Bank Safety & Soundness Advisor

Executive intelligence on bank exams, enforcement and risk management.

February 28, 2011

Tips for Survival in the Post-Dodd-Frank Universe

As the chasm between have (or buyer) and have-not (or seller) banks continues to open, thanks in no small part to Dodd-Frank, banks will want to make sure they're solidly with the haves. Here's one way to do it. Banks should consider seeking extra capital even if they're plenty healthy, counsels Mark Kanaly, a partner with Alston & Bird LLP, Atlanta, Ga. For one, it's a strong signal to regulators that you're a healthy institution, he argues. At the same time, you don't want your bank's capital ratios to draw any kind of negative attention from regulators, he says. The risk may be too high.

"Banks need to play from a position of strength," Kanaly says. "I know it's hard and I know that it's dilutive, but banks do need to raise capital before they think they'll need it. This is a new world and it's all about capital. If you get behind, if you're being criticized by examiners about capital, it's almost too late. Perversely, you're better off getting capital even if you don't need it."

In this market, banks can't risk losing their well-capitalized status, he adds. "Unfortunately, this is a

See Page 6

M&A to Rise Post Dodd-Frank

The Dodd-Frank Wall Street Reform and Consumer Protection Act wasn't intended to charge up merger activity – in fact, in the few areas where Dodd-Frank actually touches on M&A, it makes it more complicated and difficult. Nevertheless, the net impact of the act will be to open up a chasm between healthy, capital-rich banks and their struggling peers. For community banks, where diversification and profitability are already hard to come by, this will likely bring intensified merger activity and soon, experts predict.

"There's nothing in the bill that directly says one thing or another about M&A, but the unintended consequence will be pressure to consolidate, to preserve capital and gain efficiencies," says John Douglas, who heads the bank regulatory practice at Davis Polk & Wardwell in Washington, D.C. and New York.

Why do experts expect more merger activity? One reason is the cost of compliance, which could drain the profitability of any number

(continued on page 2)

Dodd-Frank Incentive Rules to Rely on Nebulous Standards: Ultimately, Examiners Will Determine "Excessive" Pay, Experts Contend

New federal rules on incentive-based compensation aim to keep "excessive" compensation and incentivized risk out of banks. The trouble is, the proposed regulation doesn't define excessive. Banks may be forced to monitor, justify and disclose incentive-based compensation plans to federal regulators, but what ultimately constitutes "excessive" may not be clear until it's too late for banks, experts say.

"Banks can't deal with this," says Stuart Stein, a partner with Hogan Lovells US LLP in Washington, D.C. "They're not going to be able to. This is a principles-based regulation, not rules-based and the problem with that is: You just can't know if your compensation is excessive."

As required by Dodd-Frank, federal regulators issued a joint

(continued on page 4)

SUBSCRIBER SERVICES

MISSION:

Bank Safety & Soundness Advisor provides independent, executive intelligence on bank exams, enforcement and risk management.

EDITORIAL:

Need us to investigate a topic? Want to express your opinion? Please call or e-mail us.

Publisher:

Aaron Steinberg
800-929-4824 ext 2471
asteinberg@banksoundness.com

Group Publisher:

Hugh Kennedy
800-929-4824 ext 2213
hkennedy@banksoundness.com

SUBSCRIPTIONS:

Direct questions about subscriptions to:

Phone: 1-877-320-7147;
Fax: 301-287-2945;
or send an **e-mail** to Customer@banksoundness.com.

Published weekly (48 times a year).
 Price: $595/yr.

EDITORIAL CONCERNS:

Our goal is to provide you with the most accurate and balanced information available anywhere. If you ever feel we're not living up to this standard, I want to know about it. Please call me, Hugh Kennedy, Group Publisher, direct at 1-800-929-4824 ext. 2213.

ADDRESS:

Bank Safety & Soundness Advisor
Two Washingtonian Center
9737 Washingtonian Blvd., Ste. 100
Gaithersburg, MD 20878-7364

M&A

(continued from p. 1)

of banks, adds William Taylor, another partner with Davis Polk &Wardwell. Dodd-Frank's several thousand pages of regulations will swamp banks with compliance expenses, which cut right into a bank's bottom line.

"As a general matter, it's the cost of compliance with the new regulations, as well as the capital requirements, that will force some banks that were marginally profitable into a position where they no longer are," he says.

Since smaller banks aren't typically well positioned to diversify their loan portfolio or expand geographically, they'll have to keep a lot of capital on hand to counterbalance that cyclical risk.

The act also raises capital and leverage ratio thresholds, which will complicate merger activity and stimulate it at the same time. Section 607 of Dodd-Frank amends the Bank Holding Company Act of 1956 to require that a bank holding company (BHC) be "well capitalized" and "well managed" before acquiring a bank in another state. As Michael Aiello and Heath Tarbert, both partners in the New York, N.Y. offices of Weil, Gotshal & Manges LLP, point out in a recent Banking Law Journal article, "Bank M&A in the Wake of Dodd-Frank," the standard used to be a lot lower.

