

A Return To Bank Capital Concerns And Enforcement Actions

by Joseph Lynyak

In this dystopian environment we find ourselves in, the downturn in the U.S. economy will soon begin to ripple through the banking industry. Although the Federal Reserve appears to have acted prudently by establishing credit facilities should a liquidity crisis emerge, an equally important concern is what may be a wave of defaults and insolvencies by businesses forced to shut down due to the COVID-19 pandemic. This in turn will begin to impact financial institutions’¹ balance sheets and capital calculations—which may inevitably lead to a new wave of cease and desist and capital directives by the “Banking Regulators.”²

This Alert is intended to refamiliarize financial institutions and their officers, directors and affiliates with the bank enforcement process—with emphasis on the enforcement tools regularly employed by the Bank Regulators to address capital deficiencies.³

A. The Current Economic Situation

The U.S. economy has experienced extreme shock and losses as the COVID-19 pandemic has forced the closure of innumerable small, medium and large businesses for periods exceeding three months. Although the federal government adopted a series of economic stimulus measures intended to provide temporary funding to prevent layoffs of employees, the current major stimulus measure—the Paycheck Protection Act—has a shelf-life of eight weeks, following which recipients of stimulus funds will likely experience a lack of working capital to return to normal (or the new normal) operations.

Regardless of the size of a financial institutions (e.g., community, mid-sized or SIFI), a credit crisis is potentially looming. This is because the economic stimulus measures adopted by Congress might best be viewed as preventing an immediate shock to the banking system, since numerous credit defaults have been postponed for several months (another iteration of “flattening the curve”). Further, the Banking Regulators have encouraged the use of loan modifications by amending the “troubled debt restructuring” or “TDR” rules to avoid write-downs; similarly, mortgage relief has been afforded to

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homeowners whose home loans were purchased or insured by Fannie Mae, Freddie Mac, FHA and certain other federal mortgage-related agencies.

The effect of these efforts, which hopefully will avoid a liquidity crisis similar to that suffered in 2006-2008, may merely postpone credit deterioration, loan defaults, insolvencies and foreclosure actions undertaken by financial institutions. Eventually these deteriorating credit conditions will result in substantial increases in a financial institution's "Allowance for Loan and Lease Losses" ("ALLL"), loan write-downs and reduction in a financial institution's regulatory capital—resulting in a new wave of enforcement actions not experienced by financial institutions for more than a decade.

B. Frequently Used Capital Enforcement Tools

Although the federal Banking Regulators have numerous enforcement options they may employ to achieve capital adequacy by a financial institution, there are several enforcement options that most frequently are employed by the Banking Regulators to achieve capital compliance by a financial institution.⁴

These primary capital enforcement authorities are:

- Prompt Corrective Action⁵;
- Capital Directives⁶;
- Cease and Desist Orders⁷;
- Civil Money Penalties⁸;
- Safety and Soundness Authority⁹; and
- Removal and Prohibition Orders¹⁰.

Each will be discussed separately.

1. Prompt Corrective Action

Section 38 of the FDI Act authorizes the Banking Regulators to mitigate risk to the FDIC insurance funds by mandating capital compliance with the several capital categories that apply. A "prompt corrective action order" or "PCA" order is similar to the authority under the International Lending Supervision Act of 1983 (12 U.S.C. 3901 *et seq.*) ("ILSA"), discussed below, and is frequently included in a comprehensive cease and desist order. Depending upon the level of capital deterioration, a financial institution may be subject to a range of requirements, including: (a) restoration of capital; (b) improving management; (c) electing a new board of directors; (d) removing specified officers and directors; (e) asset growth and activities restrictions; and (f) capital distributions limitations.

2. Capital Directives

Pursuant to the ILSA, the Banking Regulators have the authority to issue capital orders that focus on the particular needs of a financial institution. Unlike other enforcement authority, however, judicial precedent strongly suggests that there is virtually no right to an administrative review of the determination to issue a capital directive, and that any

subsequent judicial review is limited as well.¹¹

3. Cease and Desist Orders

A cease and desist (“C&D”) order is the platform on which many capital directives are placed. Pursuant to Section 8(b) of the FDI Act, a Banking Regulator can issue a C&D order to correct or eliminate a violation of a statute, rule, regulation, or unsafe or unsound practice at a financial institution. The issuance of a C&D order (which is frequently agreed to by the financial institution by means of a consent stipulation) typically subjects the bank or savings institution to a panoply of regulatory restrictions and reporting requirements, as well as significant additional liability if the corrective measures required by the C&D order are not properly implemented.¹²

Because of the unwillingness of financial institutions to administratively contest proposed C&D orders, banks and savings associations often agree to corrective measures that do not precisely correlate to the operational deficiencies that lead to the issuance of the C&D.

