Hunton & Williams

Community Banking Update

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Hunton & Williams LLP Top Ranked in SNL Financial League Tables for Second Consecutive Year

Firm Advises on 11 Bank Acquisitions

Hunton & Williams LLP ranked #1 for the second consecutive year in SNL Financial's league tables for bank and thrift legal advisers, by number of deals. SNL Financial is a multisector-focused information and research firm in the financial information marketplace.

The firm's Financial Institutions Corporate and Regulatory lawyers advised on 11 whole bank acquisitions during 2008.

"Despite the down economy and a much lower number of whole bank M&A deals being done nationally and in Texas, the Financial Institutions Group at Hunton & Williams LLP was still able to sign 11 deals," said Charles "Stormy" Greef, partner. "We were pleased to have been involved in all of these transactions and look forward to continuing our work with clients and prospective clients in what promises to be an interesting year ahead."

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The State of Banking 2009

by Peter Weinstock

We have issued literally dozens of client alerts since the crisis in banking became acute in the fall of 2008. Despite the torrent of information that has already been provided, there are a number of issues that have flown below the radar or need further clarification. We have attempted to address some of these below.

Liquidity

There have been several developments regarding the regulatory and market reaction to liquidity issues.

Wholesale Funding

Wholesale funding has become a negative term, and, unfortunately, the regulators have been painting with a broad brush. In a number of the almost 40 bank failures since the start of 2007, the failed institution had a high portion of funding from brokered deposits and Federal Home Loan Bank advances. Some of these banks were relatively new players that had entered banking after the "dot.com" meltdown with the strategy of using brokered deposits to fund a niche lending program. In other cases, the banks employed aggressive growth strategies that relied heavily on wholesale funding. Because the bank regulators have seen that wholesale funding has often been quick to flee a deteriorating bank, the FDIC, in particular, has strongly discouraged the use of wholesale funding by financial institutions altogether, regardless of condition.

If a bank becomes less than "well-capitalized" under the Prompt Corrective Action (PCA) standards, its wholesale funding eligibility is severely limited or even prohibited. If a bank enters into a formal administrative action, then the regulators can drop its capital rating one level on the PCA scale. Thus, a bank that would otherwise be well capitalized would be deemed to be only "adequately capitalized" if its primary federal regulator places it under a supervisory order. This circumstance then triggers the application of the brokered deposit limitations.

In light of this combination of factors, banks, even high-performing institutions, have been reluctant to push 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 where it would do the most good to spark new lending.

FDIC Proposed Action on Interest Rates

The FDIC has recently issued a statement noting its broad authority to establish limits on the interest rates that a financial institution can pay. The statement reads as follows:

> [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 . . .. *[T]his 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 a bank's capital rating under PCA. To date, the FDIC has not adopted any such additional restrictions, but it is soliciting comments on whether the adoption of such restrictions would be appropriate. 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. Comments were due on the proposal on or before April 6, 2009.

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 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 lower capital category under the PCA rules.

TLGP

On October 14, 2008, the FDIC announced the Temporary Liquidity Guarantee Program (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 to enable them to add capital to their subsidiary banks. Recent FDIC pronouncements have indicated that the TLGP guarantee will be extended only to bank holding companies on an extraordinary basis.

Banks can, however, issue senior unsecured indebtedness equal to 2% of their liabilities as of September 30, 2008, provided that they had no senior unsecured indebtedness on that date. (Otherwise, the limit is 125% of the amount of senior unsecured debt outstanding as of September 30, 2008). The FDIC guarantee extends until December 31, 2012, but the debt must be issued before October 1, 2009.

The indebtedness guaranteed 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 at least six placement agents that would be willing to assist financial institutions in issuing such indebtedness. The pricing on this type of funding is generally based on the three-year Treasury rate or three-month LIBOR. The all-in cost for such issuances tends to be 350-375% (this includes the FDIC's 1% 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.

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 are once again scrutinizing appraisals supporting collateral values and other real estate owned. The appraisals are being evaluated for staleness and also to determine whether the comparables are appropriate. The examiners are also looking into whether banks have an appropriate appraisal

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The bank holding company issuing the debentures and warrants to the UST may be able to receive an additional interest deduction taken over the life of the debentures.

review process. Banks should, therefore, review these processes prior to the next examination to ensure that they will pass muster with the regulators.

