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May 11, 2009

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NEWSLETTER OF THE **BANKING AND SPECIALTY FINANCE** PRACTICE GROUP OF MANATT, PHELPS & PHILLIPS, LLP

Stress and the Smaller Banks: PPIP or Merge?

Harold P. Reichwald

With the release last week of the results of the much-anticipated Supervisory Capital Assessment Program ("SCAP") – or stress test – of the country's nineteen largest banks, there seems to have been a collective sigh of relief that matters were not much worse than disclosed. Some of these banks already have announced plans to go to the market to raise capital to meet the targets set for them and others have expressed confidence that they can earn enough during the rest of 2009 to meet those targets.

The question remains, however, about the relevance of these stress tests for the nation's remaining 8,000 or so banks not part of the SCAP. Will the smaller banks be excluded from such scrutiny? Secretary Geithner stated that "Supervisors will not extend the stress test to the rest of the banking system." Can this be the simple answer? Experience has shown that while SCAP may not be rigorously applied to the smaller banks in the same manner, nevertheless, the regulators will apply some or even all of the same techniques and analysis. After all, the goal of the bank examination and supervisory process is to ensure the safety and soundness of each institution examined, which inherently is a forward-looking analysis.

Thus, the smaller banks can expect to have imposed on them requirements that they stress test their portfolios taking into account expected macro economic performance over the next two years. It is certainly likely that the bank regulators will force an analysis of more than one possible economic scenario, just as was applied in SCAP but having in mind the individual asset profile of each institution.

Just as important, the bank regulators have at their disposal tools with which to require banks to conform to higher capital ratios

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beyond the previously established minimums and they are not loathe to use them. To date, it appears that the most exacting tool has been the entry of a cease and desist order, usually entered on consent but with some consultation and negotiation with bank management. A cease and desist order can have consequences that extend beyond merely requiring that additional capital be raised by a certain date.

However, the bank regulators also have another important tool sanctioned by the regulations, namely, the Individual Minimum Capital Requirements ("IMCR"). A decision made by a bank regulator imposing IMCRs on a bank is a formal process to which a bank can and should respond if and when IMCR is proposed. A decision to impose IMCR carries the same force as a cease and desist order and can be enforced in the same way but it does not give rise to other consequences for the institution, such as directly impeding its liquidity management or restricting its credit processes.

Under these circumstances – and with the likelihood of additional capital requirements being imposed on them – smaller banks will face difficult challenges, forcing individual banks and their boards of directors to consider whether the best strategy might not be a merger or consolidation or a significant participation in the FDIC's legacy loans program or PPIP. After all, one of the ways a bank can meet newly imposed minimum capital ratios is to shrink the balance sheet and PPIP may be the best way to do that and retain independence. On the other hand, managing through this economic crisis is the ultimate challenge for senior management and directors of a bank. With that in mind, many might conclude that a negotiated merger or acquisition is the best way out.

What we learn from the SCAP exercise is that the problem will not go away and that merely trying to earn the way out of the crisis probably is not the answer. Given the real possibility of further losses in commercial real estate and credit card portfolios, we can expect banks to be encouraged to either participate in PPIP or seek a merger partner or even to do both.

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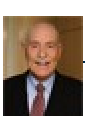

Harold P. Reichwald Mr. Reichwald is a highly experienced banking and finance attorney whose career encompasses domestic and international matters for banks and specialty finance institutions. His experience comprises a broad range of matters including: governance matters, sophisticated financial transactions such as asset securitization, LBOs, project finance, corporate lending and restructuring; representation of a variety of domestic and foreign financial institutions before the FDIC, Comptroller of the Currency, the Federal Reserve Board and other bank regulatory agencies in connection with new product development, chartering new banks and branches, issues arising out of the bank examination process and enforcement actions demanded by regulatory authorities. In addition, Mr. Reichwald has counseled senior executives, boards of directors, audit committees and credit review staffs of financial institutions, including conducting special investigations on their behalf. Mr. Reichwald's experience includes serving as Executive Vice President and General Counsel for Crocker National Corporation and its subsidiary, Crocker National Bank.