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"Shock and Awe": When Banking Agencies Unleash Their Regulatory Weapons

BY V. GERARD COMIZIO AND LAWRENCE D. KAPLAN

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I. Introduction

In the wake of the savings and loan crisis in the 1980s, the U.S. Congress amended the Federal Deposit Insurance Act ("FDIA") to give the federal banking agencies an imposing arsenal of supervisory and enforcement weapons to deal with depository institutions (collectively, "Banks") – and also, notably, their parent companies and their respective affiliates (collectively, "Holding Companies") – that pose potential safety and soundness risks to the FDIC deposit insurance fund. These provisions primarily target supervisory resolution of capital, managerial and operational deficiencies. Foremost among these are the Prompt Corrective Action ("PCA"), Operational and Managerial Standards ("OMS"), Troubled Condition ("TC"), Individual Minimum Capital Directive ("IMCR") rules and the "traditional" enforcement powers (collectively, "Regulatory Intervention Rules"). Together, these rules

provide a formidable and comprehensive system for bank supervision that lay dormant for many years during a prolonged housing finance boom and record profits in the banking industry.

The recent mortgage meltdown, adverse macroeconomic conditions, and increase in troubled banks and bank failures have caused the appropriate federal banking agencies ("AFBAs") to pull these regulatory weapons out of mothballs and aim them at both Banks and their Holding Companies. Given the broad authority under the Regulatory Intervention Rules for the AFBAs to significantly impact the operations and management of Banks and their Holding Companies, it is extremely important to understand the scope of these rules, their consequences and how to mitigate their adverse effect. Failure to a) anticipate and prevent potential actions that may be taken by an AFBA under these rules, and b) adequately address issues presented when subjected to these rules, can result in a downward spiral of supervisory and enforcement actions – ranging from CAMELS exam rating downgrades, memorandums of understanding, supervisory agreements, cease and desist orders and civil money penalties to, in the case of troubled institutions, a potential death spiral ending in government seizure.

II. Section 38 of the FDIA: The PCA Rules – What Are They?

Section 38 of the FDIA establishes a comprehensive PCA framework to address capital deficiencies and supervisory problems of Banks. The PCA system is indexed primarily, but not exclusively, to capital levels as the trigger of regulatory intervention. As such, it is a system of escalating supervisory oversight and scrutiny, operating restrictions, sanctions and penalties based primarily on a Bank's capital levels. It is composed of five (5) major categories: Well Capitalized, Adequately Capitalized, Undercapitalized, Significantly Undercapitalized and Critically Undercapitalized. Of these, the three (3) most significant categories are Well Capitalized, Adequately Capitalized, and Undercapitalized, discussed below. As a Bank's capital condition deteriorates, the AFBAs can increasingly restrict a Bank's operations, culminating with closing down the Bank if necessary.

PCA directives are considered to be a type of enforcement order under the enforcement provisions of Section 8 of the FDIA and failure to comply with a PCA directive can result in cease and desist orders, civil money penalties, bans from the banking industry and judicial enforcement measures.

A. Well Capitalized – Not to Be Confused With "Things Are Fine"

As the name implies, a well-capitalized Bank is one that "significantly exceeds" all of its required capital requirements. Being well capitalized generally puts the Bank outside of the regulatory zone of concern for purposes of the PCA rules. However, it is not by any means a shield from regulatory consequences or action under the Regulatory Intervention Rules, because of two major exceptions: first, under the PCA rules, well-capitalized institutions may actually be reclassified as "adequately capitalized" by an AFBA (see discussion below), based on criteria other than capital, if an AFBA concludes that the Bank is in an unsafe or unsound condition, or is engaged in unsafe or unsound practices and has not corrected the deficiency. The AFBA has to provide written notice of its intent to reclassify a Bank downward. Procedures do exist to permit Banks to contest the need for a reclassification and can require the AFBA to order an informal hearing. Second, a well-capitalized bank can become subject to an IMCR (discussed below) if an AFBA believes a Bank does not have sufficient capital to support its portfolio or operational risk.

B. Adequately Capitalized – Why Are We Here and How Do We Get Out?

Becoming "adequately capitalized," or otherwise being downgraded from well capitalized by an AFBA has two major regulatory consequences in addition to higher FDIC-Insurance premiums:

1) a general prohibition on accepting brokered deposits (subject to waiver), and 2) possible imposition of certain PCA restrictions.

1. *Section 29 of the FDIA – Prohibition of Brokered Deposits*

Section 29 of the FDIA prohibits any Bank that is adequately capitalized from directly or indirectly accepting, renewing or rolling over any brokered deposits, absent applying for and receiving a waiver from the FDIC. On a case-by-case basis, the FDIC may waive the prohibition upon a finding that brokered deposit activities pose no safety and soundness risk to a Bank. Frequently, in granting a waiver, the FDIC will limit the volume of brokered deposits an adequately capitalized Bank may accept. Waivers may be revoked at any time.

