Bank Safety & Soundness Advisor

Executive intelligence on bank exams, enforcement and risk management.

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FDIC Criticizes Silverton Bank Directors for Individual Loan Approval Decisions

The FDIC filed another lawsuit last week, this time against former directors and officers of the since-failed Silverton Bank in Atlanta, Ga. The lawsuit has gotten a lot of industry attention for its tales of excess – bank officials purchased fancy new offices and not one, but two corporate jets, which they flew to a lot of resorts, according to the FDIC – but the suit is just as notable for what it says about the FDIC's legal strategy. Once again, the FDIC goes granular on loan decisions. In making a case for negligence, the complaint, like others before them, discusses individual loans and individual loan approval decisions made by members of the bank's board.

The complaint lists and discusses, at length, 15 loans that "caused significant loss to the bank," and were all approved by the director/defendants "in blatant violation of the duties owed them to the bank," according to the FDIC. The document criticizes bank directors for weak due diligence and a total lack of business judgment.

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Should Bank Directors Approve Loans?

Many community bank boards approve a wide range of loans – above and beyond the loans they're required to approve. But should they? As FDIC lawyers continue to hammer failed bank directors who sat on loan committees and approved bank loans, many industry experts are beginning to suggest that the legal risk for loan approval is just too high.

There are certain loans board directors have to approve – insider loans and those subject to Regulation O. Traditionally, many community bank boards approve other loans, too, including individual loans that the bank perceives as especially risky. The practice itself may turn out to be too risky for bank directors. Recent FDIC lawsuits filed against failed bank directors go into great detail on individual loan decisions made by bank board members (see story, at left). Though the FDIC hasn't explicitly stated it, the lawsuits create a different, higher level of responsibility for loan approving directors (compared to those who don't sit on the loan committee or approve loans), experts say.

The legal risk is now so high that, barring some kind of clarification

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CFPB Could Bring Backdoor Regulatory Risk to Community Banks

The newest regulator on the block, the Consumer Financial Protection Bureau, will only directly regulate financial institutions with at least $10 billion in assets, which puts most community banks beyond its reach. Does that mean that community banks won't have to worry about the CFPB? Not directly, but there are sidelong ways the newest regulator in Washington can make you and your bank's life more difficult.

The CFPB, in contrast with the other federal financial regulators, has made it readily apparent that it intends to maintain strong ties with state attorneys general across the country and one way in which the agency plans to foster that relationship is by sharing information. And there's little reason to believe that the CFBP, which has no statutory authority with community banks, won't share what information it gets about community banks with those state attorneys general, who do, says Chris Willis, a partner in the Atlanta office of Ballard Spahr LLP.

One way in which the CFBP could collect and funnel community bank information to attorneys general is when it collects community

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Loan Approval

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on director liability from the FDIC, bank directors should consider dropping loan approval altogether, argues the American Association of Bank Directors. The organization's executive director David Baris, who is also a partner with Buckley Sandler, LLP in Washington, D.C., outlined his organizations position in a recent letter to the FDIC, asking for clarification on bank director liability involving loan approvals.

Directors face much higher legal risk when they deal directly with loan approvals, Baris wrote. The AABD argues that bank directors raise their personal liability by voting for approval of loans, approving loans where the loan committee has received a board or committee loan package, or serving on a director loan committee. "There are very serious risks of potential personal liability that do not justify directors' involvement in the loan approval process unless the FDIC satisfactorily clarifies their appropriate role and corresponding personal liability," he wrote.

The American Association of Board Directors now advises board members to avoid approving any loans they aren't required to approve until the FDIC clarifies its expectations and requirements.

The FDIC, in response, calls the AABD's advice "somewhat disturbing," and notes that, when it comes to bank directors, loan approvals and responsibility, nothing has changed.

"The FDIC has not altered its expectations or requirements for bank directors and those standards have remained unchanged for many years," writes FDIC general counsel Michael Krimminger. "In short, bank directors owe duties of care and loyalty in fulfilling their responsibilities. The FDIC has only filed complaints against bank directors who failed to adhere to these long-standing standards. Consequently, there is no basis for your contentions that the standards require clarification or that the FDIC is imposing new requirements on bank directors that put them at risk of liability for appropriately performing their responsibilities … We certainly do not believe it to be in the public's interest, or in the interest of the banking industry, for you to urge bank directors to avoid applying their experience and judgment to important credit decisions of the institution."

