

Financial Institutions

www.schiffhardin.com

Darren C. Baker

312.258.5538
dbaker@schiffhardin.com

Lorraine M. Buerger

312.258.5837
lbuerger@schiffhardin.com

Matthew Galo

312.258.5643
mgalo@schiffhardin.com

David S. McCarthy

312.258.5653
dmccarthy@schiffhardin.com

Gary L. Mowder

312.258.5514
gmowder@schiffhardin.com

Harold S. Nathan

212.745.0813
hnathan@schiffhardin.com

Peter L. Rossiter

Client Service Group Leader
312.258.5579
prossiter@schiffhardin.com

John Schietinger

312.258.5817
jschietinger@schiffhardin.com

David H. Williams

404.437.7010
dwilliams@schiffhardin.com

Jason L. Zgliniec


312.258.5795
jzginiec@schiffhardin.com

To Our Clients and Friends:

The financial crisis that reached what we hope was its most intense period last Fall continues to affect bankers' lives every day and will likely produce profound changes in banking and bank regulation. Those developments are happening so quickly that they are the stuff of newspapers. In this *Financial Institutions Update*, we try to give you some perspectives on longer term issues, some information about more settled aspects of the regulatory response to the financial crisis, and a heads-up on more mundane but important regulatory developments.

- **Allan Immelman**, Managing Director at RSM McGladrey, contributes a primer on risk and capital, analyzing the ways in which we think about and use various concepts of capital – including the very important concept of economic capital.
- In our **Regulatory Roundup**, we cover topics ranging from developments that may make private equity a new source of capital to banks, especially failed banks, to recent changes in Regulation C.
- **Darren Baker's** piece on the recent Treasury guidance on the Troubled Asset Relief Program - Capital Purchase Program executive compensation restrictions will be of interest to all participants in that program – and, as a leading indicator of what may be down the road, to others as well.
- An article by **Lori Buerger** on the FDIC receivership process is also particularly timely.

We are pleased to bring you the September 2009 edition of the Schiff Hardin *Financial Institutions Update*.



Pete Rossiter

RISK AND CAPITAL – A WORKING RELATIONSHIP?

by Allan Immelman
Managing Director RSM McGladrey

The significant failures in financial control, regulation and risk management which led to the current financial crisis should not detract from the very positive developments made in these disciplines. Large, internationally active financial institutions have been at the forefront of the development of sophisticated and forward-looking risk management approaches and techniques for years. Responsible regulators have made significant strides in aligning the regulatory environment with best practices in risk management, providing capital rewards for those who have excelled or demonstrated significant improvements in the relationship between their actual and projected risk-based performance.

Governmental interference and human fallibility appear to be more the primary issues underlying the crisis. In the U.S., these include supporting exercises in self regulation, maintaining very poor underwriting practices, staying in the game to remain competitive while knowing the bubble would eventually burst, providing special privileges to Fannie Mac and Freddie Mac by allowing them to attract capital they could not under pure market conditions and thus distorting the housing market, and proliferating structured products with complexities that exceeded the capabilities of risk managers, rating agencies, investors, insurers and their tools to understand and price the underlying exposures.

This leaves many of our community and other banks out in the cold, struggling to maintain adequate capital levels to counter the effects of deteriorating asset quality, earnings and liquidity. Increasingly, more are failing or being placed on regulatory agencies' watch lists. Many community banks are struggling to come to grips with the necessity to anticipate future losses and evaluate their impact on earnings and capital, having never needed to do so in the past. Many are therefore ill-equipped to price risk into their products, or accurately quantify and manage the risk associated with their deteriorating assets. It can also be argued that this problem is exacerbated by a regulatory model which is still based on early standards, incorporates risk poorly and does not reflect risk-based measures implicit in economic capital standards, which best practice and new regulations do.

In the words of John Walter from Bank of America, a consistent and comprehensive economic model accomplishes two goals:

- "It provides a common currency of risk that management can use to compare the risk-adjusted profitability and relative value of businesses with widely varying degrees and sources of risk."
- "It allows bank management and supervisors to evaluate capital adequacy in relation to the risk profile of the institution."

John C. Walter, "Economic Capital, Performance Evaluation and Capital Adequacy at Bank of America," 2004.