"Although the well-managed standard involves considerable discretion among regulators, the required capital ratios leave little room for flexibility," they write. "… Although some regulators customarily demand higher capital ratios prior to approving merger or acquisition applications, Dodd-Frank may push them to raise any unwritten, de facto limits even higher."

Those same raised capital standards will simultaneously add extra pressure to banks already struggling to add capital. Those regulatory standards may put a drag on M&A, but the net effect will be more merger activity, especially among community banks, argues Mark Kanaly, a partner with Alston & Bird LLP, Atlanta, Ga.

The new capital standards are, in part, designed to bolster financial institutions against cyclical risk, he says. And since smaller banks aren't typically well positioned to diversify their loan portfolio or expand geographically, they'll have to keep a lot of capital on hand to counterbalance that cyclical risk.

"If I'm a small bank that does real estate lending, I may not be able to expand into industrial lending," he says. "From a cyclical risk perspective, the regulators will want me to hold sufficient capital to weather another event like the one we're going through. Since my portfolio lacks diversity, it's risky and will need to add a lot more capital."

"There will be pressure on some banks to sell and pressure on other banks to buy," Taylor adds. "For the latter group they will need to consolidate to generate synergies."

The trouble is, everyone's looking for capital, and, as many banks are finding, getting capital just to meet regulatory standards is a tough sell. Banks have to accept that the new regulatory standards make raising capital that much more difficult, says Kanaly. "The bloom has come off the rose for small banks trying to raise capital," he says. "When investors are looking at investment opportunities and are looking at banks that are planning to hold capital, not deploy it, it's just not sexy. It won't generate interest."

At the same time Dodd-Frank has eliminated other popular means for adding Tier 1 capital. The Collins amendment killed TruPS for all but the smallest banks, but since there's no market for TruPS, they're not useful for anyone. In the meantime, Kanaly adds, you can issue preferred stock but Basel III will have something to say about its utility as Tier 1 capital.

"You can issue preferred stock, but in Basel III, if you put out a preferred instrument and want it to count as Tier 1 capital, it has to include a trigger that allows regulators to convert it to common stock at their discretion," he says. "What investor will want an investment like that?"

"The biggest thing, going forward, is that when regulators say tier one capital, they really mean common stock," he adds. "All the trust preferreds we've been using [as Tier 1 capital] won't have the legs that they used to."

Higher capital standards, harder-to-get Tier 1 capital and a thick slice of regulatory burden: It's all been thrown at banks at once, which means that the immediate post-Dodd-Frank era will be a crucible for many community bankers, argues Jeff Werthan, a partner with Katten Muchin Rosenman LLP in Washington, D.C. Werthan estimates that, as a result of Dodd-Frank complications, bank M&A will shoot up within two years.

"Banks need to think about whether or not they can meet these new requirements, if they can deal with this new era of regulation," says Werthan. "They have to ask themselves: 'Do I have the energy, the expertise and the capital to survive?' If the answer is no, then they have to think about what they have that they could sell. They need to think about putting themselves on the market so they don't fall farther behind the eight ball. If they wait too long, they could end up farther behind the competition, exposed to greater regulatory risk and find themselves with a less saleable product."

Ultimately, these provisions in Dodd-Frank will sharpen the distinction between the haves and have-nots, Werthan adds. "When you put all these things together, I think what you're going to see is that some institutions on the margin, ones that are capital challenged, regulatory challenged or both – will finally decide to cash in their chips and sell." ■

The Merger Approval Process Quickens

Are regulatory approvals for M&A speeding up? The answer may be yes. A merger transaction in 2010 took, on average, 128 days, or a little over four months, according to a study conducted by FIG Partners, Atlanta, Ga. In 2009, the average merger transaction took 165 days to close, or around 5.5 months.

"Our results show that 2010's M&A deals experienced more efficient closing times," said Chris Marinac, director of research with FIG Partners. "There are 78 deals from 2010 which haven't closed and our results may be skewed from these remaining deals. Nonetheless, we feel that greater efficiency in deal completion times is possible as regulators are increasingly permissive on consolidation to unfold in the banking sector the next several quarters and beyond."

Marinac also points to a few recent examples of quickie merges to bolster his point. ONB-Old National and GABC-German (which purchased Monroe Bancorp and American Community, respectively) both closed deals in under 90 days. The longest deal from 2010, so far, is the merger of Steele Holdings and American State Bank – a 309-day process. The longest '09 merger, Western Liberty Bancorp / Service 1st Bank of Nevada, beats it, with a running time of 415 days. ■

Incentive

(continued from p. 1)

proposal on incentive-based compensation earlier this month. The rules only apply to banks with at least $1 billion in assets and also include heightened regulation for banks at $50 billion and up.