According to Baris, this issue hangs on a hazy distinction: To what extent are bank directors like lending officers?

"Our view is that directors are not professional bankers," Baris says. "Most haven't been to school to learn how to approve loans. They can ask questions and review files, but they don't have the level of expertise that a loan officer does. We're concerned that the FDIC isn't treating them any differently than they would a loan officer."

"The FDIC response didn't fix the problem," Baris adds. "The case law, the complaints [from FDIC law suits] clearly reflect that directors take on more risk and more personal liability when they approve loans."

The Backstory

The FDIC is right in that, when it pursues former bank direc-

tors for loan approval decisions, it isn't doing anything new, but that doesn't necessarily mean that the regulator is being fair, says Peter Weinstock, a partner with Hunton & Williams, LLP in Dallas.

"What the FDIC is doing is consistent with what they did in the '80s, but you could say they went too far in the '80s, too." he says. "At least the last two times in the cycle, through the last two crashes, the FDIC went after bank directors for their decisions to approve loans. We can ask if what they're doing is appropriate, but what they're doing is not novel."

Missing Expertise?

New or not, FDIC expectations are out of line with most directors' skill sets, argues Hal Reichwald, a partner with Manatt Phelps & Phillips LLP, Los Angeles.

"Often community bank directors are less able to supervise lending functions, primarily because in many cases, they don't have the expertise," he says. "To put a director on a loan committee and expect them to analyze the loan file and come to conclusions on their own is asking a lot of these people. For loan committee members to come in and listen to a presentation by a bank officer who is promoting acceptance of a proposed credit, to have the package in front of him and spend 20 minutes on 10 loans - how can he do justice to the analysis that must be done?"

At some point, directors have to decide if the benefits of loan approval outweigh the risks, Reichwald says. It's becoming increasingly hard to say that they do, he adds.

"I've seen several cases where board members were held out for special liability," he says. "What if it turns out that the decisions you made to approve the loan, based on hindsight, turn out to be wrong or inept or overtaken by unforeseen circumstances? Why put yourself in greater harm? FDIC is putting members of the loan committee in a special category. It's holding them out for a liability that others don't have."

On some level, this regulatory pressure, and the special liability that comes along with it, is a predictable symptom of market downturns, says Weinstock. In recessions, bank boards will feel pressure from the regulators to get more deeply involved in bank operations. At times, regulators are pushing for bank directors to get too involved, he says.

"We're concerned that the FDIC isn't treating them any differently than they would a loan officer."

"The FDIC wants community bank boards involved on a much more granular basis than is appropriate," he says. "When a bank starts to have problems, they want directors involved in everything, approving everything. But it's not generally consistent with the skill set of community bank directors to be doing that. The regulators are putting them in a position of having to micromanage the bank, and that's not good for the bank."

Remedies

Nevertheless, Weinstock adds, bank directors shouldn't let their frustration with the FDIC blind them to their banks' best interests. It's one thing to be aware of, and try to mitigate legal risk. It's another thing to stall intentionally your bank's loan growth just to make a point to the FDIC.

Cutting out all approvals is "self-defeating, because you'd be harming your own bank by not making the good loans that are out there," he says. "Loans in this environment are the safest loans there are. Loan-to-volume ratios are low and the cash flow is stress tested."

Bank directors worried about legal risk should look to structural changes first, such as building and relying on a credit function that can handle most if not all loan approvals. Another method is to use outside help, he says.

"Third party loan reviews have always been something directors have been allowed to do," he says. The FDIC has much more of an uphill climb when a loan passes muster with outside loan review and with the regulators – in exams – and then goes bad. [Bank director] liability is based on information available when the decision was made."