Rather than wait for regulatory reaction, community and other banks can achieve this on their own through adopting an economic approach to capital adequacy. First, a clear understanding of capital is fundamental.

Accounting capital, the best known term, is the sum of items on the claims side of the balance sheet (e.g. book value of shareholders' equity, paid-in capital and retained earnings). It views capital mostly as a source of funding and risk has no bearing.

Regulatory capital, on the other hand, refers to specific categories of equity and "equity-like" claims and is used to meet capital regulations. These officially defined tiers of capital attempt to reflect different liquidity characteristics and different levels of capacity to absorb losses. Potential for loss is defined partly by how regulators assign risk categories to assets to officially measure the risk weighting of assets. It is widely seen to have three main flaws:

- It is one-size-fits-all, inflexible and rules-based.
- It does not consider a bank's unique strengths, positions and niches.
- It does not account for shareholders' perceptions of, and tolerance for, risk.

Long before the days of regulatory capital requirements, banks and money changers always held capital, and even allocated capital, based on their unique, perceived risks. The role of government and regulation changed over the past century, evidenced by the printing of fiat money, demanding ever lower fractional reserve requirements, protecting banks with deposit insurance and regulating and controlling lending. Naturally, that environment resulted in banks having less responsibility to hold, manage and allocate capital and capital ratios fell from 40% in the mid 1800's to 6% in the mid 1980's.

After the well publicized series of crises and scandals in the late 1980's, national and international regulators asserted the need for capital standards, and banks increased capital since then to the 10% average we saw at the onset of the current crisis. These early standards incorporated risk poorly and had many flaws, allowing bankers to play the system and find ways to hold less capital than was required by their true risks. The latest regulations, exemplified in Basel II, attempt to repair these flaws by incorporating the risk-based measures implicit in economic capital in the determination of regulatory capital and by requiring banks to hold not just regulatory capital, but also to calculate economic capital requirements. These advances do not apply in the U.S. to regional and community banks but despite this, several regional and some community banks have developed or are exploring implementation of economic capital models, and more are expected to do so.

Economic capital differs from accounting and regulatory capital by focusing directly on risk, as perceived and measured by the bank bearing the risk. It is not based on accounting, funding strategy or balance sheet composition. Rather, it is based on holding sufficient "equity-like" claims to cover losses arising from exposure assumed by the bank. It serves to underpin all the actual risks carried by the bank. It can be thought of as "true" capital and is not a balance sheet item. Required economic capital is the maximum amount of unexpected losses potentially arising from all sources that

could be absorbed while remaining solvent, with a given confidence level over a given time horizon. Regulatory capital, on the other hand, is the maximum amount of unexpected losses that could be absorbed without any loss to depositors (or their insurer), for a given confidence level over a given time horizon.

Another way of looking at the difference is to understand their objectives. Regulatory capital is designed to provide protection to depositors and financial system stability whereas economic capital focuses on shareholder wealth maximization. Economic capital is the capital banks would choose if there was no regulatory capital minimum.

Ultimately, economic capital based on risk should be compared to both actual capital held by the bank and the regulatory minimum. A sensible risk based capital adequacy framework should match the measured risk with financial resources available to cover the total amount of losses over a given time horizon. These financial resources include not only book capital, or common equity, but also loan loss reserves and income generated during the period. Business performance must therefore be compared across activities with widely varying degrees of risk.

Given that the goal is to ensure capital adequacy for a certain level of solvency, volatility of market value is the best measure of a bank's risk and therefore its capital requirement. This aligns risk measured by management with risk based returns required by shareholders and bondholders (the market values). Best practice institutions measure capital based on unexpected loss (volatility around unexpected loss) and compare their estimate of required capital with financial resources (common equity and loan loss reserves) available to cover unexpected loss. Since expected loss (a cost of doing business) is covered by future margin income (priced-in to cover operating costs as well as expected loss and provide favorable return on capital), it is excluded from the measurement of economic capital. Likewise, future margin income is excluded from calculation of financial resources. This suggests that failing to price-in expected loss is a key to why so many community banks are responding too late to address the impact of credit quality.

