HUNTON & WILLIAMS

COMMUNITY BANKING UPDATE

June 2009

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The Saga Continues – More on the State of Banking 2009

By Peter G. Weinstock

The Impact of CAP "Stress Testing" on Banks Under $100 Billion

On February 25, 2009, the United States Department of the Treasury ("Treasury") announced the terms and conditions of the Capital Assistance Program ("CAP"). Under CAP, the federal banking regulators are conducting forward-looking "stress tests" to evaluate the capital needs of banks with assets exceeding $100 billion. These stress tests have led to much discussion about the approach Treasury will take (such as issuing preferred shares that will be converted to common stock at a discount) if the test results are that the institution needs additional capital that is not forthcoming from the private sector.

What has not been discussed is how the bank regulators will evaluate banks with assets of $100 billion or less on a going-forward basis. Stress testing of loan portfolios and liquidity sources that yield positive results will benefit those facing regulatory pressures. For others, however, such testing likely will exacerbate regulatory presumptions of a financial institution's problems.

The CAP stress test considers the following:

- the impact on earnings and capital from economic conditions, including future economic conditions,
- concentrations of credit and asset quality issues,
- declines in asset and collateral values,
- off-balance-sheet and other contingencies,
- the quality of capital,
- other available sources of capital, and
- a catch-all for other risks.

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Examiners are already asking about stress testing, but appear to be leaning toward an even more aggressive approach to classifications and risk assessment. Banks should, therefore, be prepared to respond to overzealous examiners who may be more likely to classify fully performing loans and to draw other unfavorable conclusions solely on the basis of current economic forecasts (see table of economic indicators at right), such as national declines in real estate values and job losses, without considering other factors that may be particularly relevant to the institution in question.

Economic Indicators Used in CAP Stress Tests

	2009	2010
Real GDP[1]		
Average Baseline	-2.0	2.1
Consensus Forecasts	-2.1	2.0
Blue Chip	-1.9	2.1
Survey of Professional Forecasters	-2.0	2.2
Alternative More Adverse		
Civilian Unemployment Rate[2]		
Average Baseline[3]	8.4	8.8
Consensus Forecasts	8.4	9.0
Blue Chip	8.3	8.7
Survey of Professional Forecasters	8.4	8.8
Alternative More Adverse	8.9	10.3
House Prices[4]		
Baseline	-14	-4
Alternative More Adverse	-22	-7

1 Percent change in annual average.

2 Annual average.

3 Baseline forecasts for real GDP and the unemployment rate equal the average of projections released by Consensus Forecasts, Blue Chip and Survey of Professional Forecasters in February.

4 Case-Shiller® 10-city composite, percent change, fourth quarter of the previous year to fourth quarter of the year indicated.

Unintended Consequences of Rate Floors

Most banks have become successful in instituting interest rate floors on floating rate loans. As a result, loan yields are not falling even as deposit costs drop. Consequently, net interest margins are widening. Banks need every dollar of interest income in this environment.

Notwithstanding the current state of economic affairs, we can pretty much count on inflation continuing over the long run. In a rising-rate environment, interest rate floors yield perverse results. These floors are currently 1 – 3 percent above what the stated rates on the loans would yield. Consequently, as rates rise, borrowers will not pay more on loans. Thus, net interest margins will be squeezed.

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Many interest rate shock tests do not reflect this shrinkage in net interest margins. Such tests should be revised to take into account the scenarios in which deposit costs increase while loan yields do not (until rates exceed the loan floors). With the information from these shock tests, bankers may well want to consider some form of adjustable floors that will maintain or minimize the loss of spread. These modified floors should be imposed now when interest rate pressures remain slight. In addition, to maintain these negotiated returns, bankers should consider imposing prepayment penalties. While competition for loans is on the decline, it is a good time for banks to use their leverage in setting credit terms that will ensure a reasonable rate of return for the bank.

Bank Compensation Programs

The political hysteria surrounding the AIG and Merrill Lynch bonuses threatens to engulf all financial institutions whether or not they participated in the TARP Capital Purchase Program. At the recent ICBA convention, Federal Reserve Chairman Ben Bernanke called for examiners to pay “close attention” to compensation practices as part of examinations. He said, “poorly designed compensation policies can create perverse incentives that can ultimately jeopardize the health of the banking organization.”