Loan-to-Value Ratios

The bank examiners have been scrutinizing bankers' compliance with the loan-to-value (LTV) requirements. Recent examination reports have also criticized banks for failing to track LTV ratios in excess of the supervisory limits and report such exceptions to the board of directors. Other criticisms in regard to the LTV requirements include:

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

Texas Delinquency Ratio

Texas examiners are calculating Texas banks' delinquency ratios to determine whether the banks' 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 1 capital and the allowance for loan losses. Bankers should be mindful of this and place even greater emphasis on monitoring delinquencies.

Capital

The bank regulators have begun to focus on 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% equity and 75% 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 Developments

TEFRA Disallowance

On January 15, 2009, the United States Tax Court ruled in favor of the IRS in a case involving the 20% 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% TEFRA disallowance continues even after three years. For more information, see the upcoming issue of ICBA's *Subchapter S: The Next Generation* newsletter that we co-edit with RSM McGladrey.

TARP

Subchapter S banks that elect to issue debentures to the U.S. Treasury (UST) under TARP will also be required to provide the government with a warrant for additional debt representing 5% of the securities received by the UST. The warrant will be exercised immediately and will bear interest at a rate of 13.8% from the date of issuance.

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

These are only a few of the recent developments affecting banks. We will follow up with additional client alerts and newsletters as important new issues surface.

Redemption of S Corporation Stock

by Zonnie Breckinridge

"Sale or Exchange" or "Distribution"

There are two ways that a Subchapter S corporation shareholder can dispose of his stock in the company: sell it to another person or sell it back to the company. The latter transaction, known as a stock redemption for tax purposes, is often the more common method of disposition in the S corporation context. Section 302 of the Internal Revenue Code (IRC) governs a corporation's stock redemptions. This section considers a redemption to be either a "sale or exchange" or a "distribution," and, depending on the form applied to the transaction, it will have different tax consequences to the taxpayer as well as the company.

Under IRC Section 302, for a redemption to be treated as a "sale or exchange," the transaction must meet at least one of the following three tests: (1) the transaction must result in a complete redemption of all of the S corporation stock owned by the selling shareholder (the "complete redemption test"); (2) immediately after the redemption, the selling shareholder must own less than 50% of the total voting power of the company and the percentage of the company's voting stock owned by the selling shareholder immediately after the redemption must be less than 80% of the company's total voting stock owned by the shareholder immediately prior to the redemption (the "substantially disproportionate test"); or (3) the redemption is not essentially equivalent to a dividend (the "not essentially equivalent to a dividend test"). For purposes of these three tests, ownership will

include the shareholder's direct, indirect and constructive ownership of the company's stock. Constructive ownership is determined based on the "attribution rules" discussed below. In general, if a selling shareholder transfers 100% of his stock to the company, he will meet one of these tests unless he is deemed to own shares of company stock under the "attribution rules" described below. The "not essentially equivalent to a dividend" test is based on all facts and circumstances surrounding the redemption. In general, to meet this test the shareholder must be able to demonstrate a "meaningful reduction" in his proportionate ownership of the company based on all facts and circumstances. The Internal Revenue Service has indicated in published rulings that a minority shareholder whose relative interest in the company is minimal (i.e., less than 1%) and who exercises no control with respect to the corporate affairs would generally be considered to have a meaningful reduction upon his sale of some of his shares back to the company.

If the selling shareholder meets at least one of the tests under IRC Section 302, the disposition of his stock will be treated as a "sale or exchange," and the taxpayer will report the sale just as if it were a sale to a third-party individual. In that case, the selling shareholder will recognize gain or loss in an amount equal to the difference between the amount received for his redeemed shares and his tax basis in such shares. This gain or loss will be capital gain or loss provided that the shareholder had held these shares as a capital asset.

If, on the other hand, a selling shareholder does not meet the tests noted above, the redemption price paid by the company will be treated as if a distribution was made to the shareholder. If the company is a C corporation, the distribution will be taxed as a dividend to the shareholder to the extent of the company's undistributed earnings and profits. However, this may not be the case with a Subchapter S corporation. The taxability of an S corporation distribution depends on several factors. Moreover, the transaction could be tax-free to the shareholder.