Effective capital allocation requires performance evaluation, the objective of which is to measure the contribution of a business to shareholder value after fully adjusting for risk, and thus provide a basis for strategic planning, ongoing performance monitoring, product pricing and tactical portfolio management decisions. To evaluate performance, Risk Adjusted Return on Capital (RAROC) systems assign capital to businesses to determine a risk adjusted rate of return. It is obtained by dividing net income for each business by its required economic capital (you may need to make adjustments to accounting net income to remove timing distortions inherent to accounting). If RAROC is higher than the cost of equity, then the business is creating value for shareholders.

However, since RAROC is a measure of profitability, it may result in rejecting value-increasing projects that will lower average return. Performance should therefore also be evaluated according to the shareholder value-added (SVA) of the business by comparing the return of each business to the bank's cost of equity (shareholder's required rate of return). Because cost of equity is based on systemic risk, the risk measure used for SVA calculations must be based on risk contribution rather than stand-alone risk. This is calculated by subtracting the cost of equity capital from operating earnings of the business. SVA uses economic capital as the risk "currency" and therefore allows comparison of activities with varying risk characteristics. This

overcomes the RAROC limits by incorporating the size of the investment, not just its rate of return.

The necessity to effectively align value with risk management in community banking has never been more apparent. The economic approach presented in this paper should provide an intuitive solution to addressing this need for both the banker and the regulator, as the resulting capital levels should provide the comfort that both the level of risk carried by the bank is understood and managed and a sufficient, justifiable capital buffer is being maintained. The role of management in these processes therefore cannot be over-emphasized. Risk management, ultimately, is about the quality of management practices.

Allan Immelman is responsible for the consulting practice of RSM McGladrey in the Chicagoland and Great Lakes regions. Over the past 22 years Allan has specialized and gained extensive experience in advising and assisting regulated financial institutions and large multi-national corporations with their risk management needs and development of risk management frameworks. He can be reached at 847.413.6277, or at allen.immelman@rsmi.com.

Allan led a "Big 4" national financial institutions external audit and specialist advisory services practice and has extensive financial markets experience gained as treasurer of a Global 200 corporation. He has consulted and advised extensively on treasury operations, risk management, regulation and financial disclosure to banks and corporations in the USA, Southern Africa, Asia, the United Kingdom and Europe. In 2002 he was appointed to lead the investigation into financial market participants to assist the South African Presidential Commission of Enquiry establish causes behind the rapid depreciation of the rand.

*The views and opinions expressed in this article are those of the author and are in no way intended to reflect the views and opinions of RSM McGladrey Inc., McGladrey & Pullen LLC or any firm within the RSM network.

REGULATORY ROUNDUP

The bank regulatory agencies' focus on credit quality in light of the current strains in the economy and financial markets has not resulted in any let-up on other regulatory fronts and has produced its own set of regulatory changes. Here are some recent developments of interest.

Private Equity to the Rescue?

The deepening banking crisis led the Federal Reserve in September 2008 to loosen some of the restrictions on the investment by private equity funds in banks and bank holding companies. With the acquisition of most of the assets and liabilities of BankUnited, FSB by a new bank owned by a consortium of private equity investors, this new flexibility has shown its practical utility.

For the most part, private equity funds cannot become bank holding companies ("BHCs") because, among other reasons, they are engaged through other investments in activities not permitted for BHCs. The Fed's September 2008 Policy Statement, codified at 12 CFR 225.144, adds to a line of interpretations to help determine when a minority investor does (or does not) have enough "control" over a bank or BHC so as to make it a BHC itself.

Some of the new flexibility is in these areas:

- The investor may own as much as 33% of the organization's total equity (though it still must hold less than 15% of any class of voting equity).
- The investor may have as many as two representatives on the board, so long as that is no greater a proportion of the board than its approximate proportionate interest in the organization and not over 25% of the board. (Investor representatives should not serve as chairman of the board or a committee.)
- Investor representatives may serve on board committees, so long as they do not make up over 25% of the membership or have the authority to make or block decisions on behalf of the banking organization.

The Policy Statement contains a good deal of other guidance on matters such as communications with management, the relevance of other business relationships to a control determination, and the acceptability of various covenants restricting actions of the banking organization. Although it does provide some additional flexibility, the Policy Statement makes it clear that the test for control remains a facts and circumstances test — suggesting that consultation with the Fed remains very much in order.

