Bank Safety & Soundness Advisor

Executive intelligence on bank exams, enforcement and risk management.

January 24, 2011

Lessons from the S&L Crisis

The FDIC doesn't want former directors and officers taking bank documentation from a failed bank after receivership (see "FDIC Demands Bank Docs after Receivership," the *Bank Safety & Soundness Advisor*, January 17, 2011), which means that former directors and officers could end up subpoenaed and confronted with old documents on the stand.

How much of an imposition is that for directors and officers? Well, how good is your memory? According to historical precedent, you'll need a good one. The typical loan cited in a Resolution Trust Corporation (RTC) complaint was made eight to nine years before the complaint was filed. That's according to an American Association of Bank Directors (AABD) study of RTC cases against directors and officers in the wake of the S&L crisis.

It's a difficult situation made much worse for directors and officers without recourse to bank documents, the study argues: "Memories about how and why the loan was made are dim and the documentary evidence is often overwhelmingly important."

The recol-

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Wary Banks Likely to Temper Skepticism for SBLF Capital, Experts Say

The OCC's Small Business Lending Fund program offers fresh piles of Tier 1 capital for community lenders. However, many community lenders are still dealing with TARP headaches – and having a hard time extricating themselves from the government capital infusion program. Should recent TARP experience give community lenders pause? Yes, experts say, but the OCC's deal may be too good to pass up.

The Treasury and the OCC have gone out of their way to separate the SBLF from TARP. The OCC even addresses the issue directly in its "Getting Started" guide for the program. Nevertheless, the legacy of TARP will likely have a sizable impact on participation in the program. Many banks are still dealing with the lingering complications and interventions that came along with TARP funding and a lot of banks are leery to get involved in a program that might somehow bring new conduits for invasive government action, even in exchange for Tier 1 capital.

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FDIC's Case against TruPS Weak, Critics Charge

The FDIC sure knows how to kick an instrument when it's down. The Collins Amendment in the Dodd-Frank Act already strips the once-popular, much maligned trust preferred security (TruPS) of its Tier 1 capital status. Now, the FDIC argues that, in the run up to the financial crisis, bank holding companies (BHCs) stuffed with TruPS were less resilient and took on more risk than other BHCs. The FDIC may have concluded that TruPS helped fuel the financial crisis, but this study doesn't prove it, critics counter.

In its most recent issue of Supervisory Insights, the FDIC runs through a history of the instrument and then narrows to a simple formulation: Significant amounts of TruPS bring too much risk and capital weakness to BHCs. "The experience of the past several years suggest that BHCs that relied on TruPS as regulatory capital were weaker because of that reliance, assumed more risk, and failed at a higher rate than other BHCs," the FDIC concludes.

The agency thesis rests on four supporting arguments:

1. Reliance on TruPS increased financial leverage in banking organizations, making them less resilient when the market soured;

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Publisher:

Aaron Steinberg
800-929-4824 ext 2471
asteinberg@banksoundness.com

Group Publisher:

Hugh Kennedy
800-929-4824 ext 2213
hkennedy@banksoundness.com

SUBSCRIPTIONS:

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ADDRESS:

Bank Safety & Soundness Advisor
Two Washingtonian Center
9737 Washingtonian Blvd., Ste. 100
Gaithersburg, MD 20878-7364

TruPS

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2. BHCs deep in TruPS "appear to have levered the proceeds" to make especially risky loans;

3. The presence of significant amounts of TruPS on the books increases the likelihood of failure, since the FDIC has more difficulty attracting investors for such banks; and

4. When one bank buys another's TruPS and the issuer fails, the "double-counting of capital" in the system magnifies total industry losses.

"I'm less convinced about the causation between TruPS and riskiness," says former FDIC General Counsel John Douglas, who now heads the bank regulatory practice at Davis Polk & Wardwell in Washington, D.C. and New York. "There seems to be some correlation here, but I don't know whether [the FDIC shows] causation."

It's true that TruPS increased financial leverage, but that's "not a new story," adds J. Paul Forrester, a partner in the Chicago office of Mayer Brown LLP. "If you didn't know that TruPS had a debt-like component, then shame on you."

The remainder of the FDIC's arguments are pretty weak, Forrester adds. "These conclusions don't make much sense," he says. "Did TruPS make banks riskier? I don't know how you can draw that conclusion from the data. There's no direct or compelling evidence here that they did."

The FDIC's concerns over finding investors for TruPS-filled failed banks is an ex post facto argument and the agency's argument on double-counting just doesn't make sense, he adds.

"I don't understand the argument that [when a bank buys TruPS issued by another bank] it creates interlinkages," he says. "There's only one loss, borne or not borne by the TruPS. This [study] is an important work, but only the first two points are arguably relevant. And the second of those two isn't demonstrated by the data."

