April 2009

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# The Saga Continues — More on The State of Banking 2009

*By: Peter G. Weinstock*[1]

### The Impact of CAP on Banks Under $100 Billion in Assets

On February 25, 2009, the UST announced the terms and conditions of the Capital Assistance Program ("CAP"). Under CAP, the federal banking regulators will conduct "stress tests" to evaluate the capital needs of banks with in excess of $100 billion in assets. These "stress tests" have been much discussed with regard to what approach UST will take if it determines that such institutions need additional capital and such capital is not forthcoming from private sources.

What has not been discussed is how the bank regulators will evaluate banks under $100 billion in assets on a going-forward basis. Stress testing of loan portfolios and liquidity sources that yield positive results will assist those facing regulatory pressures. For others, however, such testing will exacerbate regulatory presumptions of a financial institution's problems. Unfortunately, there is becoming less choice here.

Examiners are already asking about stress testing. Banks should consider taking the offensive to ensure that loan reviews can be defended because they anticipate declines in real estate/collateral values, job losses and other economic factors. It is worth considering whether the UST's benchmarks are actually helpful as a "stop loss" on examiner exuberance.

The CAP stress test considers the following:

- the impact on earnings and capital from economic conditions, including future economic conditions,
- concentrations of credit and asset quality issues,
- declines in asset and collateral values,
- off-balance-sheet and other contingencies,
- the quality of capital (which is a topic that I raised in the prior "State of Banking 2009"),
- other sources of capital available, and
- a catch-all for risks not reflected in this list.

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| | 2009 | 2010 |
|---|---|---|
| **Real GDP**[1] | | |
| Average Baseline | -2.0 | 2.1 |
| Consensus Forecasts | -2.1 | 2.0 |
| Blue Chip | -1.9 | 2.1 |
| Survey of Professional Forecasters | -2.0 | 2.2 |
| Alternative More Adverse | | |
| **Civilian unemployment rate**[3] | | |
| Average Baseline[2] | 8.4 | 8.8 |
| Consensus Forecasts | 8.4 | 9.0 |
| Blue Chip | 8.3 | 8.7 |
| Survey of Professional Forecasters | 8.4 | 8.8 |
| Alternate More Adverse | 8.9 | 10.3 |
| **House prices**[4] | | |
| Baseline | -14 | -4 |
| Alternative More Adverse | -22 | -7 |

[1] Percent change in annual average.

[2] Baseline forecasts for real GDP and the unemployment rate equal the average of projections released by Consensus Forecasts, Blue Chip, and Survey of Professional Forecasters in February.

[3] Annual average.

[4] Case-Shiller® 10-city composite, percent change, fourth quarter of the previous year to fourth quarter of the year indicated.

## Perverse Effect of Floors

Most banks have become successful in instituting interest rate floors on floating rate loans. As a result, loan yields are not falling even as deposit costs do drop. Consequently, net interest margins ("NIMs") are widening. Banks need every dollar of interest income in this environment.

We will have inflation. The interest rate floors yield perverse effects in a rising rate environment. These floors are currently between 1-3% above what the stated rates on the loans would yield. As rates rise, the borrowers will not pay more on the loans, thereby squeezing the NIM.

Many interest rate shock tests that I have seen do not reflect this NIM shrinkage. Such tests should be revised to recognize that deposit costs increase while loan yields do not until rates exceed the loan floors. Consequently, bankers should consider some form of adjustable floors that will maintain or minimize the loss of spread. These modified floors should be imposed now when interest rate pressures remain slight. Last, to maintain these negotiated returns, bankers should consider prepayment penalties.

## Compensation

The political hysteria surrounding the AIG and Merrill Lynch bonuses threatens to engulf all financial institutions whether they accepted TARP or not. At the ICBA convention, Federal Reserve Chairman Ben Bernanke called for examiners to pay "close attention" to compensation practices as part of examinations. He said "poorly designed compensation policies can create perverse incentives that can ultimately jeopardize the health of the banking organization."

In light of: (i) Mr. Bernanke's statements, (ii) President Obama's assertions that the compensation programs of all financial institutions — not just those receiving TARP — should be regulated, and (iii) Congress's willingness to grandstand on this issue, it can be expected that the bank regulators will add compensation reviews back into examinations.

Since 1991, when Congress adopted the FDIC Improvement Act, bank regulators were given the authority to regulate bank compensation. The regulators apply the following standards:

*A. Excessive Compensation*

Excessive compensation is prohibited as an unsafe and unsound practice. Compensation shall be considered excessive when amounts paid are unreasonable or disproportionate to the services performed by an executive officer, employee, director, or principal shareholder, considering the following:

1. The combined value of all cash and non cash benefits provided to the individual;

2. The compensation history of the individual and other individuals with comparable expertise at the institution;

3. The financial condition of the institution;

4. Comparable compensation practices at comparable institutions, based upon such

factors as asset size, geographic location, and the complexity of the loan portfolio or other assets;

5. For post employment benefits, the projected total cost and benefit to the institution;

6. Any connection between the individual and any fraudulent act or omission, breach of trust or fiduciary duty, or insider abuse with regard to the institution; and

7. Any other factors the agencies determine to be relevant.

*B. Compensation Leading to Material Financial Loss*

Compensation that could lead to material financial loss to an institution is prohibited as an unsafe and unsound practice.

