Bank Safety & Soundness Advisor

Executive intelligence on bank exams, enforcement and risk management.

August 29, 2011

FDIC Criticizes Silverton Bank Directors for Individual Loan Approval Decisions

The FDIC filed another lawsuit last week, this time against former directors and officers of the since-failed Silverton Bank in Atlanta, Ga. The lawsuit has gotten a lot of industry attention for its tales of excess – bank officials purchased fancy new offices and not one, but two corporate jets, which they flew to a lot of resorts, according to the FDIC – but the suit is just as notable for what it says about the FDIC's legal strategy. Once again, the FDIC goes granular on loan decisions. In making a case for negligence, the complaint, like others before them, discusses individual loans and individual loan approval decisions made by members of the bank's board.

The complaint lists and discusses, at length, 15 loans that "caused significant loss to the bank," and were all approved by the director/defendants "in blatant violation of the duties owed them to the bank," according to the FDIC. The document criticizes bank directors for weak due diligence and a total lack of business judgment.

See Page 5

Should Bank Directors Approve Loans?

Many community bank boards approve a wide range of loans – above and beyond the loans they're required to approve. But should they? As FDIC lawyers continue to hammer failed bank directors who sat on loan committees and approved bank loans, many industry experts are beginning to suggest that the legal risk for loan approval is just too high.

There are certain loans board directors have to approve – insider loans and those subject to Regulation O. Traditionally, many community bank boards approve other loans, too, including individual loans that the bank perceives as especially risky. The practice itself may turn out to be too risky for bank directors. Recent FDIC lawsuits filed against failed bank directors go into great detail on individual loan decisions made by bank board members (see story, at left). Though the FDIC hasn't explicitly stated it, the lawsuits create a different, higher level of responsibility for loan approving directors (compared to those who don't sit on the loan committee or approve loans), experts say.

The legal risk is now so high that, barring some kind of clarification

(continued on page 2)

CFPB Could Bring Backdoor Regulatory Risk to Community Banks

The newest regulator on the block, the Consumer Financial Protection Bureau, will only directly regulate financial institutions with at least $10 billion in assets, which puts most community banks beyond its reach. Does that mean that community banks won't have to worry about the CFPB? Not directly, but there are sidelong ways the newest regulator in Washington can make you and your bank's life more difficult.

The CFPB, in contrast with the other federal financial regulators, has made it readily apparent that it intends to maintain strong ties with state attorneys general across the country and one way in which the agency plans to foster that relationship is by sharing information. And there's little reason to believe that the CFBP, which has no statutory authority with community banks, won't share what information it gets about community banks with those state attorneys general, who do, says Chris Willis, a partner in the Atlanta office of Ballard Spahr LLP.

One way in which the CFBP could collect and funnel community bank information to attorneys general is when it collects community

(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).

Copyright 2011. 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

Loan Approval

(continued from p. 1)

on director liability from the FDIC, bank directors should consider dropping loan approval altogether, argues the American Association of Bank Directors. The organization's executive director David Baris, who is also a partner with Buckley Sandler, LLP in Washington, D.C., outlined his organizations position in a recent letter to the FDIC, asking for clarification on bank director liability involving loan approvals.

Directors face much higher legal risk when they deal directly with loan approvals, Baris wrote. The AABD argues that bank directors raise their personal liability by voting for approval of loans, approving loans where the loan committee has received a board or committee loan package, or serving on a director loan committee. "There are very serious risks of potential personal liability that do not justify directors' involvement in the loan approval process unless the FDIC satisfactorily clarifies their appropriate role and corresponding personal liability," he wrote.

The American Association of Board Directors now advises board members to avoid approving any loans they aren't required to approve until the FDIC clarifies its expectations and requirements.

The FDIC, in response, calls the AABD's advice "somewhat disturbing," and notes that, when it comes to bank directors, loan approvals and responsibility, nothing has changed.

"The FDIC has not altered its expectations or requirements for bank directors and those standards have remained unchanged for many years," writes FDIC general counsel Michael Krimminger. "In short, bank directors owe duties of care and loyalty in fulfilling their responsibilities. The FDIC has only filed complaints against bank directors who failed to adhere to these long-standing standards. Consequently, there is no basis for your contentions that the standards require clarification or that the FDIC is imposing new requirements on bank directors that put them at risk of liability for appropriately performing their responsibilities … We certainly do not believe it to be in the public's interest, or in the interest of the banking industry, for you to urge bank directors to avoid applying their experience and judgment to important credit decisions of the institution."