For an S corporation that was formerly a C corporation, if the corporation has accumulated earnings and profits (E&P) from its prior C corporation years, the taxability of a distribution paid on the redemption of a shareholder's stock will depend on the amount that the company has in its Accumulated Adjustments Account (AAA) and the adjusted tax basis of the selling shareholder. The AAA is the accumulated but undistributed net profits from the years the company has been an S corporation. A distribution to a selling shareholder of an S corporation will be tax-free to the shareholder to the extent that the amount of the distribution does not exceed either the shareholder's tax basis or the amount of the company's AAA. If the distribution to the selling shareholder exceeds the shareholder's tax basis but not the company's AAA, then the excess is treated as a capital gain from the sale of the stock to the extent of the AAA. If the distribution to the selling shareholder exceeds the company's AAA, the excess is taxed as a regular dividend to the extent of E&P from prior C corporation years. Most dividends (as opposed to distributions) paid by an S corporation will be treated as "qualifying dividends" subject to the current maximum federal income tax rate of 15%. To the extent the distribution exceeds the amount of the company's E&P from prior C corporation years, then the excess will be treated first as a tax-free return of any remaining portion of the shareholder's tax basis in his stock and then as capital gain. If the S corporation has no undistributed E&P from prior C corporation years, then the distribution will be treated first as a tax-free return of the selling shareholder's tax basis and then as capital gain.

Attribution Rules

For purposes of determining whether a selling shareholder meets one of the tests set forth in IRC Section 302, a selling shareholder will be deemed to "constructively" own company shares under the attribution rules of IRC Section 318. In general, the attribution rules treat a shareholder as owning: (a) shares of stock owned by certain relatives, related corporations, partnerships, estates or trusts, and (b) shares of stock the shareholder has an option to acquire. When the attribution rules apply, a selling shareholder may be "deemed" to own shares actually held by another shareholder who is a lineal descendant, even if the selling shareholder owns no shares in his own right. If a shareholder would have met the complete redemption test except for attribution from a family member, then the shareholder can waive that family attribution and qualify the transaction as a complete redemption if all of the following requirements are met:

1. immediately after the redemption, the selling shareholder has no interest in the company (including as a director, officer or employee), other than as a creditor;
2. the selling shareholder does not acquire any such interest (other than stock acquired by bequest or inheritance) within 10 years of the redemption;

3. the selling shareholder files an agreement to notify the Internal Revenue Service (IRS) of any acquisition described in item 2 above and retains records as may be required by the IRS (i.e., copies of income tax returns and any other records indicating fully the amount of tax that would have been payable had the redemption been treated as a dividend);
4. if the selling shareholder acquires such an interest in the company (other than by bequest or inheritance) within 10 years from the redemption, then the statute of limitations to assess a deficiency ends one year after the shareholder notifies the IRS of the acquisition;
5. the selling shareholder did not make any tax avoidance dispositions of any stock in the company in the 10 years before redemption to a person who still owns the stock at the time of distribution and whose ownership is attributable to the selling shareholder; and
6. the selling shareholder did not make any tax avoidance acquisitions of any part of the redeemed stock in the 10 years before the redemption from a person whose ownership of the stock would be attributable to the selling shareholder.

In order for the above waiver to be effective, the selling shareholder must file the agreement to notify the IRS of any acquisition within 10 years of the redemption as part of the shareholder's return for the year of the distribution, unless the shareholder can show reasonable cause why this could not be done. In such case, the shareholder may be granted an extension of time to file the waiver and requisite agreement.

Sale Versus Distribution

If a redemption is made by a C corporation, the selling shareholder generally prefers the "sale or exchange" tax treatment noted above. If the redemption is treated as a "distribution" in such case, none of the redemption price is allowed to be offset by the shareholder's basis in his stock.

In the S corporation context, however, this is not always the case. See the example below.

Peter owns 40% of the S corporation's 1,000 shares of outstanding common stock, or a total of 400 shares of the company's common stock, which he has owned for several years. His basis in those shares is $4,000,000, or $10,000 a share. The company has no other shares outstanding and has no accumulated earnings and profits. Peter is not an officer, director or employee of the company and has no relatives who have any interest in the company. Peter sells 100 shares of his company common stock back to the company for $1,500,000, or $15,000 a share.

