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The Bank Doctor

By Jeff Horwitz, Maria Aspan

EUGENE A. LUDWIG
PROMONTORY FINANCIAL

In 2001, Eugene Ludwig opened a consulting business with little more than a secretary and a thick rolodex of contacts from his days as a top banking regulator. An astute, driven college friend of Bill Clinton's, Ludwig had presided over a momentous five years for banking as comptroller of the currency. Even as he prodded banks to embrace fair lending and modernize their risk management, he championed their push into securities markets and used preemption to pry state regulators off the OCC's turf.

At the heart of his new firm's business model was the prescient premise that as banks diversified into new states and markets they would be concentrating their exposure to Washington's oversight. Navigating regulations—and the aims of the people who made them—would become as vital to modern banking as managing credit risk.

"I think it is insane not to follow those rules with vigor," Ludwig says. "First, more than on balance they're designed to make the system and institutions better and safer. Second, they're the law."

With close to 400 employees and some 1,400 consulting engagements under its belt, Promontory Financial Group has built a shadow network between banks and regulators. The firm is a sort of ex-regulator omnibus, capable of forecasting, mimicking and occasionally even substituting for the financial industry's supervisors.

For those who view regulators and the industry as generally reasonable and well intentioned, that work might be viewed as a blessing. But the expertise and impressive connections that shaped Promontory's success are now threatening its reputation, and potentially its future business.

Promontory's strengths, and its connections, stem directly from Ludwig. Clients and rivals alike profess admiration for his intelligence, good cheer and tireless work ethic, and former colleagues from in and out of government have flocked to work for him. He has set out to build an auxiliary, if not better, private-sector regulator, one that—for a fee—will whip problem banks into better shape.

"Promontory in general and Gene in particular know the banking industry very well. They know the problems that the industry has, they know regulation extremely well, and they've hired a lot of first-class people," says Bob Wilmers, CEO of M&T Bank, which brought in Ludwig to speak to its board in November.

Sandy Weill is another fan. The former Citigroup CEO, who founded an education nonprofit where Ludwig is a board member, was Citi's nonexecutive chairman when the bank hired Promontory to overhaul its Japanese business (although Weill says he was not involved in those discussions).

"If one looks around at who can really be helpful as an outside influence on making this industry better … I think he and his company do that incredibly well," Weill says.

Ludwig is quick to argue that Promontory's influence and its deployment of well-connected staff members extends only in one direction.

"We don't lobby—it's not our business. We do the opposite of influencing government. We try to influence the private sector in terms of what the government wants it to do," he says. (Ludwig did register as a lobbyist for Countrywide after being hired to advise the mortgage giant on its dwindling options in late 2007, though there's no record he performed any advocacy work.)

Indeed, while Promontory could easily bring a client's concern to a high-level regulator's attention, former employees and industry insiders say that any client making such a request doesn't understand the value of the firm. Promontory knows how to please regulators, they say, but it doesn't try to cajole them.

Ludwig says he considers himself a bank doctor, one who specializes

in emergency medicine but prefers providing long-term care.

"In the early days, we analyzed the problem, made recommendations, and then left," he says. "Increasingly we found it's more efficacious to be around to implement the recommendations and then order a back test."

The firm's popularity and prolific work has created a powerful network effect: given the breadth of its client list, it can spot emerging regulatory trends.

"They can say, 'We know you've never been criticized for doing something this way in your last three [Bank Secrecy Act] examinations, but you're going to get criticized for it on the next one,'" says H. Rodgin Cohen, a partner at Sullivan & Cromwell and an occasional recipient of referrals from Ludwig's firm. "Promontory is extremely scrupulous in not divulging what's happening at any other institution, but they've got a wealth of experience."

Promontory's outsized success has raised fears that consultants have usurped roles best played by regulators themselves. Chosen as the foremost consultant in the OCC's aborted independent foreclosure reviews, Promontory was an obvious beneficiary of regulators' disastrous and expensive effort to outsource the solution to the foreclosure debacle.

