

UPDATE

News of Developments in the Financial Sector and Related Areas

** IN THIS ISSUE **

Regulation O

Regulatory Enforcement Actions

Regulation O

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). Regulation O limits the amounts and terms a bank may lend to an insider and was adopted to prevent an insider from obtaining an extension of credit on preferential terms.

Recently the Office of the Comptroller of the Currency ("OCC") issued Interpretive Letter No. 1096 which dealt with an individual who had become an executive officer of a bank as well as a member of the bank's board of directors, resulting in the individual becoming an insider of the bank subject to Regulation O. Earlier, the bank had granted the individual two loans on non-preferential terms. The combined total of these two loans exceeded the limitation of Regulation O on loans to executive officers. Both the OCC and the Federal Reserve Board take the position that the requirements of Regulation O apply at the time a loan or extension of credit is made. As a result, loans or extensions of credit that were made to an individual before he or she became an executive officer are grandfathered as long as they were made in

good faith and not in contemplation of the individual becoming an executive officer.

Although the loans were grandfathered, no new loans could be made to the individual, and the two existing loans may not be renewed except in compliance with Regulation O.

Regulatory Enforcement Actions

The banking industry will see an increase in regulatory enforcement actions with banks experiencing loan portfolio problems resulting in inadequate capital and unresolved compliance issues. Probably the greatest issue facing banks during the coming months will be the ability to remain in compliance with regulatory capital requirements.

Bank regulatory agencies have a variety of enforcement actions available to them ranging from *informal actions*, such as voluntary board resolutions and memorandums of understanding, to *formal actions*, such as written agreements and cease and desist orders. Informal actions are not available to the public, while formal orders are available to the public. Informal enforcement actions provide a bank with explicit guidance and direction and evidence the commitment of the board of directors of the bank to correct identified problems, such as set forth in an examination report, before they adversely affect the bank's performance or cause further decline in the bank's condition. Informal actions are viewed as voluntary corrective administrative actions and represent an alternative to formal actions.

Formal actions which have the most impact on a bank are available to the public and in most cases are accessible on the website of the regulatory agency having supervisory responsibility over a bank.

Enforcement actions by bank regulatory agencies are issued for unsafe and unsound conditions or violations of law and regulations. These actions will typically direct the bank to insure the safety of its insured deposits, preventing unsafe and unsound banking practices and violations of law, insuring minimum capital levels and requiring adequate compliance programs. Depending on the circumstances, an enforcement agreement or order will require (i) a bank to maintain an approved capital plan and minimum capital, (ii) board monitoring committees, (iii) retention of outside experts and professionals to prepare and revise bank policies and procedures, (iv) a written plan for reduction in classified assets, (v) a management plan, (vi) a strategic plan, (vii) limitations on the hiring of new management personnel and (viii) periodic progress reports to bank regulatory agencies.

In those situations where a bank fails to achieve compliance with an informal enforcement action, a formal enforcement action will generally follow to address the outstanding deficiencies. A cease and desist order can be issued with consent of the bank through its board of directors or following an administrative hearing. In either case, whether by consent or through an administrative hearing, a cease and desist order is legally indistinguishable in its effects.

In those situations where a bank has failed to achieve compliance with a formal enforcement action, additional enforcement actions are available, such as the assessment of civil money penalties against the board of directors, enforcement of the action by a federal court or a requirement

for the sale, merger or voluntary liquidation of the bank.

Regulatory bank enforcement actions increase the operating costs of a bank, while at the same time, revenues and funding sources may decline as a result of customer and credit concerns. Civil money penalties may be substantial for failure to comply with an agreement or order once it is entered which is a substantial reason for addressing an enforcement action aggressively and effectively in order to resolve the underlying issues.

It is important for a bank to retain the services of legal counsel when facing the possibility of a regulatory enforcement action. Once a regulatory action becomes known, a bank must be prepared to address concerns of its employees, shareholders, customers and creditors. Depending on the terms of credit agreements between the bank and its lenders, funds for liquidity may no longer be available, or alternatively, have to be immediately repaid. It is imperative that a bank be prepared to deal with these concerns and issues prior to regulatory enforcement actions becoming available to the public.

It is important to work with legal counsel who have experience in regulatory enforcement actions and dealing with bank regulatory agencies. Our firm has extensive experience in representing financial institutions before federal and state banking and securities agencies and is available to assist and answer questions involving regulatory enforcement actions.

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