Bank Safety & Soundness Advisor

Executive intelligence on bank exams, enforcement and risk management.

March 5, 2012

Community Banks Prepared for Regulatory Compliance, FDIC Says

It's 2012 in America. Community banks have a long to-do list. But if there's one item on that list on which banks are, generally speaking, up to speed, it's regulatory compliance. That's according to Jim Watkins, FDIC Deputy Director of Supervisory Examinations, who addressed bank challenges as part of the FDIC's recent Future of Community Banking Conference late last month.

Banks are, not surprisingly, worried about earnings and feeling behind on succession management. But when it comes to regulatory compliance, they're doing alright, he said.

"Some challenges we're hearing about relate to earnings," Watkins said. "A number of examiners say that getting earnings has been a challenge. Retaining staff has also been characterized as a challenge. In regards to meeting regulatory requirements, examiners, initially, have been saying that banks seem well staffed in that regard. There were a few instances where banks needed to increase staff, but most banks are okay with it. They're

See Page 6

Fed, FDIC Examiners Increasingly Targeting Bankers' Base Salaries

True or false: when it comes to salary, regulators are really only focused on the risk-magnifying potential in big-bank incentive plans. For an increasing number of banks, the answer is false. Publicly, regulators talk about new Dodd-Frank-mandated rules on incentive risk for the biggest banks, but in practice, examiners are using safety and soundness criticism and the threat of formal action to micromanage not only the incentive plans, but also the base salaries of bank executives and directors.

"We are seeing increasing scrutiny by the regulators on senior management compensation," says Thomas Bieging, a partner with Bieging, Shapiro & Burrus, LLP, Denver, Colo. "The issue is not just incentive compensation, which has been addressed in Dodd-Frank, but rather base or salary levels. The attitude seems to be that if the bank declined under the existing senior management's watch, then their core compensation should be adjusted

(continued on page 2)

Georgia Court Dismisses FDIC's Simple Negligence Charge

In what has been a long season of bad news, former directors and officers of failed banks finally got some good news last week. A district court judge in Georgia – the epicenter of recent bank failure – found that, indeed, the state's business judgment rule protects directors from claims for simple negligence , a claim the FDIC has included in nearly every suit it brought against former bank directors and officers across the country in the last few years, no matter what individual state law has to say about it. The case helps to establish just how business judgment rule protections apply in cases like this and may limit the scope and severity of claims the FDIC brings against former officers and directors.

The FDIC filed suit against former directors and officers of Integrity Bank, Alpharetta, Ga., seeking to recover over $70 million in losses. In their suit, the agency's lawyers alleged negligence, gross negligence and breach of fiduciary duty. The defendants argued that Georgia's business judgment rule and the former bankers "presumption of good faith" protects them from the FDIC's simple negligence charge. Last week, the judge agreed and dismissed the simple negligence and breach of fiduciary

(continued on page 4)

SUBSCRIBER SERVICES

MISSION:

Bank Safety & Soundness Advisor provides independent, executive intelligence on bank exams, enforcement and risk management.

EDITORIAL:

Need us to investigate a topic? Want to express your opinion? Please call or e-mail us.

Publisher:

Aaron Steinberg
800-929-4824 ext 2471
asteinberg@banksoundness.com

Group Publisher:

Hugh Kennedy
800-929-4824 ext 2213
hkennedy@banksoundness.com

SUBSCRIPTIONS:

Direct questions about subscriptions to:

Phone: 1-877-320-7147;
Fax: 301-287-2945;
or send an **e-mail** to Customer@banksoundness.com.

Published weekly (48 times a year).

EDITORIAL CONCERNS:

Our goal is to provide you with the most accurate and balanced information available anywhere. If you ever feel we're not living up to this standard, I want to know about it. Please call me, Hugh Kennedy, Group Publisher, direct at 1-800-929-4824 ext. 2213.

ADDRESS:

Bank Safety & Soundness Advisor
Two Washingtonian Center
9737 Washingtonian Blvd., Ste. 200
Gaithersburg, MD 20878-7364

Base Salary

(continued from p. 1)

downward or increases severely limited."

"Examiners will continue to pressure bank boards to take action – to reduce or limit core compensation – even when presented with a compensation study from a third party showing compensation levels to be within the median range for the bank's peer group," he adds.

Your managers may have held the bank together during tough economic times. Your board may want to recognize that effort and managerial skill. It doesn't seem to matter, Bieging says, since examiners "attribute little or no value to the fact that senior management kept the bank afloat during turbulent times."

