New Regulations Impact Bank Operations

Alvin C. Harrell, Oklahoma City University School of Law

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1. Federal Reserve Issues New Regulation F Governing Interbank Liabilities

Section 306 of the FDIC Improvement Act of 1991 added a new section 23 to the Federal Reserve Act, governing interbank liabilities. The Federal Reserve Board ("FRB") issued Regulation F to implement the new limitations on interbank liabilities.

Regulation F requires banking institutions with FDIC-insured deposits to adopt and implement policies and procedures to evaluate and control their exposure to loss in the event of default or insolvency of a correspondent bank. When fully phased in, the regulation will require that an institution's overnight credit exposure with regard to a correspondent that is less than "adequately capitalized" be limited to not more than 25 percent of the exposed institution's total capital. There is a one year phase-in period, beginning June 19, 1994, during which the limit will be 50%.

Regulation F, however, is not without its critics. Some have argued that it could have a negative impact on the ability of banks to extend credit, particularly for small and medium-sized businesses. Others have raised concerns about the potential for regulatory arbitrage, where banks could circumvent the new rules by engaging in transactions with non-bank entities.

In light of these concerns, the Federal Reserve Board has been closely monitoring the implementation of Regulation F and has been receptive to feedback from the industry. The Board has indicated that it will be reviewing the impact of the regulation on banks and the broader financial system on a regular basis.

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The rule contains important provisions regarding procedures for considering capital restoration plans, the administration of holding company performance guarantees, for issuing directives to take prompt corrective action, for reclassifying an institution based on unsafe and unsound condition and for the dismissal of a director or senior executive officer.

V. Conclusion

The three items described above will have a significant effect on the banking industry. For institutions and their directors and officers, they pose significant challenges. With stakes under the FDICIA now higher than ever before, directors and officers must commit themselves to planning for compliance with FDICIA's mandates. At a minimum this should include:

- Establishing an Audit Committee that complies with the new requirements.
- Retaining independent counsel for the Audit Committee.
- Consulting with the institution's independent public accountants regarding the implementation of the regulatory compliance review.
- Identifying safety and soundness areas in which the institution may be performing below its peers and implementing corrective measures.
- Taking steps to maintain adequate levels of capital.

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The prudential standards provisions of Regulation F were effective June 19, 1993, with a 30 month transition period to full implementation. Prudent policies and procedures had to be in place by June 19, 1993. The Guidelines for Credit Exposure are subject to transition rules: There is no specific credit exposure limit until June 19, 1994; then for one year (until June 19, 1995) exposure to a correspondent that is not well capitalized will be limited to 50 percent of the bank's capital; after June 19, 1995 such exposure will be limited to 25 percent.

The board of directors of each bank must review its Regulation F policy at least annually (but need not approve individual correspondent relationships). In reviewing and approving its policy, the board must consider the credit and liquidity risks, including the operational risks, inherent in establishing and maintaining a correspondent banking relationship.

Where the bank's exposure to a correspondent is significant (considering the size and maturity of the exposure and the condition of the correspondent), the bank must periodically review the financial condition of the correspondent. However, this does not require periodic review of the financial condition of correspondents where the bank's exposure is not significant, as where small balances are maintained for clearing purposes.

In reviewing the financial condition of a correspondent, a bank must consider any deterioration in that condition, as well as other factors that may bear on the correspondent's financial condition. This review may be based on publicly-available financial data, e.g., published quarterly or annual financial statements, or third party rating information.

A bank may rely on its holding company, or a correspondent, or a banker's bank, to choose other correspondents with which to place federal funds, so long as the bank reviews and approves the selection criteria used.

A bank may set separate limits for different forms of exposure, products, and maturities. The bank should develop or otherwise acquire audit procedures to monitor compliance with these limits. These should include specific limits on the bank's intraday exposures, where the size of the intraday exposure and the condition of the correspondent indicate a significant risk to the bank.

As noted, during the one-year phase-in period beginning June 19, 1994, for the percentage limitation on correspondent credit exposure, the bank's exposure to any correspondent that is less than "adequately capitalized" is limited to a maximum of 5 percent of the bank's total capital. However, beginning June 19, 1995, this limit will be reduced to 25%. Formal, specific limits on this exposure will not be necessary where the bank's policies and procedures effectively limit credit exposure to less than 25 percent, as where relatively small balances are maintained for clearing or similar purposes. "Credit exposure" does not include settlement exposure, transactions where the bank acts as agent, and other forms of exposure not covered by the capital adequacy rules.