In the wake of the BankUnited transaction, the FDIC Chairman issued a proposed policy on the participation of private equity firms in the bidding process and on how their ownership may be structured. The proposal received some criticism from private equity funds, and the final policy loosened the restrictions some. Private equity investors will still be required to put up at least twice the capital required of other bidders and maintain it for the first three years. Stay tuned.

One Ripple Effect of TARP – A Fed Sleeper on Dividends and Buy-Backs

In February and March 2009, the Federal Reserve Board issued and then revised SR 09-04, “Applying Supervisory Guidance and Regulations on the Payment of Dividends, Stock Redemptions, and Stock Repurchases at Bank Holding Companies.” Noting that the guidance is “especially relevant” for BHC’s receiving public funds under the Emergency Economic Stabilization Act of 2008, the SR letter goes on to review the Fed’s capital planning guidance. It also imposes what amount to new approval requirements for all BHCs planning to pay dividends or repurchase or redeem equity securities:

- For payment of dividends, consultation with the relevant Federal Reserve Bank is necessary (1) if the proposed dividend would exceed earnings for the period; (2) if the dividend could result in a material adverse change in capital structure; or (3) the dividend represents a material increase in the dividend rate.
- The Federal Reserve Bank should be informed, and the BHC should eliminate, reduce or defer any dividend, where (1) the past four quarters’ income, net of dividends already paid, will not cover the proposed dividend; (2) prospective earnings are not consistent with the organization’s capital needs and overall financial condition; or (3) the BHC is in danger of not meeting minimum capital adequacy ratios.
- For repurchases or redemptions of equity securities, BHCs are required to inform the Federal Reserve whenever the proposed action would result in a net reduction of the BHC’s outstanding common or perpetual preferred stock below the amount outstanding at the beginning of the quarter.

These new requirements are in addition to existing requirements, such as the Regulation Y Section 225.4(h)(i) requirement that non-exempt BHCs give notice of actions that would reduce net worth by 10% or more.

Some clients for whom stock repurchases and reliable dividends are important have reached out to Federal Reserve Banks and worked out a method for “clearing” proposed dividends and a level of stock repurchases, with indications that the Fed will entertain proposals going out a year. In light of these new requirements, a proactive approach is definitely in order if you pay dividends or if stock repurchases are important to your strategy.

Some Breathing Room for Trust Preferred

On March 17, 2009, the Federal Reserve Board announced the postponement of new limits on the inclusion of trust preferred stock and other restricted core capital elements in Tier 1 capital for BHCs. The Fed cited “continued stress in financial markets” and the efforts of BHCs to increase capital as the reasons for the postponement. As a result, the new limits take effect March 31, 2011.

Present rules allow the inclusion of two core capital elements, trust preferred and cumulative preferred stock in Tier 1 capital, but only up to an amount equal to 25% of core capital before deduction of goodwill. The new rules would make two changes for most BHCs: (1) the 25% limit would be calculated after deducting goodwill from core capital; and (2) certain minority interests in subsidiaries would be added to the core capital elements subject to this overall limit. For internationally active BHCs, the new rules would also lower the limit to 15%.

As a result, BHCs will have an additional two years in which more of their trust preferred can count as Tier 1 capital.

Small Business Administration Loan Changes

The federal government has recently taken several steps in order to boost lending to small businesses through the Small Business Administration (the “SBA”). On February 17, President Obama signed into law the American Recovery and Reinvestment Act of 2009 (the “Recovery Act”), which authorized the SBA to reduce or eliminate certain fees on 7(a) and 504 loans. On March 16, the SBA announced temporary increases to guarantees on 7(a) loans to 90% from their former level of 75-85%, and the Treasury Department announced commitments of up to \$15 billion to purchase small business loan securities in the secondary market in order to increase liquidity. These changes are designed to assist banks in their efforts to securitize current SBA loans and reduce the risks and costs associated with issuing new loans, thereby increasing small business investment.

Following are the three most significant changes to the SBA lending program.

