Hunton & Williams
Client Alert

February 2009

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# The State of Banking 2009

*By: Peter G. Weinstock[1]*

We have issued literally dozens of client alerts since the crisis in banking became acute toward the middle and fall of 2008. Despite the torrent of information that we have provided to our clients, there are a number of issues that have flown underneath the radar or which need further defining.[2] I have attempted to tackle certain of these issues below.

## Liquidity

There have been a number of developments regarding the regulatory and market reaction to liquidity issues.

**Examiner Scrutiny**. Wholesale funding has become a negative term. Unfortunately, the regulators are painting with a broad brush. In a number of the almost 40 bank failures since the start of 2007, the failed financial institution had a high portion of funding from brokered deposits and federal home loan bank ("FLHB") advances.

A number of players entered banking after the "dot.com" meltdown with the strategy of using brokered deposits to fund a focus on a particular type of lending. In other cases, there were growth strategies that were based on wholesale funding. The experience of bank regulators in such circumstances has been that wholesale funding has been quick to flee a deteriorating bank.

In the event a bank becomes less than well capitalized or worse on a prompt corrective action ("PCA") basis, its wholesale funding eligibility is subject to regulatory limitations and potential prohibitions.[3] If a bank enters into a formal administrative action, then the regulators can drop it one level on the PCA scale. Thus, a bank that is well capitalized but which signs a cease-and-desist order could be deemed to be only adequately capitalized for PCA purposes. This triggers the advent of the brokered deposit rules.

In light of this combination of factors, banks, even high-performing banks, have been hesitant in pushing back against examiners who advise them to reduce their reliance on wholesale funding. Obviously, this has had national ramifications because it limits a free flow of funding to where it would do the most good to spark new lending.

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[2] In the event you have not received our client alerts, please do not hesitate to call me at my number or email me, and I will be happy to provide you with copies.

[3] Please contact me if you would like a copy of our memorandum of the rules under such circumstances.

**FDIC-proposed Action on Interest Rates**. The FDIC has recently issued a proposal concerning interest rates that an institution that is only adequately capitalized or worse can pay. Tucked away in the FDIC's proposal is the following:

> [S]ection 29 [of the FDI Act] authorizes the FDIC to impose by regulation or order, such additional restrictions on the acceptance of brokered deposits by any institution as the [FDIC] may determine to be appropriate … *this broad grant of authority does not refer to capital categories* (emphasis added).

Thus, the FDIC could adopt additional restrictions on the acceptance of brokered deposits without regard to capital categories. To date, the FDIC has not adopted any such additional restrictions, but the FDIC is interested in obtaining comments on whether the adoption of such restrictions would be appropriate.

Comments are due on the proposal on or before April 6, 2009. In effect, the FDIC is requesting whether it should impose a rate cap on the amounts that all financial institutions can pay for brokered deposits.

The FDIC proposes to establish a "national rate," which would be calculated and published by the FDIC. The FDIC has said that rate will be a simple average of rates paid by all insured depository institutions in branches for which it has available data.

The FDIC will define a market area as any readily defined geographic area in which the rates offered by one institution will affect the rates offered by other institutions operating in the same area. The FDIC will now presume that the rate in any market is the average national rate unless it determines, based on available information, that the average rate in that market differs from the national rate.

In short, for institutions that are less than well capitalized, they will be required to pay a rate that is no more than 75 basis points higher than the national rate, unless an institution can overcome the FDIC's presumption that the national rate will also be the local rate. This restriction is in addition to the restrictions on brokered deposits for adequately capitalized banks or banks that are in a lesser PCA category.

**TLGP**. On October 14, 2008, the FDIC announced the temporary liquidity guarantee program (the "TLGP"). The TLGP enables financial institutions to issue senior unsecured indebtedness with a government guarantee. Initially, it was hoped that the FDIC would also afford that guarantee to holding companies in order to enable them to add capital to their subsidiary banks. Recent FDIC pronouncements have indicated that such a use of the TLGP guarantee will be granted only on an extraordinary basis.

