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Financial Services Report

Regulatory Examination and Enforcement
What to Expect and How to Respond

Over the last 12 months, the banking industry has witnessed unprecedented events: bank failures have increased substantially, including the largest thrift failure in U.S. history; the government has negotiated the sale and backing of Bear Stearns, while Lehman Brothers was allowed to fail; the government has placed Fannie Mae and Freddie Mac into conservatorship and bailed out AIG with an $85 billion bridge loan; and major consolidations have occurred that will reshape the financial industry landscape forever. This country has not witnessed financial industry turmoil this significant in over 20 years, and the more recent market activity is “a once-in-a-century type of event.”[1]

The credit crisis has already been longer and more severe than originally expected, and for financial institutions it is far from over. Money center financial institutions were impacted by the subprime/credit crisis relatively quickly, with ongoing negative effects. Many regional and more community banks, however, have just begun to feel the impact as the real estate market remains stagnant, if not eroding in some regions. For these institutions, especially those with large commercial real estate portfolios, the asset quality picture is grim. In response, the banking regulators are spreading out to examine institutions with asset concentration in suspect industries. Examinations will be followed by charge-offs, which will imperil capital ratios and, for some, cause institutional failure. Anticipating the increasing number of problem institutions, the FDIC announced its intention to rebuild its receivership staff earlier this year, expecting more bank failures in institutions with assets of $1 billion to $10 billion and a high concentration of commercial real estate assets. Accordingly, banks, their directors, and their management teams must prepare for increased enforcement and be aware of the numerous regulatory enforcement actions that can be imposed upon the institution and the individual directors.

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This update is divided into two parts. Part I will address the appropriate responses of managers and directors in the face of regulatory enforcement and describe the actions available to bank regulatory agencies directed at problem institutions. Part II, which will be released in the near future, will address the types of formal enforcement actions regulatory agencies can impose on individual directors or officers of those institutions. The focus of this update will be on the Federal Deposit Insurance Corporation (FDIC), but all of the bank regulatory agencies

have similar powers, focus, and agenda.

[1] Interview of Alan Greenspan by George Stephanopoulos of ABC's *This Week*, Washington, D.C. (Sept. 14, 2008).

Agency Oversight

Most Cited Regulatory Concerns

Recent regulatory actions and bank failures have revealed several areas of distress for regional and community banks, the most common of which are the following:

- Commercial real estate, in particular construction and development loans;
- Out-of-market lending, especially in high-risk regions;
- Overreliance on brokered deposits;
- Lack of liquidity;
- Home equity lines of credit;
- Several loans tied to a few obligors or guarantors; and
- Government-sponsored enterprise (GSE) investments.

These concerns have caused, at a minimum, strained capital ratios, increased loan loss reserves, and decreased earnings; at worst, the problems have led to bank runs and failures.

Whether a scheduled examination is upcoming or an agency has capital concerns, directors should assess whether any of the above represent problem areas in their institution and begin addressing them quickly. If the institution's capital is deteriorating, managers and directors must immediately begin outlining plans for raising capital. In the current economic environment, locating interested investors will take much longer than expected, if investors can be located at all. If and when examination procedures commence, the bank can take steps to make the examination process smoother.

Agency Examination

Increasingly over the last 30 years, bank examinations have become more formal and serious. Partly, this is because the agencies' enforcement powers have increased substantially over that same time period. Consequently, executive officers and directors must be prepared to discuss regulatory hot issues in detail. In addition, management and the board must be heavily involved in every aspect of the examination process.

Pre-Examination

Before an examination begins, directors and officers must remain vigilant by staying up to date on regulatory hot issues, being aware of major problem areas within the bank, and receiving outside assistance where necessary. For example, the bank may require appraisers to reassess the underlying value of construction and development properties, or the bank may need to alter its lending policies. In addition, the bank should retain assistance quickly, including attorneys, when enforcement action is imminent. Managers should detail any mitigation action, with the expectation that it will be utilized to combat the agency's perceptions of the bank's financial condition. Once the bank has the appropriate information or makes the appropriate changes, it may be able to resolve agency concerns quicker and on more advantageous terms.

Directors and officers must effectively manage the examination.