1) **Fee Eliminations.** The SBA will temporarily eliminate the SBA section 7(a)(18)(A) fees (the upfront guarantee fees) on all eligible 7(a) loans approved by the SBA on or after February 17, 2009. The SBA will also eliminate two fees from eligible 504 Development Company Program loans that were approved on or after February 17, 2009: 1) Third Party Participation Fees (3 CFR 120.972 fees); and 2) CDC Processing Fees (13 CFR Section 120.971(a)(1) fees). All of these fees will be eliminated until the funds allotted are exhausted, which the SBA believes will occur on approximately December 31, 2009. If fees have already been paid on loans approved after February 17, 2009, the SBA will make funds available to refund payments beginning on approximately May 1, 2009.

2) **Guarantee Increases.** The SBA has made a 90% guarantee available for 7(a) loans submitted via standard 7(a), CLP PLP Small/Rural Lender Advantage, Community Express, Patriot Express, Export Express and Gulf Opportunity loan programs. The SBA's maximum guaranteed amount remains at \$1,500,000, so the largest loan that will receive the maximum guaranteed amount is \$1,666,666. This guarantee amount became effective on March 16, 2009 and, unlike the fee elimination provision, the guarantee increase is not retroactive to loans made on or after February 17, 2009.

3) **Purchases of Securities Backed by 7(a) Loans.** The Treasury Department has committed to spend up to \$15 billion to purchase securities in the secondary market that are backed by 7(a) loans packaged from July 1, 2008 to the end of 2009. The Treasury Department is pursuing this program in order to increase liquidity in the secondary market and free up bank capital in order to encourage banks to make more loans to small businesses.

Regulation C Amendments – Home Mortgage Disclosure

In October 2008, the Federal Reserve Board ("FRB") approved amendments to the compilation and reporting of loan data provisions of Regulation C (Home Mortgage Disclosure) to conform to Regulation Z's definition of "higher-priced mortgage loans." A higher priced mortgage loan is defined in Regulation Z as consumer purpose, closed-end loans secured by a consumer's principal dwelling and having an annual percentage rate ("APR") that exceeds the average prime offer rates for a comparable transaction published by the FRB by at least 1.5% for first-lien loans, or 3.5% for subordinate-lien loans. This definition is meant to exclude prime loans while focusing on subprime loans. (For more detail regarding Regulation Z, see the November 2008 issue of the *Financial Institutions Update*.)

Under the amended Regulation C, lenders must collect and report the spread between the APR on a loan and a survey-based estimate of APRs currently offered in prime mortgage loans of a comparable type if the spread is equal to or greater than 1.5% for a first-lien loan or 3.5% for a subordinate-lien loan. The FRB hopes that over time these changes will serve to make the data reported more consistent with prevailing mortgage market pricing, increasing predictability of data reporting. The amendment takes effect on October 1, 2009.

TREASURY ISSUES LONG-AWAITED GUIDANCE ON EXECUTIVE COMPENSATION AND CORPORATE GOVERNANCE STANDARDS

The U.S. Department of the Treasury (“Treasury”) recently issued interim final rules (the “Interim Final Rules”) implementing, and providing highly anticipated guidance with respect to, the executive compensation and corporate governance requirements of Section 111 of the Emergency Economic Stabilization Act of 2008 (“EESA”), as amended by the American Recovery and Reinvestment Act of 2009 (“ARRA”). These implementing regulations are of great significance to companies that are currently participants in the Capital Purchase Program (“CPP”) under the Troubled Asset Relief Program (“TARP”), since those companies are expressly required to comply with Section 111. The Interim Rules are also enlightening to companies that are not currently CPP participants,, since they give those companies a sense of the duties and restrictions to which they may be subject should they participate in a program to which EESA and ARRA apply. The Interim Final Rules set forth certain restrictions upon, and certain actions required of, every recipient of financial assistance under TARP (a “Recipient”), although the rules may apply somewhat differently depending on the amount of financial assistance received and whether the Recipient has securities registered with the SEC under the securities laws (a “Public Recipient”).

Effectiveness and Applicability: The Interim Rules became effective on June 15, 2009. They apply to all entities that have or will receive financial assistance under TARP. This includes participants in the CPP, but not borrowers under the Term Asset-Backed Loan Facility. The requirements and restrictions generally remain in effect for the period (the “TARP Period”) in which any obligation arising from financial assistance under TARP remains outstanding, not including any period in which the government holds only warrants to purchase the common stock of a Recipient. Generally, the restrictions of the Interim Rules apply to a Recipient’s senior executive officers or “SEOs” (defined as the principal executive officer, the principal financial officer and the next three most highly compensated executive officers), and, depending on the particular rule, certain other of the Recipient’s most highly compensated employees, which are identified for any particular fiscal year based on the compensation paid to those employees in the prior fiscal year.