Under the proposal, some covered banks will have to defer 50% of annual incentive-based compensation for three years. It requires bank boards to identify bank officers who can, by virtue of their position, put the bank at risk of substantial loss and approve as well as monitor their incentive-based compensation. Regulators will also expect covered institutions to submit a yearly report on incentive-based compensation.

The regulation follows from 2010 FFIEC guidelines on incentive-based compensation. The major difference, however, is that the regulators will be monitoring incentive-based compensation now, too, and, without any clear definition of "excessive" in place, it won't be easy for a bank to prove that its compensation plan didn't create excessive risk, Stein says.

"You can't know if you've created an unknown risk until it's too late," he says. "How long did the industry – as well as investors and the regulators – fail to recognize the risk in so much of the subprime and alternative mortgage market? No one thought it was risky at the time. The regulators say: your compensation can't be excessive, but how do you decide?"

The inspecificity of the regulation can only lead to greater examiner leverage, says Mary Mullany, a partner with Ballard Spahr LLP in Philadelphia, Pa. Financial institutions already under scrutiny can expect examiners to take a long, deep look at their compensation plans.

"The health of an organization will play a big part [in compensation-focused exams]," she says. "If the regulator has a safety and soundness concern with an institution and then finds that it's paying compensation at the upper end of the scale for similar sized institutions, that institution will be at more risk for having their compensation challenged."

One way banks can make their case to the regulator is by comparing themselves, and their incentive-based compensation, to peer banks. But, adds Stein, the problem is, what constitutes a peer?

"You can look at [incentive based compensation] relative to a group of peers, but it's hard to say what a peer is," he says. "If you're a $250 million bank, does that

What Regulators Want in Your Compensation Report

In order to keep tabs on incentive plans, the regulators will require all banks above $1 billion in assets to submit a yearly report to their primary regulator.

"The act requires a covered financial institution to submit an annual report to its appropriate Federal regulator disclosing the structure of its incentive-based compensation arrangements that is sufficient to determine whether such compensation structure provides covered persons with excessive compensation, fees, or benefits, or could lead to material financial loss to the covered financial institution," states the regulation.

Here, according to the regulation, is what your regulator will expect to be included in that report:

- a clear narrative description of the components of the incentive-based compensation applicable to covered persons, and the types of covered persons to which they apply;
- a succinct description of the covered financial institution's policies and procedures governing its incentive-based compensation arrangements;
- for "larger covered financial institutions," a description of any specific incentive compensation policies and procedures for its executive officers, and other covered persons who the board of directors, or committee thereof, determines individually to have the ability to expose the institution to possible losses that are substantial in relation to the institution's size, capital, or overall risk tolerance;
- any material changes to the covered financial institution's incentive-based compensation arrangements and policies and procedures made since the covered financial institution's last report was submitted; and
- the specific reasons the covered financial institution believes the structure of its incentive-based compensation does not provide covered persons with incentives to engage in behavior that is likely to cause it to suffer a material financial loss, and is not excessive. ■

mean that your peer can't be the $5 million bank competing with you in your market?

Nevertheless, banks will need to find ways to justify incentive-base compensation, adds Mullany. Peer comparison is one way. Another is to look to section 162(m) from the internal revenue code, she suggests.

That part of the code came into play with regards to financial institutions that took TARP funding and it can serve as a guide here, too, she says.

"Something like this can help an institution articulate why their compensation isn't excessive," she says. "It can help a bank articulate a goal, an objective, a payment based on pre-determined criteria."

Now more than ever, a bank's emphasis now needs to be on documentation. "What you don't want is a bonus without having left any paper trail to explain why you paid it," Mullany adds.

When it comes to incentive-based compensation, the basis for a board's judgment has to be documented, Stein agrees. "If [the board] doesn't go through the process and document it, the examiner can question the results," he adds. "We've seen enforcement actions [regarding compensation]. It's not that unusual right now."

Best Practices?

Banks under a billion in assets won't have to worry about meeting the new regulatory requirements, but those banks may want to pay attention anyway, says Mullany.

"The parts [of the proposed regulation] about having established policies and procedures is a best practice that any bank should be thinking about," she says.

How the Regulators Will Vet Your Compensation Plans

As the new incentive-based compensation regulation makes clear, the regulators will reserve the right to determine just what constitutes "excessive" incentive-based pay. Nevertheless, the new regulation does detail some of the factors regulators will consider when vetting your payment plan.

"[The] proposed rule instructs that compensation would be considered excessive if amounts paid are disproportionate or unreasonable to the amount, nature, quality and scope of services performed by the covered person, among other factors," states the proposed regulation.