During the Examination

Directors and officers must effectively manage the examination. In part, this requires preparing answers or action plans aimed at resolving agency concerns. Managers should be open and responsive to working with the agency, but must remember to have updated facts and information in order to push back where appropriate. Managers should meet regularly with the agency during the examination to appraise the problem areas in preparation for the exit interview.

Exit Interview

Prior to conducting the exit interview, officers and directors should prepare responses and

be prepared to remediate and/or negotiate the findings of the examination report. During the exit interview, officers must professionally respond to criticisms with new facts (if any), action plans, expert opinions, or any other information relevant to the agency's concern. Preparation is the key: the better prepared executive officers become prior to and during the examination, the better the exit interview outcome. Just as important, however, is that management gives the overall impression that it is not only willing to solve the bank's problems, but that management is capable of doing so. The agencies have some discretion in enforcement procedures, and to the extent the examiners believe the managers possess the wherewithal to fix problem areas, enforcement may be less severe.

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Post-Exit Interview

After the examination, officers must keep commitments made during the examination or the exit interview. More importantly, officers must comply with examination recommendations: repeat criticisms that appear on subsequent examinations are an important consideration for the agencies when contemplating enforcement actions and assessing the willingness of management to remediate problems.

Overall, executive officers and directors should participate in the examination process and negotiate enforcement areas where possible. Nevertheless, enforcement actions may still be necessary.

Enforcement Powers

An enforcement action usually commences after an examination or after the institution's capital has dropped below an acceptable level, driven off of a call report. In either event, the institution will know of a pending action before any enforcement begins. The agencies possess numerous options to address the situation. For troubled institutions, the agencies will institute either informal or formal enforcement actions. Where an institution's capital levels fall below the regulatory requirements, the agency will institute *prompt corrective action* (PCA).

As an initial matter, the concept of "unsafe and unsound" practices is important in all regulatory actions against banking institutions. No formal definition for the term exists in the Federal Deposit Insurance Act, but common examples have evolved through formal proceedings. The FDIC divides unsafe and unsound practices into three categories: actions, conditions, and lack of action. Operating without an adequate level of capital is an example of an unsafe and unsound *action*. Excessive net loan losses may be considered an unsafe and unsound *condition*. Finally, failure to provide adequate supervision over the operation of the institution may be considered an unsafe or unsound *lack of action*. Unsafe and unsound practices constitute only one prerequisite for instituting enforcement actions. As described more fully below, the FDIC may also institute enforcement actions if the institution has violated a rule or regulation or has not complied with a written agreement.

Informal Actions

Informal actions are broadly defined as voluntary commitments entered into by the institution's board of directors. A *memorandum of understanding* (MOU) is one example of an informal enforcement mechanism. MOUs are used for institutions that are deemed supervisory concerns, but still retain sufficient financial capacity to make their survival likely. Use of an MOU is appropriate where the regulator believes that management possesses the resources and understands the institution's problems sufficiently to address the problems without regard to formal enforcement. The FDIC usually assigns these types of institutions a rating of 3, and the FDIC generally

utilizes MOUs for these institutions in lieu of formal enforcement action.

The FDIC regional representative typically drafts the MOU, and the institution's board of directors sign it. MOUs outline, with relative specificity, the problems that need addressing and the outcomes that are expected. The institution and its board should require precise language and clear expectations, because while an MOU is considered informal enforcement, violating an MOU will likely lead to formal enforcement action under § 1818(b), described more fully below.

In addition to MOUs, the agencies may use other informal mechanisms, including board resolutions or commitment letters. A violation of a written agreement, however, could be used as a basis for formal enforcement.

Formal Enforcement Actions

It is the FDIC's policy to take formal enforcement actions against institutions with composite ratings of 4 and 5 where there is evidence of an unsafe or unsound practice. For institutions with a composite rating of 3, if informal enforcement actions are not commenced, then formal action will be instituted.

Cease and Desist Orders

A *cease and desist order* (C&D order) is an FDIC order issued to stop violations of law or written agreements and to require certain affirmative actions to correct deficiencies. See 12 U.S.C. § 1818(b). The FDIC may issue a C&D order when:

If an institution receives a "less-than-satisfactory" rating for asset quality, management, earnings, or liquidity (that has not been corrected), the regulatory agency can deem the institution to be engaging in an unsafe or unsound practice and institute C&D order proceedings.

