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## Regulatory Consequences for Banks Participating in the TARP CPP

*By Zonnie Breckinridge*

On January 3, 2009, John F. Bovenzi, deputy to the chairman of the FDIC, in an appearance before the Committee on Financial Services of the U.S. House of Representatives, stated that the FDIC will measure and assess in examination ratings how banks that have received government assistance have utilized these funds to meet the purposes of the U.S. Department of the Treasury's Capital Purchase Program (CPP), implemented as part of the Emergency Economic Stabilization Act's (EESA) Troubled Asset Relief Program (TARP).

The CPP allows certain financial companies to apply for capital augmentation from the Treasury of up to 3 percent of risk-weighted assets. To date, most of the larger financial institutions and more than 1,600 community banks have applied to participate in the CPP.

Bovenzi noted that the impetus for the CPP by the Treasury was to deflect what the government perceived as an inevitable and substantial reduction in the supply of new credit by banks in response to the financial market turmoil. It had been standard banking practice during previous periods of significant credit distress to conserve capital by curtailing lending. It was believed that lending standards were likely to be tightened

further due to higher funding costs resulting from the overall uncertainty in the financial markets. Thus, the Treasury implemented the CPP as a means of countering the procyclical economic effects of financial sector de-leveraging.

Following the announcement of the CPP, in November 2008, the federal bank regulators issued the *Interagency Statement on Meeting the Needs of Creditworthy Borrowers*, encouraging banks to actively seek ways to make sound loans to household and business borrowers. More recently, on January 12, 2009, the FDIC issued a financial institution letter stating that state nonmember banks that received federal assistance would be required to demonstrate to the bank examiners at their next safety and soundness exams how they used any assistance they had received from the government. Significantly, in his statement to the committee, Bovenzi noted that as part of the FDIC's ongoing supervisory assessments of bank earnings and capital, the agency will be taking into account how available capital is deployed to generate income through "responsible lending." A bank's adherence to the standards set forth in the November interagency statement would be reflected in the FDIC's assignment of CAMELS ratings when the bank is next examined.

The FDIC is in the process of drafting guidance to its bank examiners for evaluating participating banks' compliance with EESA and the CPP investment agreements, as well as the banks' success in implementing the standards set forth in the November 12 interagency statement. Bovenzi noted that this examiner guidance will "focus on banks' use of TARP CPP funds and how their capital subscription was used to promote lending and encourage foreclosure prevention efforts."

While Bovenzi was speaking only for the FDIC, which has supervisory authority over state nonmember banks, the other bank regulators may very well feel pressure to adopt similar proposals.

So, what does this mean for community banks participating in the CPP? Banks will be required to "track" the use of the funds made available through federal programs and provide appropriate information to the regulatory agencies about how these funds were deployed. Moreover, the FDIC has indicated that it will require insured financial institutions to include information about their use of the funds in public reports, such as reports to shareholders and financial statements.

For banks that have significant residential mortgage loans on their books, they will likely be required to demonstrate their efforts to accelerate the pace of loan modifications to halt and reverse any rising foreclosure trends. In the commercial sector, however, it is unclear what practices the agency will expect banks to implement. Not only in the November interagency statement but

in virtually every pronouncement on the subject of bank lending since then, the regulatory agencies have been consistent in their use of terms such as "prudent" and "responsible" lending to "creditworthy" borrowers. Beyond documenting the bank's efforts to find borrowers in their communities that meet the bank's credit standards and can demonstrate a rock-solid source of repayment, it is difficult to imagine what else will be required of these institutions.

One thing CPP participants should consider is following the lead of the large banks like Bank of America and JPMorgan Chase, who have taken out full-page ads touting their lending initiatives, and mount a public relations campaign.

Of course, a careful review by management of the bank's compensation programs and dividend-paying policies and practices should be made by management of every bank receiving TARP funds, to ensure that the limitations set forth in the CPP investment agreements will continue to be met. Beyond that, maintaining sufficient capital and reserves will be essential. Under current regulatory authority, the agencies have significant discretion to impose greater capital requirements than those set forth in the guidelines, as the agencies continue to evaluate capital adequacy more subjectively rather than rely on a mechanical analysis of ratios.

Even those banks not receiving TARP funds should consider some of these measures, as it is likely that bank examiners will use the

same or similar standards for all their supervisory reviews.

While it is always difficult to predict what the regulators will do, some combination of the efforts noted above and an enhanced program for managing credit quality issues at the bank should prepare the bank for the best possible outcome when the examiners come to call.