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Regulatory Developments in Banking

By: Peter G. Weinstock[1]

Stock Buybacks, Going-private Transactions and Other Opportunities

Throughout this client alert I stress the need for margin-of-error capital. Nonetheless, financial institutions with capital to spare (or even borrowing capacity) should consider the opportunities associated with stock buybacks. Bank stock currently is trading at levels that we have not seen in a generation. Shareholders have shown a willingness to accept tender offers at current pricing. Such offers provide an opportunity to monetize shares in privately held companies. Financial institutions may also wish to consider mandatory transactions in order to effect Subchapter S elections or going-private transactions.[2] This environment can provide dramatic opportunities for tax savings (Subchapter S) or accounting, legal and compliance cost savings (going-private transactions at a reasonable capital cost).

Rescuing the Industry's Image

Recently, one of my clients was featured on a hatchet-job news story on television for attending a bankers' convention. The client had accepted $2 million of TARP in order to grow its franchise by making loans.

What I found most upsetting was the interview of the trade association representative. He spoke about how the trade association tried to cancel the convention but was contractually bound to go forward. He also said that bankers need some R&R (the news story interposed clips of bankers golfing). The thrust of the entire story was bankers using bailout money to golf.

I now believe the time has come that bankers need to get aggressive in polishing their image. Financial institutions that have taken TARP need to explain that the government will make money on TARP investments in their bank. All bankers need to engage in a public-relations offensive. I have linked an article that I wrote, which was published in the Friday, May 15, 2009, edition of the *American Banker*, regarding steps bankers should take in "rescuing the industry's image."

Collateral Dependent Loans

The instructions to the call reports ("RAP") require banks to charge off all loans that are deemed to be dependent on

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[2] We have worked with a number of institutions on going-private transactions that did not involve squeezing out shareholders. Even without cash-out transactions, such a transaction can provide cost savings.

the collateral for repayment. In other words, when the cash flow no longer justifies the borrower's ability to repay the loan without the liquidation of the underlying collateral, then the loan must be written off or written down to the amount justified by the cash flow.

Under generally accepted accounting principles ("GAAP"), a business is not required to charge off a loan until there is no longer a reasonable prospect of collecting the loan. Thus, under GAAP, a loan still may be maintained on the books if the source of the repayment of the loan is the underlying collateral. This creates a GAAP/RAP distinction.

In past years, this distinction may not have mattered. Now, however, I have heard that, at least, the FDIC is making this a point of contention in examinations.

Presumably, the reason for the harshness of the call report instructions is the impact of such charge-offs on the allowance for loan loss methodology. Under the Interagency Policy Statement, the methodology for determining the unallocated general reserve must reflect the bank's charge-off history. Accordingly, charging off collateral dependent loans would mandate increases to the general allowance, thereby reducing earnings and effectively reducing capital.

Bankers should be vigilant in making sure the files have a strong discussion of the cash flow related to loans. Bankers should not wait until the examiners ask about a loan before inquiring of borrowers and developing this information. Borrower cash flow information should be scrutinized with the call report instructions in mind. To the extent that other sources of repayment and their related cash flow can be brought to bear, then a write-down may be avoided.

National Interest Rates on Deposits

As I indicated in *The State of Banking 2009*, the FDIC had requested comments on a proposal to set a national rate for banks to pay in the event they become subject to FDIC limitations on brokered deposits and interest rates. The FDIC is concerned that troubled institutions are bidding up interest rates. The FDIC's final rule is intended to address this concern.

As most bankers are now painfully aware, if a bank is less than well capitalized, then it needs a waiver in order to accept brokered deposits. Such an institution, however, also faces limitations on the interest rates it can pay relative to other financial institutions in its market or financial institutions nationally. Under Prompt Corrective Action ("PCA"), a bank's primary regulator can drop a bank's capital category one level if the bank is deemed to be in a "troubled condition." Thus, a "well-capitalized" institution may be redesignated as only "adequately" capitalized.

An adequately capitalized institution that receives a brokered deposit waiver still cannot pay interest rates that are more than 75 basis points above the rates paid on similar deposits in either its normal market area or the national rate. Adequately capitalized institutions that do not receive the waiver may not pay rates that are 75 basis points or higher than the rates paid in their normal market. In other words, such institutions can compete only for nonlocal deposits if the rates paid in the institution's normal market area are competitive with nonlocal rates.

If a financial institution is undercapitalized on a PCA scale (or the institution is adequately capitalized, but is dropped one level on the PCA ladder because it is in a troubled condition), the institution must adhere to the rates in its normal market area and also must adhere to prevailing nonlocal rates for any nonlocal deposits. In other words, the institution may not outbid a nonlocal institution for nonlocal deposits.

Certainly, it will be unsuccessful in doing so because the final rule applies only to less-than-well-capitalized institutions. In contrast, all banks are under pressure to increase their local deposits even if they must pay up to do so.

The final rule defines a national rate as "a simple average of rates paid by all insured depository institutions and branches for which data are available." The FDIC will publish the national rate.[3] Thus, the FDIC will presume that the prevailing rate in a market is a national rate and an adequately capitalized institution that has received a brokered-deposit waiver may not pay a rate of more than 75 basis points above that rate.