"Regulators threaten to cite the board for unsafe and unsound banking practices if they were to award salary increases or bonuses."

Examiners aren't taking the issue lightly, he adds. Banks that continue to insist on bumping up salary or bonuses will see swift examiner action.

"The intervention is very direct with the regulators threatening to cite the board for unsafe and unsound banking practices if they were to award salary increases or bonuses," he says.

Regulators have claimed that incentive risk is not an exam priority. Last fall, for example, Jack Jennings, the Senior Associate Director for the Division of Banking Supervision and Regulation at the Federal Reserve Board, said that incentive risk was a much larger factor in the overall risk profile of larger firms and regulators will focus their attention there.

"[Incentive risk] was a problem at the largest firms," he said. "Does it apply to the smaller firms? We're still looking for alignment of practice in all firms, but to be honest, compensation at smaller firms is not at the top of our priority list. It wasn't a driver [of risk] at smaller firms like it was in bigger firms."

Now, as it turns out, regulators may be more focused on compensation at smaller banks than they let on.

"Now the focus is not just on incentive compensation, but total compensation," Gerrish says. "We have one client at a bank around $300 million who is making around $600,000. The regulators decided that this was excessive."

It's not an easy case to justify salaries like this to examiners who, as a practical matter, make a lot less than that, Gerrish adds.

"If a bank officer makes $300,000-to-$500,000 and the bank examiner makes $80,000 per year, that's a problem right there."

Some regulators have long treated compensation for senior managers as a safety and soundness issue. FDIC regulation, for example, describes excessive pay as an unsafe and unsound practice, though the agency hasn't really defined what, exactly, excessive pay is and that will give examiners a lot of subjective power in exams, Gerrish adds.

On this score, at least, OCC-regulated banks can consider themselves lucky. OCC examiners have shown little interest in second-guessing board decisions about salary, says Peter Weinstock, a partner with Hunton & Williams LLP, Dallas, Texas. That has not been the case with their colleagues in the FDIC and Federal Reserve, he adds.

"For over twenty years, the OCC has been principles-based [in regards to salary]," he says. "If the board is doing what they're supposed to do, and they're free of self interest, the OCC will tend to defer to the board. They're least interested in micromanaging salary. The Federal Reserve and the FDIC are much more interested in evaluating performance and comparing performance against what the compensation is relative to the rest of the industry."

Typically, however, FDIC and Federal Reserve examiners won't follow up on salary criticisms for the best run banks. But once those banks slip to a CAMEL 2 or lower, all bets are off, Weinstock says. A formal administrative action will likely require a management study and a compensation study within the management study. And examiners will use the studies as justification to push for salary changes.

But examiners will, on occasion, push for salary adjustments even without management studies. "The FDIC regional offices have used the existence of any administrative action, including a safety and soundness MOU, to push for changes in compensation levels and structure of compensation," he says. "The basis for this push is the FDIC's safety and soundness regulations which provide that a financial institution can only pay 'reasonable" compensation.' What is reasonable is a multiple factor test? My experience is that the FDIC will push for a reduction in compensation if the financial institution's overall compensation is above its peer group. This is not just for management, but the board as well."

And when examiners do insert themselves in your bank's salary decisions, it can get granular awfully fast.

"Right now with clients, we're seeing examiners comment on such things as the percentage of compensation increases – whether or not, for example – a raise should be 15% or 25%," says Bieging. "Examiners are really drilling deep. They're usurping the prerogative of the board and it's becoming more problematic."

Compensation risk – and the micromanagement that can come with it – hasn't risen to the top of regulators' list of concerns, but it is on the regulatory radar and is poised to rise quickly, says Gerrish.

"If we're looking at what's coming down the road, as banks start to make money again and executive incentives kick in, this will be a hot button."

(continued on page 4)

Unreasonable Salaries

The FDIC has long linked banker salaries to safety and soundness concerns. Here, from Appendix A to Part 364—Interagency Guidelines Establishing Standards for Safety and Soundness, is how the agency defines excessive compensation:

Excessive compensation is prohibited as an unsafe and unsound practice. Compensation shall be considered excessive when amounts paid are unreasonable or disproportionate to the services performed by an executive officer, employee, director, or principal shareholder, considering the following:

- *The combined value of all cash and non-cash benefits provided to the individual;*
- *The compensation history of the individual and other individuals with comparable expertise at the institution;*
- *The financial condition of the institution;*
- *Comparable compensation practices at comparable institutions, based upon such factors as asset size, geographic location and the complexity of the loan portfolio or other assets;*
- *For post-employment benefits, the projected total cost and benefit to the institution;*
- *Any connection between the individual and any fraudulent act or omission, breach of trust or fiduciary duty, or insider abuse with regard to the institution; and*
- *Any other factors the agencies determine to be relevant.* ■

Base Salary

(continued from p.3)

Ways to prepare

You may think that your bank's executive and director salaries are entirely justified – and/or none of the regulators' business – but your examiner may not be inclined to agree. That's why many banks with an eye on regulatory intervention have committed to proactive strategies. Here's what you can do.

