September 2009

Contacts

Peter G. Weinstock
1445 Ross Avenue
Suite 3700
Dallas, Texas 75202-2799
(214) 468-3395
pweinstock@hunton.com

Peter Weinstock is practice group leader of the financial institutions corporate and regulatory section of Hunton & Williams LLP. Mr. Weinstock writes and speaks frequently on topics of interest to community bankers.

The Evolving Landscape for Financial Institutions

This is the fourth client alert that I have written this year dedicated solely to the evolving landscape that banks are confronting. Nowhere is the ground shifting more than in financial institutions' interaction with regulatory authorities. Several of these issues are discussed below.

Commercial Real Estate

The regulators' position with regard to commercial real estate lending ("CRE") has changed dramatically in the past three years. In 2006, the bank regulators issued guidance regarding CRE lending. Specifically, the guidance provided that, in the event a bank's non-owner-occupied CRE loans approached 300 percent of capital or more, then the financial institution had to ratchet up its underwriting, monitoring and other facets of risk mitigation. Nowhere in the guidelines was there a cap on CRE lending. Even still, the reaction of the banking industry to the guidelines was near pandemonium. Bankers were concerned that the guidelines would be a de facto cap. The bank regulators responded to clarify that the guidelines were merely benchmarks and were not limitations.

How the world has changed! The bank regulatory authorities are absolutely looking at non-owner-occupied CRE of 300 percent as a maximum. The Federal Deposit Insurance Corporation ("FDIC"), in particular, seems determined to wipe out the "scourge" that is CRE lending. A financial institution that is materially over this level is virtually assured some administrative action. The other CRE ratio that is getting significant attention during examinations is the acquisition, development and construction ("ADC") loan above 100 percent of capital. We have had financial institutions that file quarterly reports reflecting CRE levels above 300 percent or ADC levels above the 100 percent ratio receive phone calls to advise them of accelerated timing of examinations, between-examination "visitations," information requests and even proposed administrative actions independent of any examination.

Of course CRE and ADC loans by themselves do not indicate violations of law or the existence of unsafe and unsound conditions or practices (the prerequisites for administrative action). Nonetheless, the regulators are drilling down from there to find the support necessary for a corrective action document.

The issues that are often discussed include the following:

- Interest reserves. The regulatory authorities believe that interest reserves mask deterioration and asset quality issues. This is the case even if the customer funded the interest reserve to provide credit enhancement.

- Interest-only credit. The regulators expect all loans, including ADC loans, to be placed on an amortization schedule. Loans to be repaid from home sales by builders are especially susceptible to criticism in light of the current low absorption levels.
- Disbursements. Have loan officers approved disbursements with sufficient evidence that the project was within the approved budget? Additionally, is there independent confirmation that approval conditions have been met?
- Guarantees. Examiners will criticize the lack of personal guarantees as showing "soft" underwriting.
- Collaterally dependent loans. Loans in which cash flow has diminished may become "collaterally dependent," with attendant write-downs required.
- Credit administration. The credit administration function should be centralized with separation of duties. Loan proposals should be independently reviewed prior to submission to the board.
- Reporting. Do loan policies call for a monthly report of the status of troubled CRE and ADC loans by the senior officers? Have these reports been made? Are there workout plans on all significantly criticized assets? Has the board been reviewing these plans?

Appraisals

Appraisals must include the current market value of the property in its actual physical condition and subject to the zoning in effect as of the date of the appraisal. Many bankers do not wish to order current appraisals because they will show deterioration in asset values and no one is paying to run these appraisals. Examiners are coming into financial institutions armed with an analysis of declines in real estate values in the market. Examiners expect that bankers will have ordered test appraisals. Accordingly, examiners are arriving ready to shoot down appraisals that they believe are old (close to a year or more), based on dated or obsolete comparables or otherwise not in compliance with safety and soundness regulations.

To fend off the brunt of this onslaught, bankers should have an enhanced appraisal review function. Bankers must undertake a comprehensive review of their appraisal review function to ensure that appraisals are based on regulatory standards, so that subsequent loss estimations are accurate. Bankers should be fully conversant with the regulations, especially the Financial Institutions Reform, Recovery and Enforcement Act of 1989 (FIRREA) regulations regarding appraisals. For instance, in the last few years, some bankers stopped providing written requests for appraisals with instructions because the letter was a "form." All appraisals on significant property should be pulled and re-examined. Again, test appraisals should be considered. When appraised values no longer justify a "pass" rating, the banker should seek new collateral and guarantees.

Allowance

These asset issues translate into additional provisions to the allowance for loan losses. Bankers have been trying to grow their allowances by equal monthly provisions. Although it may seem like heresy, in the short term it is more important to have an accurate allowance than it is to be profitable. The ramifications of an inadequate allowance translate through almost all of the ratings and will almost certainly translate into an administrative action of some kind. If the allowance is substantially inadequate, then formal administrative action is likely. In contrast, if a financial institution is losing money, then that will result in a lower rating on earnings and, to a lesser extent, on capital and management. Management that is running a bank with an inadequate allowance will be deemed to be unsatisfactory. Management running a bank that is losing money still can be satisfactory. Moreover, bankers who have taken provisions are thought to have recognized their institutions' issues. They are afforded some trust by examiners for doing so. When examiners believe the allowance is inadequate, they feel that they have only addressed the tip of the iceberg and more issues will arise later.

