

REGULATORS VS COMMUNITY BANKS: THE LATEST FROM THE BATTLEFRONT



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Federal legislative and bank regulatory actions have placed additional burdens and responsibilities on community banks. Steve Eisen will review these regulatory risks in light of recent regulatory activities and stories from the examination and enforcement trenches to assist bankers and their advisors in mitigating these risks.

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Or, in other words:



1. **IS IT ALL DODD-FRANK ACT? (Jon Huntsman Story)**

(a) No – just an example of statutory/regulatory/examiner burdens which I call:

REGULATORY RISK

PLAY AT
YOUR
OWN
RISK

(b) 5,000 Pages of New Regulations. "Congress consistently underestimates the complexity and volume of the regulations resulting from new laws. Based on the number of pages of regulations resulting from previous laws, the Dodd-Frank Act will result in more than 5,000 pages of new regulation for traditional banks. This is in addition to the 50 new or expanded regulations affecting banks over the last two years." (www.aba.com/aba/documents/news/CommBankImpact70910.pdf)

(c) Get Back to Business. "Congress and the Obama administration have launched a series of measures against the banking industry that are retarding economic growth. Dodd-Frank is causing a great deal of uncertainty and is imposing tens of billions in additional costs to the industry while doing little to address the issues that led to the recent crisis...[A] priority must be to curtail the government's relentless attack on the banking system and to do everything we can to allow banks to get back into the business of lending and promoting economic growth." William M. Isaac, former chairman of the FDIC, American Banker, September 9, 2011, p. 8.



(d) State Regulator Understands. Commissioner Gonzales stated in the Tennessee Department of Financial Institutions 2010 Annual Report that "Since financial institutions are, in many respects, a mirror of the local economy, we expect financial institutions to continue to deal with economic challenges. Financial institutions will also face a changing regulatory environment as federal regulatory reform is implemented." Commissioner Gonzales at the TBA annual meeting in 2011 suggested that regulators should not overreact, should not be too aggressive, should not put everyone in the same box, and should beware of consumer overreaction.

2. STORIES YOU DID NOT WANT TO HEAR

(a) Impairments. Examiner's make own appraisal, which is lower than professional appraisal:

(i) Gilbert Barker, OCC, Deputy Comptroller for the Southern District, Testimony before House Financial Institution Subcommittee on Financial Institutions, August 16, 2011, stated that examiner will not classify or write down loans solely because the value of the underlying collateral has declined to an amount less than the loan balance. He suggested that examiners first will focus on the adequacy of cash flow to service the debt. He also stated that based on the October 2009 Interagency Commercial Real Estate Policy Statement "appropriately supported assumptions" used by appraisers are to be given a "reasonable degree of deference" by examiners in accepting such appraisals



(ii) Ex: National Bank in East Tennessee (regulated by OCC) - president – "might lose jobs," examiner – "that's not my problem"

(b) Brokered Deposit Battle

(i) Policy is to Manage²

(ii) Examiners Want Elimination

(iii) Battle When Order Proposed – Liquidity Crisis vs. Notice of Charges



(c) SBLF Bureaucracy. Inconsistent documents, losing stock certificates and other docs, using inexperienced law firm with threatening contract lawyers working from their homes all over the northern seaboard, closing started 1 year after law passed and only 3 months before law expired, decided that dividend restrictions were an issue at last minute and only gave banks one month to get waivers (which turned into a political battle between Fed and Treasury), rejected over 60% of applications without giving any reason – originally approved \$30b, only about \$10b even applied and only about \$4b closed

² Funding and Liquidity Risk Management Interagency Guidance (PR-55- 2010, March 17, 2010; FIL-13-2010, April 5, 2010). The federal financial institution regulatory agencies issued guidance to provide sound practices for managing funding and liquidity risk and strengthening liquidity risk management practices. The policy statement emphasizes the importance of cash flow projections, diversified funding sources, stress testing, a cushion of liquid assets, and a formal contingency funding plan as primary tools for measuring and managing liquidity risk. Each financial institution is expected to manage funding and liquidity risk using processes and systems commensurate with the institution's complexity, risk profile, and scope of operations. See <http://www.fdic.gov/news/news/financial/2010/fil10013.html>

(d) Request for CPA Work Papers – letter from Joseph Meade, Acting Deputy Regional Director of the FDIC (Dallas Region), to one of my bank clients on August 29, 2011: "the FDIC has established a program to review external auditor's work papers to enhance the supervision of institutions." This is based on a 1999 Interagency policy statement³ requiring banks to include in their engagement letters with external auditors the right of examiners to review the work papers.