II. New Real Estate Lending Standards Issued

Section 304 of the Federal Deposit Insurance Corporation Improvement Act of 1991 ("FDICIA") required the banking regulatory agencies to adopt uniform regulations and standards to govern (1) loans secured by a lien on or interest in real property and (2) loans to finance construction of a building or other real estate improvements, with or without a lien (hereinafter "real estate loans"). The final rule was published in the Federal Register on December 31, 1992, and became effective March 19, 1993. It applies only to depository institutions with deposits insured by the FDIC.

The regulatory agencies published a Joint Proposal on July 16, 1992, offering two alternative approaches to compliance with the mandate of FDICIA section 304. One

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constraints on the commercial mortgage market. While our government's interest in the development of secondary markets is welcomed, it is also cause for great concern.

No policy exists to govern the development of secondary markets. Most of these markets have developed because of shifts in the strategic needs and preferences of three parties — the borrower, the originator, and the end investor. The market for residential home mortgage loans has simultaneously profited and suffered from the development of a secondary market. Homeowners have benefitted, but traditional originators — thrifts and commercial banks — have seen the price of their assets erode as they attempt to compete with Government Sponsored Enterprises (GSEs) who borrow at a marginal spread over Treasuries.

There is nothing novel about a playing field in which the U.S. Government is a competitor. The good that GSEs do comes at a price in terms of product standardization and lower yields. And based on recent GSE legislation, it seems clear from what has occurred to date that the two largest housing GSEs, Fannie Mae and Freddie Mac, will retain their favored position in the marketplace. While Fannie and Freddie were required to increase capital somewhat, they will continue to escape many of the regulatory constraints placed upon depository institutions.

Bankers should be suspicious about the role of government. Its well-intentioned tinkering usually creates an unfair subsidy or tax for different market participants. The time would appear ripe for the government to develop a policy to assist the development of secondary markets without undermining the long-term profits of the intermediaries it is trying to serve. Governmental activity in the secondary markets should work towards a level playing field for all bank and non-bank institutions involved, rather than subsidizing some players and penalizing others.

VII. Impact on Commercial Banks

Banks need to begin determining where they can add value today in the securitization process and develop appropriate strategies. Securitization should not imply that everything should or will be securitized. Arthur Andersen's Vision 2000 estimates that by the end of the decade the securitization of commercial loans will grow 150 percent, but it will remain relatively small — at only five percent of commercial loans originated.

Banks should not hurry to forego their distinctive intermediary role as relationship lenders. That is the one competitive advantage they have over investment banks. But the role of relationship lender must be played only in arenas in which relationship lending is considered a value-added service by the borrower.

For example, for middle-market, small-business, and private-bank lending, banks appear to have a defensible strategic position. At the same time, emerging secondary markets should instill a market discipline to the underwriting of consumer and commercial credit.

The perversions of deposit insurance have historically kept borrowing costs artificially low for high-risk borrowers. In the future, borrowers who cannot meet the underwriting requirements for the secondary market will be segregated to the non-conforming portfolio, which will charge a risk-based premium. Thus, profitability should be enhanced for both low-risk originators and high-risk portfolio lenders.

VIII. Outlook for the 1990s

Banks can use the secondary markets to do their own strategic positioning. It will depend on the size and strategy each bank decides to embrace. Large, full-service banks need to understand the levels of cost efficiency and capital-market relationships required to compete with non-banks. Community banks need to understand the types of businesses that can be exploited against those who are hungry to securitize the world.

Standardization of certain product will allow all banks to tap into secondary markets. Instead of resisting trends to securitization, bankers should embrace them to the extent that antiquated laws will allow securitization to be used as a tool to affect cost of equity.

Banks have an opportunity to be visionary in the development of these new markets. As members of this highly threatened industry, they should:

- Position themselves strategically to participate in the emerging secondary markets.
- Push with unprecedented urgency for worthwhile bank reform.
- Leverage the industry's strength of conservative wisdom, using the sophisticated tools of strategic planning, technology, asset/liability management, and credit management.

