VEDDER PRICE

Financial Services Report

A report designed to provide news and analysis of recent legal and regulatory developments in the financial services industry

February 2007

Federal Reserve Approves Relief from Capital Requirements for Bank Holding Companies Under $500 Million in Assets

The Federal Reserve Board has approved regulatory revisions that expand the definition of "small bank holding company" and clarify the treatment of subordinated debt associated with trust preferred securities issuances. The revised rules raise the asset threshold that bank holding companies ("BHCs") must meet to qualify for treatment under the Federal Reserve's Small Bank Holding Company Policy Statement ("Policy Statement") from less than $150 million to less than $500 million. Also under the revised rules, any subordinated debt associated with trust preferred securities that are issued by qualifying small BHCs will, for most purposes under the Policy Statement, be considered as debt. Under the previous rule, such subordinated debt associated with trust preferred securities was not considered as debt.

These new revisions will likely affect the majority of BHCs. According to the Federal Reserve, under the new rules, as many as 85% of BHCs may qualify for treatment under the Policy Statement. Qualifying for treatment as a small BHC has its advantages. For instance, a BHC that qualifies as a small BHC under the Policy Statement is subject to the Federal Reserve's capital guidelines at the bank level only, rather than on a consolidated basis. Additionally, qualifying small BHCs, as compared to larger BHCs, are allowed to use a higher amount of debt to finance acquisitions.

All BHCs must comply with the Federal Reserve risk-based leverage capital guidelines ("Capital Guidelines") unless they qualify as small BHCs under the Policy Statement. As previously noted, qualifying small BHCs are subject to more limited capital requirements and are allowed to operate with a higher level of debt than larger BHCs.

Traditionally, the Federal Reserve has discouraged the use of debt by BHCs to finance acquisitions because it believes that high levels of debt at the BHC level can impair the BHC's ability to serve as a source of strength for its subsidiary banks. Recognizing that small BHCs typically do not have access to the same funding facilities as large BHCs when engaging in acquisitions, in 1980, the Federal Reserve issued the Policy Statement, which loosened the debt restrictions for small BHCs. By explicitly permitting the formation and expansion of small BHCs with debt levels that are higher than would typically be permitted for larger BHCs, the Policy Statement helped facilitate the transfer of ownership of

In This Issue

small community banks in a manner that is consistent with safety and soundness.

Prior to the recent revisions, the Policy Statement provided that BHCs with pro forma consolidated assets of less than $150 million, that were not engaged in any non-banking activities involving significant leverage, were not engaged in significant off balance sheet activities, and did not have a significant amount of outstanding debt being held by the general public, would qualify for treatment as a small BHC under the Policy Statement. Such qualifying small BHCs were eligible to use debt to finance up to 75% of the purchase price of an acquisition. The small BHCs, however were subject to a number of ongoing requirements. For example, one of the principal requirements was that the small BHC must reduce its parent company's debt in such a manner that all debt is retired within 25 years of being incurred.

Moreover, under the previous version of the Policy Statement, subordinated debt on the parent company's balance sheet that was issued in connection with trust preferred securities was not treated as debt. The cash-flow impact, however, of such subordinated debt was included in the Federal Reserve's review of the financial condition of the BHC.

New Asset Threshold

The revisions to the Policy Statement raise the asset threshold for qualification under the Policy statement from less than $150 million to less than $500 million. Under the revised guidelines, BHCs with consolidated assets of less than $500 may qualify, subject to qualitative requirements, for the relaxed capital requirements of the Policy Statement. By raising the asset threshold to $500 million, the Federal Reserve estimates that approximately 85% of all BHCs may qualify for treatment under the Policy Statement. This is a substantial increase from the 55% of BHCs that were previously eligible to qualify under the $150 million asset threshold.

Changes in Qualitative Criteria

In addition to raising the asset threshold for eligibility under the Policy Statement, the Federal Reserve also modified the qualitative criteria for determining eligibility. Not only must a BHC meet the new "less than $500 million" quantitative threshold to qualify for treatment under the Policy Statement, a BHC must also meet the following qualitative criteria:

1. The small BHC must not be engaged in significant nonbanking activities, either directly or through a non-bank subsidiary;

2. The BHC must not conduct significant off balance sheet activities, including securitizations or managing or administering assets for third parties, either directly or through a non-bank subsidiary; and

3. The BHC must not have a material amount of debt or equity securities (other than trust preferred securities) outstanding that are registered with the Securities and Exchange Commission ("SEC").