After the redemption, Peter will own 30% of the 900 shares of remaining company stock outstanding, so he meets the substantially disproportionate test of IRC Section 302. Peter meets the first part of this test because he owns less than 50% of the voting stock after the redemption, and he meets the second part of this test because, after the redemption, he will hold less than 80% of the stock he held before the redemption. (Peter owned 400 shares before the redemption and 300 shares after; 80% of 400 shares is 320 shares.)

The redemption would, therefore, be treated as a “sale or exchange,” and Peter would realize a capital gain in the transaction. Peter’s adjusted basis of $10,000 per share or $1,000,000 in the aggregate in the stock that he sold back to the company would result in a long-term capital gain to Peter of $500,000, which at today’s capital gains rate would be taxed at the long-term capital gains rate (currently 15%) as he had held the redeemed shares for more than one year.

If, however, the company had redeemed only 50 of Peter’s 400 shares for $15,000 a share, he would not have met the substantially disproportionate test because his ownership of company voting stock would not have been reduced by 20% over his prior ownership. Peter may argue that the reduction should be treated as a “meaningful reduction” in his ownership, but if he was active in the company, this could be a difficult argument. If Peter is unable to convince the IRS that the reduction from being a 40% to a 30% owner is a meaningful reduction, then he may be deemed to have received a “distribution.” As the company did not have any accumulated earnings and profits, Peter would compare the $750,000 distribution paid to him for his shares to his $4,000,000 basis in the stock, and all of the $750,000 paid to him in the redemption would be tax-free. Peter’s basis in the remaining shares would now only be $3,250,000.

Redemption Using a Note

If the S corporation gives the shareholder a note for part of the purchase price it pays for the shares it is redeeming, this could have a distinct impact on the tax treatment of the transaction. If the redemption is taxed as a “sale or exchange,” the selling shareholder can defer reporting the gain on the sale until the sales proceeds are received.

If, on the other hand, the redemption is treated as a “distribution,” the shareholder cannot defer the realization of the consideration for tax purposes. Rather, the shareholder will report the cash and the fair market value of the note received as a current year distribution. The fair market value of the note typically will equal its face amount, assuming it bears a reasonable interest rate and there is no reasonable basis for questioning the likelihood of repayment.

It should be noted that the company’s interest expense on the note used to redeem the shares may not necessarily be deductible as an ordinary expense. The treatment of the interest payments for tax purposes will depend on the types of assets held by the S corporation.

Effect of Redemption on AAA

The S corporation rules require that an S corporation reduce its AAA by the percentage of stock redeemed. Thus, if 10% of the company’s stock is purchased by the company, the AAA should be reduced by 10% (through line 5, Other Adjustments). Companies often fail to make this adjustment, which results in an overstatement of the AAA balance. Because S corporation distributions must come out of the AAA to be tax-free, if the AAA is overstated, in an audit, this could come back to harm the S corporation, particularly if the company has paid significant distributions that could be recast as taxable dividends.

Another adjustment that is often missed is the adjustment to the company’s E&P for stock redemptions. Under Section 312(n)(7) of the IRC, like the AAA, E&P should also be reduced by the percentage of stock redeemed. Failure to reduce E&P results in an overstated balance in the company’s prior C corporation’s earnings, with the potential of subjecting future distributions by the company to taxation when they should not be.

Conclusion

In conclusion, whenever an S corporation is considering a purchase of its shares from a shareholder, it is important to be mindful of the redemption rules in the IRC to determine how the transaction should be treated for tax purposes by the selling shareholder and the resulting impact on the S corporation.

Private Label Paper and its Regulatory Backlash *by Robert Flowers*

Although many independent banks across the United States have had little to do with the current economic abyss into which the country has fallen, the impact of the financial industry crisis and related mortgage fallout has begun to creep into the lobbies and onto the financial statements of banks. This impact is felt not just by struggling banks but also by well-rated and well-run independent financial institutions, and its negative effects often approach like a thief in the night. This "stealth bandit" is beginning to arrive in the form of non-government-backed private label paper, more commonly referred to as mortgage-backed securities, or "MBOs." The effects of holding MBOs, particularly those that have been downgraded, can reach far and wide into an otherwise sound and well-capitalized bank.