In light of Mr. Bernanke’s statements, White House assertions that the compensation programs of all financial institutions — not just those receiving TARP funds — should be regulated, and

Congress's inclination to grandstand on this issue, it can be expected that the bank regulators will once again include serious compensation reviews in their examinations.

Since 1991, when Congress adopted the FDIC Improvement Act, bank regulatory agencies were given the authority to regulate bank compensation. In doing so, they measure compensation programs against the following standards:

A. 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:

1. The combined value of all cash and noncash benefits provided to the individual;
2. The compensation history of the individual and other individuals with comparable expertise at the institution;
3. The financial condition of the institution;
4. 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;
5. For post-employment benefits, the projected total cost and benefit to the institution;
6. 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
7. Any other factors the agencies determine to be relevant.

B. Compensation Leading to Material Financial Loss
Compensation that could lead to material financial loss to an institution is prohibited as an unsafe and unsound practice.

In light of this heightened scrutiny of executive compensation, banks should follow many of the "best practices" that have arisen since the adoption of Sarbanes-Oxley and the SEC's changes to compensation disclosure requirements, even if the institution is not subject to these requirements. In addition, banks should consider adopting the practices imposed on recipients of TARP funds to support their compensation programs. These include:

- Adoption of or amendments to policies or the employee handbook to make it clear that the bank expects employees to consider long-term, as well as short-term, risks to the bank in connection with all transactions;
- As part of the policy, preparation of objectives (what behavior is the bank trying to encourage) and how the bank's compensation plan seeks to achieve these objectives;
- Review of all compensation plans to verify that they do not provide incentives to take risks that are not condoned by senior management or the board (the compensation committee should engage in this review annually);
- Certification/documentation by the compensation committee that it has completed such a review;
- Reasonable performance goals that do not require excessive risk-taking to achieve them; and
- A mix of short- and long-term compensation with clawback provisions for long-term payments made that, in retrospect, are not deserved.

Allowance for Loan and Lease Losses

Most financial institutions do not need prompting to review, and perhaps revise, their general reserve methodologies in recognition of the differences in their recent loss experience as compared with that during previous periods. At a minimum, banks should shorten their typical five-year time frame for reviewing their loss history to not more than a three-year horizon. Even three years may be too long of a period to include in the analysis due to the precipitous changes in the economy in the current period. Clearly, more weight should be placed on the results of the last year or other period from which loan losses started to spike.

The Interagency Policy Statement on the Allowance for Loan and Lease Losses states that estimates of loan losses should reflect consideration of all significant factors that affect collectability of the portfolio, including the level and trend of nonperforming assets, delinquencies and charge-offs, imprecision of appraisal accuracy, prospective trends in the economy and the possible effect of such trends on commercial real estate and commercial and industrial loans that have not become classified. Banks should assess each factor to determine whether risk is increasing, remains flat or is declining. Even though the bank's CPA firm has signed off on the bank's reserves and its methodology, this should not make the loan committee complacent. In the current climate, examiners may require higher allowances, notwithstanding a clean audit.

Enhanced Bank Holding Company Oversight and the "Source of Strength" Doctrine

On February 24, 2009, the Federal Reserve promulgated a supervisory letter (SR 09-04) that requires Federal Reserve staff to "evaluate the comprehensiveness and effectiveness of management's capital planning." Principally, the Federal Reserve intends for holding companies to consider how they will serve as a "source of strength" to their financial institution subsidiaries. Although the statutory underpinnings of the Source of Strength Policy Statement are of questionable validity, the Federal Reserve expects holding companies to husband their resources for their banking subsidiaries over the claims of the holding companies' creditors and shareholders.

Holding companies that are developing financial weaknesses or that are at risk of doing so are expected to consult with the Federal Reserve about their condition and plans for addressing any resultant capital needs. Moreover, the Federal Reserve expects a bank holding company to inform the agency reasonably in advance of declaring or paying a dividend that exceeds earnings for the period for which the dividend is being paid or that could result in a material adverse change to the company's capital structure.