A particularly quick turn of the revolving door only added to recent criticism that the firm has blurred the line between regulator and consultant. In January, Promontory hired Julie Williams, the former chief counsel at the OCC and a Ludwig protégé; days later, the OCC replaced Williams with Amy Friend, who was a managing director at Promontory after serving as staff director for the Senate Banking Committee.

That "trade" sparked mutters, though it was somewhat unusual: with a few high profile exceptions, former regulators who go to Promontory tend to stay.

Ludwig's hires include former senior officials from the OCC, the Federal Deposit Insurance Corp., the Treasury Department, the Federal Reserve System, the Securities and Exchange Commission, and assorted state agencies and foreign regulatory bodies. It even has half a dozen former staffers from the Consumer Financial Protection Bureau, which is not even three years old yet.

His staff is what has helped Ludwig sell Promontory to troubled banks as a regulator-for-hire, a private-sector proxy that will root out a bank's problems and ready it to face the real thing.

"You can't solve these problems without having people with expertise and experience," Ludwig says.

He resents the mounting suspicions about the flow of people coming and going between government agencies and Promontory's global offices, saying that what happened with Williams and Friend was "a coincidence" and calling charges of a revolving door "quite unfair."

An irony of the Williams-Friend incident is that it came at a time when some in Washington are questioning whether Promontory has lost influence in the wake of post-crisis regulatory shakeups. Agencies including the OCC have new leaders trying to distance themselves from their predecessors' perceived mistakes. Some regulators have privately questioned the efficacy of consultants, and a recent New York Times article contained some anonymous regulator swipes at firms including Promontory.

"They seem to hold themselves out to clients as a far more serious part of the regulatory system than the regulators currently appear to consider them," says Joshua Rosner, managing director of research firm Graham Fisher.

But Promontory is betting that the increasing centrality of regulation will make the firm even more indispensable.

"Saying [Promontory] is a go-between or a translator, I think that understates what they do," says former Soros Fund Management CEO Duncan Hennes, who helped Ludwig establish Promontory and is on its advisory board. Regulators "are overworked for sure, and having a firm like Promontory there to help with a good faith effort can help determine the direction in which the rules are written."

The foreclosure review debacle notwithstanding, Promontory's approach has satisfied many industry customers.

"They had a really good understanding of what the regulators were looking for," says a board member of one foreign-owned bank that hired Promontory about two years ago to help it comply with new executive pay rules. With Promontory's guidance, "on a scale of one to 10, we knew where we were versus our peer banks, we knew what we had to get to and what kind of timeline we had to get there. … They also gave us some very practical ideas of how to respond to the regulators in terms of what we could and couldn't do," says the director, who spoke on the condition of anonymity.

Such intervention serves the broader public interest by producing manageable regulation and spirit-of-the-law compliance, Hennes argues.