What constitutes a "significant" amount of non-banking activities or a "material" amount of SEC-registered debt or equity will depend on the size, activities and condition of a particular BHC.

According to the Federal Reserve, these changes to the qualitative criteria reflect the changes to the banking industry over the last two decades, including the nature of the operations of many of the smaller BHCs. For example, following the enactment of the Gramm-Leach-Bliley Act in 1999, banks were allowed to expand the range of non-banking activities in which they could engage. The Federal Reserve believes that significant involvement in these expanded non-banking activities may result in a higher level of operations, legal and reputational risk to the overall banking organization and, as a result, BHCs taking part in significant non-banking activities should not be covered by the Policy Statement.

Unlike the previous version of the Policy Statement, the revised criteria excludes any BHC that has a material amount of SEC-registered debt or equity securities outstanding. The Federal Reserve believes that when BHCs have a material amount of SEC-registered securities, it is an indication that the BHCs exhibit a higher degree of complexity of operations and have access to multiple funding sources, which warrants excluding them from the Policy Statement.

Changes in Treatment of Trust Preferred Securities

The revisions to the Policy Statement provide that subordinated debt associated with trust preferred securities is treated, for most purposes under the Policy Statement, as debt. Under the previous version of the Policy Statement, subordinated debt on the parent company's balance sheet that was issued in connection with trust preferred securities was not treated as debt. Specifically, under the new rule, subordinated debt associated with trust preferred securities is considered as debt in determining whether:

1. A qualifying small BHC's acquisition debt is 75% or less of the purchase price; or
2. A qualifying small BHC's debt-to-equity ratio is greater than 1.0:1.

A qualifying BHC, however may exclude from debt an amount of subordinated debt associated with trust preferred securities equaling up to 25% of the small BHC's stockholder's equity, minus parent company goodwill.

Furthermore, subordinated debt associated with trust preferred securities is not considered as debt in determining compliance with the Policy Statement's ongoing 12-year debt reduction and 25-year debt retirement requirements. Under these ongoing debt reduction and retirement requirements, small BHCs must reduce their parent company debt consistent with the requirement that all debt be retired within 25 years of being incurred. The Federal Reserve also expects small BHCs to reach a debt-to-equity ratio of .30:1 or less within 12 years of the incurrence of the debt.

To provide qualifying small BHCs with adequate time to conform their debt structures, the Federal Reserve has provided for a five-year transition period. During this time, all subordinated debt associated with trust preferred securities issued prior to the date of the proposed rule (September 8, 2005) is not considered debt under the Policy Statement. This temporary non-debt status, however, terminates if the qualifying small BHC issues or has issued additional subordinated debt associated with a new issuance of trust preferred securities after the date of the proposed rule. For those trust preferred securities issuances that were pending on the date of the proposed rule, there is a five-year transition period, during which subordinated debt associated with the trust preferred securities issued on or prior to December 31, 2005 will not be considered debt under the Policy Statement. Qualifying small BHCs may also refinance existing issuances of trust preferred securities without losing the exempt status of the related subordinated debt under the Policy Statement during the transition period, as long as the amount of subordinated debt does not increase.

Revisions to Regulatory Reporting

The Federal Reserve is also expected to issue a separate notice revising the regulatory reporting requirements for BHCs meeting the new definition of "small bank holding company." Under these expected new revisions, qualifying BHCs would be required to submit parent-only financial data on the form FR Y-9SP on a semi-annual basis. Currently, BHCs with assets of $150 million or more must file parent-only and consolidated financial data on a quarterly basis.

Preemption of State Laws by National Bank Subsidiaries: Does It Make a Difference?

It has been an intense battle fought in multiple courtrooms and argued on editorial pages and in banking circles throughout the country. The final arguments took place in late 2006 before the Supreme Court. That is when the Supreme Court heard oral arguments involving Wachovia Bank and its failure to register its mortgage subsidiary with the State of Michigan. When the Supreme Court renders its decision this spring, the question will receive its final answer. That question is whether a subsidiary of a national bank engaged in mortgage banking activity is subject to registration, supervision and examination by state authorities.

So far, three United States Courts of Appeals have considered the question. Each one of these courts has concluded that a state has no such registration, supervision or examination power over a national bank subsidiary. This has deterred neither the state attorneys general nor the state banking commissioners. Over thirty state attorneys general have signed on to an amicus brief urging the Supreme Court to reverse the decisions of the lower courts and find that a state may supervise the affairs of an operating subsidiary of a national bank.