Formation of Compensation Committee and Evaluation of Compensation Plans:

- By the later of 90 days after the closing date of an agreement for the provision of financial assistance between a Recipient and Treasury or September 14, 2009, a Recipient must establish a compensation committee and maintain it through the remainder of the TARP Period. A Recipient that does not have securities registered with the SEC pursuant to the federal securities laws (a “Private Recipient”) and has received \$25 million or less in financial assistance under TARP is not required to form a compensation committee and can carry out the duties established for the compensation committee through its full board of directors.
- By the later of 90 days after the closing date of the agreement between the Recipient and Treasury or September 14, 2009 and at least every six months thereafter during the remainder of the TARP Period, the compensation committee

(or the full board of directors for qualifying Private Recipients) must discuss, evaluate, and review with senior risk officers of the Recipient compensation plans applicable to both CEOs and employees in general to identify and limit features that could encourage unnecessary or excessive risk-taking, behavior based on short term results and not on long-term value creation, or manipulation of reported earnings of the Recipient.

- At least once per fiscal year, the Recipient must prepare (or revise in subsequent years) a narrative description identifying compensation plans and describing how these types of risks have been limited, and the compensation committee (or full board of directors for qualifying Private Recipients) must also certify the completion of the reviews discussed above within 120 days of the completion of each fiscal year. For Public Recipients, the narrative description and certifications should appear in the Compensation Committee Report appearing in the annual proxy statement. For Private Recipients, the narrative description and certifications must be provided to the Recipient's primary regulator and to Treasury.

Bonus Limitations: The Recipient must prohibit the payment or accrual of any bonus payment during the TARP Period to or by certain of the Recipient's most highly compensated employees. The number of employees to which this bonus limitation applies ranges from the single most highly compensated employee for companies receiving less than \$25 million of financial assistance to all of the CEOs and the next 20 most highly compensated employees for a company receiving \$500 million or more in financial assistance. A bonus payment includes any payment that is, or is in the nature of, a bonus, incentive compensation or retention award. A bonus generally does not include payments to or on behalf of any employee as contributions to any qualified retirement plan, benefits under a broad-based benefit plan, bona fide overtime pay, or bona fide and routine expense reimbursements, but may include contributions to, or increases in benefits under, a nonqualified deferred compensation plan, regardless of when the actual payment will be made under the plan. The bonus payment limitations do not apply to (i) a grant of long-term restricted stock, provided that the value of this grant does not exceed one-third of the employee's annual compensation for the fiscal year or (ii) payments pursuant to a legally binding right under a valid employment contract, to the extent such right existed as of February 11, 2009.

Prohibitions on Golden Parachute Payments: The Recipient must prohibit any golden parachute payment to an CEO and any of the next five most highly compensated employees during the TARP Period. The term "golden parachute payment" means any payment for the departure from a Recipient for any reason, or any payment due to a change in control of the Recipient, except for payments for services performed or benefits accrued.

Clawback Requirements: The Recipient must ensure that any bonus payment made to an CEO or the next 20 most highly compensated employees during the TARP Period is subject to a provision for recovery or "clawback" by the Recipient if the bonus payment was based on materially inaccurate financial statements (which includes, but is not limited to, statements of earnings, revenues or gains) or any other materially inaccurate performance metric criteria.

Perquisite and Compensation Consultant Disclosures: The Recipient must annually provide a narrative discussion of: (i) the details of any perquisite (any perquisite or personal benefit or property provided to an individual that (1) is not

integrally and directly related to the performance of the individual's duties and (2) confers a direct or indirect benefit that has a personal aspect) with a value for a fiscal year exceeding \$25,000 that is provided to the employees subject to the bonus limitations discussed above and (ii) any engagement of a compensation consultant by the Recipient or its board of directors. Such disclosures must be provided within 120 days of the completion of a fiscal year any part of which is a TARP Period. Public Recipients will include these disclosures in their annual proxy statements and Private Recipients must provide the disclosure to Treasury and its primary regulator.