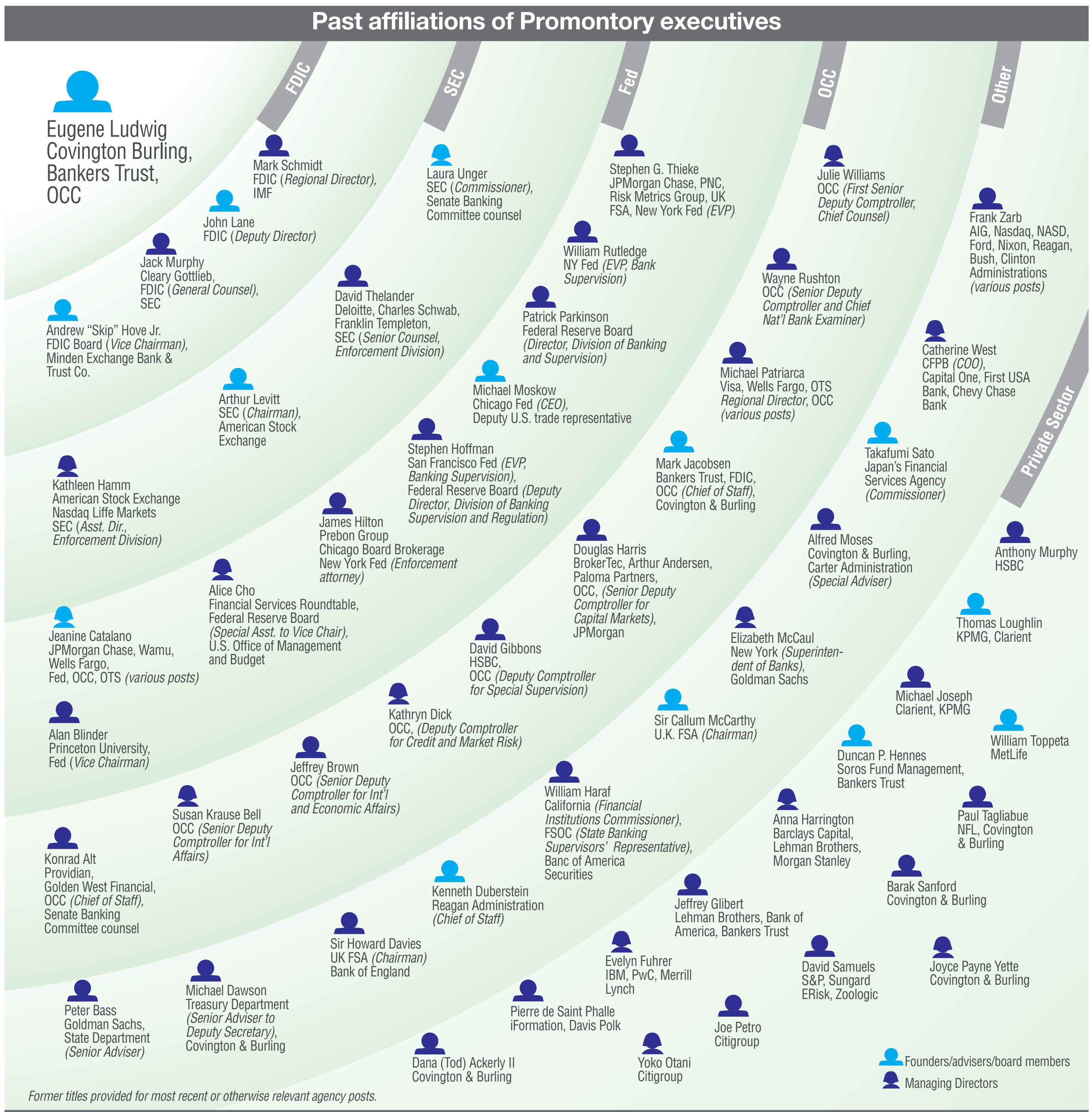
"Best of all for the taxpayer, it's paid for by clients," he says.

When Ludwig founded Promontory, he had been a lawyer for Covington & Burling, a banker for Banker's Trust, and a key player in financial regulation. But he'd never run a business.

The son of a country doctor and a former Broadway actress, Ludwig grew up in York, Pa. He met future President Clinton at Oxford, and they both attended Yale Law School. Clinton selected Ludwig for comptroller in 1993. His role in the administration allowed him to meet several of the people who would become Promontory co-founders, including Alan Blinder, then a member of the president's Council of Economic Advisers and eventually a Fed vice chairman.

"A foundation of the business, then and I believe now, was a kind of arbitrage and interlocution between regulators and banks," says Blinder, a Princeton economist who remains on Promontory's advisory board. "We were working for the banks, we were hired by the banks, but very often with the enthusiastic approval of the regulators. And we spent a lot of time talking to the

PROMINENT PEOPLE



regulators about what it would take to make the banks right."