TruPS Complicates Resolutions

The FDIC's negative assessment may be driven by its recent experience with TruPS, says Douglas.

"The FDIC has been frustrated by TruPS and that shades [the agency's] attitude towards it," he says. "It's been difficult for them to deal with, especially when it comes to [failed banks that] took part in those TruPS pools. There just hasn't been a good way for the FDIC to get concessions out of them."

It wasn't so much the role TruPS played in the run-up to the recession as it is the frustration of dealing with TruPS in receivership that's giving the regulator fits, Forrester adds. TruPS CDO pools came in two varieties and both have proven to be big impediments to orderly resolutions. One variety has no manager and requires a 2/3 vote threshold from all classes of holders in order to make any changes, a structure that makes deals "practically impossible," he adds.

"If you're an issuer, you want to cut a deal with the holder – you want to ask them to waive conditions," he says. "But you don't

have anyone to talk to."

The second variety of TruPS CDO does involve a manager, but that sort of instrument hasn't proven any easier for regulators to unwind, he adds. "Unfortunately, there's a cliff problem with the CDO security. The CDO manager does have the authority to restructure collateral, but the issues the manager faces are complicated."

If an investor loses out on any TruPS after that CDO manager authorizes a change, that investor can sue the CDO manager for losses. As a result, CDO managers aren't especially keen to agree to changed conditions, he adds.

The End of Debt Instruments as Capital?

Smaller BHCs will be able to hold existing TruPS, even as the Dodd-Frank Act phases them out everywhere else. Nevertheless, argues Douglas, banks should view the regulators' treatment of TruPS as part of a larger shift in regulatory thinking.

"What we're going to see is a movement away from debt instruments that count as capital," he says. "We already see that in the Basel III proposals coming out now. We are going to see a greater push on the part of FDIC and regulators in general, towards common equity and its equivalents serving as capital elements."

Banks should expect to see much more emphasis on the regulators' new favored form: common stock and its equivalents, including perpetual preferred stock – and that could have an impact on future exams, he adds.

"I don't think any banks [that are small enough to keep it] will be told that TruPS doesn't count [as capital]," he says. "But those banks may be told, in a back-handed fashion, to get more common equity."

TruPS Use, by the Numbers

TruPS were designed to fit around and function within regulatory rules and that explains their popularity, says Forrester. "Tax deductible equity is nirvana for a corporation," he adds.

The FDIC study certainly bears this out. BHCs were drawn to the tax deductibility of TruPS interest payments and the fact that the instrument counted as Tier 1 capital. According to the study, a large number of BHCs took the Federal Reserve up on its offer to count the instrument as Tier 1 capital. Of the approximately 1,000 BHCs reporting on form Y-9C, around two-thirds held TruPS at some point in the last five years, according to FDIC data. What's more, in that same period, a little under one-third of those BHCs watched their Tier 1 TruPS hit or exceed 25% of total Tier 1 capital at least once.

Smaller BHC got in on TruPS, too. Transaction costs kept those smaller BHCs from bringing TruPS directly to the market, but they could – and did – sell them into collateralized debt obligations (CDOs). The FDIC quotes a Fitch report, which notes that, since 2000, 1,813 banking entities issued TruPS that were purchase by TruPS CDOs in an aggregate

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TruPS, a Regulatory Timeline

1996 – The trust preferred security (TruPS) era begins when the Federal Reserve issues a press release on a new financial structure. It goes like this: A bank holding company (BCE) creates a wholly-owned special purpose entity, which can issue cumulative preferred stock to investors. The BHC borrows the proceeds from the entity using a long-term subordinated note. Under the accounting rules of the time, the BHC consolidates the entity and the transaction occasions a minority interest in the consolidated subsidiary. BHCs, thrilled with the instrument's capital status and tax advantages, flock to TruPS.

2003 – FASB makes a change. FASB's Interpretation no. 46, Consolidation of Variable Interest Entities (FIN 46 and FIN 46R) no longer requires the consolidation of the SPE created to issue TruPS. BHCs begin reporting the subordinated debt issued to the SPE as a liability instead of reporting the preferred stock as a minority interest in a consolidated subsidiary.

2005 –The Federal Reserve addresses the FASB accounting change by lowering TruPS limits for larger, international firms, but opts to allow TruPS to keep their Tier 1 capital status.

2007 – TruPS continues to grow in popularity – and claim a larger share of Tier 1 capital. Among BHCs that issued TruPS, the percentage of TruPS that those BHCs counted as Tier 1 capital hits 18% this year – a high water mark.

