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FINANCIAL INSTITUTIONS GROUP

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"TROUBLED CONDITION" DESIGNATION – A TRAP FOR THE UNWARY COMMUNITY BANKER

Federal bank regulators have at their disposal a wide variety of enforcement mechanisms. Using these tools, they can circumscribe or even steer the operations of an underperforming financial institution. These range from matters requiring attention to formal enforcement actions and prompt corrective action directives. On the whole, these enforcement mechanisms are applied sequentially, increasing in severity if an institution fails to comply with the previous enforcement device. In an important aspect, however, the "troubled condition" designation exists outside this traditional enforcement structure and therefore has consequences that bank management may not immediately recognize.

WHEN IS A BANK "TROUBLED"?

The Federal Deposit Insurance Corporation (FDIC) deems a state nonmember bank to be in "troubled condition" if it is (i) assigned a Uniform Financial Institutions Rating System, or CAMELS, composite rating of 4 or lower, (ii) subject to an FDIC-initiated proceeding to terminate or suspend its deposit insurance, (iii) subject to a cease-and-desist or order or written agreement with the FDIC or state banking authority requiring action to improve its financial condition or (iv) "informed in writing by the FDIC that it is in troubled condition… on the basis of the bank's most recent report of condition or report of examination, or other information available to the FDIC."[1, 2]

The first three of these four criteria share certain important characteristics: they are discreet regulatory actions that can be taken only in accordance with well-defined standards and only where certain circumstances and conditions have been demonstrated to exist. These three criteria are thus challengeable in the first instance and appealable either by intra-agency appeal, formal administrative process or, ultimately, in the courts. The fourth criterion -- which allows the FDIC to impose the troubled condition designation on "*other information available to it*" – differs in dramatic fashion from the other three.

In this latter instance, the FDIC veers from the common sense approach represented by its application of the first three criteria by grabbing the right to impose the very consequential "troubled condition" designation at whim with no obligation or apparent need to explain or even disclose the basis for this potentially draconian action. Remarkably, the "troubled condition" designation simply springs into being upon the delivery of a letter

[1] 12 C.F.R. § 303.101(c).

[2] "Troubled condition" is defined by the Office of the Comptroller of the Currency at 12 C.F.R. § 5.51(c)(6), the Federal Reserve Board at 12 C.F.R. § 225.71(d), the Office of Thrift Supervision at 12 C.F.R. 563.555 and the National Credit Union Administration at 12 C.F.R. § 701.14(b)(3).

to the bank stating that: "Based on information available to the FDIC… please be advised that we deem the bank to be in "troubled condition," as that term is defined in section 303.101(c)(4) of the FDIC's Rules and Regulations." It is hard to imagine a starker example of regulatory overreach.

EFFECTS OF TROUBLED CONDITION

Two explicit consequences flow from the troubled condition designation. First, such banks are required to obtain the prior written consent of the FDIC before making any changes in senior management or their boards of directors.[3] Second, troubled banks are prohibited from making, or agreeing to make, golden parachute payments to institution affiliated parties as defined in Part 359 of the FDIC's regulations without first receiving FDIC approval.[4] In general, neither of these consequences has a significant or immediate impact on bank operations, particularly because neither impacts the economics of daily bank operations.

However, being deemed a troubled bank bears a third consequence: a troubled bank is prohibited from accepting, renewing or rolling over any brokered deposit unless it has applied for and been granted a waiver by the FDIC.[5] Brokered deposits include any deposits originated by a bank as a result of offering rates significantly higher than the prevailing rates of interest on deposits offered by other insured depository institutions in that bank's normal market area.[6] This is generally understood to limit a troubled bank to offering deposit rates at not more than 75 basis points above the national rate paid on deposits of comparable size and maturity.

Consistent with the FDIC's now-you-see-it-now you-don't approach to its troubled condition designation process, there is no written regulation that directly imposes the brokered deposit restrictions on institutions deemed "troubled." This is startling given the dire impact deposit rate restrictions can have on an institution's liquidity and risk management. The brokered deposit restrictions are circuitously imposed as a result of being less than "well capitalized" pursuant to the prompt corrective action standards set forth in Section 38 of the Federal Deposit Insurance Act, or PCA.[7] Pursuant to PCA, no bank can be deemed well-capitalized if it has a CAMELS composite rating of 4 or lower.