In its early days, in addition to offering risk management, compliance, business strategy, restructuring and regulatory consulting services, Promontory billed itself as a private equity and venture capital firm. "We explored that extensively, with the conclusion reached, probably reluctantly, that it wasn't going to work because neither Gene nor I had a track record in the private equity business," Blinder recalls.

If Promontory was unfocused at the time of its launch, its self-image was fundamentally shaped by its earliest clients. One evening a few months after Ludwig set up shop, he picked up the phone to a deep Irish accent. The caller asked him to hold while the CEO of Allied Irish Banks came on the line.

It was not—as Ludwig initially suspected, given the time in Ireland—a hoax. Allied Irish's Baltimore-based subsidiary had racked up $750 million in currency losses and exposed a fundamental failure of firm oversight.

"They believed that they had to identify their problem, what fixes were needed,

make it completely public, and do it all within 30 days," Ludwig says. "Otherwise the company would collapse."

Ludwig partnered with Hennes, a former Bankers Trust colleague whom he paid by the hour. With the help of external auditors, they tried to untangle the bank's trading book and governance problems. They wrote up a report documenting the bank's failings, flew to Dublin, and presented it to the board and to the Irish business press.

"It was written like a novel," Hennes recalls. "Gene's goal, and Allied Irish's goal, was for it to be the final word."

The Ludwig Report, as it quickly became known, made a new name for its author and for Promontory. It also led to the sackings of the bank's U.S. subsidiary executives but endorsed the competency of the parent company's top officials, giving them the credibility to move on.

"Once the press read [the report], the stock traded higher than before the fraud was discovered," Ludwig said. "It should have been a formative event for financial institutions."

But even Ludwig admits that radical transparency isn't an easy sell in banking. Helping banks try to prevent regulatory flare-ups—or more often, to contain them—turned out to be steadier work.

With so many agency veterans on staff, the firm has a near-pitch-perfect ability to approximate how regulators will approach a bank's books and proscribe fixes. "Law firms have been doing murder board and mock hearings for clients for decades," says someone who's seen Promontory walk clients through regulatory paces. "Promontory does that on the regulatory side. Gene was the first to come up with that model."

In the earlier part of the last decade, the firm also did a robust business in merger due diligence and regulatory strategy. When PNC Financial Services Group pursued the acquisition of Riggs Bank—then mired in a money-laundering scandal that Promontory was helping Riggs sort out—the firm helped close the sale. When General Motors wanted FDIC approval to sell off GMAC, Ludwig helped convince the FDIC to let it happen.

Resentment of Promontory's omnipresence — and its hefty fees — has mounted at some banks, especially since the foreclosure-review process imploded.

"If the regulators are saying jump on your right foot for 10 miles, we'll tell you 20 miles," one attorney quips of their strategy. "And once you've done it, we'll tell the regulators that you 'get it,' and you will pay us well for repairing your regulatory relationship."

Regulatory and compliance consulting is a crowded field, but Promontory sets itself apart with its staff list.

Some recruits have come from Ludwig's old stomping grounds. At least nine of Promontory's current managing directors previously worked at the OCC, and others came through Bankers Trust. The staff also includes at least five lawyers formerly with Covington & Burling, where Ludwig used to be a partner.

Other hires find their way to Ludwig through his vast network of personal and professional connections. New hire Joe Petro, the former head of security at Citigroup, says he came to Promontory by way of former Citi CEO Chuck Prince, who made an introduction after Petro told Prince about his plan to retire. Two days after a meeting with Petro, Ludwig sent him an offer letter.

Aided by bank examiners' customary retirement age of 55, Promontory has assembled a top-heavy staff. Instead of hiring a few key people to direct large groups of young associates, Ludwig pursued a "reverse pyramid" structure, in which senior leaders operate with relatively small staffs of junior consultants.

"There are a lot of very senior, very experienced people, and not that many at the associate level," says Ann Jaedicke, who briefly worked for Promontory after more than 30 years at the OCC.