Banks can, however, issue senior unsecured indebtedness equal to 2 percent of their liabilities on September 30, 2008, provided that they did not have any senior unsecured indebtedness on that date. The FDIC guarantee extends until June 30, 2012.

The indebtedness issued under the TLGP is not considered wholesale funding. In addition, unlike a CD, if rates increase, the noteholder under the TLGP cannot pay a penalty and reclaim its money. In response to the TLGP, we are aware of more than six placement agents that would be willing to assist financial institutions in issuing such indebtedness.

The pricing on such funding is generally based off of the three-year Treasury rate or the three-month LIBOR. The all-in cost for such issuances tends to be 350–375 percent (this includes the FDIC's 1 percent special assessment).

We have negotiated agreements with a variety of these placement agents. The funding received is obviously a commodity to the issuing bank. Accordingly, it is important to be mindful of differences in placement agents, trustee fees and the overall costs of issuance. Even though we represent issuers, certain of the placement agents asked us to help them to improve their program.

## Regulatory Issues

In addition to wholesale funding, the regulators are revisiting issues that they have not stressed since the early '90s.

**Real Estate Appraisals**. The regulators again are scrutinizing the appraisals supporting collateral values and other real estate owned. The appraisals are being evaluated for staleness and also for whether the comparables are appropriate. The examiners have once again raised the question of whether banks have an appropriate appraisal review process.

**Loan-to-Value Ratios**. The bank examiners have been refocusing on scrutinizing bankers' compliance with the loan-to-value ("LTV") requirements. Recent examination reports have also criticized banks for failing to track LTVs in excess of the supervisory limits and reporting such exceptions to the board of directors. Other criticisms of banks concerning the loan-to-value requirements are:

- basing analysis off of only the funded balance rather than the total loan commitment,
- reporting LTVs in excess of bank policies without also noting exceptions to supervisory limits,
- failing to limit the value used to calculate LTVs for real estate to the level of cost or appraised value, and
- failing to track the aggregate volume of loans in excess of the LTVs as a percentage of capital in order to ensure that the aggregate level of exceptions is consistent with the requisite minimum.

**Texas Ratio**. The examiners are calculating the Texas ratio for banks as an indication of whether the bank's deterioration warrants an administrative action or further scrutiny. The Texas ratio equals the sum of (nonperforming assets and 90+ delinquent loans) divided by the sum of (Tier I capital in the allowance for loan losses).

## Capital

The bank regulators have begun to focus upon the quality of a bank's capital, rather than just the mathematical application of the ratios. Examiners are instructed to consider the source of the capital and whether there will be lender or investor pressures on the holding company that might render the capital that had been injected less than permanent.

The rating agencies are also considering that issue. For instance, Moody's had said that capital coming into a new organization from TARP is not as reliable as other sources of capital. Moody's treats TARP funds as 25 percent equity and 75 percent debt for the purpose of its calculation of tangible common equity. Although A.M. Best takes a similar approach, it has said it will consider the capital of the companies taking TARP funds on a case-by-case basis.

## Subchapter S

**TEFRA Disallowance**. On January 15, 2009, the United States Tax Court ruled in favor of the IRS in a case involving the 20 percent TEFRA disallowance. The question presented was whether the TEFRA disallowance phases out after a financial institution has been taxed under Subchapter S for three years. The Tax Court determined that the 20 percent TEFRA disallowance continues even after three years. For more information, see the upcoming issue of ICBA's "Subchapter S: The Next Generation" newsletter, which we co-edit with RSM McGladrey.

**TARP**. For Subchapter S banks that elect to issue the debentures to the U.S. Treasury ("UST") under TARP, they will be required to also provide the government with a warrant. The warrant represents 5 percent of the securities received by the UST. The warrant is deemed immediately exercised and bears interest at 13.8 percent from the date of issuance.

The UST is paying only for the debentures. The warrants will all have a nominal exercise price. Accordingly, the price paid for the debentures will be allocated between those debentures and the warrants. This creates the possibility of original issue discount ("OID"). As a result, the bank holding company may be able to receive an additional interest deduction taken over the life of the loans.

There are many other issues that have arisen in the current environment. If you would like to see our client alerts, please do not hesitate to contact me.