Specifically, the Federal Reserve believes that dividends, as well as trust preferred debt service distributions and stock repurchases and redemptions, should be limited or eliminated if:

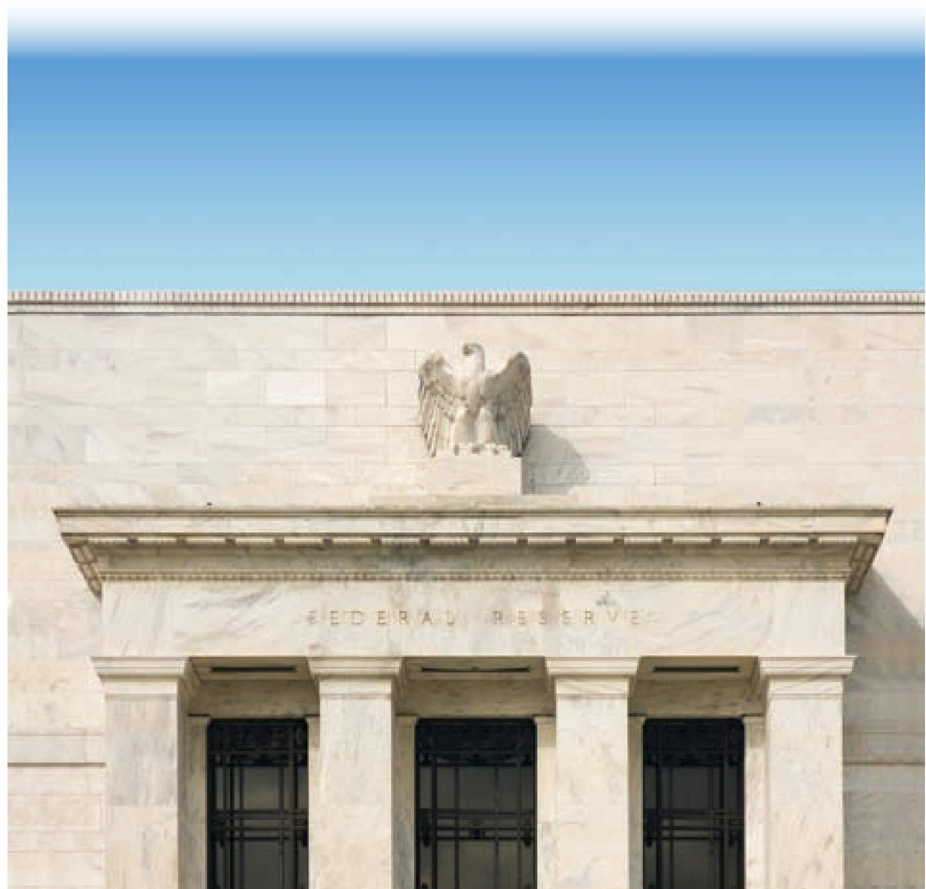
- The company's net income for the past four quarters, net of dividends previously paid during that period, is not sufficient to fully fund the dividends;
- the company's prospective rate of earnings retention is not consistent with its capital needs and overall current and prospective financial condition; or
- the company will not meet, or is in danger of not meeting, its minimum regulatory capital adequacy ratios.

Failure to maintain a capital position that matches the holding company's overall risk could result in a supervisory finding that the organization is operating in an unsafe and unsound manner. The result, at a minimum, will be a suspension of dividends (including dividends on TARP securities) as well as payments on trust preferred securities.

In line with the foregoing, the Federal Reserve is also requiring that it be furnished with copies of the governance documents of any entity (including a trust) that acquires 10 percent or more of the stock of a bank or bank holding companies. The purpose of this requirement is to provide the Federal Reserve with information to enable it to enforce the Source of Strength Policy Statement with respect to any entity that might be deemed to be a bank holding company.

Temporary Liquidity Guarantee Program (TGLP) Cautionary Note

The FDIC has prohibited banks from issuing notes guaranteed under the TLGP if the bank has a less than "satisfactory" rating. For those banks that do issue guaranteed debt, they must record the debt on FDIC*connect* within five calendar days of issuance. The FDIC takes this obligation very seriously and will consider enforcement action for failure to abide by this requirement.



20 Percent TEFRA Disallowance Applied to QSub Bank

By Jeff Blair

The road for the proper federal income tax treatment of banks as S corporations has not always been smooth. An example of a recent bump can be found in the United States Tax Court's decision in *Vainisi v. Commissioner*. In *Vainisi*, the Tax Court reviewed whether the 20 percent reduction in the amount of interest expense incurred by a bank in carrying certain tax-exempt obligations should apply to a bank that is a qualified subchapter S subsidiary ("QSub").