Capital

Of course, what all this leads to is whether the financial institution has sufficient capital. How much capital is enough? Bankers should run their own analysis and put together their own projections. There needs to be enough capital to get them through to the other side of the current economic woes while maintaining acceptable ratios. Please see the client alert titled "With Apologies to Jan Brady: Capital, Capital, Capital," dated March

2009. The regulators have drastically increased the benchmark ratios.

OCC Capital Letters

The Office of the Comptroller of the Currency (the "OCC") has been sending letters to national banks advising them that they must establish minimum capital levels under 12 U.S.C. § 3907(a)(2). Although these letters look like "capital directives," as discussed below they are not. Nonetheless, such a letter can be a precursor to a capital directive.

Title 12 U.S.C. § 3907 provides for a two-step process in establishing individual capital requirements for a bank. Part (a)(2) of 12 U.S.C. § 3907 provides that each federal banking agency has the authority to establish such minimum levels of capital for a banking institution as the agency, in its discretion, deems to be necessary or appropriate in light of the particular circumstances of the banking institution. In addition, part (b)(2) of 12 U.S.C. § 3907 provides that in addition to, or in lieu of, any other action authorized by law, the federal banking agency may issue a directive to a banking institution that fails to maintain capital at or above its required level as established pursuant to 12 U.S.C. § 3907(a).

The OCC's regulations provide that, if the OCC determines that higher minimum capital ratios are necessary or appropriate for a particular bank, the OCC will notify the bank in writing of the proposed minimum capital ratios and will provide an explanation of why the ratios proposed are considered necessary or appropriate for the bank. The bank may then respond to any or all of the items in that notice. After the response period, the OCC will decide whether individual minimum capital ratios should be established for the bank and, if so, the ratios and date the requirements will become effective. The bank will be notified of the decision in writing.

Traditionally, the only time the OCC used the authority in 12 U.S.C. § 3907(a)(2) was in an administrative action with a capital component. Now the agency is using such powers for banks that are not problem banks, but regarding which the OCC believes circumstances dictate need more capital.

A bank that does not have or does not maintain the minimum capital ratios applicable to it under a § 3907(a)(2) letter will be subject to such administrative actions or sanctions as the OCC considers appropriate.

The establishment of minimum capital ratios for an individual bank is different from the issuance of a capital directive. A capital directive is a formal administrative action and it is public. A capital directive also triggers the bank to be deemed to be less than well-capitalized. Thus, a capital directive has significance in terms of Prompt Corrective Action (PCA) sanctions. In addition, failure to heed a capital directive is potentially punishable by civil money penalties. In contrast, the OCC is treating a letter, such as discussed above, as a possible precursor to a capital directive.

In essence, the OCC is using the authority under § 3907(a)(2) as a more formal way to push national banks to meet higher regulatory standards. The OCC has been pushing national banks to have at least an 8 percent leverage ratio and a "fully funded" allowance.

Administrative Actions

The number of banks operating under either formal or informal administrative action has skyrocketed. It seems that the bank regulators are reporting 40 to 50 banks per month entering into formal administrative action. This does not even include the number of institutions that agree to informal actions. Informal actions are generally not reported. The thrust of these documents is the capital provision. Generally, financial institutions will be required to achieve and maintain 8 percent leverage ratios and 12 percent risk-based capital ratios. Recently, there have been administrative actions with 9 percent leverage and 13 percent total risk-based capital ratios. There is room to negotiate these levels and the timing in which the capital ratios must be achieved. Nonetheless, I cannot stress enough the need to be proactive.

Important Ratios

Bankers need to remember these important benchmarks:

1. Texas Ratio = (nonaccruals + OREO)/gross capital funds (i.e., capital and reserves)

If TR > 100% = viability of bank becomes questionable

2. Coverage Ratio = classified assets/(Tier 1 capital + ALL)

If CR > 25–30% = bank is candidate for MOU or other informal action

If CR > 80% = bank is candidate for formal agreement, C&D or other formal action

3. Allowance Coverage Ratio is ALL/classified assets. New minimum ALL is 1.4–1.5% of loans

If ACR < 100%, then potentially a problem bank (industry average at

June 30, 2009, was less than 70% — a 15-year low)

4. If provisions for loan losses are consistently less than charge-offs = potentially problem bank (more than a one-quarter blip)

5. If nonaccruals + OREO > 3% of total assets = administrative action likely. Anything above 1.0% of total assets is an issue to watch, especially depending on trend

6. If nonperforming assets > 5% of total assets = formal administrative action likely

New Withholding Rules

The Obama administration has promulgated new withholding rules for international transactions. I have attached a client alert regarding that topic.

Safe Harbor for Loan Modification Plans

The Obama administration announced its home affordable modification program ("HAMP"). HAMP provides a safe harbor for certain modifications of one-to-four-family mortgages. I have attached a client alert on HAMP.

Visit the Financial Industry Recovery Center at www.huntonfinancialindustryrecovery.com
A Resource for Clients and Colleagues Concerning the Financial Crisis