That question is whether a subsidiary of a national bank engaged in mortgage banking activity is subject to registration, supervision and examination by state authorities.

The State of Michigan is not challenging the idea that a national bank needs not register with the state in order to engage in mortgage banking activity. That question is and has been settled for a long time. A national bank is exempt from supervision by state authorities. Congress has stated that only the Office of the Comptroller of the Currency ("OCC") has the right to exercise "visitorial powers" over a national bank. No state law attempting to subject a national bank to the examination and supervision of state authorities has ever survived judicial scrutiny. Once Congress has spoken definitively on a subject, such as who may examine a national bank, no state authority may decide otherwise.

Rather, the State of Michigan is challenging whether the OCC can extend the doctrine of preemption beyond a national bank itself to a legally separate entity that is owned by the national bank. The OCC argument is that a national bank is not limited to engaging in only the specific enumerated powers listed in the statutes, but that Congress also gave a national bank the power to engage in activities that are convenient or useful to those specifically enumerated activities. The OCC has determined that it is convenient and useful for a national bank to operate through an operating subsidiary, so long as the activities conducted in such a manner are the same activities as are permissible for the national bank itself. Thus, the OCC reasons, a state may not regulate an operating subsidiary of a national bank.

Getting beyond the legal fine points of these arguments, the question remains: does all of this make any difference, or is this just attorneys arguing about fly specks?

It makes a difference. To begin with, there can be no real argument that the operating subsidiary structure is a convenient and useful mechanism for a bank. Due to its separate corporate structure, an operating subsidiary can help shield a parent bank from third-party liability. When an activity involves inherent risk, such as the operation of an insurance agency or the ownership of property acquired in satisfaction of a debt previously contracted, it is a prudent business practice to conduct the activity outside of the bank structure and in a subsidiary. In addition, the separate legal status of a subsidiary allows for greater flexibility in the event the parent bank decides to exit that particular business line. It is far easier to spin off a separately incorporated subsidiary than to sell an unincorporated division of a bank.

If the Supreme Court chooses to follow the trend of the last twenty-five years, it will find in favor of the OCC and Wachovia Bank. The OCC is justifiably proud of its record before the Supreme Court. Whether the subject has been brokerage, branching or insurance, the OCC has an impressive record of victories before the Supreme Court. At the same time, it is a different Court today than only a few years ago.

A decision adverse to Wachovia could unleash a flood of litigation against some of the largest banks in the country. Those banks have been relying upon OCC regulations as authority for the premise that their mortgage subsidiaries were not subject to state law rules that might govern such things as the amounts they might charge for late fees or returned checks. A reversal by the Supreme Court could expose those institutions to perhaps hundreds of millions of dollars in damages. Compliance costs for those institutions would also soar, since they would now have to comply with the laws of each state, or transact mortgage business directly through the bank.

A decision adverse to Wachovia could unleash a flood of litigation against some of the largest banks in the country.

Do the Big Banks Get All the Breaks?

Anyone who thinks big banks and small banks are regulated in the same fashion is either unfamiliar with banking or naïve. Yet, for all the differences, there are still similarities. Take for example the recent story of the Wells Fargo Bank and the Office of the Comptroller of the Currency ("OCC"). This story played out in the national media over the course of several months and contains lessons about bank supervision for banks of all sizes. From publicly available information, one can piece together much of what happened.

In late 2004, the OCC conducted a Bank Secrecy Act ("BSA") examination of Wells, and concluded that Wells had weaknesses in its BSA program. As stated in the August 18, 2006 report by the Office of the Inspector General (the "IG") of the Department of the Treasury, the deficiencies included weak internal controls, inadequate independent testing, lack of oversight, and failure to file suspicious activity reports ("SARs"). To any experienced banker, that list of deficiencies sounds like a recipe for an enforcement action.

Predictably, the OCC enforcement machinery started to grind away. Memos were written, documented and analyzed. A recommendation for a cease and desist order against the bank was made and fully vetted among OCC attorneys and review examiners. Just before that recommendation became final, the CEO of Wells went to Washington and met with the most senior officials of the OCC. That first recommendation never became final, but was changed. Instead of receiving a cease and desist order, Wells now only received a memorandum of understanding. The content of the document was much the same. Wells still had to improve its BSA program in specific ways, and receive the input and approval of the OCC before adopting the improvement plan. However, the document would now be styled as a memorandum of understanding, not a cease and desist order. From a legal perspective, the differences between the two are enormous. A cease and desist order is a public document that exposes all of the transgressions of a bank for the world to see. A memorandum of understanding is not publicly available. Moreover, a violation of a cease and desist order can subject the responsible party to severe penalties, including a civil money penalty action and a removal proceeding. A violation of a memorandum of understanding is not subject to any specific penalty.