According to Baris, this issue hangs on a hazy distinction: To what extent are bank directors like lending officers?

"Our view is that directors are not professional bankers," Baris says. "Most haven't been to school to learn how to approve loans. They can ask questions and review files, but they don't have the level of expertise that a loan officer does. We're concerned that the FDIC isn't treating them any differently than they would a loan officer."

"The FDIC response didn't fix the problem," Baris adds. "The case law, the complaints [from FDIC law suits] clearly reflect that directors take on more risk and more personal liability when they approve loans."

The Backstory

The FDIC is right in that, when it pursues former bank direc-

tors for loan approval decisions, it isn't doing anything new, but that doesn't necessarily mean that the regulator is being fair, says Peter Weinstock, a partner with Hunton & Williams, LLP in Dallas.

"What the FDIC is doing is consistent with what they did in the '80s, but you could say they went too far in the '80s, too." he says. "At least the last two times in the cycle, through the last two crashes, the FDIC went after bank directors for their decisions to approve loans. We can ask if what they're doing is appropriate, but what they're doing is not novel."

Missing Expertise?

New or not, FDIC expectations are out of line with most directors' skill sets, argues Hal Reichwald, a partner with Manatt Phelps & Phillips LLP, Los Angeles.

"Often community bank directors are less able to supervise lending functions, primarily because in many cases, they don't have the expertise," he says. "To put a director on a loan committee and expect them to analyze the loan file and come to conclusions on their own is asking a lot of these people. For loan committee members to come in and listen to a presentation by a bank officer who is promoting acceptance of a proposed credit, to have the package in front of him and spend 20 minutes on 10 loans - how can he do justice to the analysis that must be done?"

At some point, directors have to decide if the benefits of loan approval outweigh the risks, Reichwald says. It's becoming increasingly hard to say that they do, he adds.

"I've seen several cases where board members were held out for special liability," he says. "What if it turns out that the decisions you made to approve the loan, based on hindsight, turn out to be wrong or inept or overtaken by unforeseen circumstances? Why put yourself in greater harm? FDIC is putting members of the loan committee in a special category. It's holding them out for a liability that others don't have."

On some level, this regulatory pressure, and the special liability that comes along with it, is a predictable symptom of market downturns, says Weinstock. In recessions, bank boards will feel pressure from the regulators to get more deeply involved in bank operations. At times, regulators are pushing for bank directors to get too involved, he says.

"We're concerned that the FDIC isn't treating them any differently than they would a loan officer."

"The FDIC wants community bank boards involved on a much more granular basis than is appropriate," he says. "When a bank starts to have problems, they want directors involved in everything, approving everything. But it's not generally consistent with the skill set of community bank directors to be doing that. The regulators are putting them in a position of having to micromanage the bank, and that's not good for the bank."

Remedies

Nevertheless, Weinstock adds, bank directors shouldn't let their frustration with the FDIC blind them to their banks' best interests. It's one thing to be aware of, and try to mitigate legal risk. It's another thing to stall intentionally your bank's loan growth just to make a point to the FDIC.

Cutting out all approvals is "self-defeating, because you'd be harming your own bank by not making the good loans that are out there," he says. "Loans in this environment are the safest loans there are. Loan-to-volume ratios are low and the cash flow is stress tested."

Bank directors worried about legal risk should look to structural changes first, such as building and relying on a credit function that can handle most if not all loan approvals. Another method is to use outside help, he says.

"Third party loan reviews have always been something directors have been allowed to do," he says. The FDIC has much more of an uphill climb when a loan passes muster with outside loan review and with the regulators – in exams – and then goes bad. [Bank director] liability is based on information available when the decision was made."

Bank boards can also vet lists of perspective loans from loan officers without approving any loan, adds Baris. "Directors could still have the opportunity to advise the loan officers about what they know about a relevant property, person or company," he says. "They can do this at a board meeting without necessarily approving the loan. Instead, they'd function as an information source." ■