In general, IRC section 291(a)(3) indicates that a financial institution that incurs interest in carrying qualified tax-exempt obligations ("QTEOs") must reduce its tax deduction for that interest expense by 20 percent (the "20 percent TEFRA disallowance"). However, IRC section 1363(b)(4) states that "[t]he taxable income of an S corporation is computed in the same manner as for an individual, except that section 291 shall apply if the S corporation (or any predecessor) was a C corporation for any of the three immediately preceding taxable years."

Prior to *Vainisi*, several S corporation banks that had converted from a C corporation had taken the position that based on the language of IRC section 1363(b)(4), the 20 percent TEFRA disallowance applied to them only for the first three years after becoming an S corporation or a QSub. Thereafter, the QSub was not subject to the TEFRA disallowance.

The petitioners in *Vainisi* were two individuals who owned 100 percent of an S corporation ("First Forest") that held 100 percent of the stock of a QSub that qualified as a financial institution for purposes of IRC section 291 (the "Bank"). For taxable years 2003 and 2004, First Forest's tax returns showed deductions for the

full amount of the interest incurred on various QTEOs held by the Bank. The Internal Revenue Service contested these deductions and issued deficiency notices indicating that the interest expense deductions were subject to the 20 percent TEFRA disallowance.

The IRS argued that the interest deductions were subject to the 20 percent TEFRA disallowance because the QTEOs were held by the QSub Bank and not First Forest, the S corporation parent. This argument was based on the fact that the 20 percent TEFRA disallowance is a special banking rule that is applicable to all banks, regardless of their status as a C corporation, S corporation or QSub. The argument was supported by language in Treasury Regulation section 1.1361-4(a)(3) that indicates that if either an S corporation or a QSub is a bank, any special rules applicable to banks under the Internal Revenue Code continue to apply separately to both the S corporation and the QSub as if the deemed liquidation of the QSub had not occurred. The IRS argued that, based on the Treasury Regulation, the rules of IRC section 1363(b)(4) apply separately to S corporations that were former C corporations and QSubs that were former C corporations. Accordingly, as the language of IRC section 1363(b)(4) mentions only S corporations that were former C corporations and does not mention QSubs that were former C corporations, the position of the IRS was that IRC § 1363(b)(4) should not apply to QSub banks that were former C corporations.

Conversely, the petitioners claimed that under the language of IRC section 1363(b)(4), the 20 percent TEFRA disallowance applies to an S corporation's taxable income computation only if the S corporation was a C corporation for any of the three immediately preceding taxable years. The petitioners also argued that subsequent language in Treasury Regulation section 1.1361-4(a)(3) supported their position by carving out an exception from the language argued by the IRS. The second sentence of Treasury Regulation section 1.1361-4(a)(3) states that "[f]or any QSub that is a bank, however, all assets, liabilities, and items of income, deduction and credit of the QSub, as determined in accordance with the special bank rules, are treated as assets, liabilities, and items of income, deduction, and credit of the S corporation." Because First Forest had been an S corporation for more than three years, and all of the assets, liabilities and items of income, deduction and credit of the QSub Bank were treated as those of First Forest, pursuant to Treasury Regulation section 1.1361-4(a)(3), the interest expense deductions for the QTEOs held by the Bank were not subject to the 20 percent TEFRA disallowance.

