HUNTON & WILLIAMS

CLIENT ALERT

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Prompt Corrective Action

By: Peter G. Weinstock[1]

I. Introduction

For over a decade, up through 2007, bank failures were few and far between. There were more than enough buyers for even troubled banks. A couple of years ago, I represented a CAMELS-5 rated bank that was sold when the FDIC Division of Resolutions was in the process of putting together bid packages. Even that bank sold for two times book value. Now the environment is different. The market for troubled banks is much more limited. Bailout capital is scarce and regulatory pressure is more extreme. As a result, the number of bank failures in this "crisis" seems to be heading inexorably toward 100. Bankers need to understand what the regulatory ramifications are if the bank begins to experience problems.

The genesis for how the regulators will respond to a troubled bank comes from the FDIC Improvement Act of 1991 (the "Act"). Ironically, the purpose of the Act was to provide the FDIC with the resources to resolve anticipated bank failures. What ultimately emerged from Congress represented a significant increase in congressional micro-management of the banking industry and further expanded regulatory authority over financial institutions. This situation may seem like one of the 'Back to the Future' movies because the efforts of both George Bush and Barack Obama to increase funding have resulted in legislation laden with further restrictions.

II. Capital Standards

Prompt Regulatory Action. The Act included a system for prompt corrective action that still provides today's regulatory handbook. To reduce losses to the FDIC as insurer, Congress mandated prompt corrective action by the regulators when a bank begins to experience difficulty.

1. *Categories of Capitalization*. The Act sets out the following five categories of capital and mandates corrective action for banks in certain of the categories. As discussed below, the bank regulators can drop a bank a level below what would otherwise be warranted by a bank's capital levels alone.

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"Well Capitalized""	"Adequately Capitalized"	"Undercapitalized"	"Significantly Undercapitalized"	"Critically Undercapitalized"
A bank is "well capitalized" if it significantly exceeds the required minimum levels of capital (risk-based and leverage). Practically a 5% leverage ratio and a 10% total capital ratio.	A bank is "adequately capitalized" if it meets the required minimum levels of capital – a 4% leverage ratio and an 8% total risk-based capital ratio.	A bank is "under-capitalized" if it fails to meet *any* required minimum level of capital less than 4% leverage and 8% total risk-based capital ratio.	A bank is "significantly undercapitalized" if it is *significantly* below *any* required minimum level of capital. Less than 3% leverage ratio or less than a 6% total risk-based capital ratio.	A bank is "critically undercapitalized" if it fails to meet the "critical capital" level to be determined by the regulators – a 2% leverage ratio.

2. ***Capital Distributions***. A bank may not make capital distributions, such as dividends, if to do so would render it undercapitalized. Management fees to people or a holding company that controls a bank are considered capital distributions.

3. ***Restrictions***.

"Well Capitalized"	"Adequately Capitalized"	"Undercapitalized"
None. Well-capitalized banks are actually benefited. They may accept brokered deposits and the regulators may examine them less frequently.	None. Adequately capitalized banks are subject to some restrictions. Significantly, although they may accept brokered deposits, they can do so only with an FDIC waiver. Even with a waiver, the bank cannot pay a rate that "significantly" exceeds (75 bps) rates in the normal market area or the national rate on deposits outside such area.[2] FHLB restrictions begin to apply. Risk-based deposit premiums will also increase.	The appropriate regulator must closely monitor the condition of, require a "capital restoration plan" from, limit growth by and limit access to the Federal Reserve's discount window by an undercapitalized bank. The appropriate regulator's approval is required for acquisitions, branching or entering new lines of business.

[2] The FDIC has recently proposed to define such terms.

"Significantly Undercapitalized"	"Critically Undercapitalized"

Executive bonuses or raises without regulatory approval are prohibited.
 	
The regulators *must* prohibit the payment of subordinated debt and *must* require the bank to undertake one or more of the following:
 	
→ sale of securities,*
→ securities to be sold be voting stock,*
→ eliminate the sister bank exemption to Section 23A,*
→ further restrict transactions with affiliates,
→ limit interest rates paid,
→ require the bank to limit or terminate "excessively" risky activities,
→ improve management by:
    → requiring a new board to be elected,
    → dismissing any director or executive officer who has served at least 180 days, or
    → requiring the bank to hire executive officers,
→ prohibit deposits from correspondent banks,
→ require divestitures:
    → by the bank of any subsidiary,
    → by the bank's parent of any nondepository affiliate, or
    → by the bank's parent of the bank itself,
→ require any other actions.
 	
* The Act presumes that these actions are appropriate to take.
	A critically undercapitalized bank must be placed in conservatorship or receivership within 90 days of such a determination unless FDIC and appropriate regulators determine that other action would protect the deposit fund. Redetermination is required every 90 days.
	