Prohibition on Tax Gross-Ups: The Recipient is prohibited from providing (formally or informally) tax gross-ups to any of the CEOs and next 20 most highly compensated employees during the TARP Period. For this purpose, a gross-up means any reimbursement of, or providing a right to payment of, taxes owed with respect to any compensation, provided that it does not include gross-ups under a tax equalization agreement with respect to foreign taxes.

Excessive or Luxury Expenditures Policy: By the later of 90 days after the closing date of the agreement between the Recipient and Treasury or September 14, 2009, the board of directors of the Recipient must adopt an excessive or luxury expenditures policy, provide this policy to Treasury and its primary regulator, and post the text of this policy on its Internet Web site, if the Recipient maintains a company Web site. For purposes of EESA, "excessive or luxury expenditures" means excessive expenditures on any of the following that are not reasonable expenditures for staff development, reasonable performance incentives, or other similar reasonable measures conducted in the normal course of business: (1) entertainment or events; (2) office and facility renovations; (3) aviation or other transportation services; and (4) other similar items, activities or events for which the Recipient may reasonably anticipate incurring or reimbursing expenses. The Interim Rules provide additional guidance on the specific types of written standards that should be included in the policy.

Say on Pay: Recipients must permit a separate, non-binding, shareholder vote to approve the compensation of executives as disclosed in its annual proxy statement. In practice, this requirement only impacts Public Recipients.

Certification Requirements: In addition to the certifications required of the compensation committee or the full board discussed above, within 90 days after the end of each fiscal year any portion of which is during the TARP Period, the principal executive officer and the principal financial officer of the Recipient must provide certifications to the applicable primary regulator and Treasury that various actions required by the Interim Rules have been taken.

SPOTLIGHT ON THE FDIC RECEIVERSHIP PROCESS

On July 5, 1934, Mrs. Lydia Lobsiger was the first depositor to receive a disbursement check from the newly-formed Federal Deposit Insurance Corporation (“FDIC”), following the failure of the Fond du Lac State Bank of East Peoria, Illinois.

Much has changed in the 75 years since Mrs. Lobsiger received her modest check, which could not have exceeded \$2,500.00 (the maximum amount insured at that time). Since its formation the FDIC’s processes and procedures for receivership have evolved. Following is a summary of the key aspects of the FDIC’s current receivership process.

When the FDIC is appointed receiver of a failed financial institution under the Federal Deposit Insurance Act (12 U.S.C. § 1821 et. seq.) (the “FDI Act”), it acts in a capacity distinct from its roles as insurer, regulator or conservator. As receiver, the FDIC steps into the shoes of the failed bank, with the goal of liquidating the institution while minimizing loss, thereby increasing the amount available for reimbursement to the FDIC and other creditors.

The Resolution Process

The resolution process reflects the FDIC’s focus upon the least-cost resolution (that is, the FDIC’s obligation to determine the most cost-effective form of liquidating the failed institution) and depositor preference (in which depositor claims are elevated over those of general creditors).

In most instances, the FDIC’s preferred resolution is an assisted purchase and assumption (“P&A”) transaction. In such transactions, the FDIC solicits bids, on a strictly confidential basis, from likely acquiring financial institutions. The winning bidder becomes the acquiring institution, which assumes all the deposits, certain assets and certain liabilities of the failed institution, and generally also receives cash from the FDIC.

Significantly, many of the terms of the P&A transaction are not determined as of the closing of the deal. Financial institutions that participate as the acquirer in a P&A transaction, with the FDIC as the counter-party, quickly discover that it is distinctly different than the transactions with which they might normally be involved. Acquiring financial institutions are required to exercise a great deal of faith with regard to matters such as determination of final terms and completion of transaction documents.

Post-closing activities between the FDIC and the assuming institution are handled during a settlement process, typically lasting from 180 to 360 days after the bank failure. Adjustments made during the settlement process reflect any exercise of options by the acquirer, any repurchase of assets by the receiver or “put back” of assets to the receiver by the acquirer, and any post-closing valuation of assets sold to the acquirer at market prices.

The FDIC may choose to utilize a “bridge bank” or conservatorship authority as an interim measure to swiftly close failing institutions, while it determines how best to sell the assets to one or more acquiring institutions. (A bridge bank is a full-service national bank chartered by the Office of the Comptroller of the Currency and controlled by the FDIC.)