The regulatory sleight of hand is hardly subtle. The FDIC first issues a notice that the bank is in troubled condition based on the nebulous "other information" standard. Thus, for a bank last rated a CAMELS composite 3 or higher, the FDIC avoids having to cite to an examination report conclusion that the institution was a composite 4; something that would otherwise be a pre-requisite to a "troubled condition" finding. Once it has by unexplained fiat deemed the bank to be in "troubled" condition, the FDIC next makes the counter-logical argument that because all 4-rated institutions are by definition troubled, all troubled institutions are presumptively 4-rated. This presumptive 4-rating now provides the justification for (a) the "troubled institution" designation itself and (b) the regulatory consequences of that rating. This circular *non sequitur* gives new meaning to the term bootstrapping. By taking the single step of deeming a bank to be in troubled condition on an otherwise unsubstantiated basis, the FDIC is able to treat a bank as if it were 4-rated. A 4-rated bank is only "adequately capitalized" for the purposes of the PCA and therefore subject to the brokered deposit restrictions.

[3] 12 C.F.R. § 308.151.

[4] 12 C.F.R. Part 359.

[5] 12 C.F.R. § 337.6(b)(2).

[6] 12 C.F.R. §337.6(a)(5)(iii).

[7] 12 C.F.R. § 337.6(a)(3).

Manufacturing Liquidity Risk to Support a Future Enforcement Action

It is not uncommon for the FDIC to advise an institution in "troubled condition" that it is facing increasing liquidity risk. Citing the requirement that deposit rates be lowered per the restrictions on brokered deposits, the FDIC often concludes that such deposit rate reductions will result in significant deposit runoff. In some instances, the FDIC will assume one hundred percent runoff of deposits above the national rate caps plus 75 basis points. No prudently operated bank projects complete runoff as deposit rates fall. Accordingly, every bank's liquidity will appear insufficient when compared to the FDIC's one hundred percent runoff scenario. This conjectured inability to cover the FDIC-projected deposit runoff will be presented by the FDIC as evidence of a looming liquidity crisis that threatens the institution's viability. Invariably, this hypothetical liquidity crisis will be used by the FDIC to present the besieged bank with the "option" of signing a consent order or facing issuance of a notice of charges for the imposition of an order to cease and desist.

In short, by issuing a "troubled condition" notice to a 3-rated bank on the basis of "other information available to the FDIC," the bank will immediately face significant pressures on its deposit funding strategies. As a result of this FDIC-created liquidity crisis, unless the "troubled condition" designation is immediately challenged, the institution should expect the commencement of formal enforcement action.

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This brief discussion of the consequences of the troubled condition designation is not comprehensive and is for general information purposes only. If you would like to learn more about this topic or how Pryor Cashman LLP can serve your legal needs, please contact Pinchus Raice at 212-326-0104, praice@pryorcashman.com or Robert Lamonica at 212-326-0810, rlamonica@pryorcashman.com.

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Pinchus Raice is the Chairman of the Financial Institutions Group. Pinchus represents financial institutions and individuals in negotiating and completing mergers and acquisitions in the community banking industry, and represents banks and bank officers and directors before all federal and state bank regulatory agencies, including contested administrative proceedings. Pinchus has served as counsel to numerous New York and New Jersey-based commercial and savings banks in a wide range of matters; as in-house counsel to a New York savings bank; and as a federal bank regulator with the FDIC's New York office.

Pinchus has extensive experience representing financial institutions in informal regulatory enforcement actions, such as commitment letters and board resolutions, memoranda of understanding and safety and soundness compliance plans, and in formal enforcement actions, including consent orders, cease and desist orders, formal written agreements, safety and soundness orders and PCA and capital directives. Pinchus also has extensive experience representing boards of directors in a broad range of administrative enforcement matters and court proceedings, including defense of civil money penalty actions and removal and industry bar orders and defense of FDIC-receivership lawsuits claiming breach of fiduciary duty.

In June 2008, Pinchus and co-author David Thomas received the Burton Award for Legal Achievement for their article *Sinners at the Pearly Gates – A Primer on the Standards of Admission to the Banking Fraternity*. The presentation was made at the Library of Congress.

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Robert Lamonica is a member of Pryor Cashman's Banking and Finance Group and Corporate Group, concentrating on financial institution regulatory matters, merger and acquisition and enforcement actions.

Robert has worked closely with state-chartered banks, national banks, thrifts and bank holding companies in managing regulatory compliance, conducting acquisitions and issuing securities. He regularly counsels financial institutions on compliance and enforcement matters involving federal and state regulatory agencies and has participated in the defense of directors and officers involved in regulatory liability actions.

In the past year, Robert's financial institution representation included the acquisition of a thrift through a multi-tier holding company, the sale of a majority interest in a national bank and the investigation of a complex fraudulent transaction scheme at a state-chartered bank.

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Prior to joining Pryor Cashman, Robert worked as an analyst with the Emory University Endowment where he was responsible for reviewing and tracking investments in private equity partnerships, hedge funds, and real estate investment trusts.

Robert is a 2007 graduate of Emory University School of Law, where he was a member of the Moot Court Society, and the Goizueta Business School, where he earned a Master of Business Administration in finance in addition to his law degree.