As Frank McGuire, who helped found Federal Express, said, "The best way to predict the future is to create it."

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alternative would have identified a range of loan-to-value ratios considered to be prudent for each type of real estate loan. The other alternative provided a single, maximum loan-to-value ratio that would be considered prudent for each category of loan.7 The final regulation does not provide for maximum loan-to-value ratios, though the related Interagency Guidelines issued by the agencies follow the maximum loan-to-value ratio approach of the second alternative.

The Supplementary Information accompanying the new regulation notes that most of those commenting on the Joint Proposal characterized the proposed real estate lending standards as unnecessary and even counter-productive in terms of safety and soundness (due to significantly increased monitoring and management costs).8 A majority of those commenting on the proposal "did not believe that a congressionally mandated regulation providing real estate lending

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and accompanying working papers. Recognizing the limitations of its own resources, the Committee used the assistance of nearly a dozen special advisors and advisory groups on the specialized topics, including real estate, the operation of the filing system, intellectual property, oil and gas matters, and the like. All advisors participated, like members of the Committee, on a noncompensated basis.

After careful study and deliberation, the Study Committee recommended that a drafting committee to revise Article 9 should be formed according to existing arrangements between the Conference and the Institute for the purpose of revising UCC Article 9. The Committee's substantive recommendations for revision fall into three general categories.

The first concerns the scope of Article 9. Article 9 has proven to work well for a wide variety of types of collateral, both tangible and intangible. However, certain types of personal property currently are excluded from the scope of Article 9, often for reasons that may not be persuasive in the context of contemporary commercial practices. The Committee recommends that the scope of Article 9 be expanded to encompass certain personal property that Article 9 currently excludes: deposit accounts, tort claims, and insurance claims. The Committee also recommends that Article 9 be amended to be the exclusive source of the law governing attachment and perfection of security interests in notes secured by real property and similar real estate-related obligations. In addition, the Committee recommends that Article 9 apply not only to sales of accounts and chattel paper, as is currently the case, but also to the sale of many types of general intangibles representing a right to payment.

The second category of recommendations includes those that facilitate perfecting a security interest and improve the public function of perfection. Several recommendations address the possibility of making the filing of a financing statement a permissible means of perfecting a security interest with respect to collateral as to which filing ordinarily is not effective, such as instruments, letters of credit, and investment securities. The Committee also recommends that a single choice-of-law rule govern nearly all security interests perfected by filing. The recommendations also seek to clarify, and in some cases facilitate, the maintenance of perfected status with respect to security interests in both original collateral and proceeds. The Committee also strongly encourages efforts to enhance the accuracy, speed, and general efficiency of the Article 9 filing system, and recommends that the drafting committee explore revisions to alleviate filing-related problems in a variety of areas. In addition, the Committee recommends revision of both Article 9 and federal law to facilitate perfecting security interests in intellectual property subject to federal law (i.e., copyrights, trademarks, and patents).

The third general category relates to enforcement. The Committee recommends several proposals to clarify Part 5 of Article 9. These recommendations also address a number of issues concerning the obligations of account debtors on intangibles. They attempt to clarify that, although a perfected security interest enjoys priority over certain competing claimants, perfection does not impose upon the account debtor any obligations to the secured party. This distinction between perfection and enforcement becomes particularly important with regard to obligations owed by financial institutions, such as banks and stockbrokers. The recommendation would clarify the duties that these account debtors owe when their obligations are encumbered by a security interest.

The report of the Study Committee is available from the Order Department of the American Law Institute, 4025 Chestnut Street, Philadelphia, PA 19104-3099, for $20 plus $2.75 postage. The Appendices containing specialized advisory group reports is another $30 plus $5.50 postage. Both are offered for $45 plus $7.50 postage.

A drafting committee to revise Article 9 has been constituted. Its chair is William M. Burke of California. There are three Institute Representatives and six members of the Conference. The reporters are Professor Stephen L. Harris of the University of Illinois and Professor Charles W. Mooney of the University of Pennsylvania. The first meeting of the drafting committee is scheduled for early November. Drafts of revised Article 9 will be available for the cost of reproduction and postage from the Conference office, 676 North St. Clair Street, Ste. 1700, Chicago, IL 60611. The telephone number is (312) 915-0195.

