubtful that this phrasing provides a meaningful difference from the existing language. Presumably the FDIC could issue vague written notifications of a "proposed" enforcement action as easily as it could issue a notification of its "intent to pursue" an enforcement action. The proposed Guidelines would benefit from greater procedural clarity on this issue. Something akin to formal notice to the bank should be required.

The Proposed Amendments add a time frame within which either the agency must pursue an enforcement action or the bank's access to the appeal process is revived. The Proposed Amendments would make SARC appeal rights available to an institution where the FDIC has provided that institution with written notice of a recommend or proposed formal enforcement action, but fails to pursue such action within 120 days of the written notice – provided, however, that the FDIC may extend this 120 day period if the FDIC notifies the institution that the relevant division director is seeking formal authority to take an enforcement action. SARC appeal rights would also be made available under the proposed amendments if the FDIC fails to initiate an enforcement action within 120 days of the written notice where the FDIC referred the matter to certain specified agencies. The Proposed Amendments also note that these additional appeal rights may be extended if the FDIC and the institution agree and deem it appropriate in order to reach a mutually agreeable solution.

This change alleviates previously mentioned concerns that the FDIC never actually pursues its intended action. However, the Proposed Amendments would still provide an avenue for the FDIC to delay an institution's access to the intra-agency appeal process for months.

Informal Enforcement Actions:

The proposed Guidelines would permit a bank to appeal the FDIC's decision to initiate an informal enforcement action. As previously noted, this is a welcome change that conforms the FDIC's procedures to those of its sister agencies.

Effect of Enforcement Action on Intra-Agency Appeal:

The proposed amendments provide that a formal enforcement-related action or decision does not affect the appeal of any MSD that is pending under the Guidelines. This is a positive clarification in the Guidelines.

Conclusion

Comments on the proposed guidelines will be accepted until 60 days after its publication in the Federal Register. Publication occurred on August 4, 2016 and comments must be received on or before October 3, 2016. For additional information, visit www.federalregsiter.gov.

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