Bank boards can also vet lists of perspective loans from loan officers without approving any loan, adds Baris. "Directors could still have the opportunity to advise the loan officers about what they know about a relevant property, person or company," he says. "They can do this at a board meeting without necessarily approving the loan. Instead, they'd function as an information source." ■

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bank customer complaints, he argues. The CFPB plans to collect any and all financial institution customer complaints and it may very well share that information with state attorneys general.

The CFPB has been aggressive in establishing relations with other state and federal agencies designed to help collect and disseminate consumer information, including complaints. The CFPB recently announced an agreement it signed with the Federal Trade Commission that not only allows the CFPB to access complaints on the FTC's complaint database, Consumer Sentinel, but also allows for the CFPB to enter the complaints it receives into the Sentinel database . The FTC's Consumer Sentinel database is already accessible to more than 50 federal agencies and over 100 state agencies.

"By participating in the Consumer Sentinel database, we hope to further enhance this already useful database for ourselves and for others," the CFPB notes at its website. "We can use the data to help make the market for financial products and services work better for consumers."

The CFBP isn't limiting complaints just to institutions it supervises, Willis says. Anyone can complain about any financial institution through the CFPB website, and that's why community banks and credit unions may end up affected by the CFPB, even without the direct regulatory authority.

"There's ample reason to believe that there'll be close cooperation between the new regulator and attorneys general," he says. "The agency has the authority to send information about complaints with attorneys general, who do have enforcement authority."

"The better you can resolve the complaints and the more satisfaction you can give to your customers, the better you can mitigate the risk of government enforcement."

And customer complaints are precisely the thing that catches the eye of an attorney general, he adds. "When it comes to attorneys general, they go after the [financial institutions] they get the complaints about."

What can community banks do about the information share? Nothing directly. But banks can save themselves a lot of trouble, including regulatory trouble, by being proactive about complaints and customer service, Willis suggests. In fact, whether banks realize it or not, customer service can have a direct, and often unhappy connection to regulatory peril.

"You can control regulatory risk by thoroughly handling customer complaints," he says. "The better you can resolve the complaints and the more satisfaction you can give to your customers, the better you can mitigate the risk of government enforcement."

This potential complaint hotline, running from the CFPB to the states is a classic example, Willis adds.

"I've been on multiple panels with state and federal regulators, and they all agree: The way to stay off the regulatory radar is to avoid complaints," he says.

The key to heading off potentially hazardous regulatory intrusion is for a bank to capture as many complaints as it can and handle the dissatisfied customers behind them before the complaints ever make their way to a regulator's inbox. A proactive methodology can also head off private litigation,

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FDIC's Problem Bank List Shrinks

In a modest bit of good news for the industry, the FDIC's problem bank list shrunk for the first time in several years. It hasn't been since the third quarter of 2006 that the number of banks on the FDIC's problem bank list has gone down, but it finally happened at the end of the second quarter, 2011. The FDIC counts 865 banks on the list, down from 888 at the end of the first quarter. Total assets of problem institutions also declined from $397 billion to $372 billion.

In the second quarter, 39 banks were absorbed by mergers and 22 banks failed – the smallest number of failures since the first quarter of 2009, the agency notes. ■

No Forbearance for Banks, Says OCC

Should regulators give troubled banks time to work out their credit problems? No, and furthermore, PCA rules won't allow it, says the OCC. In his recent comments to Congress on the state of Georgia banker/regulator relations, OCC deputy comptroller for the southern district Gil Barker tackled the subject of regulatory forbearance and the wisdom of giving troubled banks extra time to handle their troubles.

"In this environment, some have talked about the need for regulatory 'forbearance,' where supervisors allow troubled banks to ignore credit problems in the hope they will go away over time," he said. "This is not permissible under generally accepted accounting principles. Nor would it be advisable. As the savings and loan crisis of the 1980s demonstrated, regulatory forbearance, by delaying the recognition of problems, can ultimately make those problems and their cost of resolution far worse. The savings and loan experience caused Congress to enact the PCA regulatory regime in FDICIA that expressly rejects regulatory forbearance." ■

Silverton

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Silverton, a banker's bank, had plenty of CEOs on its board. According to the regulator, that expertise and engagement with the bank's lending decisions leads directly to higher responsibility and subsequently liability, says Hal Reichwald, a partner with Manatt Phelps & Phillips LLP, Los Angeles.