Reportedly, a whistleblower at the OCC is responsible for making all of this public. Had not some undisclosed OCC employee leaked these events to Congress, presumably out of some sense of righteous indignation, the IG would never have investigated and made the details of this story public in its eighty-page report to Congress, and along the way found the OCC soft on regulating Wells.

There is more to the story than just a behind the scenes look at bank regulation. There are lessons for all banks, large and small, about the examination process. Here are some to consider:

- *It isn't over until it's over.* Regardless of what an examiner might say as he or she leaves the bank, it is still possible for the outcome of the examination to change, even after the examiner has left. Admittedly, it is difficult to change the conclusions of the examination. However, it does happen at both the small and large bank level.

- *The sooner, the better.* The best time to influence the examination is during the examination. Once the examiners reach their conclusions, it becomes increasingly difficult to change their minds. Examiners make decisions by consensus. In making a decision about whether a bank is a composite "2" or "3," an increasing number of examiners will informally or formally participate in that decision as it moves forward. Ultimately, five to ten examiners may participate in the decision by the time the decision is final and committed to a final document. It is far easier to convince one or two examiners in the field to see a given situation from a different perspective than to convince ten examiners they are wrong. The best opportunity is during the examination. Every bank should anticipate what the examiners will find. Every bank should be prepared to present its best arguments on every issue before the examination even begins.
- *Hell hath no fury like a regulator whose recommendation is not taken.* Going over an examiner's head is a risk that needs to be managed carefully. A reversal of the outcome in favor of the bank can be interpreted as a sign that the examiner was not only "wrong" but also incompetent. Some examiners will go to great lengths to prove that they are not wrong, *e.g.*, become a whistleblower. The answer is to pick your battles carefully and try to win the battles at the field level. Keep your field examiner involved in the appeal process and aware of what the bank is doing.
- *Credibility counts.* Notwithstanding the length of the IG report, not everything that occurred between the OCC and Wells is disclosed to the public. The IG did not disclose much about the content of the meeting between Wells and the OCC. However, it is a fairly safe bet that Wells argued that the problems were not as bad as portrayed by the examiners, and that Wells would do everything humanly possible to improve its BSA program. Presumably, Wells was promising the implementation of the best BSA program available. Unless Wells had carefully built its credibility over the years, its pleas to the OCC for leniency would never have been granted. Any challenge has to be supported by a true commitment. The bank must deliver on that commitment. There will not be a second chance.

One can look at the IG report and conclude that it is just another example of a big bank getting its way. Alternatively, one can look at this episode as evidence of the regulatory system working. Bank regulation should not ever become so mechanical that individual circumstances are never taken into account. Large or small, any bank can appeal examiner findings. Not always, but sometimes, both large and small banks can cause the examination findings to change. How one goes about making that challenge will have an impact on its success. The acknowledgment of an issue and the commitment to correct it, fortified by carefully nurtured credibility, go much further than whining about the attitude of individual examiners.

Commercial Real Estate Guidelines Adopted

Because bank examiners are almost inherently risk adverse, they have long looked at credit concentrations with unease. Concentrations of credit have been discouraged by aggressive enforcement of lending limits, as well as the traditional jawboning of admonishing banks "not to put all their eggs in one basket." Following the enactment of the Federal Deposit Insurance Corporation Improvement Act of 1991, the federal banking agencies were required to consider whether concentrations of credit needed to be supported by additional capital under the capital adequacy guidelines. Notice of proposed rulemaking was published. Comments were considered. But ultimately, the initiative collapsed when the agencies stated that the need for extra capital due to a credit concentration would be approached on a case-by-case basis. In short, the agencies recognized that, when it comes to concentrations of credit, one size does not fit all.

Perhaps this lesson that one size does not fit all was relearned by another generation of examiners this past year. In January 2006, the federal banking agencies published proposed guidance on commercial real estate concentrations. The proposal first defined what would be considered an institution with a commercial real estate concentration, and then set forth expectations that an institution with a commercial real estate concentration "should have both heightened risk management practices and levels of capital that are higher than regulatory minimums and appropriate to the risk in their CRE lending portfolios."

