

Directors Digest

A Community Bank Directors Advisor

Issue #86 - August 2014

Is Your House in Order?

By Kenneth E. Moore and Michael K. Staub, STUART | MOORE Attorneys at Law

No one likes to receive a call from a regulator asking you to withdraw an application or face a formal denial of planned expansion activities. Recent guidance from the Board of Governors of the Federal Reserve (Fed) highlights common issues in applications and notices, and serves as a great reminder that a financial institution should be sure its house is in order before filing an application or notice. Failure to do so risks an outright denial of, or request to withdraw, an application, which results in wasted time and perhaps the scuttling of business plans. The board of directors is wise to familiarize itself with common issues that can be avoided, or at least managed up front, to ensure, as best one can, a positive response from the regulators. This article will discuss briefly the recurring issues recently identified by the Fed as presenting the most common problems with regulatory applications.

Organizations with Less-Than-Satisfactory Ratings or Enforcement Actions

If your financial institution has a composite CAMELS rating of 3 or lower, component ratings of 3, less than satisfactory ratings in compliance or Community Reinvestment Act (CRA), or is subject to an enforcement action, you should assume any application or notice regarding expansionary activities will be problematic. The Fed is quite clear in Supervisory Letter 14-02 (SR 14-02) on this subject stating, "Organizations rated less than satisfactory or operating under a formal enforcement action are expected to resolve the issues that led to the less-than-satisfactory rating or the enforcement action prior to seeking approval from the Federal Reserve to engage in any expansionary activities, including mergers, acquisitions, asset purchases, investments, new activities, and branching." Boards must keep their management teams focused on resolving less-than-satisfactory condition(s) before pursuing expansion.

Consumer compliance and CRA concerns present a barrier to applications just like safety and soundness issues. We have recently seen more compliance related deficiencies cause problems with applications recently than at any time in the past. SR 14-02 states, "Proposals involving institutions with less-than-satisfactory consumer compliance ratings or other significant consumer compliance issues face barriers to approval and have been discouraged." If a recent compliance examination revealed problems in your bank's compliance process, fix those issues promptly or face barriers to expansion efforts.

Other Financial Factors

Even if your financial institution is rated satisfactory across the board, regulators also consider a number of financial factors in reviewing applications that could derail your plans. The fundamental requirement is that an institution be financially sound, both currently and on a pro forma basis. Prior to submitting applications, directors should confirm that an appropriate analysis of asset quality, liquidity, and capital has been conducted and shows strong levels of each. With respect to capital, at a minimum, pro forma capital levels must fall within "well-capitalized" levels, but the analysis does not stop there and even more capital may be

required. SR 14-02 makes clear that capital levels must “be commensurate with the organization’s risk profile.”

Other Managerial Factors

Regulators look carefully at the competence, experience and integrity of board members, officers and principal shareholders when considering applications. Directors should recognize that this type of review is not limited to applications for approval of new management or board members. Issues of competence, experience and integrity bear equally on expansionary applications. In the context of acquisitions, a board must expect that regulators will consider the management team’s experience, or lack thereof, in integrating acquired institutions. Common concerns identified by the Fed in SR 14-02 include insufficient banking experience, demonstrated problems with financial responsibility and negative background information discovered in due diligence.

Other Factors

Bank Secrecy Act (BSA) compliance and business plan concerns round out the common barriers to regulatory applications. If your institution has been identified as having BSA compliance concerns, you should assume those concerns must be remedied before expansionary activities are undertaken. Additionally, in the context of a merger or acquisition where the target has BSA compliance concerns, an acquirer is advised to discuss the issue with its regulators to determine if the concerns will be inherited by the acquirer following the transaction. Moreover, if an application involves submission of a business plan, the regulators will look closely at the assumptions and results which are included in the plan. SR 14-02 clarifies, “Proposed business plans that substantially increase the risk to an organization or raise safety and soundness concerns have been viewed unfavorably and have been a barrier to approval.” Overly aggressive assumptions, undue concentrations and managerial deficiencies are all business plan items that can derail an application.

Conclusion

Prior to undertaking expansionary activities that require regulatory approval, a board is wise to ensure that its financial institution: (1) is rated satisfactory across the board, (2) resolved outstanding enforcement actions and compliance concerns, (3) can demonstrate financial soundness before and after the proposed expansion, (4) employs appropriately experienced and vetted management and board members, and (5) proposes a reasonable business plan. In short, make sure your house is in order before submitting regulatory applications. Failing to do so may lead to a phone call requesting that your institution withdraw its application or face a formal denial.

Kenneth E. Moore is a partner in, and Michael K. Staub is of counsel to, STUART | MOORE (www.stuartmoorelaw.com), a law firm with offices in San Luis Obispo, Calif. and Washington, DC that specializes in the representation of financial institutions. They can be reached at 805-545-8590.