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April 8, 2009

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

Today's Bank Regulatory Enforcement Landscape—Tough Disclosure Issues And Unintended Consequences?

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Dear Bank CEO and Directors,

Your community bank has been consistently 2–rated and complimented by your friendly examination team during several years of good earnings. Then you followed your residential and commercial construction and developer customers into the lending swamp that was 2007 and 2008, and suddenly business also was not so good for longtime commercial loan customers. When your examiners arrived again to look back, their tone changed to "Shoulda, Coulda." You should have identified your risks and exposure earlier and you could have taken action sooner to stop your earnings slide. The inadequacies identified by the examiners in hindsight include inadequate management and Board supervision, overconcentration in real estate lending, inadequate policies and credit and risk management practices, and inadequate liquidity planning. The Exit Meeting message: Those 1 and 2 component ratings from before are now 3 and 4 ratings. Your bank is in "troubled condition", you need more capital and an enforcement action will be forthcoming.

Unfortunately, this scenario is becoming very common. We believe it will soon be (if it is not already) as commonplace for banks to be working through some form of safety and soundness supervisory enforcement action as it was for banks in the past to receive enforcement orders regarding their Bank Secrecy Act and anti–money laundering compliance shortcomings.

Now your Board is meeting to review the requirements of a draft enforcement action. No matter what the title on the document—Cease & Desist Order, Consent Order, Written Agreement or

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Memorandum of Understanding—many of the provisions read the same. Appoint a Compliance Committee; adopt a Strategic Plan, a Capital Plan and a Liquidity Policy; adopt credit risk management policies; obtain prior approval for dividends, obtain prior approval for any changes in directors or officers; do not make any golden parachute payments, and so on.

THE ENFORCEMENT ACTION LANDSCAPE

Here is where the enforcement actions can differ with dramatic consequences. If an enforcement action is a formal order or a written agreement issued pursuant to Section 8 of the Federal Deposit Insurance Act and if that enforcement order requires the bank to meet and maintain a specific capital level for any capital measure, the bank will no longer be well capitalized under the Prompt Corrective Action regulations regardless of what its actual capital ratios may be. In that case the bank may no longer accept or renew brokered deposits without hard–to–get FDIC approval. Alternatively, the federal banking agencies have the separate supervisory authority to impose individual minimum capital ratios ("IMCR") to address agency concerns about capital without immediately impacting the bank's ability to accept brokered deposits. For example, the Office of the Comptroller of the Currency had not used its IMCR authority in 12 CFR Part 3 from 2005–2007, but then issued 15 IMCRs to national banks in 2008 and had issued 32 IMCRs though February of 2009. IMCRs are issued by separate correspondence that is considered confidential supervisory information. Once imposed, if the bank fails to achieve or maintain the new capital ratios, the agency may pursue a separate enforcement action or seek sanctions.

THE DISCLOSURE DILEMMA

There are several disclosure issues publicly traded banks and bank or savings and loan holding companies must address when a supervisory enforcement action is imminent. Should your shareholders be told about all of your regulatory problems, and the corrective action you are taking? What about the market generally and analysts covering your stock? What about the bank's depositors or the community press, which might print an article that triggers a withdrawal of deposits and thereby makes your liquidity problems worse?

When should these developments be disclosed? Perhaps it is best to address all such developments in the next quarterly report? Or perhaps an 8–K Item 8.01 Other Event filing is appropriate for certain items, either with or without a Press Release where management or the Board can add positive statements about the corrective action already undertaken? Also, the substantive terms of an enforcement action are rarely watered down by negotiation after the document is delivered by the regulatory agency to the Board for consideration and execution, usually in an in-person meeting. When directors know with some certainty that significant restrictions and improvement requirements are coming in an enforcement order, or that new minimum capital ratios will be imposed, the Board can be presented with difficult business judgment decisions as to whether and when to disclose such regulatory developments. Each situation tends to be unique and there can be valid reasons for selecting one of perhaps several well–supported disclosure positions.

The difference between a formal and an informal enforcement action is important both as to the seriousness of the supervisory action and with respect to disclosure. An informal memorandum of understanding (MOU) is generally used when examiners conclude that the circumstances warrant a milder form of action than a formal supervisory action. As required by law, a formal enforcement action will be available verbatim on the agency's web site within a few weeks after it is executed and effective. The existence of an informal MOU will not be disclosed by the agency and the text of the MOU will not be posted on the agency's web site. However, the existence and the requirements of an MOU may be disclosed at the discretion of the Board. If an MOU contains requirements or restrictions that likely would be considered material and disclosable under the securities laws, disclosure is generally advisable regardless of the form of the enforcement action in which they are contained, and the decisions of the Board should be when and how.

The standard for disclosing regulatory developments generally is whether an enforcement action contains matters with potential financial impact that an investor would consider material in making an investment decision regarding a bank or company. Also, when any other material development is disclosed, such as a decision by the Board to reduce or suspend dividends, the securities laws require that you disclose any other material information known at the time. The bank's accountants may also have a view about the need to disclose regulatory developments that may have a financial impact on the bank if they are providing earnings or financial statements being disclosed in public filings.

The examination team whose findings prompted an enforcement action is not generally involved when approvals to pay dividends or other relief from the enforcement action are sought. Therefore, management and directors cannot rely on their examiners' understanding of the challenges facing the bank or any words of encouragement as to how soon corrective efforts might result in relief from the enforcement action. The agency's enforcement division and senior management will make those determinations. Enforcement actions generally stay wholly or partially in place for at least one and usually two full examination cycles.

Furthermore, if a bank receives an enforcement action, the Board of its holding company should be prepared to receive similar results and a similar enforcement action when the holding company is next examined or inspected. This enforcement action, whether formal or informal, often imposes financial restrictions on the holding company that are similar to those the bank has agreed to with its primary banking regulators (whether the State, FDIC, OCC or the Federal Reserve for state member banks), such as requiring prior approval for dividends or payments on certain debt. The Office of Thrift Supervision has less formal statutory and regulation authority over savings and loan holding companies, but it is following a similar tough examination and enforcement pattern.

Of immediate concern in the current economic crisis is whether banks with supervisory enforcement restrictions on paying dividends will at least receive relief to dividend sufficient funds to their parent holding companies for the quarterly dividend payments due on any preferred stock that has been issued to the U.S. Treasury under the TARP Capital Purchase Program. Technically, if dividend payments are not paid in full for six quarters, the U.S. Treasury would be entitled to elect two directors to the company's board of directors.

We advise that banks and their holding companies consult bank regulatory and securities counsel on these issues, preferably in advance of the next examinations. Consulting firms are often part of a proactive team of advisors to help banks and holding companies steer away from or out of troubled regulatory waters and deal with these disclosure decisions.

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of new banks, interstate and other expansion by banks, bank holding companies and other financial institutions and the requirements and restrictions on expansion of state and federal bank regulatory agencies; bank supervision and examination, and general banking corporate matters and regulatory and legislative developments.