



15 Percent Tier 1 Leverage: Undercapitalized?

Law360, New York (December 19, 2011, 6:01 PM ET) -- Managing the Tier 1 capital ratio, or leverage ratio, is a key pillar of successful banking. Maintaining an excessively elevated Tier 1 ratio will in most instances produce an underleveraged balance sheet that results in operating losses.[1] If you sanction excessive capital erosion, your federal and state bank regulators will be howling while subjecting your bank to the strictures of prompt corrective action.

Leverage of capital, supported by the full faith and credit of the federal government in the form of FDIC insurance, is what makes banking possible. Just like any company that borrows to grow, the magnification of potential losses is the flip side of the potential for increased returns. With the government left holding the bag to restore customer deposits in the event of receivership, it is no surprise that the Tier 1 capital ratio is closely monitored and the subject of considerable wrangling between regulators and the banks they oversee.

Minimum Tier 1 Leverage

Section 38 of the [Federal Deposit Insurance Act](#) requires an institution's primary federal regulator to take prompt corrective action, or PCA, to resolve the institution's problems.[2] In determining what corrective actions to take and when to take them, the PCA statute requires that the regulators establish bright line rules for capital levels.

To be "well capitalized" for the purposes of the PCA statute, each of the federal bank regulators requires a minimum leverage ratio of 5 percent or greater.[3] Despite the regulations, de novo banks and banks subject to informal and formal enforcement actions are often required to maintain Tier 1 capital ratios anywhere between 8 percent and 12 percent.[4] The FDIC oversees the greatest number of depository institutions. Accordingly, this article focuses on the FDIC's regulatory apparatus.

Consent Orders — A Primrose Path to Undercapitalized Status?

Let's assume that we have a bank with a 15 percent leverage ratio, a leverage ratio that handily exceeds the minimum required to be deemed "well capitalized" for PCA purposes. The FDIC excludes from the definition of "well capitalized" any bank that is subject to a written agreement, order, capital directive or PCA directive issued by the FDIC requiring the maintenance of a specific capital level.[5]

On the day our hypothetical 15 percent leverage ratio bank signs a consent order that contains a capital maintenance provision, by regulatory fiat it immediately becomes merely "adequately capitalized" notwithstanding its outsized leverage ratio. Indeed, we have seen the regulators attempt to impose this unhappy matrix on a client, and they were successfully rebuffed only when aggressively challenged.

Agreeing to the imposition of a consent order would have a relatively modest impact from a PCA perspective provided we assume the bank is subject only to the direct consequences of being deemed merely "adequately capitalized." But that is not the case. The consequences of the "adequately capitalized" label are broader and more troubling.

In particular, the FDIC is empowered to require an adequately capitalized bank to comply with certain mandatory or discretionary supervisory actions as though the bank had been classified an “undercapitalized” institution.[6] This is true despite the fact that the bank’s leverage ratio continues to exceed the definition of “well capitalized.” The FDIC effects this reclassification by making a determination that the bank is in unsafe or unsound condition after providing notice and opportunity for a hearing.

In most instances, because the FDIC must defend its unsafe/unsound determination at an administrative hearing, there is in place an adequate deterrent to the FDIC inappropriately pursuing a reclassification. Consent orders, however, almost uniformly contain a recital that potentially obviates the need for a hearing: “Having determined that the requirements for issuance of an order under 12 U.S.C. § 1818(b) ... have been satisfied ... the FDIC hereby orders ...”[7]

The requirements for issuing a cease-and-desist order under 1818(b) are (i) engaging in unsafe or unsound practices and (ii) violating a law, rule, regulation, condition imposed in writing or written agreement. Akin to the grade school axiom about rectangles and squares, all violations of law are unsafe or unsound practices whereas not all unsafe or unsound practices are violations of a law, rule or otherwise. Violation of law is merely a specific subset of the general category of unsafe or unsound banking practices. In effect, the FDIC’s recitation that an order is justified is shorthand for stating that it has determined that unsafe or unsound practices exist.