"The FDIC complaint goes out of its way to seek to hold [the bank's] directors to a higher standard of conduct because they had specialized knowledge of the banking industry," he says.

The FDIC's complaint supports Reichwald's assertion. "These defendants were required to discharge their duties in good faith and with that diligence, care, and skill which an ordinarily prudent person in a like position would exercise under similar circumstances," the FDIC wrote about the former Silverton directors and officers. "These defendants in fact possess greater skill, knowledge, and intelligence in regards to the banking industry, and as such, they should be held to a standard of an ordinarily prudent person with these superior attributes."

"The FDIC complaint goes out of its way to seek to hold [the bank's] directors to a higher standard of conduct because they had specialized knowledge of the banking industry."

What sorts of criticisms does the FDIC levy against directors and their decisions over individual loans? How deep does the FDIC's criticism get into individual loan decisions made at Silverton? Here's a sample.

1. Directors didn't properly factor in local economic conditions. With regards to one loan, a $6.3 million commitment to a $10.1 million acquisition and development participation loan, the FDIC notes that directors who approved the loan "failed to heed warnings and react in a prudent manner in light of known market deterioration in Smyrna, Georgia [the site of the townhome development project]. Market surveys revealed that the housing market was deteriorating as of April 2007. Furthermore, increased inventory levels were present. Market conditions continued to worsen throughout 2007."

2. Directors relied on loan approval forms. On a participation loan involving a Florida-based subdivision project, bank directors voted to fund the loan, apparently based on a high rating the guarantor's liquidity earned on the loan approval form. As it happens, the guarantor's cash "may have been tied up 'in escrow' and not even

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available," and that the guarantor actually had "virtually zero liquidity." The guarantor's tax analysis, financial statement, and contingent liabilities schedule were all attached to and referenced in the loan approval form. Had the bank's approving directors "reviewed these documents, they would have noticed this glaring inconsistency," the FDIC insists.

3. Directors failed to perform adequate due diligence. The approval of a participation loan for an Idaho development violated several of the bank's loan approval policies, argues the FDIC. The bank failed to collect from guarantors or principals several required financial documents, such as the previous three years' financial statements, audited financial statements and tax returns. The contractor and subcontractor bonds were not in the file and part of the property was secured with a second deed of trust behind the original owners, which violated bank policy. "Approval of this loan despite the failure to comply with the requirements of the bank's policies was reckless and represents a complete disregard of the interests of the Bank," the FDIC wrote. "By failing to acquire or analyze information regarding the financial condition of the borrower or the guarantors there was simply no basis (much less an informed basis) upon which to approve this loan."

4. Directors deviated from the bank's lending policy without adequate explanation. In 2005, one bank director approved a revolving line of credit to developers of a condominium project based in Jacksonville, Fla. The approval of the loan violated bank loan policy requirements because it exceeded the LTV policy maximum, the FDIC argues. The LTV on the loan was 80 percent, while bank policy set a maximum of 75 percent. The regulator also took exception with the director's explanation of the loan approval. "The loan memo failed to completely identify the LTV exception on multifamily construction and inadequately justified the high LTV by stating that presales of the project should be sufficient to cover the loan as well as reliance on the guarantors' liquidity," the agency argues.

5. Directors made flat-out bad decisions about loan approvals. Silverton directors approved a plan to refinance an existing line of credit for FirstCity Bankcorp. FirstCity wanted the line to rise from $600,000 to $2 million to help support growth in its loan portfolio. Two bank directors initially approved a 30-day, interest only note for $1.5 million, which subsequently rose to $5 million over two years. Noting that the primary source of repayment came from cash dividends up-streamed from the borrower's subsidiary bank, the FDIC concludes that "Simply stated, this borrower should have never been issued this loan. Since the inception of this loan, the borrower had increasingly high credit concentrations." ■

CFPB

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too, he adds.

"There's a strong correlation between customer service and a bank's litigation experience," he says. "I think in today's environment, where there's so much interest in enforcement and financial institutions, every dollar and every hour spent on customer service and complaint resolution are dollars and hours well spent." ■