As the receiver of failed banks, the FDIC at times becomes the temporary owner of “atypical” assets as the result of loan foreclosures. In its 75 years, the FDIC has been faced with the challenge of liquidating its ownership of oil tankers, shrimp and tuna boats, race horses, taxi cab fleets, a coal mine, art objects, bakeries, kennels, warehouses full of meat, real estate including churches and synagogues, Hollywood movies and, in one instance, a house of prostitution.

Bank Closures

As of August 31, the FDIC has been declared receiver of 84 financial institutions during 2009. This is in contrast with 2005 and 2006, two consecutive years when no financial institutions were placed into FDIC receivership. (The years 2008 and 2007 saw 26 and three bank failures, respectively. The years 2004 and 2003 saw four and three bank failures, respectively.) Despite the volume of bank failures, media reports of the process surrounding bank failures have generally been favorable, praising the FDIC’s professionalism and efficiency.

When a bank closure is imminent, the FDIC assembles a team from its offices around the country, including specialists in accounting, legal, human resources, information technology, media relations and other areas, led by a “Receiver-in-Charge” and “Closing Manager.” The FDIC team conducts organizational meetings, on a confidential basis, with representatives of the acquiring institution and its legal representatives during the days immediately preceding closure of the failed institution. During that time, the Purchase and Assumption Agreement between the FDIC and the acquiring bank is reviewed and executed, to be effective on the date the failed bank is closed. The FDIC typically conducts bank closures at the close of business on Friday evenings. The failed bank’s facilities re-open for business, under the ownership of the acquiring institution, on Saturday morning or the following Monday.

The FDIC’s Authority and Discretion

The FDI Act grants the FDIC broad statutory authority and protections. For instance, in its role as receiver, the FDIC is not subject to court supervision, although its decisions are subject to limited judicial review. The most significant of the FDIC’s powers for expediting the liquidation process are: (1) determining claims, (2) repudiating contracts, and (3) placing litigation on hold.

In determining claims, the FDI Act requires that all rights of claimants be determined based upon written records as they exist at the time of the bank failure. All claimants must submit claims within 90 days of FDIC notice, and the FDIC will allow or disallow within 180 days of submission.

The FDI Act grants the FDIC discretion to repudiate or disaffirm any of the contracts of the failed institution. When the FDIC chooses to repudiate a contract, the damages for which it can be liable are limited to actual compensatory damages as of the date of the FDIC's appointment as receiver.

The FDIC's right to temporarily suspend ongoing litigation is designed to allow it to assess and evaluate the facts of each case. The FDIC's suspension power applies to all litigation, including suits filed after the institution's failure.

In addition to working with financial industry clients of all sizes in ongoing regulatory compliance efforts designed to avoid regulatory jeopardy, Schiff Hardin's Financial Institutions Practice Group has recently assisted banking clients in navigating the process of FDIC receivership. For more information or to discuss the FDIC's process in more detail, contact any member of the [*Financial Institutions Practice Group*](#).



233 S. Wacker Drive
Suite 6600
Chicago, Illinois 60606

One Atlantic Center
Suite 2300
1201 West Peachtree Street
Atlanta, GA 30309
t 404.437.7000
f 404.437.7100

225 Franklin Street
Suite 2600
Boston, MA 02110
t 617.848.5750
f 617.848.5784

233 S. Wacker Drive
Suite 6600
Chicago, IL 60606
t 312.258.5500
f 312.258.5600

One Westminster Place
Lake Forest, IL 60045
t 847.295.9200
f 847.295.7810

900 Third Avenue
New York, NY 10022
t 212.753.5000
f 212.753.5044

One Market
Spear Street Tower
32nd Floor
San Francisco, CA 94105
t 415.901.8700
f 415.901.8701

1666 K Street, N.W.
Suite 300
Washington, DC 20006
t 202.778.6400
f 202.778.6460

1000 Skokie Blvd.
Suite 215
Wilmette, IL 60091
t 847.920.9327
f 847.920.9329

This publication is for the general information of clients and friends of our firm. It does not provide legal advice for any specific matter. Readers should consult a lawyer directly for such advice. This publication, or parts of it, may be considered attorney advertising material under professional conduct rules applicable to lawyers.