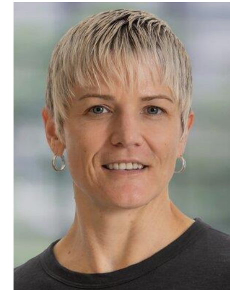
New OCC Bank Policy May Be An Enforcement Warning

By **Jennifer Sutton and Rodgin Cohen** (June 7, 2023)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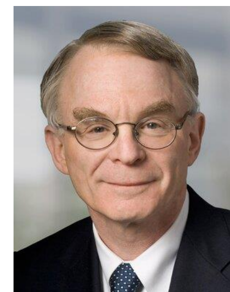
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On May 25, the Office of the Comptroller of the Currency issued a revised version of its policies and procedures manual regarding bank enforcement actions.[1]

The revisions, which are found in a new Appendix C,[2] address the OCC's consideration of supervisory and enforcement actions against banks that exhibit "persistent weaknesses," and appear to further remarks delivered by acting Comptroller Michael Hsu earlier this year regarding what he described as the "too-big-to-manage (TBTM) problem."[3]

Viewed in the context of those remarks, Appendix C appears to deliver a stark warning that the OCC is prepared to use even its most severe tools, including mandated divestitures, to address the "too-big-to-manage problem."

In addition, although the revisions, much like the bank enforcement policies and procedures generally, do not purport to constrain the OCC's discretion in any given case, they may be viewed as providing guideposts for banks of all sizes by articulating a presumption of increasingly severe enforcement measures and a potential time period against which persistence may be gauged.

"Too Big to Manage" Remarks

In Jan. 17 remarks delivered at the Brookings Institution, Hsu described the too-big-to-manage problem as one in which a bank, by virtue of its size and complexity, becomes "so big and complex that control failures, risk management breakdowns, and negative surprises occur too frequently."

In the remarks, he discussed five signs that a bank may be at risk of becoming too big to manage, including:

1. What he termed the "(im)materiality illusion," meaning that a large bank's overreliance on materiality determinations can result in red flags getting missed;

2. What he termed the "isolated incident/bad apple illusion," meaning the default presumption by a larger bank that a problem is isolated and reflective of a bad apple, instead of suggestive of similar problems lurking elsewhere;

3. The consistent identification by supervisors of more risks and problems than the bank's internal risk and control functions;

4. Indifference at senior levels to issues raised by risk managers, auditors and regulators; and

5. Rushed integrations when banks merge, creating "diseconomies of scale."[4]

According to Hsu, the most effective way to fix issues at a too-big-to-manage bank is to simplify by divesting businesses, curtailing operations and reducing complexity, because the core problem is the bank's size and complexity.

He expressed the view that a clear escalation framework is key to both knowing when a bank is too big to manage, and ensuring due process and fairness in making that determination.

Such a framework, according to Hsu, would give banks sufficient opportunities to address deficiencies, with a bank's repeated failure to do so then becoming "presumptive evidence that it is at the limits of its manageability."

He outlined a four-level escalation framework used by the OCC, which he said adheres to due process by affording banks the opportunity to fix their problems before increasingly severe action is taken:

- First, a bank is put on notice of weaknesses, generally with a matter requiring attention.
- Second, if significant weaknesses go unaddressed by the bank, the concern may be escalated into a public enforcement action.
- Third, if the weaknesses continue to persist and "negative surprises continue to occur, ... a restriction on growth, business activities, capital actions, or some combination may be warranted." According to Hsu, in general, the OCC will consider these restrictions when a bank has failed to fully remediate a deficiency in the agreed-upon time frame. Rationales for imposing these restrictions could include repeat offenses, repeated delays in meeting remediation milestones, or similar new violations.
- Fourth, if the restrictions are ineffective and the weaknesses still are not remediated, the OCC will consider "simplification via divestiture — what some refer to as 'breaking up the bank.'"

Before concluding, Hsu stated that the OCC is "considering steps to provide greater transparency and predictability into [this] escalation framework."

Bank Enforcement Policies And Procedures Manual Revisions

Appendix C appears to be the OCC's attempt to provide transparency and predictability with respect to the too-big-to-manage problem. And, indeed, the OCC's press release links to the acting comptroller's January remarks.[5] Appendix C "generally applies to a bank that is subject to [the OCC's] heightened standards" and to "other banks with operations that are highly complex or otherwise present a heightened risk throughout the bank."

Further, "[i]n determining whether a bank's operations are highly complex or otherwise present a heightened risk, the OCC considers the bank's size, risk profile, complexity of products and services, and the scope of operations," and may take into account, among other things, the affiliate structure, whether affiliates engage in nonbank activities and the bank's reliance on third-party service providers.