4. Civil Money Penalties

The Banking Regulators may assess civil money penalties against an insured financial institution and its officers and directors for any alleged violation of law, regulation, agreement between an institution and its Banking Regulator, or unsafe or unsound practice. For basic violations (*i.e.*, regardless of fault), the Banking Regulators may assess a penalty in the amount of \$10,245 for each day an alleged violation continues; for reckless violations that result in harm to the financial institution, the maximum penalty rises to \$51,222 a day per violation; and for violations that indicate criminal or quasi-criminal activity, violations carry a punitive penalty as high as \$2,048,915 per day for each targeted officer and director of the institution and the insured depository itself.¹³

The civil money penalty authority is frequently utilized by the Banking Regulators because of its impact on the leadership of the financial institution. Because civil money penalties are typically imposed on officers and directors individually (*i.e.*, thereby creating personal liability), the mere threat of a proposed assessment requires the immediate attention of those individuals, and may result in a financial institution capitulating to whatever remedial action has been requested by the Banking Regulators.¹⁴

5. Safety and Soundness Authority

Section 39 of the FDI Act established the authority for the Banking Regulators to promulgate standards for the safe and sound operation of a financial institution. Joint agency guidelines require an insured institution to adopt a laundry list of required policies and procedures addressing various components of the financial institution’s operations, including: (a) internal controls; (b) loan documentation; (c) credit underwriting; (d) interest rate exposure; (e) asset growth; (f) compensation; and (g) other operational and managerial standards set by the Banking Regulators. In that regard, the Banking Regulators are authorized to issue a directive to a financial institution to develop a plan

to correct weaknesses in the institution's operations and to take other corrective action. Because a violation of Section 39 of the FDI Act is *per se* an unsafe and unsound practice and condition, the requirement of submitting a safety and soundness plan is frequently included as part of a C&D order.¹⁵

6. Removal and Prohibition

Finally, in the instance in which capital compliance is not achieved, under Section 8(e) of the FDI Act, the Banking Regulators can issue orders against a financial institution's officers and directors, removing such individuals from their positions with the institution and prohibiting further involvement in the banking industry. Upon the issuance of a removal and prohibition order, the officer or director is also prohibited from being associated with another regulated depository institution (including a holding company), until such time as permission is received from a Banking Regulator.¹⁶

C. Current Steps to Consider Possible Bank Capital Issues

Unlike the speed by which other bank credit crises have occurred over the decades—suddenly and generally without warning—the current COVID-19 pandemic indicates that: (a) credit will begin to deteriorate; but (b) reasonable advance planning can commence to anticipate the upcoming capital crisis. This is because, unlike previous credit crises referenced above, the stimulus actions taken by the Treasury, the SBA and the Federal Reserve may delay for several months the necessity of immediately declaring wholesale defaults, negotiating TDRs and foreclosing on collateral.

This unusual and unexpected luxury of preparing for eventual bank capital deterioration offers a financial institution the opportunity to prepare itself, members of management and its board of directors against the imposition of enforcement orders alleging unsafe and unsound practices.

Stated another way, while eventually the Banking Regulators will begin to issue capital orders, a financial institution can begin to prepare to defend itself against allegations of mismanagement and breach of fiduciary duty. Among other things, a bank or savings association should consider the following:

1. Review and Revise Bank Safety and Soundness Policies and Procedures

Because bank capital deficiencies are viewed (and responded to) in hindsight by the Banking Regulators, a financial institution's management and board of directors is often accused after the fact of lax management and operation of the bank or savings association, with severe enforcement actions being taken. Stated another way, enforcement actions often accuse an institution's management and board of not anticipating and managing a credit crisis.