The banking industry did not sit back and let the proposal pass unnoticed. Collectively, the agencies received over 4,400 comments. Considering that there are less than 9,000 FDIC insured institutions, the number of comments was significant. The comments were overwhelmingly negative, and advocated addressing concentrations on a case by case basis.

The agencies published final guidelines on December 6, 2006. Significant adjustments were made to the final guidelines. Probably the most important distinction was that of tone. Unlike the proposal, the final guidelines do not deem an institution to have a commercial real estate concentration based on whether the amount of commercial real estate loans held by the institution exceeds certain ratios based upon capital. Rather, an institution is expected to identify its own concentrations. Moreover, the guidance recognizes that there may be segments inside an institution's commercial real estate portfolio that do not all present the same risk. These segments may be secured by different property types, present vastly different credit risks, be supported by different capital levels, and/or be managed by different risk management processes. The agencies caution that an institution should not segment its commercial real estate portfolio to avoid the appearance of concentration risk.

The final guidelines reflect a reasonable approach. There should be no need to lump a takeout or a condo development loan in suburban Chicago that is 35% pre-sold with a 65 unit motel loan in Florida that is in the third year of a five-year term. The reality is that commercial real estate loans are unique. Some may have many similarities to one another, others relatively few. One size does not fit all today, just as one size did not fit all ten years ago.

None of this means the industry can go back to the way it might have been monitoring commercial real estate loans several years ago. On the contrary, the guidelines have raised the performance standard. Each bank will be expected to have a better understanding of its commercial real estate portfolio. Any bank with a sizeable commercial real estate portfolio should be prepared to segment that portfolio to show that it is not a monolithic group of loans that are all likely to behave in the same manner. Segmentation based upon geography, types of loans, duration and loan-to-value limitations are some examples of appropriate distinctions. Sound credit practices, including ongoing monitoring of the credits, are essential. Management information systems, capable of tracking all of these variables, must be in place. The importance of Board of Director involvement in these processes cannot be overstated.

The agencies have tried to quiet the ire of the industry by emphasizing that the guidelines are just that: guidelines. The agencies have gone so far as to suggest that any banker report any examiner who acts otherwise. Better advice is to be prepared. The expectation as to how a bank should manage its commercial real estate portfolio is higher today than it was only a short while ago.

Contributing Attorneys: James M. Kane and Hope D. Schall.

Executive Editors:

Robert J. Stucker	312-609-7606
Daniel C. McKay II	312-609-7762
James M. Kane	312-609-7533 (*Practice Leader)*
Douglas M. Hambleton	312-609-7684
Jeffrey C. Davis	312-609-7524
Daniel O'Rourke	312-609-7669
Willie J. Miller	312-609-7790

Editor-in-Chief:

James M. Kane	312-609-7533

VEDDER, PRICE, KAUFMAN & KAMMHOLZ, P.C.

Vedder, Price, Kaufman & Kammholz, P.C.

Chicago
222 North LaSalle Street
Chicago, Illinois 60601
312-609-7500
Fax: 312-609-5005
Contact: James M. Kane

New York
805 Third Avenue
New York, New York 10022
212-407-7700
Fax: 212-407-7799
Contact: Neal I. Korval

Washington, D.C.
875 15th Street, N.W., Suite 725
Washington, D.C. 20005
202-312-3320
Fax: 202-312-3322
Contact: Theresa M. Peyton

New Jersey
Five Becker Farm Road
Roseland, New Jersey 07068
973-597-1100
Fax: 973-597-9607
Contact: John E. Bradley

About Vedder Price

Vedder, Price, Kaufman & Kammholz, P.C. is a national full-service law firm with approximately 235 attorneys in Chicago, New York, Washington, D.C. and New Jersey. Vedder Price provides a broad range of services to its financial institutions clients, including:

- charter conversions, mergers and acquisitions, purchases and sales off institutions, including antitrust counseling;
- chartering and organization of *de novo* institutions;
- issuance of equity, debt and hybrid securities as both issuers' and underwriters' counsel;
- representation, advocacy and litigation before federal and state regulatory agencies and tribunals and white-collar criminal representation;
- preparation of securities registration and reporting filings;
- general corporate legal services, including employment, technology licensing and other contractual relationships;
- professional/director liability counseling;
- environmental and lender liability representation;
- tax, pension and profit-sharing and ERISA assistance; and
- litigation and dispute resolution matters.