There is seemingly no part of the financial regulatory ecosystem the firm does not draw from. (Promontory's employees include two former American Banker editors.)

Many on the staff are lawyers, but the firm mainly offers proscriptive suggestions, not legal advice.

Ludwig has experts "on operational risks, all the compliance issues associated with national banks, dealing with the OCC and the CFPB. He's assembled the right mix of people to be able to go out to these banks and have any conversation associated with risk-taking," says Cliff Rossi, a former risk executive at Citi who is now a teaching fellow at the University of Maryland's Robert H. Smith School of Business, where Ludwig is on the advisory board of a financial policy center.

For retiring regulators, part of Promontory's appeal is the pay. People familiar with the compensation for managing directors there say the pay is in line with or slightly above that offered by D.C. law firms, suggesting that it allows high-level OCC, FDIC and Fed officials to trade up to salaries approaching seven figures.

The pay, and the experience it suggests, translates into premium prices for Promontory's customers. "We were all grey eminences," Blinder says. "Promontory Financial Group is not cheap. They don't compete with the lowest prices."

The chief grey eminence appears to have done particularly well. The firm's financials are private, but CapGen, a private equity fund launched in 2007 by Ludwig and two former financial services executives, has taken stakes worth hundreds of millions of dollars in distressed banks. In one CapGen deal, Ludwig invested as much as $24 million of his own money toward a recapitalization of a single bank, Jacksonville Bancorp, SEC filings show.

Besides money, another of Promontory's allures for former regulators is that they can stick with the kind of work to which they're accustomed. Current and former Promontory staffers say that regulators, perhaps wary of sullying their credibility through advocacy, often don't want to directly join private financial institutions or the law firms and lobbying outfits that represent them. They'd

prefer to carry on with work that is closer to policy implementation or supervision.

Williams, a career OCC attorney, says she interviewed with several law firms after leaving the agency, but found the idea of Promontory more comfortable.

"I really valued the experience I'd had working for Gene when he was comptroller," she says, adding that she also sees Promontory's business model as "helping firms" solve their regulatory problems. "It's a very constructive role, different from a situation with a law firm where potentially the position could be adversarial," Williams says.

As a home for ex-regulators who don't quite want to change their line of work, Promontory has certain limitations on what it can offer clients, according to rivals and industry insiders.

"Promontory is distinguished and troubled by the fact that the bulk of its consultants are former supervisors. I think that creates revolving door concerns, and that creates a lack of fully understanding the business constraints of a company, because people take [more of] a supervisory view of problems," says one consultant who sometimes competes with Promontory.

Ludwig scoffs at this and says the firm has been hiring more from the private sector. Besides Petro, Promontory recently picked up Catherine West, who had a brief tenure with the CFPB but is mainly known for her work as an executive at Capital One, which she is now affiliated with as a board member.

The balance of Promontory's staff has a decidedly public-sector background. Two thirds of the company's U.S. managing directors spent most of their careers at a supervisory agency.

Detractors deride Promontory's hiring as a lavish, industry-funded, semi-retirement plan for former regulators. But more often than not, people affiliated with the firm say, employees are close to matching Ludwig's own 14-hour days.

"It's a great place to work," Jaedicke says. "But being a managing director at Promontory is just not a part-time job."

In the run-up to the financial crisis, Ludwig gave banks a great deal of advice. They would have done well to have listened to more of it.

"Twenty-four to 36 months from now we will probably be in the unpleasant part of the credit cycle," he wrote in an American Banker opinion piece in August 2005, warning that "off balance sheet" structures would not protect banks. (Ludwig remains a frequent contributor to American Banker's BankThink blog.)

Over the next two years, Ludwig warned that mortgage underwriting standards had deteriorated, that low delinquencies were artificial, that Alt-A loans were behaving suspiciously like subprime and that complex risk transference instruments would falter when the downturn arrived.