Here's what regulators will be looking at before weighing in on your program:

• the combined value of all cash and non-cash benefits provided to the covered person;

• the compensation history of the covered person and other individuals with comparable expertise;

• the financial condition of the covered financial institution;

• comparable compensation practices at similar institutions, based upon such factors as asset size, geographic location, and the complexity of the institution's operations and assets;

• for post-employment benefits, the projected total cost and benefits to the institution;

• any connection between the individual and any fraudulent act or omission, breach of trust or fiduciary duty, or insider abuse with regard to the covered financial institution; and

• any other factors the appropriate Agency considers relevant. ■

There is another best practice embedded in the new regulation: matching incentive compensation with the risk timeline. "Compensation programs are usually short term but the risk is usually longer term," says Walter Smiechewicz, chief audit executive with First Niagara Bank, ($21 billion), Lockport, N.Y. "This is the classic risk mismatch: taking risks that are three to five years in length, but tying compensation to first-year numbers."

The new regulation's insistence on deferred incentive-based compensation makes a lot of sense, says Smiechewicz. Financial institutions should want to make sure that any incentive it offers actually fits with the firm's plan.

"Every audit we plan includes a look into compensation," he says. "We ask: What is the compensation structure? What are employees incented to do? We have to make the determination as to where the risk takers in the bank are spending their time. We need to make sure that we can trace [incentives] back to strategy. The [incentive-based compensation] rules fit right in with this." ■

Survival

(continued from p. 1)

black and white situation. If you're not already an acquirer, absent a strategic transition, it's very difficult to become one. I can only point to a handful of banks with less than a 5% capital ratio that found capital. The die is being cast early."

Banks should take a long hard look at their regulatory fitness, too, says Jeff Werthan, a partner with Katten Muchin Rosenman LLP in Washington, D.C. Banks need to know if they can accommodate these new regulations, that they can deal with the new regulator and comply with state law, he says. No bank can expect to survive and remain profitable without "capable people" in compliance.

"Banks need to think about whether or not they can meet these new requirements, if they can deal with this new era of regulation," Werthan says. "They have to ask themselves: 'Do I have the energy, the expertise and the capital to survive?' If the answer is no, then they have to think about what they have that they could sell. They need to think about putting themselves on the market so they don't fall farther behind the eight ball. If they wait too long, they could end up farther behind the competition, exposed to greater regulatory risk and find themselves with a less saleable product."

Also, banks need to be realistic about their potential for growth and health even if they aren't obviously ailing. There are a lot of banks out there that aren't necessarily hurting for capital or in regulatory trouble, but they may not have good long-term prospects, either, says Richard Garabedian, a partner with Luse Gorman Pomerenk & Schick, P.C., Washington, D.C.

"Some banks aren't in the situation where they have the FDIC wolf at the door, but they may still end up moribund for years," he says. "They may not have enough capital or earnings to gain traction, which means they can't be aggressive in pricing products. Other banks will be eating their lunch for several years. Some banks may be content to live in this zone, but others may say, 'Let's suck it up and find a partner; let's make it a better world for both of us.'"

Too Many Sellers

Merger activity may be primed to take off at some point, but it's pretty stalled right now, notes Francis X. Grady, a partner with Grady & Associates, Cleveland, Ohio. And the reason, he says, is because there just aren't enough buyers. New regulation may be growing the sellers' ranks, but they're also keeping potential buyers out of the market.

"The catch is, acquirers need to be well-capitalized and well-managed," he says. "Regulators are being very cautious. There's no shortage of sellers, but there aren't as many acquirers as you'd like. And until you have more buyers able to navigate the approval process, you won't see that many."

In the meantime, banks are still waiting until the very last minute to sell, but as many of them are finding, there's really no such thing as the 'last minute,' argues Michael Voinovich, a managing director and partner with Paragon Capital Group, LLC, in Cleveland, Ohio.

"We've found that, in many cases, a sale is a last attempt to stave off a takeover by the FDIC or, at minimum, the recognition that the bank won't raise any additional capital," he says. "It's a surrender rather than a value-creation opportunity."

When banks wait until that late in the process, they cut themselves out of any hope for an unassisted transaction. "It takes out any of the bank buyers that might be looking," he adds. "If a bank is qualified to buy another bank – if it has the capital and regulatory approval – then it won't buy the bank then. It will wait for the FDIC to call and bid on it through them."

A lot of banks try to exhaust what remedies they have for raising capital before considering a merger, but by then, it's too late. "The only thing [capital-starved] banks have going for them is time," Voinovich says. "Once that expires, so do the good options."

To banks in need of capital, Voinovich recommends seeking capital and merger alternatives concurrently. "Don't try to run a process where you look for capital, [conclude that] it didn't work and then try to find a buyer," he says. "You have to do both at the same time and evaluate your options at the end of the process. Banks don't have time to do one and then the other." ■