2010 – The Dodd-Frank act puts an end to TruPS as Tier 1 capital for BHCs holding $500 million or more in assets. ■

Wary Banks

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Back in October, the *Bank Safety & Soundness Advisor* conducted a poll asking bankers if they'd participate in the program. That survey unearthed a fair amount of skepticism about the program. Of the 60 bankers who responded, only six said they would definitely participate, while 33 said they would not. Another 21 were undecided.

Even after the release of the program guidelines, that skepticism hasn't abated, says Joe Harenza, the CEO of Griffin Financial Group. The reason: The government changed the rules on TARP and banks haven't forgotten.

"We have [clients] tell us that they don't care what the government says – it's a bait-and-switch," Harenza says. "These bankers are saying, 'If the government is giving us money, there must be a catch and if there's no catch now, they'll get us later. Can you really trust these guys?' There's a natural suspicion out there."

"We've talked to two good-sized banks about the program recently – [banks] who both need Tier 1 capital," he adds. "Both said, 'Are you kidding me?"

Harenza's firm has briefed 30 banks on the program and only around ten have expressed any real enthusiasm for the program, he adds.

A lot of banks are worried about potential public relations troubles for taking public funds, but they shouldn't be, Harenza adds. "There isn't a TARP-like stigma to this," he says. "This isn't viewed as bailout capital. It's really viewed as growth capital, as an indirect stimulus to create jobs."

According to the program details, the SBLF program differs from TARP in several significant ways. It doesn't share the same funding source or administering organization. It doesn't require the issuance of warrants or executive compensation restrictions, either. Nevertheless, there is one notable similarity between the two programs that may prompt plenty of concern: Banks may not exit the program without regulatory approval.

"This does give me some pause," says Allyn Dixon, an attorney with Dickinson, Mackaman, Tyler & Hagen, P.C., Des Moines, Iowa and Washington D.C. "If you've done what you're supposed to do, why should you need approval to get out? This seems like an unnecessary intrusion."

Dixon thinks a fair number of banks will overcome their trepidation, anyway. The lure of Tier 1 capital may be too great to resist. The SBLF is "a little different

Is the SBLF Program Right for You?

The SBLF could work for a wide range of community banks and thrifts, says Joe Harenza, the CEO of the Griffin Financial Group. But it will be especially useful for financial institutions in one of three specific situations, he adds.

1. For banks that need capital badly. "If you really need capital, then take as much capital from this program as you can get, since it is Tier 1," Harenza says. "It is available and the cost is cheap, even at the maximum dividend rates. Although, if the government asks you to match the capital it gives you with more capital of your own, it could have a downside."
2. For banks seeking growth capital. Banks in this situation should also take as much as they can and deploy it at a rational yield, Harenza advises. But make sure you get the yield, he adds. "If you take this capital and you can't lever it, it may be putative to earnings and returns. You have to be sure you can grow your loans. There's no real penalty for not deploying it but there will be a penalty if you can't make loans at a yield that is in excess of your cost of funds plus a spread."
3. For banks looking to swap out TARP. "If you want to swap out of TARP, then use this vehicle to the extent the regulators facilitate it without negative or unintended consequences.

There is at least one issue all TARP holders should weigh before jumping into the Treasury program. With the SBLF, 90% of proceeds of the sale of preferred shares to the government has to be dropped from the holding company to the bank, Harenza explains. If you keep TARP, it is a higher coupon – the cost of funds will be higher – but you can keep those proceeds at the bank holding company level.

Some banks may opt not to invest in this because of the requirement. ■

The government has a heartfelt belief that sometime in the next two years, loan demand [for small business loans] will be there. Right now, the evidence suggests that it's not.

from TARP," he says. "It's a more simplified, streamlined program. We think a number of smaller banks are going to seek funding, especially because it's Tier 1 capital. We've had several clients express interest, though none, so far, have applied."

Despite industry reservations, some banks will get involved with the government again, agrees Jeff Werthan a partner in the Washington, D.C. office of Katten Muchin Rosenman LLP. "A lot of banks are hurting for [Tier 1 capital]. Any time you can get it, you have to weigh the pros and the cons."

One potential con: Examiners will account for the fact that your SBLF capital is still not the same as common equity capital. "When you analyze the instrument itself, it's noncumulative preferred, which ordinarily won't sit well with examiners compared with common equity, but under the law, it will count," Werthan adds. "What will it mean for your examiners? Most of them are smart people. They'll understand that they have to count it if the organization gets it. My guess is that most examiners will weigh the quality of that tier 1 capital in assessing the overall capital of the institution, recognizing that SBLF capital has a debt-like component."

Despite all this, banks will look past their TARP skepticism and the reason is that the terms of the program are so good, Harenza argues.