But even he didn't call just how far the industry had strayed. "Banks have generally been cautious, and the bank supervisory agencies have been appropriately prudent," he wrote in August 2007.

As the crisis deepened, Promontory made some prominent cameos, working Countrywide toward a relatively soft landing (for itself, at least) with Bank of America and advising companies like Morgan Stanley on how to rethink themselves as bank holding companies.

As crisis management yielded to reform efforts, Ludwig penned op-eds on the merits of a unified banking regulator and the need for regulators to focus on the shadow-banking system.

But Promontory wasn't among the packs of financial industry lobbyists that descended on the Hill to argue for and against provisions in the Dodd-Frank Act as the landmark legislation was crafted. The firm's specialty became relevant later: rules, cleanups and compliance.

Regulators "are relying on the industry to fully implement things that haven't been finalized yet," Hennes says. "This is where Promontory excels."

The crisis also changed the stakes of the work. For the next decade at least, Ludwig says, "regulators are not going to allow you to get away with lax behavior."

But the last few years have brought that premise into question, sometimes in situations involving Promontory clients.

In 2008, MF Global lost $142 million on a trader's bad bets in wheat futures. In a consent order the next year, the loss was described by the Commodity Futures Trading Commission as MF Global's fourth serious risk management failure in five years. In addition to paying a $10 million fine, the brokerage agreed to hire Promontory to advise it on "policies and procedures in the risk aspects of the company's business."

But in the period that followed, MF Global continued to head in a perilous direction. When John Corzine became CEO in 2010, a Moody's analyst noted that the firm "had significantly increased its balance sheet leverage," and appeared to have a "structural dependence on interest rates to generate basic profitability."

Promontory saw things differently. In May 2011 the firm issued its second annual CFTC consent order review to MF Global's board, declaring that under Corzine's leadership MF Global had turned itself around. "MF Global senior management has set a 'tone at the top' that supports a best practice enterprise - wide risk management framework and compliance culture that is supported by MF Global's revised compensation framework," Promontory wrote in a report later obtained by the Financial Times through a Freedom of Information Act request. Out of 60 risk management metrics used by Promontory, MF Global's systems were listed as "effective" in every instance.

A Promontory spokeswoman says the firm performed the service it was contracted to do. According to the consent order, Promontory was in charge of reviewing the implementation of controls in the brokerage's commodities operation, which would have been separate from the areas where MF Global ran into trouble six months later, with bad

trades and account irregularities that led to the firm's collapse. The CFTC declined to comment on Promontory's mandate, but the consent order states that Promontory also was to make "any additional recommendations as are deemed necessary … to ensure the effectiveness of MF Global's … risk management, supervision, and/or compliance programs."

At the time of Promontory's review, Corzine's team was deep in the European sovereign debt market, making big, partially hedged bets that were cleared by MF Global's board—not its risk management group. And during the two months Promontory spent evaluating MF Global, the trading firm pushed out its head of risk management, Michael Roseman. According to Roseman's own Congressional testimony, he was sacked after challenging Corzine's personal trading book.

There have been other brushes with controversy, too, more recently regarding sanctions controls. Last year, when New York State's Department of Financial Services accused Standard Chartered of processing more than $250 billion in illicit Iranian financial transactions, the bank issued an aggressive defense: all but $14 million of the transactions had been reviewed and cleared in an internal investigation conducted by Promontory.

The state agency, the Treasury Department and Promontory all declined to comment on the discrepancy. It's possible that the transactions approved by Promontory were allowable under the standards of the Office of Foreign Asset Control—standards which were eventually determined to be weak and subsequently tightened.

However, New York wasn't party to those legal standards—and it had a trove of damning emails, jurisdiction over the bank's record-keeping and the ability to revoke Standard Chartered's banking license. Standard Chartered quickly caved, paying New York a $340 million fine.

"I don't think there's been much change in the federal oversight of sanctions policy—OFAC has been very consistent," Sullivan & Cromwell's Cohen says. "The change occurred when New York state became a more active player through the Department of Financial Services. Maybe someone anticipated it, but I don't know anybody who did."