1. Don't just give out salaries and incentives – think about how you'll explain them to regulators.

Once your bank figures out what it wants to do with salaries and incentives, it can help to think through your salary risk and how you plan to explain it to examiners, says Gerrish. "Once you're done [setting salary], say, 'Gee, if things go well here, there are individuals who could make a lot of money – can we justify it?'"

2. Back up your arguments with empirical data.

Your salary data may not sway your examiner, but it may be the best method you have.

"We're seeing banks that aren't in this situation setting up compensation committees and looking for more data to support their conclusions at the board level," Bieging says. "They're looking at various surveys out there to see where they stand, on a regional and national basis. It's an appropriate thing to be doing and it's becoming a more common practice."

For more on regulatory interest in bank compensation, see "Incentive Risk Not an Exam Priority for Smaller Banks, Regulators Say," *BSSA*, November 7, 2011 and "FDIC Litigation Aimed at Incentive Compensation," *BSSA*, May 9, 2011. ■

Negligence

(continued from p.1)

duty claims.

"Despite a long-standing policy of only pursuing gross negligence claims, the FDIC has been pursuing simple negligence claims," says Robert Ambler, an attorney with Womble Carlyle Sandridge & Rice, LLP, Atlanta, Ga., who also represents one of the Integrity Bank defendants. "This is the first court to rule that directors are protected by the business judgment rule and that the FDIC needs to demonstrate gross negligence. The higher standard is a greater burden [to prove] for the FDIC."

Recent FDIC suits against former officers and directors often include three claims: simple negligence, gross negligence and breach of fiduciary duty. Of the three, simple negligence is the broadest, easiest to prove charge. And the FDIC has been including it in suits, despite the fact that the Financial Institutions Reform, Recovery and Enforcement Act of 1989 (FIRREA) established gross negligence, the more serious, more difficult to prove claim, as a national minimum standard for director and officer liability.

A 1997 Supreme Court decision, knows as the Atherton case, found that under FIRREA, the FDIC must prove gross negligence in order to prevail in court unless state law allows for claims of simple negligence. As a result, the first step in these cases is to determine whether state law will allow simple negligence claims against former officers and directors

The FDIC broached the Atherton decision in its 1997 annual report, stating that it would "continue to follow its long-standing practice of bringing claims against outside directors where investigation shows them to have been grossly negligent or worse. However, where applicable state law provides an ordinary care standard, the FDIC still will sue outside directors believed to be guilty of gross negligence but will allege only what is required under the law."

In 2010, FDIC officials confirmed that policy to the *Bank Safety & Soundness Advisor*, saying that "in states that set the standard for directors and officers at simple negligence, we use that standard." (See "FDIC Sues IndyMac Officers, Civil Demand Letters Widespread," *BSSA*, August 2, 2010.)

Having the opening to use that standard is one thing. What state-level business judgment protections have to say about it is another. Previously, only one case, the 1999 decision FDIC v. Castetter, found that under California law, the business judgment rule protects the director defendants from liability for purely negligent acts. Now former directors and officers have another.

Cases like this help to clarify the applicability of state's business judgment rule protections for former officers and directors, particularly at the motion to dismiss stage. The FDIC has argued that state laws lack clarity , which is why this determination – whether or not the Georgia business judgment rules protect directors and officers from simple negligence claims – is a significant development in this early round of FDIC suits, says Mary C. Gill, a partner with Alston & Bird LLP, Atlanta, Ga.

"Generally speaking, one of the initial, most critical issues in FDIC cases against directors and officers is in whether the state law will recognize a negligence claim," Gill says. "This is the first decision in the recent wave of litigation by the FDIC where the district court firmly holds that the business judgment rule does apply and that it protects the directors from claims of simple negligence under Georgia law," she says. "Since state laws are so similar, it will be given weight in other districts. There was one earlier decision [on simple negligence and business judgment rule protections] in California. This is the complement to that."