	If bank is, on average, critically undercapitalized for 270 days, then a receiver must be appointed unless the bank:
	
	→ has positive net worth,
	→ is in *substantial* compliance with an approved capital restoration plan,
	→ is profitable,
	→ is reducing its ratio of nonperforming loans to total loans, and
	→ the FDIC chairperson and the appropriate regulator certify that the bank is both viable and not expected to fail.
	
	The FDIC must by regulation or order prohibit a critically undercapitalized bank, without approval, from:
	
	→ entering into any material transaction not in the ordinary course of business,
	→ extending credit for any highly leveraged transactions,
	→ amending its Articles or bylaws,
	→ making a material change in its accounting methods,
	→ engaging in a "covered transaction" as defined in Section 23A,
	→ paying "excessive compensations," or
	→ paying interest on deposits in excess of prevailing rates.

These restrictions are cumulative as a bank begins down the prompt corrective action ladder.

4. *Capital Restoration Plan*.

a. *Contents of Capital Restoration Plan*. A capital restoration plan must include:

- the steps the bank will take to become adequately capitalized,
- the level of capital to be attained during each year in which the plan is in effect,
- how the bank will comply with the restrictions or requirements applicable to a bank in that category of capital,
- the types and levels of activities in which the bank will engage, and
- any other information the appropriate regulator may require.

b. *Criteria for Accepting Plan*. The regulator may not accept a capital restoration plan unless the regulator determines that the plan:

- includes the contents discussed above for a plan required by the Act,
- is based upon realistic assumptions and is likely to succeed in restoring the bank's capital, and
- would not appreciably increase the risk, including credit risk, interest rate risk and other types of risk to which the bank is exposed.

c. *Holding Company Guarantee*. If the undercapitalized bank is owned by a holding company, that holding company must guarantee that the bank will comply with the plan until the bank has been adequately capitalized and provide appropriate assurances of performance.

The amount of the "guarantee" is equal to the lesser of 5% of the bank's total assets or the amount needed to achieve recapitalization.

d. *Deadlines for Submission*. A bank will have not more than 45 days after it becomes "undercapitalized" to submit a plan. The appropriate regulator then would have not later than 60 days after the plan is submitted to accept or reject the plan.

5. *More Stringent Treatment*. If a bank is in an unsafe or unsound condition or engages in an unsafe or unsound practice, such as if the bank is subject to an administrative action, the appropriate regulator may:

- reclassify a "well-capitalized" bank as an "adequately capitalized" bank (this generally will happen),
- require an "adequately capitalized" bank to comply with one or more of the provisions applicable to "undercapitalized" banks (other than adoption of a capital restoration plan), or
- require an "undercapitalized" bank to take one or more of the actions authorized for "significantly undercapitalized" banks.

In the current environment, generally the FDIC will not give a waiver of its brokered deposit restriction. Thus, a downgrade of the prompt corrective action category is potentially a disaster.

6. Least-cost Resolution and Too Big to Fail.

a. *Cost Test*. The Act replaced the prior cost test, under which a proposed FDIC action needed just to have been less expensive to the insurance fund than a liquidation, with a new requirement. The Act mandated that the proposed action must be the least costly of the various alternatives.

b. *Uninsured Deposits*. The Act prohibited the FDIC from taking any action, directly or indirectly, that would have had the effect of increasing losses to the insurance fund by protecting depositors for more than the insured portion of their deposits or creditors other than depositors. The FDIC was able to continue to engage in purchase and assumption transactions in which uninsured deposit liabilities are assumed; provided, however, that the insurance fund did not incur any loss with respect to those deposit liabilities in an amount greater than the loss that would have been incurred if the bank had been liquidated. The obvious problem of having uninsured customers subsidize the FDIC's resolution costs resulted in the need to increase coverage to avoid bank runs.

c. *Systemic Risk Exception*. If the board of directors (upon a two-thirds vote) of the FDIC, the board of governors of the Federal Reserve System (also on a two-thirds vote) and the secretary of Treasury (in consultation with the president) determine that the FDIC's compliance with the "least-cost resolution" formula would have a serious adverse effect on economic conditions or financial stability and that financial assistance would mitigate such adverse effects, then the FDIC may take other action as necessary. In such case, however, the FDIC must recover the loss arising from such action expeditiously from one or more emergency special assessments. The FDIC used this authority to provide open-bank assistance that otherwise would not have been permitted as discussed below.

d. *Open-bank Assistance*. The Act provided that open-bank assistance was permissible, but must be limited to circumstances in which it is the least costly alternative (absent a systemic risk) and the management is competent and not engaged in insider abuse. As a result, the FDIC will shop a bank on a closed-bank basis to compare the cost of an open-bank transaction. I was able to shepherd through the FDIC the last open-bank transaction absent the systemic risk exception, but that was over 15 years ago.