1. The institution has engaged or is engaging in unsafe and unsound actions;
2. The bank is violating, or has violated, a law, rule, or regulation, or any condition imposed in writing by the FDIC ... or a written agreement entered into with the FDIC; or
3. There is reasonable cause to believe the bank is about to engage in either of the above.

Importantly, if an institution receives a "less-than-satisfactory" rating for asset quality, management, earnings, or liquidity (that has not been corrected), the regulatory agency can deem the institution to be engaging in an unsafe or unsound practice and institute C&D order proceedings. 12 U.S.C. § 1818(b)(8).

Under the statute, institutions served with a C&D order are entitled to a hearing, but in practice, hearings on C&D orders are rare. Most C&D orders are entered as *consent orders* after consultation with the FDIC. One advantage of a consent C&D order is that the institution and its attorneys may be able to negotiate some of the terms before it is finalized. If the board of directors and the regional counsel cannot agree on a satisfactory consent order, then the FDIC will issue proper notice and a time and place for a formal hearing.

In addition to prohibiting certain actions, a C&D order may require the institution to take affirmative steps to correct the alleged unsafe or unsound practices, including:

1. providing restitution or reimbursement, indemnification, or guarantee against loss;
2. restricting growth of the institution;
3. disposing of loans or assets;
4. rescinding agreements or contracts;
5. employing qualified officers or employees; and
6. taking other action as the banking agency determines to be appropriate.

Temporary C&D Orders

Consent C&D orders are often employed to avoid the time-consuming hearing process, but sometimes the FDIC determines that they must act with the utmost speed. If necessary, section 8(c) provides the agency with the authority to issue *temporary C&D orders*. Such temporary orders are available when an alleged unsafe or unsound practice "is likely to cause insolvency or significant dissipation of assets or earnings of the depository institutions, or likely to weaken the condition of the depository institution or otherwise prejudice the interest of its depositors prior to the completion" of any C&D order proceedings. FDIC, Risk Mgmt. Manual of Examination Policies, § 15.1.

The temporary order, which can be imposed on the institution or individual officers or directors, is effective on service and will remain effective until administrative proceedings are complete, the agency dismisses the charges, or the temporary order is replaced with a permanent order. Within ten days of a temporary C&D order, the institution, officer, or director so implicated may file with the appropriate district court and seek to set aside, limit, or suspend the order until administrative provisions are complete. Similarly, the FDIC may apply to the district court to enforce a proper temporary order with which the institution has not complied. In addition to being an expeditious method of halting institutional activity, a temporary order may include the same affirmative steps, outlined above, as ordinary C&D orders.

Termination of Insurance

Pursuant to 12 U.S.C. § 1818(a), the FDIC may *terminate the deposit insurance* of an institution if:

1. The institution or directors have committed unsafe or unsound practices;
2. The institution or directors have violated a law or regulation, a written condition imposed by the FDIC in conjunction with an application or other request for a bank, or any written agreement entered into with the FDIC; or
3. The institution is in an unsafe or unsound condition.

This remedy is extreme and very rare. Section 8(a) actions "primarily occur when other available administrative remedies have proven unsuccessful in obtaining needed correction and/or when the bank's condition is unsafe or unsound." FDIC, Risk Mgmt. Manual of Examination Policies, § 15.1. Moreover, the FDIC recognizes that limiting the use of this remedy is appropriate as its authority under C&D orders has expanded.

Capital Directives

A *capital directive* is a final order issued to a bank that fails to maintain the minimum capital levels set forth in the regulations, and it is enforceable to the same extent as a C&D order. Once the FDIC makes an initial determination that a directive should be issued, it shall serve written notification on the institution outlining the reasons for the directive, including a current calculation of the Tier 1 leverage capital ratio. Within 14 days of receipt of this notification, the bank may respond in writing explaining why the directive should not issue. The FDIC will consider the institution's response and may issue the directive as initially drafted, modify the directive, or not issue the directive.