Banks should follow many of the "best practices" that have arisen from Sarbanes-Oxley and the SEC's changes to compensation disclosure. In addition, banks should consider the TARP (best practices — not compensation limits) to support their compensation programs. These include:

- adoption of or amendments to policies or the employee handbook to make it clear that the bank expects employees to consider long-term, as well as short-term, risks to the bank in connection with all transactions;
- as part of the policy, preparation of objectives (what behavior is the bank trying to encourage) and how the bank's compensation plan seeks to achieve these objectives;
- review of all compensation plans to verify that they do not provide incentives to take risks that are not condoned by senior management or the board (the compensation committee should engage in this review annually);
- certification/documentation by the compensation committee that it has completed such a review;
- reasonable performance goals that do not require excessive risk-taking to achieve them; and
- a mix of short- and long-term compensation with clawback provisions for long-term payments made that, in retrospect, are not deserved.

## Allowance for Loan Losses

Banks need to consider their general reserve methodologies because loss experiences in the last couple of years are so much different from those of earlier in the decade. Banks need to shorten the time frame to three years from five years. One of our clients in Arizona even uses a two-year horizon.

Those using three years for loss history should place more weight on the last year or other point during which loan losses started to spike. The Interagency Policy Statement includes factors such as level and trend of nonperforming assets, delinquencies and charge-offs, imprecision of appraisal accuracy, prospective trends in the economy and the possible effect of such trends on CRE/C&I loans that have not become classified. Banks should assess each factor to determine whether risk is increasing, flat or declining. Just because a bank's CPA firm has signed off on the bank's reserves and its methodology should not make the loan committee complacent. In the current climate, accountants are determining when examiners require higher allowances.

## Enhanced Bank Holding Company ("BHC") Oversight

On February 24, 2009, the Federal Reserve promulgated a supervisory letter (SR 09-04), which requires Federal Reserve staff to "evaluate the comprehensiveness and effectiveness of management's capital planning." Principally, the Federal Reserve intends for holding companies to consider how they will serve as a "source of strength" to their financial institution subsidiaries. Although the statutory underpinnings of the Source of Strength Policy Statement are of questionable validity, the Federal Reserve expects holding companies to husband their resources for their financial institution subsidiaries over the holding companies' creditors and shareholders.

BHCs that are, or are at risk of, developing financial weaknesses are expected to consult with the Federal Reserve. Moreover, the Federal Reserve expects a BHC to inform the Federal Reserve reasonably in advance of declaring or paying a dividend that exceeds earnings for the period (e.g., quarter) for which the dividend is being paid or that could result in a material adverse change to the BHC's capital structure.

Specifically, the Federal Reserve believes dividends, including trust preferred distributions, stock repurchases and redemptions, should be limited, deferred or eliminated if:

(1) the BHC's net income available to shareholders for the past four quarters, net of dividends previously paid during that period, is not sufficient to fully fund the dividends;

(2) the BHC's prospective rate of earnings retention is not consistent with the BHC's capital needs and overall current and prospective financial condition; or

(3) the BHC will not meet, or is in danger of not meeting, its minimum regulatory capital adequacy ratios.

Failure to do so could result in a supervisory finding that the organization is operating in an unsafe and unsound manner. The Federal Reserve intends to use its supervisory and enforcement authority to prevent dividends, stock redemptions or repurchases or satisfying trust preferred or other hybrid capital obligations.

### Ten Percent Shareholders

The Federal Reserve also is requiring copies of governance documents from all new shareholders of a BHC that: (i) are entities, including trusts, and (ii) acquire 10% or more of the stock of a bank or BHC. The purpose of this requirement is to provide the Federal Reserve with information to enforce the Source of Strength Policy Statement.

### TLGP

The FDIC has prohibited banks from issuing notes guaranteed under the TLGP if the banks have a less than "satisfactory" rating. For those banks that do issue, they must remember to record the issuance on FDI*Cconnect* within five calendar days. The FDIC takes this obligation very seriously and will consider enforcement action for the failure to abide.

### ICBA Presentation

Recently, one of my partners and I spoke at the ICBA convention regarding strategic planning to survive the credit crisis and thrive in the recovery, including acquisitions of problem banks and failed banks. Please let me know if you want me to email you a copy of the materials.

Visit the Financial Industry Recovery Center at www.huntonfinancialindustryrecovery.com
A Resource for Clients and Colleagues Concerning the Financial Crisis