By executing a consent order, a bank’s board of directors stipulates and consents to its issuance. To the extent the board consents, it waives the ability to contest. The content of a consent order is therefore not eligible for review before an administrative law judge, which review otherwise would be available in a contested cease-and-desist proceeding.

So the critical question for our purposes becomes: In executing a consent order, has a bank stipulated that it is engaged in unsafe or unsound banking practices? In most consent orders, the bank consents to the order “without admitting or denying any charges of unsafe or unsound banking practices.”[8] This seems to indicate that the answer is no and that the bank has explicitly not admitted to having engaged in unsafe or unsound banking practices.

Simultaneously, however, the bank has signed an agreement where the FDIC states that requirements for issuance of an order are satisfied (read: unsafe or unsound banking practices exist). By signing the order, could the argument be made that the directors have indirectly admitted that unsafe or unsound banking practices exist, or, even if not a technical admission, perhaps have inadvertently validated the FDIC’s finding, that unsafe or unsound practices exist?

This brings the topic back full circle to the PCA capital categories. As discussed, the consent order ipso facto reduces an otherwise “well-capitalized” bank to the merely “adequately capitalized” status, regardless of the bank’s actual Tier 1 capital ratio. If the consent order also establishes that unsafe or unsound practices exist, as validated by the directors’ consent and signatures, then neither a notice nor a hearing is required for the FDIC to reclassify the bank as “undercapitalized” for the purposes of PCA because the bank has putatively stipulated that it has engaged in unsafe or unsound banking practices. The bank cannot contest something to which it has consented.

One could fashion arguments in support of either side of the debate as to whether the “without admitting or denying” language trumps the impact of having arguably conceded that “requirements for issuance of an order [have been] satisfied.” We believe the stronger argument is that a bank cannot be deemed to having implicitly admitted to something in one part of an agreement that it explicitly does not admit to in another part of the same agreement.

Yet there is a possible argument that since a consent order could not have been issued without a finding that the bank had engaged in unsafe or unsound banking practices, the bank's assent to issuance of the order is acquiescence and acknowledgment of the factual predicate that the bank engaged in such practices.

Accordingly, we recommend that banks protect against this pitfall when negotiating the language of a consent order with the regulators. One way to gain this protection is by modifying the FDIC's proposed language as follows: "Through its stipulation, the bank has consented, without admitting or denying any charges of unsafe or unsound banking practices and without waiving its right to notice and hearing before a determination of unsafe or unsound banking practice is made pursuant to 12 C.F.R. § 325.103(d), to the issuance of this consent order."

In advocating for this change, the bank can avoid any possibility of the FDIC later taking the position that the consent order permits reclassification from adequately to undercapitalized without notice or hearing.

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[1] A survey of all Uniform Bank Performance Report reporting banks with total assets of less than \$100 million for fiscal year 2003 through fiscal year 2010 shows that, on average, a bank will not begin to generate positive earnings until its leverage ratio is below 25 percent. Earnings are very much improved when a bank's Tier 1 leverage ratio is approximately 15 percent, and will be maximized when the leverage ratio is between 8 and 10 percent. (Data compiled from <https://cdr.ffiec.gov/public/PWS/DownloadBulkData.aspx>)

[2] 12 U.S.C. § 1831o(a)(2).

[3] OCC: 12 C.F.R. § 6.4; FDIC: 12 C.F.R. § 325.103; FRB: 12 C.F.R. § 208.43; OTS: 12 C.F.R. § 565.4.

[4] Discussion of individual minimum capital ratios and other capital ratio directives is beyond the scope of this article.

[5] 12 C.F.R. § 325.103(b)(1)(iv).

[6] 12 C.F.R. § 325.103(d).

[7] See FDIC Docket Nos. FDIC-09-726b (January 29, 2010), FDIC-09-647b (February 5, 2010), FDIC-09-631b (March 2, 2010), FDIC-09-646b (April 6, 2010), FDIC-10-097b (May 18, 2010), FDIC-09-722b (June 9, 2010), FDIC-10-384b (July 28, 2010), FDIC-10-459b (August 26, 2010), FDIC-10-514b (September 9, 2010) and FDIC-10-407b (October 26, 2010).

[8] Id.