We suggest that now is the time to review a financial institution's operational policies and procedures, as well as the effectiveness of its board of directors' oversight reports and related materials. Besides updating these management tools to address the looming

credit crisis caused by COVID-19, doing so in advance of the crisis itself mitigates a charge of mismanagement and breach of fiduciary duty on the part of institution-affiliated parties.¹⁷

2. Risk Management—Preparation for a Cycle of Default, Insolvency and Foreclosure

If it is correct that the banking industry may soon experience a wave of credit defaults by commercial borrowers, a financial institution should evaluate whether it needs to retrain and reposition employees to properly address credit defaults. Among other things, current institution staff may be inexperienced in an economic downturn, and new skill sets may need to be acquired. Further, experienced legal counsel should be retained to assist in developing strategy and tactics for negotiating and resolving difficult credit defaults, including executing on collateral and responding to bankruptcy filings.¹⁸

3. Establishment of a Strong Written Record of Effective Oversight

From the perspective of risk mitigation to defend against allegations of mismanagement and breach of fiduciary duty, it is fundamentally important that management and the board of directors of a bank or savings association understand that the institution must constantly create a written record evidencing the reasonable decisions it has taken to respond to regulatory concerns, and formally place in the institution's official records the prudent steps a board and management has taken to address the upcoming credit crisis. This is because if the financial institution has acted in a responsible manner—but that information is not reflected in the institution's operational and corporate records—institution and institution-affiliated parties will be at a significant disadvantage responding to an enforcement proceeding brought by the Banking Regulators at a later date.

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Please note that this Alert is a summary of the enforcement tools that may be utilized by the Banking Regulators, but is not a comprehensive discussion of bank enforcement. An updated version of an article that was first published in the *Banking Law Journal* will soon be published that addresses bank supervision and enforcement authority in a more comprehensive manner.

¹ The analysis in this Alert applies equally to state and national banks and savings associations, which generally will be referred to as “financial institutions.”

² The term “Banking Regulators” includes the FDIC, the OCC and the Federal Reserve. Note that most state banking authorities have enforcement authority that often mirrors those of the Banking Regulators—and frequently issue joint enforcement directives to state chartered banks and savings institutions. (We exclude the CFPB from this discussion because the CFPB's primary supervisory goal is not safety and soundness, but rather, consumer compliance.)

³ Section 4013 of the CARES Act further liberalized the TDR rules as previously announced by the Banking Regulators. See *also*,

<https://www.fdic.gov/news/news/financial/2020/fil20036.html>.

⁴ The federal banking statutes—particularly the Federal Deposit Insurance Act, 12 U.S.C. § 1811 *et seq.* (the “FDI Act”), contain overlapping (and redundant) enforcement and penalty provisions; however the provisions discussed in this Alert are well understood and provide the Banking Regulators with more than sufficient authority to remedy capital and other bank operational deficiencies.

⁵ Section 38 of the FDI Act.

⁶ The International Lending Supervision Act of 1983, 12 U.S.C. 3901 note.

⁷ Section 8(b) of the FDI Act.

⁸ Section 8(i) of the FDI Act.

⁹ Section 39 of the FDI Act.

¹⁰ Section 8(e) of the FDI Act.

¹¹ The combined authority under PCA and the ILSA have enabled the Banking Regulators to set bank capital levels higher than minimal capital level minimums.

¹² It was once thought that the least onerous enforcement action taken by a Banking Regulator was the execution of a “written agreement” by which the financial institution agreed to take corrective action. Such a written agreement, commonly called a “memorandum of understanding” or “MOU,” typically contains the same language and requirements as a C&D order, and includes liability to a bank for failing to comply with its requirements.

¹³ The amount of each tier of civil money penalty is adjusted each year. See, the Federal Civil Penalties Inflation Adjustment Act Improvements Act of 2015, 28 U.S.C. § 2461 note. <https://www.govinfo.gov/content/pkg/FR-2020-01-14/pdf/2020-00217.pdf>. (Using a sports analogy, the annual adjustment might be viewed as the equivalent to “piling-on.”)

¹⁴ An institution-affiliated party receiving a notice by a Banking Regulator of the intention to assess civil money penalties cannot take the matter lightly. The few judicial decisions in the area suggest that culpability is based upon a virtual strict liability standard, which means that exoneration from liability lies solely within the discretion of the Banking Regulator following a review of a written submission from the officer or director opposing the proposed assessment of a civil money penalty.

¹⁵ This safety and soundness requirement has evolved over time to be viewed through the prism of risk management, which is the analytical process through which the Banking Regulators now approach their examination and supervision functions.

¹⁶ This authority to prohibit a member of the board or management applies whether or not the individual has severed his or her relationship with the financial institution prior to the issuance of the removal order.

¹⁷ While beyond the scope of this Alert, we suggest obtaining an evaluation of the effectiveness of the operational controls currently in place at a financial institution, and prospectively adopting remedial measures if appropriate.

¹⁸ For example, Section 1113 of the CARES Act has modified the debtor reorganization rules for small businesses, which will be in effect for approximately the next one-year period.