"It's cheap capital," he says. "Under the worst case scenario, you'll keep it for 10 years for around 7.7%. That would cost you a lot more in the marketplace. So it's a low coupon in the worst case scenario. In the best case, it's around 5.5% for ten years. That's one hell of a program, a hell of a good thing for banks."

Whether or not it will work for your bank depends on your market. It all comes down to loan demand, Harenza says.

"The program looks good," he says. "But the fundamental issue is lending. The government has a heartfelt belief that sometime in the next two years, loan demand [for small business loans] will be there." Right now, the evidence suggests that it's not, he adds. There may be some micro markets showing clear signs of demand for small business lending, but in general and across the country, that demand has been mostly absent.

The mainstream press likes to say that lenders aren't rising to meet the demand for small business loans, but really what we're seeing is the opposite, he says. "Commercial bankers state uniformly in 3Q 2010 earnings calls that while lending standards remain tight, they have the capital and are anxious to lend." Harenza says. "But its demand that's low. The Federal Reserve Beige Books for almost all Federal Reserve Districts confirm that this credit demand remains low."

There are good micro markets and banks in those dislocated areas can definitely grow assets but that doesn't apply to everyone, he argues. "We have a lot [of clients] shrinking their banks," he adds. "They're not taking deposits, because they can't make loans. And, in a lot of cases, they have the government beating their brains out for more capital."

If a bank thinks that it has or will have that demand, and it has the leverage to deploy it, it should take the money and run, he says.

Next week: the FDIC on juicing small business lending. ■

TruPS

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amount of roughly $30 billion.

The FDIC's case against TruPS relies primarily on the correlation between TruPS-filled portfolios and attributes the regulator considers high-risk. For example, the FDIC notes that roughly 70% of BHCs with "high dependence on TruPS had C&D concentrations of over 100% of risk based capital at some point in the past five years, compared to 50% of BHCs with some TruPS and 40% of BHCs with no TruPS at all. ■

S&L Crisis

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lection of RTC personal liability claims may not be a pleasant one for the banking industry, but, in light of recent FDIC legal action, it has become relevant again. In December alone, recent FDIC personal liability suits jumped 33% (see "FDIC Personal Liability Lawsuits Rocket in December," the *Bank Safety & Soundness Advisor,* January 17, 2011). According to the AABD study, the RTC filed a large volume of suits, many of them of dubious merit and predicated on narrow, technical and often inappropriate regulatory and procedural standards.

"The AABD survey [of RTC complaints shows that the RTC is attempting to hold thrift D&Os not just to FHLBB [Federal Home Loan Bank Board] or S&L industry standards when the loans were made, and not just to today's much higher standards, but to the impossible standards of "20-20 foresight" that the agency has invented," the study notes.

Here are a few more lessons and warnings from the S&L crisis:

1. The RTC attempted to "dissect" lending practices. In most cases, when the RTC filed suit and attempted to prove negligence on the part of former officers and directors, the agency focused on technical details, the day-to-day stuff of lending, a charge that's especially inappropriate for directors, the study asserts. What sorts of things did the complaints zero in on? Here are a few examples: missing information from loan files, possible defects in the appraisal of collateral, or the amount of time reviewing each loan.

2. RTC suits targeted deep pockets – i.e., the insurers. The "large majority" of suits filed against directors and officers by the FDIC and FSLIC in the '80s were targeted specifically at those directors and officers backed by insurance. When the regulators didn't explicitly target the insurers behind directors and officers, they did zero in on directors and officers who had cash on-hand. Those cases only accounted for a small fraction of settlements, however. By 1995, the RTC had collected $200 million directly from directors and officers. Most of the money taken in by the RTC came from the bankruptcy estate of the securities firm, Drexel Burnham Lambert (around $1 billion) and from insurers (who also paid about $1 billion).

3. The regulators rarely went to court to get their money. Most often, regulators got what they wanted through settlement. Through 1995, only around 15% of the outcomes against defendants came though litigation.

4. Enter the regulatory exclusion. Once insurers began to realize that claims from bank and thrift failures were "too common, large and unpredictable to insure against," they started inserting regulatory exclusions into D&O coverage. Insurers have already brought the exclusion back (see "10 Proven Ways to Reduce Your Bank's D&O Exposure," *Bank Safety & Soundness Advisor,* August 23, 2010).

5. RTC counsel had a big incentive to pursue legal action and not much incentive to be judicious about the merits of any one case. The study quotes Ira Parker, a former RTC associate general counsel who had been in charge of agency approvals for personal liability suits. RTC counsel who opted not to pursue cases faced a real political cost, he said. "…If you made the decision not to bring the action … [you knew that] you were going to be called before some committee someplace up on the Hill," he said. "… You're going to have to explain your decisions and it's not going to be a private forum … I know one thing. If I go ahead and authorize the litigation, nobody's going to criticize me." ■

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