From a liquidity and funding perspective, it is important to note that Section 29 captures a wide variety of deposit origination activity that may not, on first glance, appear to be "brokered" deposits in a market sense; thus, for example, Section 29 specifically includes within its scope any employee of a Bank who directly or indirectly engages in the solicitation of deposits from offering interest rates that are significantly higher (e.g., 75 bp) than the prevailing rate in the Bank's normal market area.

2. *Sections 38(d) and (e) of the FDIA – Operating Restrictions*

An AFBA may also require an adequately capitalized institution to comply with one or more of the restrictions in Sections 38(d) and (e) as if the institution were undercapitalized. These restrictions include:

- prohibition on capital distributions;
- prohibition on payments of management fees to controlling parties;
- requirement to submit a capital restoration plan;
- restrictions on asset growth; and
- prior AFBA approval for acquisitions, branching and entering new lines of business – essentially prohibiting growth.

Adequately capitalized status significantly increases supervisory oversight over a Bank and can be the prelude to becoming undercapitalized, absent raising additional capital to become well capitalized again, or engaging in a merger or acquisition transaction.

Supervisory or enforcement action typically is imposed by an AFBA in this situation. However, when an AFBA determines that a Bank has a realistic chance of resolving its capital challenges in a short time frame, an AFBA may forbear for a short period of time from seeking a formal supervisory or enforcement action.

C. *Undercapitalized – For Whom the Bell Tolls?*

Once a Bank has reached the undercapitalized level, it has likely been subject to a cease and desist order and other formal supervisory sanctions, and becomes subject to a broad menu of operating and managerial restrictions:

- capital distributions prohibited;
- payment of management fees to controlling person prohibited;
- a capital restoration plan required within 45 days of becoming undercapitalized;
- asset growth prohibited or restricted, or require Bank to shrink;
- prior approval by an AFBA required for acquisitions, branching and new lines of business;
- AFBA may require sale of securities, or, if grounds for conservatorship or receivership exists, direct the Bank to merge or be acquired;
- restrict affiliate transactions;
- restrict or prohibit activities of the Bank or its subsidiaries determined to pose excessive risk to institution;

- require institution to elect new directors, dismiss directors or senior executive officer or employ qualified senior executive officers to improve management;
- prohibit acceptance of deposits from correspondent banks;
- require prior approval of capital distributions by Holding Companies;
- require Holding Company to divest the Bank, the Bank to divest subsidiaries, and/or the Holding Company to divest other affiliates;
- require Bank to take any other action an AFBA determines will "better achieve" PCA objectives;
- prohibit material transactions outside the usual course of business;
- prohibit amending the institution's bylaws/charter;
- prohibit any material changes in accounting methods;
- prohibit golden parachute, change in control or excessive compensation or bonuses prohibited.

III. Section 39 of the FDIA: OMS Rules

Section 39 requires all AFBAs to establish safety and soundness standards. Section 39 of the FDIA supplements the capital-based PCA system with a complementary scheme designed to address non-capital safety and soundness-related managerial and operational standards. Pursuant to Section 39, the AFBAs have adopted the Interagency Guidelines Establishing Standards for Safety and Soundness. The Interagency Statement primarily addresses prescribed 1) operational managerial standards and 2) prohibitions on compensation that constitute an unsafe and unsound practice. A Bank will be subject to an enforcement action under Section 8 of the FDIA if, after being notified that it is in violation of one or more safety and soundness standards under Section 39, the Bank fails to submit an acceptable Safety and Soundness Compliance Plan ("**SSCP**") or fails in any material respect to implement an accepted SSCP. Section 39 does not in any manner limit the authority of an AFBA under any other provision of law to take any other supervisory or enforcement action to address unsafe or unsound practices, violations of law, unsafe or unsound conditions or other practices.

The rules specify the required content of SSCPs. Upon receipt of a SSCP, the AFBA generally will provide written notice within 30 days of whether the plan has been approved or seek additional information regarding the plan. Failure to comply with an accepted plan will likely result in formal enforcement action.

IV. Section 32 of the FDIA: TC Rules – Understanding the Consequences of Being in "Troubled Condition"

Pursuant to Section 32 of the FDIA, the TC rules provide that a Bank must notify its AFBA at least 30 days before adding or replacing any member of its board of directors, employing any person as a senior executive officer, or changing the responsibilities of any senior executive officer so that the person would assume a different senior executive position if at least one of the following circumstances applies:

- a Bank does not comply with its minimum capital requirements;
- a Bank is in "troubled condition";
- the AFBA has notified a Bank, in connection with its review of a capital restoration plan required under Section 38 of the FDIA, that a notice is required; or
- a Bank is a Holding Company and is in "troubled condition."