The directive may require that the institution:

1. Achieve a minimum leverage capital requirement;
2. Submit a plan for raising capital to the FDIC for approval;
3. Take any other action necessary to achieve the capital requirement; or
4. Some combination of the above actions.

While the authority to issue capital directives exists, the power is rarely used. "[I]n cases where it is possible to obtain a consent [C&D order] that includes an appropriate capital provision, it is preferable to take section 8(b) action instead of capital directive action." FDIC, Risk Mgmt. Manual of Examination Policies, § 15.1.

Civil Monetary Penalties

The FDIC may also use *civil monetary penalties* as a formal enforcement action for violations of law or violations of

written agreements, orders, or conditions. Civil penalties may be assessed against the institution itself or against individuals affiliated with the institution. The factors considered in assessing these penalties are the same for institutions or individuals. As such, Part II of this article will fully address the use of civil monetary penalties.

Prompt Corrective Actions

Prompt corrective actions (PCAs) are designed to quickly address capital adequacy deficiencies in banking institutions. The PCA regulations outline the capital categories: *well* capitalized, *adequately* capitalized, *under*capitalized, *significantly* undercapitalized, or *critically* undercapitalized. If an institution is rated as any of the last three categories, then the regulatory authority shall implement a PCA.

If an institution receives a PCA deeming it to be "undercapitalized," it must create and submit a *capital restoration plan* (CRP) within 45 days of the notification.

If an institution receives a PCA deeming it to be "undercapitalized," it must create and submit a *capital restoration plan* (CRP) within 45 days of the notification. The CRP must outline, using realistic assumptions, the alternatives to raising additional capital, the financial condition of the institution each year while the CRP is in effect, and the types of activities it will engage in during the process. If the institution is controlled by another entity, e.g., a bank holding company, then the controlling institution must provide a guarantee and assurances of compliance with the CRP. The PCA/CRP measure is becoming more useful to the regulators as the orders are not public. A C&D order, in contrast, is public and can put corrective action in jeopardy due to adverse publicity.

In addition, various restrictions are imposed on the institution depending on the level of capital inadequacy. "Undercapitalized" institutions may not grow assets, invest in any other company, open a new branch, or engage in any new line of business absent discussions with and possibly approval from the FDIC. In addition, the FDIC has discretionary authority to exercise further actions usually reserved for "significantly undercapitalized" institutions (discussed below).

The FDIC will require "significantly undercapitalized" institutions or "undercapitalized" institutions that fail to submit or receive approval for a CRP to carry out at least one of several actions, including recapitalization, restricting transactions with affiliates, restricting interest rates paid, "improving" management, or requiring divestiture. In addition, the institution may not pay any bonus to executives or provide any other compensation to executives that would exceed their average compensation over the prior 12 months.

The FDIC will almost always place "critically undercapitalized" institutions into receivership, with more severe restrictions on day-to-day activities. Unless authorized, these institutions may not enter into any material transaction, extend credit for any highly leveraged transaction, amend the institution's charter or bylaws, amend accounting methods, pay excessive compensation or bonuses, or pay interest on liabilities that would increase its weighted average cost of capital.

Restrictions under PCAs, therefore, can be extremely burdensome at any level of capitalization. In addition, PCAs will likely be accompanied by a C&D order, because the FDIC deems operating a bank with inadequate capital as engaging in an unsafe and unsound practice. See 12 C.F.R. § 325.4.

Troubled Institutions

In addition to the above restrictions, institutions deemed "troubled" incur additional restrictions.

"Troubled" institutions are those that have a composite rating of 4 or 5, are subject to a

proceeding to terminate deposit insurance, are subject to a C&D order, or are otherwise informed in writing by the FDIC that they are in a troubled condition. Troubled institutions must notify the FDIC at least 30 days before hiring a new director or executive officer (or changing the responsibilities of a current executive officer). In addition, the troubled institution may not accept brokered deposits, unless the institution is adequately capitalized and receives approval from the FDIC. Finally, troubled institutions may not make golden parachute payments to executives unless the institution receives consent from the appropriate federal banking agency and FDIC written concurrence.

We therefore recommend that institutions engage counsel with experience in working with the agencies early in the process to make the process as painless as posssible. Part II, forthcoming, will address how regulators can pursue institution-affiliated individuals in a personal capacity.

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