The FDIC also argued that negligence claims should not be dismissed under business judgment rules, but should rather be a question of fact and developed in court record. The Georgia court rejected that position, too, making it much easier for former directors and officers in subsequent suits to get dismissal of their simple negligence claims. If this case does help to solidify court opinion on business judgment rule protections, former officers and directors will only benefit.

"It's encouraging that a court will rule this way, even if the law is clear."

"This will cause cases to be more streamlined," Gill says. "[The FDIC's options are] narrowed to gross negligence claims. They will be required to show that officers and directors acted with a conscious indifference to the best interests of the bank – which is a much higher burden of proof."

Georgia bankers will certainly benefit from this ruling. Directors and officers in other states may as well – if courts in those states decide to consider the Georgia decision – but it shouldn't have been a surprising decision, says David Baris, a partner with Buckley Sandler, LLP in Washington, D.C. Business judgment rule protections in states like Georgia should pretty clearly protect bankers from simple negligence charges, no matter what the FDIC thinks, he adds.

"I wouldn't say this decision is not significant," he says. "It is significant in that it reiterates what we believe – that this is a gross negligence state. It's encouraging that a court will rule this way, even if the law is clear."

Former directors and officers staring down FDIC suits in other states may be able to count on some spillover benefits from the Georgia ruling. Courts in other states may consider what Georgia had to say about this case before coming to their own conclusions. But in the end, it's a matter of state law, and each state will have to come to its own conclusions, Baris says.

"Ultimately it's a state law question," he says. "The state courts will need to look at their own law."

"This case doesn't seem to break new ground," he adds. "It's pretty much following up on what's been established. You look to state law to determine if there's simple or ordinary negligence standard. If there is, then the FDIC can sue on that basis. If there isn't, they can't."

FDIC also at fault?

The gross negligence ruling is not the only positive development for officers and directors to come out of Georgia. The judge also ruled that former directors and officers are entitled to argue that the FDIC, as receiver, failed to mitigate damages to the bank. If, in fact, officers and directors can insist that the FDIC contributed to their ailing bank's total losses, it could reduce the amount of money the FDIC can get in damages.

"Even with claims for gross negligence and breach of fiduciary duty going forward, the FDIC has to show that the conduct of the defendants caused the losses claimed by the FDIC," says Hal Reichwald, a partner with Manatt, Phelps & Phillips, LLP, Los

(continued on page 6)

Ready for Regs

(continued from p. 1)

focusing on it, they're addressing it and they're staffed for it."

Watkins based his comments on the initial results of a broad bank survey the FDIC is currently conducting. In building a research agenda in parallel with the year-long series of community bank conferences, the FDIC has asked examiners to survey banks at the conclusion of safety and soundness as well as consumer protection exams. The survey, in keeping with the conference theme, deals with challenges unique to the community banking space. So far, the agency has collected survey results from nearly 900 banks. Watkins discussed some of that examiner survey's initial findings at the recent conference.

Here are some more early, if not entirely surprising results from the FDIC survey:

• Community banks are trying to raise capital. "The initial findings indicate that banks have taken steps to try, over the last three years, to raise capital through retained earnings, offerings and other means," Watkins says. "Many of them have been successful."

• They're also interested, but not especially engaged with new technology. "According to examiners, there are just a few tech leaders out there, first-to-market leaders," Watkins says. "But it's clear that community banks are focused on tech. They're looking to enhance areas of tech. And they have a strong awareness of emerging products and activities." ■

Negligence

(continued from p. 5)

Angeles. "If the FDIC's conduct as receiver contributed to the ultimate loss claimed, then perhaps the defendants have the basis for reducing the FDIC's claim."

"Also, the ruling seems to suggest that there could be an opportunity for defendants to argue that FDIC conduct prior to a bank take-over contributed to the loss, for example, by not giving the bank sufficient time to raise additional capital or rejecting offers from third parties to purchase the bank pre-closure," he adds. "The FDIC has been successful in the past in arguing that claimed pre-closure FDIC conduct cannot be used to defend against post-closure enforcement actions. Maybe that is changing. We have to await the court's further rulings."

A development like this could give significant leverage to former directors and officers and change the complexion of FDIC litigation going forward. But the FDIC won't simply sit there and take it, says Gill.

"The FDIC will fight this tooth-and-nail," she says. "It will be a fierce battleground and it will force the FDIC to refigure how cost effective it will be to pursue litigation."

For more on negligence claims against failed bank directors and officers, see "Credit Union Regulator Fails to Circumvent Business Judgment Rule; Case Points to Possible Protections for Failed Bank Directors," *BSSA*, August 22, 2011. ■