The term "troubled condition" means:

(1) 4 or 5 composite CAMELS rating;

(2) a Holding Company designated by an AFBA to either a) have an unsatisfactory CAMELS rating or b) notified in writing by the AFBA

that it has an "adverse effect" on its Bank subsidiary;

(3) the Bank or Holding Company is subject to any formal supervisory or enforcement action or PCA relating either to safety and soundness and financial viability, unless otherwise notified by the AFBA; or

(4) the Bank or Holding Company is otherwise informed in writing that it is in troubled condition.

The AFBA will waive the prior notice requirement and permit an individual to serve as a director or senior executive officer before filing a notice if the AFBA issues a written finding that:

- delay would threaten the safety or soundness of the Bank;
- delay would not be in the public interest; or
- other extraordinary circumstances exist that justify waiver of prior notice.

The TC rules essentially subject all senior officer and directors' changes to prior regulatory approval, and will include scrutiny of proposed compensation arrangements for such individuals. A troubled condition designation also generally results in significant supervisory and/or enforcement action under current AFBA policies.

V. IMCR Rules

Under the IMCR rules, minimum capital levels higher than those generally required under the general capital rules may be required by an AFBA. An IMCR may be established upon a determination that the Bank's capital is or may become inadequate in view of its "circumstances," which can include:

- a Bank receiving special supervisory attention;
- a Bank that has or is expected to have losses resulting in capital inadequacy;
- a Bank that has a high degree of exposure to credit, prepayment, interest rate, credit concentration, non-traditional activities or similar risks;
- poor liquidity or cash flow;
- high proportion of off-balance sheet risks;
- excessive growth presenting supervisory problems;
- inadequate underwriting policies, standards or procedures for loans or investments;
- may be adversely affected by the activities or condition of its Holding Company, affiliates, subsidiaries or other persons or entities with whom it has significant business relationships, including credit concentration;
- portfolio with weak credit quality or a significant likelihood of financial loss, or loans in nonperforming status or in which borrowers fail to comply with prepayment terms;
- record of operational losses above peer averages, management deficiencies or poor record of supervisory compliance.

The IMCR rules specify that an appropriate IMCR cannot be determined solely through the application of "a rigid mathematical formula or wholly objective criteria." The IMCR rules state that the decision in great part will necessarily be "based on the subjective judgment grounded in the agency expertise" of the AFBA.

The AFBA must notify a Bank in writing of a proposed IMCR, schedule for compliance with the new requirement and the specific cause for determining that an IMCR is necessary. A Bank must respond within 30 days, the time period for response may be shortened by an AFBA for good cause. In such scenarios, a Bank may offer any "information on whether an IMCR is required, what the IMCR should be and schedule for compliance." Based on a review of the Bank's response, the AFBA will issue a written decision on the IMCR. Upon receipt of the decision by the Bank, it becomes binding and represents final agency action.

VI. The "Traditional" Enforcement Action

One must not forget the "traditional" enforcement powers granted the AFBA under Section 8 of the Federal Deposit Insurance Act. Whenever a Bank is in an unsafe or unsound condition, or is engaging or about to engage in an unsafe or unsound condition, an AFBA may initiate cease and desist proceedings against the Bank or individuals or entities affiliated with the Bank. Such proceedings may be preceded by an informal enforcement action such as a memorandum of understanding or supervisory agreement. Under certain conditions, an AFBA may seek to remove individuals from participating in the affairs of the Bank and of any other insured depository institution, and may seek to impose civil money penalties against both the Bank and the individuals participating in its affairs. Far more common than PCA directives, these enforcement powers are frequently used by the regulators to effect changes in a Bank or Holding Company where an AFBA has concerns.

Important to remember is that, while there are various procedural safeguards built into the traditional enforcement powers (e.g., notice, opportunity for a hearing before an administrative law judge, right to appeal), these proceedings, in practice, highly favor the regulators. Virtually all enforcement actions are resolved by consent between the AFBA and the Bank or individual; it is the rare case that goes through the administrative hearing process, and rarer still is the Bank or individual that ultimately prevails.

VII. Facing Waterloo

While an AFBA has significant weapons to address problem Banks, ultimately the AFBAs are under a statutory obligation to resolve troubled Banks in a manner that avoids or minimizes losses to the Deposit Insurance Fund. To meet such goal each AFBA possesses an ultimate weapon – the authority to appoint the FDIC as receiver or conservator over the affairs of a problem Bank. Such action can only occur if a Bank triggers one of the statutory grounds for the appointment of a receiver and grounds exist based on capital, unsafe or unsound practices or management failures. At this point, all shareholder interests are eliminated, the Bank's board of directors and management are typically replaced, and the Bank is either sold, in whole or in part, through a FDIC bidding process or liquidated.