(e) Attempts to Correct Misstatements in Exam Report – Discuss but won't do it because "not material," but when Treasury relied on exam report for SBLF, Bank was denied \$



(f) Capital – “Well-capitalized” is no longer good enough

(i) Gilbert Barker, OCC, Deputy Comptroller for the Southern District, Testimony before House Financial Institution Subcommittee on Financial Institutions, August 16, 2011, stated most banks are expected to maintain capital levels above regulatory minimums, especially if a bank has significant risk concentrations

(ii) Resolutions for 2s, MOUs for 3s, orders for 4s and 5s

(iii) No formula for capital ratio determination

(1) Rounded them up for Eisen

(2) Always a little higher than where you are even if your numbers are well above well capitalized; no consistency (even GA says they give lower than other areas (8%/10%))

(3) Notice of Charges Admin Law Judge Statement

(iv) No credit for loan loss reserve

³ Interagency Policy Statement on External Auditing Programs of Banks and Savings Associations, 1999. Auditing interpretation (AU Section n9339.11-15) issued by the AICPA further describes the steps for providing regulators this information.

- (v) Source of capital is local, and regulators scare them away

Ex: Threats caused private \$ to bail

- (vi) Whatever level bank is functioning, regulators want some more

(g) General Antagonism and Incivility

- (i) Threatening phone calls from lawyers

- (ii) Ex: went to DC and enforcement guy there

(iii) When requested changes in proposed consent order, told "NO," "NOT," "not flexible," ... "a friendly reminder that firearms are not permitted at the FDIC's offices." – is this joking or a civility problem?



- (iv) Threatening civil monetary penalties at every turn (letter to Board confirming Exit Interview)

(h) Economic Problem – regulatory risk and uncertainty is adding to general economic and political uncertainty which is stunting the country's ability to work out of this recession

3. **WHY ARE THEY LIKE THIS?**

(a) Human Beings – self preservation, why stick their necks out, only can lose

(b) Political Risk – Congress won't help individual banks or even the industry because it looks bad; Ex: when I called a Senator's office to get help on a federal regulatory issue, I was told the staffer could not even call the agency for lunch any more since every call was recorded on an ethics log



(c) Media Pressure

(d) Concern About Setting Precedent. - Ex: I asked for broad interpretation of a particular banking law and was told not right now



(e) Inspector General. Most recent Office of the Inspector General (OIG) of the FDIC criticized the FDIC supervisory process in its August 2011 Material Loss Review of FirsTier Bank, Louisville, Colorado (Report No. AUD-11-013): "Recognizing that FirsTier's financial condition and markets were generally favorable during earlier examinations, the FDIC could have placed greater emphasis on the institution's growing risk profile during and after the January 2007 examination. Such emphasis could have included a more aggressive pursuit of the institution establishing and maintaining prudent limits on its growing ADC loan



concentration and holding higher levels of capital. In addition, the ratings assigned during the June 2008 CDB examination did not fully reflect (on a forward-looking basis) the substantial risk associated with the institution's ADC loan exposure in a weakening real estate market. Examiners became sharply critical of the bank's risk management practices during the July 2009 examination and issued a Cease and Desist Order in January 2010. However, by that time, the institution's lending markets had deteriorated significantly, making remedial efforts difficult. A more proactive supervisory approach may have influenced the bank to curb its ADC lending, increase its capital levels, and strengthen risk management before the bank's lending markets deteriorated."

(f) Word Does Not Filter Down From DC – Do examiners really hear?



(i) Shock of OCC Head of Supervision on TBA Washington Trip

(ii) Gilbert Barker's quote above offer further evidence

(g) Power Imbalance – regulators have all the deference and power as the "judge, jury, and executioner"



(h) General Comment. "The current crisis has reminded us once again that regulators are fallible. Sometimes the workload is overwhelming; sometimes regulators get too close to the institutions we supervise to fully appreciate emerging risks. Sometimes regulators are not close enough to an institution or a community and unfairly or inappropriately apply sweeping remedies." Howard F. Pitkin, Commissioner of the Connecticut Department of Banking, American Banker, August 5, 2009.