The FDIC did leave the door open for the possibility that the prevailing rate in a market is higher than the national rate. The FDIC will evaluate evidence to that effect. The FDIC will also decide whether credit unions in a market compete with other financial institutions, and if so, the FDIC will examine rates paid by such credit unions. The FDIC will also consider whether certain deposit products differ from other products and, accordingly,

[3] It is actually going to be national rates because the FDIC will publish the rate for different types of deposits.

whether different rates should be charged for the different products.

The final rule is effective January 1, 2010. This time period will enable financial institutions that are currently in a troubled condition or are only adequately capitalized or worse to pursue corrective action, including adding capital.

Admittedly, the brokered deposit and interest rate restrictions on less-than-well-capitalized institutions are based on congressional action. Accordingly, to some extent, the FDIC's hands are tied. Nonetheless, the final rule continues a trend of regulatory tightening of funding alternatives.

The impact of the significant disparity in treatment between a "well-capitalized" institution and an "adequately capitalized" institution is so significant that bankers and boards are urged to maintain more capital than what they might otherwise believe is appropriate, to provide them with a margin of error. I would be happy to provide my client alert regarding capital alternatives if it would be helpful.

OTS Restricts Growth

I have heard from a number of financial institutions that the Office of Thrift Supervision ("OTS") is advising federal savings banks, on an informal basis, that if they have concentrations of credit other than in one-to-four-family lending, then they must increase capital or shrink such portfolios.

Specifically, the OTS, in certain regions of the country, is advising federal savings banks that if their concentration in any type of credit equals or exceeds 100 percent of capital, then the federal savings bank cannot add loans in that category. Instead, the financial institution needs to adopt a plan to reduce the concentrations. For these purposes, the OTS is combining owner-occupied and non-owner-occupied commercial real estate lending into one category.

In some areas of the country, the OTS instead is saying that if such a concentration exists, the financial institution needs to assign 125 percent risk weight against those assets. Regardless of which region of the OTS is involved, the effect of such requirements is to dramatically ratchet up how much capital such institutions need.

Trickle-down Stress Testing

A recent *Wall Street Journal* article questioned the condition of the banking industry if the economic criteria used for the U.S. Treasury's stress test of the 19-largest banking firms are applied more broadly. *The Wall Street Journal* discussed the number of bank failures that could occur from application of those tests.

Bankers should anticipate that the examiners will impose some form of stress testing as part of their review of the financial institution. Please consider the information in my client alert *The Saga Continues — More on the State of Banking 2009*, from earlier this year, in this regard. Bankers should take the initiative to apply their own stress testing to their portfolios in order to preclude or at least have an argument to minimize what examiners think would be appropriate stress testing of portfolios.

TARP Re-opening for Smaller Banks

U.S. Treasury Secretary Timothy Geithner has said that the U.S. Treasury will re-open the application window under TARP for financial institutions with assets under $500 million. In addition, he has said that such financial institutions will be able to apply for funds equal to up to 5 percent of their risk-weighted assets. The 5 percent level would apply to financial institutions that have already received funds under TARP.

Financial institutions that have been approved for funding under TARP should consider whether to request the increase up to the 5 percent level. Those who have closed their issuance under TARP should resubmit their application to request the increased level of funding.

Financial institutions that do not have bank holding companies will be able to form the holding company. Thereafter, they will have a window to apply for TARP funds.

Reserve Requirement Changes

The Federal Reserve, on May 20, 2009, said that it will begin paying interest on excess reserves. Specifically, the Federal Reserve is creating excess accounts that may be placed with a Federal Reserve bank in order to obtain interest. The Federal Reserve stated that this change will be temporary, beginning on July 2, with a termination date to be determined.

The Federal Reserve also announced that it is increasing the number of withdrawals that may be made from MMDAs from three to six. Of these six withdrawals, however, only three or fewer may be made by check.

The Federal Reserve, however, made certain changes to the definition of "vault cash" that may not be as favorably received as the incremental changes discussed above. Specifically, the Federal Reserve provided that a financial institution must be able to request cash by 10 a.m. and receive it no later than 4 p.m. the same day at one of its locations at which customers can make cash withdrawals. The change to the definition of vault cash may have the effect of increasing reserves that financial institutions maintain. Financial institutions are not required to maintain reserves against vault cash. Thus, a narrower definition of the term would impose reserve requirements on cash held off premises, for example, cash in ATMs that cannot be recalled as promptly as now will be required.

Congress to the Rescue

According to the April 13, 2009, *Forbes* magazine, Eric Singer, a 56-year-old fund manager, has established the Congressional Effect Fund. The mutual fund invests in Treasury bills when Congress is in session and in the S&P 500 the rest of the time. In the 10 months that the fund has been in existence, it has returned negative 6%, versus negative 44% for the S&P 500.

According to *Forbes*, Singer looked at stock performance in the 44 years ended last December. When Congress was in session, the S&P was up an average annual 0.3%, dividends excluded. When legislators were home, stocks averaged 16.1% in annual returns.