Prompt Corrective Action

PETER G. WEINSTOCK

With the number of bank failures growing, bankers need to understand the regulatory ramifications when they begin to experience problems. In this article, the author explains the FDIC Improvement Act of 1991 which forms the basis for regulatory responses when dealing with troubled banks today.

For over a decade, up through 2007, bank failures were few and far between. There were more than enough buyers for even troubled banks. 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 higher. 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 micromanagement 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 as each effort of George Bush and Barack Obama to increase funding for the industry is ladled with further restrictions.

Peter Weinstock is practice group leader of the financial institutions corporate and regulatory section of Hunton & Williams LLP. Mr. Weinstock can be contacted at pweinstock@hunton.com.

Published in the April 2009 issue of The Banking Law Journal.
Copyright ALEXeSOLUTIONS, INC.

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.

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.

"Well Capitalized"	A bank is "well capitalized" if it significantly exceeds the required minimum levels of capital (risk based and leverage) — practically a five percent leverage ratio and a 10 percent total capital ratio.
"Adequately Capitalized"	A bank is "adequately capitalized" if it meets the required minimum levels of capital — a four percent leverage ratio and an eight percent total risk-based capital ratio.
"Undercapitalized"	A bank is "undercapitalized" if it fails to meet *any* required minimum level of capital — less than four percent leverage and eight percent total risk-based capital ratio.
"Significantly Undercapitalized"	A bank is "significantly undercapitalized" if it is *significantly* below *any* required minimum level of capital — less than three percent leverage ratio or less than a six percent total risk-based capital ratio.
"Critically Undercapitalized"	A bank is "critically undercapitalized" if it fails to meet the "critical capital" level to be determined by the regulators — a two percent leverage ratio.

Published in the April 2009 issue of The Banking Law Journal.
Copyright ALEXeSOLUTIONS, INC.

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.

Restrictions

"Well Capitalized"	None. Well-capitalized banks are actually benefited. They may accept brokered deposits and the regulators may examine them less.
"Adequately Capitalized"	None. Adequately capitalized banks are subject to some restrictions. Significantly, although they may accept brokered deposits, they can only do so 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. (The FDIC has recently proposed to define such terms.) FHLB restrictions begin to apply. Risk-based deposit premiums will also increase.
"Undercapitalized"	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 Board's discount window by an undercapitalized bank. The appropriate regulator's approval is required for acquisitions, branching or entering new lines of business.
"Significantly 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:

Published in the April 2009 issue of The Banking Law Journal.
Copyright ALEXeSOLUTIONS, INC.

"Significantly Undercapitalized," cont.	• sale of securities,*
	• securities to be sold must 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
	  – require 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.

"Critically Undercapitalized"	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 the 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,

Published in the April 2009 issue of The Banking Law Journal.
Copyright ALEXeSOLUTIONS, INC.

"Critically Undercapitalized," cont.	• 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 compensation," or • paying interest on deposits in excess of prevailing rates.

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

Capital Restoration Plan

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;

Published in the April 2009 issue of The Banking Law Journal.
Copyright ALEXeSOLUTIONS, INC.

- the types and levels of activities in which the bank will engage; and
- any other information the appropriate regulator may require.

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.

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 five percent of the bank's total assets or the amount needed to achieve recapitalization.

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.

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);

Published in the April 2009 issue of The Banking Law Journal.
Copyright ALEXeSOLUTIONS, INC.

- 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 be very hesitant to give a waiver of its brokered deposit restriction. Thus, a downgrade of the prompt corrective action category is potentially a disaster.

Least-cost Resolution and Too Big to Fail

Cost Test

The Act replaced the prior cost test, under which a proposed FDIC action just needed 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.

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 which 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.

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

Published in the April 2009 issue of The Banking Law Journal.
Copyright ALEXeSOLUTIONS, INC.

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.

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.

Published in the April 2009 issue of The Banking Law Journal.
Copyright ALEXeSOLUTIONS, INC.