Julie Williams

If the Standard Chartered affair illustrated the perils that could come from a strategy too focused on helping banks meet Washington regulators' demands, the foreclosure review mess drove home the point. As with lending practices during the housing boom, the root problem was a miscalculation by both Washington and the industry. Despite outsiders' calls for an extensive foreclosure remediation effort, the conclusion in Washington was that banks could manage the problem simply by muddling through it.

"I was disappointed that government didn't rush in and save the homeowners early on and put a floor under them," Ludwig says, arguing that federal intervention was necessary to modify securitized loans. "We could have dramatically diminished the effect of the crisis."

In the absence of such relief, consumer advocates focused their fight on the mechanics of the securitization and foreclosure processes, blindsiding banks and regulators by uncovering robo-signing and other endemic procedural failings. Facing popular rage, the OCC and Fed backpedaled themselves into the idea of facilitating comprehensive, independent reviews of foreclosures.

When banks, at the behest of regulators, turned to the consultants, Promontory was chief among them. Bank of America, Wells Fargo, and PNC picked Promontory to do the work for them, covered the tab for its services and promised to abide by its findings. Promontory developed detailed metrics — including a 14,768-item checklist for Bank of America — and hired more than 1,000 contractors to review individual loan files. "There's never been so thorough and deep a review" of foreclosures, Elizabeth McCaul, the Promontory partner heading the B of A review, told American Banker last fall.

Yet the program failed. Nearly a year and a half into the process, the reviews, which cost banks a whopping $10,000 or more per loan file, had produced no relief payments to borrowers. And the independence of reviews in which banks picked and paid their reviewers was questioned across the board. In early January, regulators called off the program in favor of a settlement. "It just doesn't make sense for these servicers to continue funneling money to consultants that could be better used to help distressed borrowers who have lost their homes," Comptroller Thomas Curry said a month after the OCC halted the reviews.

Promontory and the other consultants involved in the program had received a combined $2 billion in misspent cash.

Promontory maintains that the concept of the reviews had merit and that it did its work well. (A recent Wall Street Journal article claims that Promontory's reviewers uncovered a higher percentage of errors in bank files than did those of rival consultants, though the firm would not confirm that to American Banker.)

But even some people associated with the firm acknowledge that the job should lead to some soul-searching. "Given the experience with

the foreclosure reviews, Gene and the leadership need to decide if they ever want to do a project of that nature again, as opposed to the bank doctor business, which is where we started way back and what the firm earned its reputation on," Blinder says.

Regardless of the fallout from the foreclosure reviews, the firm is by now so well established, and the demands of regulatory compliance so abundant, that many consider the reputational effects to be manageable both for Promontory and its leader.

"Gene is a centered, outstanding individual who really cares about making the banking system safer and more efficient," says Barry Zubrow, a former JPMorgan Chase chief risk officer who has known Ludwig for 20 years and formerly served on Promontory's board of advisers.

Indeed, dozens of interviews make clear that Ludwig is the crux of Promontory's daily workings and success, to an extent that few 66-year-old retired regulators could emulate.

"I think he does it because he feels he's doing good," Hennes says. "I've never run into another person who can be cheerful when faced with challenges at the end of a 14-hour day."

Colleagues and friends see little clear succession planning at Promontory. Blinder acknowledges that while Ludwig is "disinclined to slow down," figuring out who could replace him remains "a serious question" at Promontory's board meetings.

Given the nature of the banking industry, Promontory has plenty of reason to think about planning for the long term.

"I don't think the need for this sort of business model is evaporating or even shrinking," Blinder says. "We have a lot of banks that frequently get themselves into trouble with their regulators, and when that happens, they often don't have the internal expertise to get themselves out expeditiously and with relatively little damage to the company. It's always been Promontory's business model to serve that purpose, and I for one don't think it's a dying industry." ■

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