To fully understand the challenges facing a problem Bank, it is important for boards of directors and Bank management to understand when regulators are authorized to seize a problem Bank. Grounds for receivership based upon a Bank's capital include situations when a Bank[s]:

- assets are less than its obligations to its creditors (commonly known as capital insolvency);
- is likely unable to pay its obligations or meet its depositors' demands in the normal course of business (commonly known as liquidity insolvency);
- is critically undercapitalized;
- has incurred, or is likely to incur, losses that will deplete all or substantially all of its capital, and there is no reasonable prospect for the Bank to become adequately capitalized without federal assistance;
- is undercapitalized and (1) has no reasonable prospect of becoming adequately capitalized, (2) fails to become adequately capitalized when required to do so, (3) fails to submit a capital restoration plan acceptable to its AFBA within time frames prescribed or (4) materially fails to implement its capital restoration plan; and
- otherwise has insufficient capital.
- Moreover, grounds for receivership exist based upon violations of law or unsound practices, such as:
- a substantial dissipation of assets or earnings due to any violation of statute

or regulation or any unsafe or unsound practice;

- a violation of law or regulation, or an unsafe or unsound practice or condition, that is likely to cause insolvency or substantial dissipation of assets or earnings, weaken the Bank's condition or otherwise seriously prejudice the interests of the Bank's depositors of the Deposit Insurance Fund; or
- the Bank is in an unsafe or unsound condition to transact business.

Finally, a receivership can be imposed due to a variety of critical management failures, such as:

- the Bank's board of directors has fewer than five members;
- a willful violation of a final cease and desist order; or
- concealment of the Bank's books, papers, records or assets, or refusal to submit the Bank's books, papers, records or affairs for inspection to a Bank examiner.

An AFBA merely has to document a problem that the Bank triggers on one ground, but frequently will cite to multiple grounds to mitigate challenges to its use of its ultimate weapon.

VIII. Action Plan

A. Be Aware of Danger Signs

It is important for Banks and Holding Companies to be aware of the danger signs that may lead to the imposition by their AFBA(s) of the Regulatory Intervention Rules.

If any of the following occurs, a Bank and its Holding Company are well advised to promptly retain outside counsel experienced in bank regulatory, supervisory and enforcement matters to assist in formulating strategies designed to minimize the potential application of – or hopefully seeking to avoid – the consequences of the Regulatory Intervention Rules:

- CAMELS component or overall rating downgrade below 2;
- significant exam criticism;
- capital deficiencies;
- loan portfolio issues that may impact capital levels or pose increased risk;
- economic conditions in the Bank's market area that may adversely impact the Bank's residential, consumer or construction lending activities;
- actual or threatened MOUs, supervisory agreements, or cease and desist orders;
- formal or informal regulatory directives related to capital, dividends, stock repurchases, reducing classified assets restrictions or growth regarding either the Bank or Holding Company.

B. Potential Action Required

At minimum, good business planning, adequately responding to exam criticisms and/or potential supervisory or enforcement action is extremely important and not to be understated. Depending on the regulatory or business issues presented (or perceived by the AFBA(s)), the following actions may be required by a Bank and/or its Holding Company:

(1) successful negotiation of supervisory or enforcement actions with relevant AFBA(s);

(2) capital raising transactions through private placement, rights or public offerings of equity or debt securities;

(3) potential strategic merger or business contributions;

(4) strategic sales of assets or business lines with the goal(s) of a) selling classified assets, b) selling good assets to raise capital, and/or c) narrowing business focus to core bank products or services;

(5) successful renegotiation, forbearance or extension of terms of lines of credit or other borrowings to avoid default events;

(6) updated assessment of liquidity;

(7) potential securities disclosure of adverse business or regulatory developments through Form 8-K and press release;

(8) possible board and/or management changes;

(9) preparation of an updated strategic business plan;

(10) review of D&O, insurance and indemnification coverage; and

(11) upgraded/updated compliance risk management policies and staffing.

IX. Conclusion

Being strategically prepared to handle an actual or threatened launch of the Regulatory Intervention Rules by an AFBA will go a long way to minimizing their potential impact. Forewarned is forearmed.

If you have any questions concerning these developing issues, please do not hesitate to contact any of the following Paul Hastings Washington, D.C. lawyers:

V. Gerard Comizio
202-551-1272
vgerardcomizio@paulhastings.com

Lawrence D. Kaplan
202-551-1829
lawrencekaplan@paulhastings.com

18 Offices Worldwide | Paul, Hastings, Janofsky & Walker LLP | www.paulhastings.com

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