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U P D A T E

News of Developments in the Financial Sector and Related Areas

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Loans to Insiders and Affiliates

Regulation O became effective in 1979 and governs extensions of credit by banks to executive officers, directors or principal shareholders and their related interests (commonly referred to as insiders) and was a result of the allegations of shady bank dealings by Burt Lance, who served as director of the Office of Management and Budget in President Jimmy Carter's administration during the 1970s. Regulation O was adopted with the intent to prevent insiders from obtaining extensions of credit on preferential terms, and it limits the amounts and terms a bank may lend to insiders.

On April 1, 2003, Regulation W became effective placing additional quantitative and qualitative limitations on transactions a bank may have with an affiliate with the intent to limit the exposure that a bank may have to one or more affiliates. The term *affiliate* under Regulation W is broadly defined and includes parent companies, companies under common control and companies with interlocking directorates. Regulation W implements and interprets Sections 23A and 23B of the Federal Reserve Act and requires that transactions with affiliates be adequately collateralized to assure that transactions are not unsafe or unsound.

In recent years, a number of banks have been criticized in connection with loans involving insiders such as in loan transactions (depending on the facts in each case) where the insider is an agricultural land owner and the bank makes loans to tenants of the insider. An extension of credit is attributed to an insider of the bank to the extent that the proceeds are "transferred to" or used for the "tangible economic benefit of" the insider or if the loan or extension of credit is made to a "related interest" of the insider. This "attribution rule" was designed to prevent circumvention of Regulation O through the use of nominee borrowers.

Regulation W was designed under the "attribution rule" to prevent a bank from evading statutory restrictions by using intermediaries and to limit the exposure of a bank. Any transaction by a bank with a person will be deemed to be a transaction with an affiliate of the bank if any of the proceeds of the transaction are used for the benefit of, or transferred to, the affiliate, subject to certain exemptions.

Both Regulation O and Regulation W were designed to prevent a bank from evading the statutory restrictions by using intermediaries and to limit the exposure of the bank. A loan will be attributed to an insider if the loan proceeds are transferred to or used for the tangible economic benefit of the insider or if the loan is made to a related interest of the insider. A loan will be attributed to an insider (other than the borrower) when either (i) the proceeds of the loan are used for the direct benefit of the insider or (ii) a common enterprise exists between the borrower and the insider. The common enterprise test will be met if the borrower is under common control (including where one of the persons in question controls the other) and there is a substantial interdependence between the borrower and the insider, *i.e.*, where at least 50% of the gross receipts or expenditures of the borrower comes from transactions with the insider. The facts in any given situation would have to be reviewed to determine the benefits of a specific loan transaction.

Community Development Capital Initiative

The Treasury Department recently announced the terms for the Community Development Capital Initiative Program ("CDCI Program") which will allow those institutions designated as a Community Development Financial Institution ("CDFI") to receive investments of capital from the Treasury which will qualify as Tier 1 capital. The initial dividend rate will be 2 percent compared to the 5 percent rate offered under the former Capital Purchase Program. A CDFI may apply to receive capital up to 5 percent of risk-weighted assets.

A certified CDFI is a financial institution that works in markets that are underserved by traditional financial institutions. An application for participation in the CDCI Program must be filed by April 2, 2010. It is not necessary for an institution to be designated as a CDFI at the time of its application but for those institutions who have not been certified, they must file an application with the Treasury to become certified by April 16, 2010.

For those institutions that might not otherwise be approved by their federal regulator, they will be eligible to participate in the CDCI Program by raising matching private capital equal to the amount to be received from the Treasury. The private capital must be junior to the investment by the Treasury.

Quarterly Banking Profile

The Federal Deposit Insurance Corporation ("FDIC") has issued its *Quarterly Banking Profile* reflecting the financial results for the fourth quarter of this year. The FDIC noted that asset quality has continued to deteriorate. Insured institutions charged off $53 billion in uncollectable loans during the quarter and noncurrent loans and leases increased by $24.3 billion during the fourth quarter. At the end of 2009, noncurrent loans and leases represented 5.37 percent of the industry's total loans and leases.

The net worth of the FDIC's Deposit Insurance Fund decreased by $12.7 billion during the fourth quarter. The fund balance of negative $20.9 billion reflects a $44 billion contingent loss reserve that has been set aside to cover estimated losses for anticipated closings over the next year.

The number of institutions on the FDIC's *problem list* rose to its highest level in 16 years. At the end of 2009, there were 702 insured institutions on the problem list, up from 552 on September 30, 2009. This is the largest number of problem institutions since June 1993. Problem institutions are characterized as those institutions having a risk of failing and being closed by the FDIC.

Total assets of problem institutions increased during the quarter from $345.9 billion to $402.8 billion. There were 140 bank failures for the year 2009 which is the highest total since 1992. The Quarterly Banking Profile is available on the website of the FDIC at *www.fdic.gov*.

 Comments, ideas, opinions and questions - email gbinns@ddh-ar.com - telephone (501) 375-9151 - facsimile (501) 375-6484.