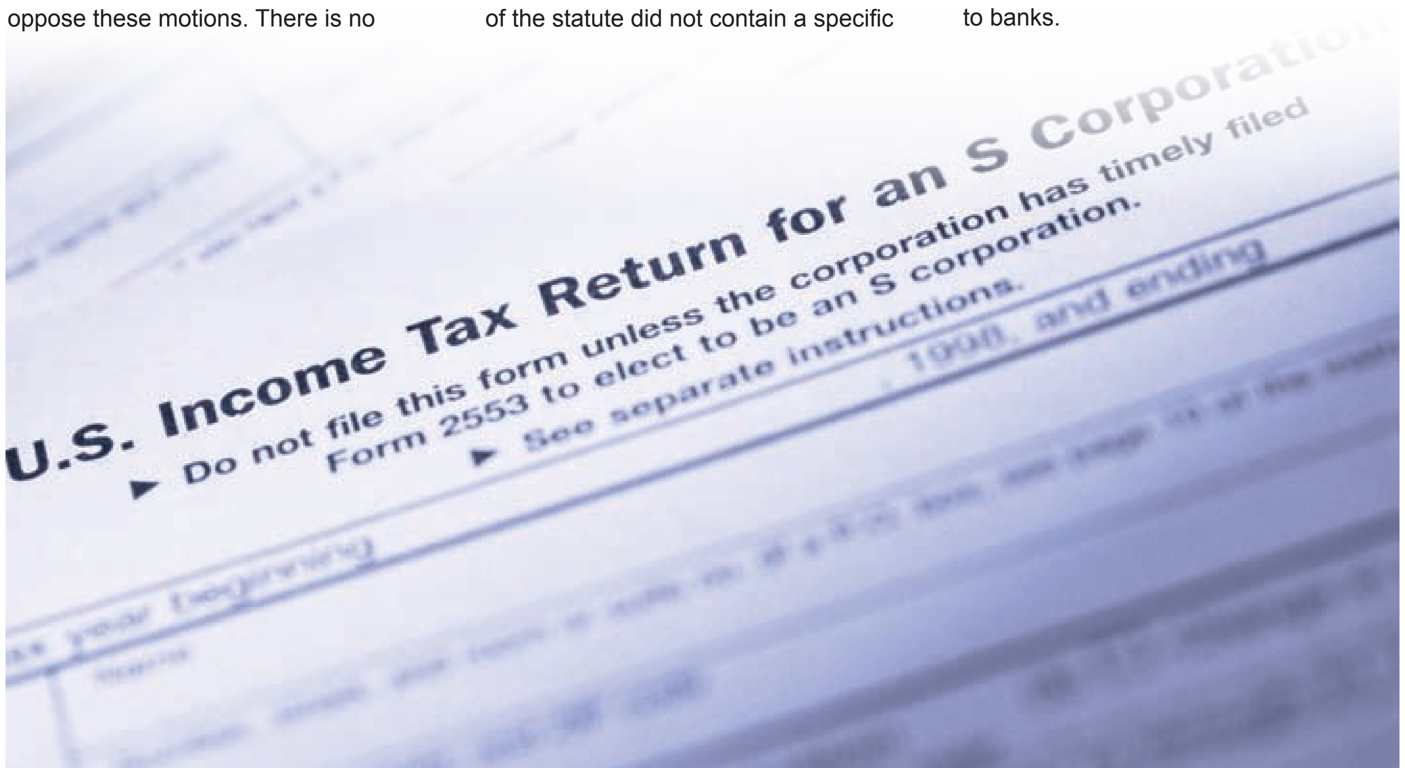
The Tax Court ruled in favor of the IRS and held that IRC section 1363(b)(4) did not apply to the Bank because the express language of IRC section 1363(b)(4) makes reference only to S corporations. Although QSubs did not exist in 1982 when IRC section 1363(b)(4) was enacted, the Tax Court reasoned that Congress could have, but did not, choose to amend that section. Accordingly, the Tax Court ruled that the

The IRS argued that, based on the Treasury Regulation, the rules of IRC section 1363(b)(4) apply separately to S corporations that were former C corporations and QSubs that were former C corporations.

Bank must calculate its own income and deductions subject to any applicable special bank rules, such as the 20 percent TEFRA disallowance, prior to passing through such income and loss to First Forest.

In reaching its decision, the Tax Court did not address whether IRC section 1363(b)(4) would apply to limit the application of the 20 percent TEFRA disallowance to just the first three years following an S election by an S corporation bank. In addition, the decision in *Vainisi* may still be amended. The petitioners in *Vainisi* have filed a motion for reconsideration with the United States Tax Court and a motion requesting that the entire Tax Court hear the case. The IRS will likely oppose these motions. There is no specific time limit in which the Tax Court must consider these motions. Thus, it is unclear how quickly there will be a decision about a rehearing. *Schams v. Commissioner*, a case with facts similar to *Vainisi*, has also been filed in the Tax Court; however, such case has been held in abeyance pending the outcome of the motions in *Vainisi* and any subsequent appeal to the United States Court of Appeals for the Seventh Circuit.

Although *Vainisi* stands for the specific rule that IRC section 1363(b)(4) applies to C corporations only for purposes of the 20 percent TEFRA disallowance, the case could have a broader (and perhaps unintended) impact. Because the case was based on the fact that the language of the statute did not contain a specific reference to QSubs and was thus inapplicable to QSubs, this same line of reasoning could be applied to other provisions of the Internal Revenue Code that specifically reference S corporations but not QSubs. Therefore, rather than representing a smoothing of the pavement, *Vainisi* could create new potholes and a new stretch of bad road ahead for the application of the S corporation rules to banks.



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Community Banking Update

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