The purpose of this article is to alert you to the regulatory impact of holding MBOs, particularly those that are rated less than investment grade, and how these MBOs and the concept of "other than temporarily impaired," or "OTTI," can thrust an otherwise healthy institution into a stress condition typically experienced by troubled institutions, and can lead to classification, liquidity and capital problems. Furthermore, these problems are not mutually exclusive, and just because a bank is not required to recognize OTTI in its portfolio does not necessarily mean that the bank is out of the woods. Any bank holding MBOs may still experience the regulatory pitfalls that accompany classification and risk-weighting issues associated with these securities. This is why it is important to understand your portfolio hold and analyze the holdings in light of the current economic environment. An ounce of prevention today may be worth more than a pound of cure tomorrow.

Which Institutions Should Be Concerned?

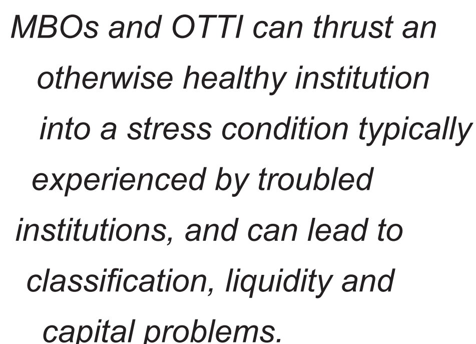
All institutions, but certainly those with a significant portfolio of MBOs, should be aware of the OTTI concept and the impact it can have on a bank's balance sheet and capital position. Credit crises, recessions and overall economic stresses can significantly affect the value of MBOs. During market downturns, accounting guidelines require a determination of value, impairment to value and, if there is an impairment to value, a determination whether that impairment is considered "other-than-temporary." If there is OTTI, the bank must take a write-down on the security with a related charge to current-period earnings and capital.

Accounting guidance under United States generally accepted accounting principles ("GAAP") requires financial institutions to categorize an investment security, such as an MBO, into one of three categories upon its acquisition (i) "held to maturity" ("HTM"), (ii) "available for sale" ("AFS") or (iii) "trading." In addition to defining the appropriate categories, GAAP also requires the bank, for each reporting period, to assess both the classification of HTM and AFS securities and, more importantly for OTTI purposes, to determine whether any decline in value of the security should be considered OTTI. The relevant accounting guidance is either FASB Statement 115 ("FAS 115") or EITF 99-20 (as amended by EITF 99-20-1), depending on the type of asset in question. EITF 99-20-1 is specifically applicable to mortgage- and asset-backed securities, while FAS 115 is the standard applicable to other assets.

How is OTTI Determined?

There are no "bright-line" or "rule of thumb" tests for OTTI, so a bank should use all available objective and identifiable information, including data prepared by outside consultants and advisers, to aid in its OTTI determination. The specific accounting principles underlying OTTI are far beyond the scope of this article, but a summary of the process may be helpful.

There is a basic three-step process to determine whether the MBOs have impairment and, if so, whether it constitutes OTTI. First, the bank must analyze its MBOs (and other securities, other than those that are "trading") to determine each security's value and whether the security has experienced impairment. For MBOs, the basic accounting rule is that the MBO will be considered "impaired" if it is probable that there has been an adverse change in estimated cash flows of the asset. In other words, the bank must assess whether it is probable that a change, whether favorable or unfavorable, could occur in the estimated cash flows of the MBO from amounts previously projected to be received by the bank on that MBO. If it is determined that the asset is impaired, the bank must recalculate the acceptable yield to determine the amount of the impairment, and then proceed to the next step to determine whether the impairment is OTTI.



The second step, determining whether the impairment is OTTI, is a very subjective test that inevitably will require assistance from outside consultants such as the bank's accountants and its investment adviser. All available data should be considered when ascertaining OTTI. The subjective exercise includes factors such as the nature and extent of the decrease in fair value of the security; the nature of the investment and the recent investment grades for the asset; the ability and intent of the bank to hold the security for a reasonable period of time (which may be in excess of one year) sufficient to achieve forecasted recovery in value; the cause of the impairment, including the financial condition and prospects of the issuer; adverse economic conditions specifically related to the issuer; the issuer's cash position or the issuer's geographic market; the severity and duration of the impairment, factoring in the length of time and extent of any market correction; forecasts of economic, market or industry trends; and any other evidence deemed to be relevant in reaching a conclusion.