The OCC also retains discretion to apply the appendix's framework to any bank.

The appendix, although abbreviated, elaborates primarily on the third and fourth levels of the escalation framework outlined in the acting comptroller's remarks.

Third Level of the Escalation Framework

Appendix C includes a nonexhaustive list of circumstances in which a bank may be deemed to have persistent weaknesses that warrant additional supervisory or enforcement action — i.e., the third level of Hsu's escalation framework. Those circumstances are as follows:

- "[C]omposite or management component ratings that are 3 or worse, or three or more weak or insufficient quality of risk management assessments, for more than three years";
- "[M]ultiple enforcement actions ... executed or outstanding during a three-year period"; or
- Failure to "adopt, implement, and adhere to all the corrective actions required by a formal enforcement action in a timely manner."

More generally in Appendix C, the OCC states that it

> has a presumption in favor of additional and increasingly severe action(s) when a bank has continuing, recurring, or increasing deficiencies for a prolonged period, particularly when a bank has not made sufficient progress toward correcting the deficiencies.

Appendix C includes a nonexhaustive list of requirements or restrictions the agency may include in such an escalated action:

- A requirement for the board to oversee the development and implementation of an action plan to promptly resolve the persistent weaknesses;
- Restrictions on growth, business activities or payment of dividends; and

- Requirements that the bank take affirmative action, including making or increasing investments targeted to aspects of its operations or acquiring or holding additional capital or liquidity.

In the appendix, the OCC states that it may also bring enforcement actions against institution-affiliated "parties who caused or contributed to" the persistent weaknesses.

Fourth Level of the Escalation Framework

If a bank fails to correct persistent weaknesses in response to prior enforcement actions or other measures, including those listed above, "the OCC will consider further action to require the bank to remediate the weaknesses" — i.e., the fourth level of the acting comptroller's escalation framework.

The manual notes that "[s]uch action could require the bank to simplify or reduce its operations, including" by reducing its asset size, divesting subsidiaries or business lines, or exiting from one or more markets of operation.

Observations

We offer several observations with respect to Appendix C.

As noted, the appendix, although comprising less than two pages of text, appears to mark the OCC's implementation of its position with respect to the too-big-to-manage problem. It should be viewed as a firm declaration that the OCC is prepared to use its most severe tools, including mandated divestitures, to address banks that, in the OCC's view, have become too big to manage.

Appendix C suggests that the OCC may generally look over a three-year period to determine persistence — i.e., whether third-level escalation is warranted. The specification of this period could provide a guidepost to banks by articulating what may be the outer limits of the OCC's patience in correcting an identified weakness.

In a similar vein, Appendix C suggests a threshold of at least two enforcement actions in effect over a three-year period as prompting third-level escalation.

It is important to note, however, that the bank enforcement policies and procedures manual is internal guidance, and that these three-year periods, like all other aspects of the manual, are not binding on the OCC.

Appendix C does not similarly outline the contours of timely compliance with a formal enforcement action for purposes of any determination of persistent weaknesses. However, it may be reasonable to argue, based on Appendix C, that a bank should have at least three years to demonstrate compliance if the remediation program is complex, such as a substantial upgrade to information technology resources and governance.

With respect to the presumption in favor of additional and increasingly severe actions, the OCC's framing suggests that, although third-level escalation is not a foregone conclusion, a bank with deficiencies that persist for several years may face an uphill battle in avoiding that outcome.

The OCC does not explain what it considers "continuing, recurring, or increasing

deficiencies" or define "prolonged period." As with the meaning of "timely compliance," it may be reasonable to argue in favor of a working definition of three years.

Although seemingly targeted primarily at larger, more complex banks, the OCC states in Appendix C that it may apply the framework, including its restrictions, to any bank. For this reason, all banks should be alert to the potential consequences of persistent weaknesses.

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[1] See OCC, Policies and Procedures Manual, PPM 5310-3, dated May 25, 2023, available at https://www.occ.gov/news-issuances/bulletins/2023/ppm-5310-3.pdf. The Bank Enforcement PPM was last updated in November 2018. For additional information, please see our client memorandum.

[2] Additional, nonsubstantive revisions were made to the Bank Enforcement PPM.

[3] See Acting Comptroller of the Currency Michal J. Hsu, Remarks at Brookings, Detecting, Preventing, and Addressing Too Big to Manage, available at https://www.occ.gov/news-issuances/speeches/2023/pub-speech-2023-7.pdf.

[4] Id.

[5] See OCC, News Release 2023-49, OCC Revises Bank Enforcement Manual to Address Actions Against Banks with Persistent Weaknesses (May 25, 2023), available at https://www.occ.gov/news-issuances/news-releases/2023/nr-occ-2023-49.html (last visited May 26, 2023).