4. LIGHT AT THE END OF THE TUNNEL

(a) Banks Push Back

(i) Argue ALLL - \$4m vs. \$0 – finally examiners say bank can pick and justify the amount

(ii) Exam Report Acknowledgement. – Do not sign state's awareness paragraph in their "acknowledgement of review of exam report"



As a Director, I am aware of my individual responsibility and liability in managing, exercising powers and discharging duties which will ensure the stability and soundness of the institution. Furthermore, I understand that the level of my responsibility and liability is not diminished by the fact that I may have no day-to-day involvement with the institution nor is it diminished by the fact that I may possess little or no ownership interest in

the institution or its holding company. Therefore, the matters directed to our attention within this report will receive prompt consideration, and you will be advised promptly if action taken.

(b) Expansionary Activity Approved?

(i) Branch approved in a new county (but beware growth limitations and length of time for approval)

(ii) Will small bank merger be approved – Dickson/Columbia?

(iii) Will bank acquisition and long move of charter be approved – Lebanon?

(c) Good Faith. Compliance with formal and informal actions is “best efforts” and “good faith effort” and reasonableness standard– will tell you in meetings, will allow you to send them a letter, but will not put in the CO because if they want to enforce the CO, they don’t want the bank waiving around in front of the judge any of these arguments; said once upon a time, they did allow in C&D’s; they hold all the cards – document efforts and wont issue monetary penalties (will still sue if bank fails)

5. **WHAT DO WE DO?**

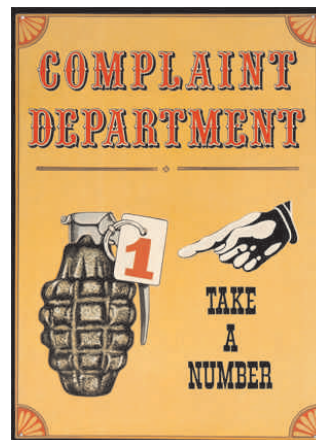
(a) Change the Appeal System

(i) Ombudsman/Admin Law Process Do Not Work

(1) Ombudsman – I have called and been told they would make some calls but could not get a decision changed

(2) FDIC Discouragement – when I told FDIC I had called Ombudsman to challenge an examiner decision, I was told I should not have done that but filed my grievance directly with the Deputy Regional Director (who happened to be the one who supposedly made the final decision on the issue the bank was challenging)

(3) FDIC Financial Institution Letter FIL-13-2011 issued March 1, 2011 - "If an institution disagrees with examination findings, it should address those concerns through communication with the examiner, field office management, or the appropriate regional office staff. Division-level informal reviews are also available. If informal efforts to resolve disagreements are not successful, an institution may pursue a formal supervisory appeal....FDIC policy prohibits any retaliation, abuse, or retribution by an agency examiner or any FDIC personnel against an institution."



(ii) Fear of Retribution - Senator Corker said at TBA convention in 2010 that nobody will complain to him for fear of retribution



(b) Buy Time (my job) Until Economy Improves

(i) Negotiate MOUs/Orders and Consider Notice of Charges (bad PR and retribution vs. time and possible capital requirement changes)

(ii) Fight Back (last week regulator said if sign today, will lower capital ratios) OR Give In and Argue for "Best Efforts" Interpretation (bank chairman told me last week that banks are like the American Indians of the 1800's where they kept getting pushed back and beaten up until they had no choice but to fight back)

(iii) Regulators Must Let Banks Get Back to Business of Lending and Promoting Growth of the Economy (Isaac quote above):



Back in 1990, the Government seized the Mustang Ranch brothel in Nevada for tax evasion and, as required by law, tried to run it. They failed and it closed. Now we are trusting the economy of our country and our banking system to the same nit-wits who couldn't make money running a whore house and selling whiskey!"

Maxine

(c) Recognize That Banking Has Changed, so we need to implement:

(i) New and Efficient Policies and Procedures

(ii) Analytical Tools for Measuring Risk (include regulatory risk)

(iii) Lower Director and Shareholder Expectations for Returns, Market Value of Stock, and Quick Profit on Sale of the Bank