If it is determined that the impairment to the MBO is OTTI, the final step in the process is for the bank to recognize an impairment loss equal to the difference between the asset's amortized investment cost and its current fair value. The bank should work closely with its third-party advisers, including its accountants, to properly calculate and report the OTTI. The impact of OTTI, which can be significant, will be seen in the bank's income statement and its balance sheet, and may require restatements of earnings, amended call or thrift financial reports and other regulatory and accounting adjustments.

Additional Concerns

Although the major concern with holding MBOs (and other securities) in this economic environment is the issue of OTTI, holding MBOs in particular can affect the bank in two other ways — asset classification and risk weighting. Each of these, in turn, can affect the bank's capital ratios and its overall regulatory health.

For asset classification, the question is how should MBOs be classified when the MBO has been downgraded to below investment grade? Under the Uniform Agreement on the Classification of Assets and Appraisal of Securities Held by Banks and Thrifts ("Uniform Agreement"), as interpreted by the bank regulatory agencies, examiners are required to use published ratings as a proxy for the classification definitions employed, including the classification of an asset as "substandard."

Under the Uniform Agreement, an asset is considered "substandard" when it is inadequately protected by the current sound worth and paying capacity of the obligor or of the collateral pledged, if any. These assets are characterized by the possibility that the *institution* (note, not the MBO itself) will sustain loss if the deficiencies are not corrected. A security rated below the four highest investment grades is normally considered "substandard." Accordingly, a single-obligor corporate bond or a multiple-obligor MBO that has been downgraded to below investment grade would be classified as "substandard" under the Uniform Agreement.

One problem here is that the Uniform Agreement is based on the premise that deficiencies relate to the characteristics of a single-obligor security, such as a corporate bond. This approach is not uniformly applicable to MBOs, which are by nature multiple-obligor securities. With MBOs, there may be some obligors with deficiencies, but many others that are well-performing, thus resulting in no overall loss to the MBOs, with a lessened probability of loss ever occurring, and certainly little, if any, possibility that the institution will sustain a loss. In other words, a broad-brush ratings approach to classification of MBOs overstates the risk.

Having said all that, and while the Uniform Agreement provides that an examiner may, in limited cases, "pass" on a security that is rated below investment grade, our experience with the regulators is that they will take a hard-line, literal approach in applying the Uniform Agreement. As a result, any MBOs held by the bank that are rated at below investment grade will likely be classified as "substandard." Obviously, the more classified assets the bank has as compared to its total assets and to its capital, the more the regulators will take notice, which will affect the bank's CAMELS ratings. This in turn can affect the bank's operations and ability to borrow funds, pay dividends and raise capital. Nevertheless, the bank should not simply nod and apologize, but should instead attempt to argue for a more favorable view of MBO classification that does not rely solely on investment ratings.

Similarly, concerning risk weighting and capital ratios, the issue is whether the bank is required to assign a risk weight to its MBOs according to the ratings-based tables under the risk-based capital guidelines (Guidelines) (which for below-investment-grade ratings would result in a 200 percent risk weighting in most cases), or whether the bank may, in the alternative, use the 100 percent (or less) risk weighting of the standard risk weightings under the Guidelines. The likely answer is that there is some flexibility, but the regulators often interpret the Guidelines differently. If the bank holds MBOs, the bank should carefully review the Guidelines applicable to it (whether OCC, Federal Reserve or FDIC guidelines — there are differences) to determine how to risk-weight the MBOs. Special attention should be paid to MBOs that are rated less than investment grade, as these MBOs may have to be weighted at 200%. If so, the bank's capital ratios can be immediately and adversely affected, which likely will bring the regulators to the bank's front door. Careful application of the Guidelines may enable the bank to "look through" the MBOs to the underlying mortgages and risk-weight them based upon the underlying mortgages (as low as 50% risk weighting) in a "bifurcated" approach to risk weighting. To do this, however, the bank must meet certain requirements, such as credit analysis and due diligence standards.

To summarize, if the bank holds MBOs, the bank should consider implementing an OTTI Policy, and in fact may be required to do so by its regulators. We are beginning to encounter this on a much more frequent basis. Furthermore, if any of the MBOs held by the bank are downgraded, the bank should promptly consider the impact of the downgrade on the bank's asset classification and capital position. Being proactive in this area is much better than getting a surprise phone call from the bank's regulators. In addition, these problems can materialize sometimes overnight, so continual attention is required if the bank holds MBOs.

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