A special aspect of the revision project involves an advisory group stemming from the former American Bar Association Task Force on the Article 9 Filing System. This advisory group under an Executive Committee will conduct further studies of the filing system and technologies available for its improvement, advise the drafting committee on needed statutory changes in Article 9, and work with filing offices and associations to implement uniform standards and technology so that data interchange procedures can accommodate both state and even local filings but also national searches.

Additional reports on the progress of the Article 9 revisions will be presented in these pages from time to time.

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The final regulation requires every insured depository institution to establish a written real estate lending policy. This policy must include loan portfolio diversification standards, prudent loan underwriting standards (including loan-to-loan ratio limits consistent with the Interagency Guidelines), loan administration procedures, and documentation, approval, and reporting requirements. The policy must be approved and reviewed at least annually by the board of directors. The institution must

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luctance. The president of a bank teetering on insolvency thought that the best use of bank funds would be to pay a substantial retainer to counsel on the day after he learned that the regulators considered his bank insolvent. As payment to an institution-affiliated party, that constituted a knowingly unsafe and unsound banking practice. The law firm was not liable because it did not knowingly participate in an unsafe banking practice at the time the retainer was received. However, had it known about the insolvency or should have been aware of the insolvent, the FDIC's position is that it could have proceeded directly against the law firm for restitution. In a similar vein, two courts have held that an attorney’s retaining lien is subject to FIRREA’s claim procedure. When a financial institution client is taken over by the FDIC, client records and files cannot be held hostage to secure payment of fees.

The profession has received a bit of comfort from the Fourth Circuit recently. In a securities fraud case a law firm which documented a transaction (or “papered” it) was not responsible for client fraud and, accordingly, was not liable to parties asserting federal securities law claims.

Recently the Office of Thrift Supervision (“OTS”) sent shock waves through the financial institution bar with its infamous administrative asset freeze against the law firm Kaye, Scholer, Fierman, Hays & Handler as an institution affiliated party. The freeze brought that 389-member firm figuratively to its knees, extracting a $41 million dollar “settlement” and a ban against a partner’s representation of thrills. Ten weeks later, the same agency extracted a sizeable settlement from an attorney who had written a single opinion for a failed thrift. The OTS position that institution-affiliated parties owe a fiduciary duty to regulators has been soundly criticized.

Finally, bank counsel was liable to the FDIC for not thoroughly investigating and then advising the board of his client bank about serious organized crime-related allegations made against the bank and its president and then telling the board, incorrectly, that the case had been settled.

L. Workers’ Compensation

Dismissal of a civil action against a bank, its holding company, and directors was ordered recently by the Oklahoma Court of Appeals. In Bowles v. First State Bank of Chattanooga, the remedy under the workers’ compensation law was held to be exclusive. The plaintiff, in that case, were the survivors of bank employees murdered in a brutal robbery. The acts of the murderers could not give rise to an action for intentional infliction of emotional distress against the defendants.

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also “monitor conditions in its real estate market to ensure that its lending policies continue to be appropriate for current market conditions.”

The regulation itself is fairly short (though very comprehensive in terms of scope). In contrast the Interagency Guidelines, effectively incorporated by reference into the regulation, are detailed and specific. The Interagency Guidelines identify loan portfolio management and underwriting considerations that will have to be addressed in every institution’s real estate lending policy, and prescribe various procedural requirements as well. Loan-to-value ratio limits must be included, and the Interagency Guidelines prescribe limits considered prudent by the regulators.

However, the agencies recognize that creditworthy loans may exceed these in limited circumstances, while at the same time “simply satisfying [a loan-to-value ratio] does not necessarily ensure a

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Oregon Court Confronts Duties of Good Faith and Fiduciary Duty in Ordinary Contract Relations

In \textit{Susina Ltd. v. Pacific First Federal}, the Oregon Court of Appeals discussed the limitations of five common lender liability theories in the context of a difficult factual setting.

In \textit{Susina} the lender accepted a deed to a shopping mall in lieu of foreclosure. As a part of the deed in lieu transaction, the parties executed a contract allowing the plaintiff (owner of the debtor corporation) to temporarily continue managing the property and upon sale of the mall to receive a portion of any sales price in excess of $6 million. Subsequently, the lender arranged for a sale that would have resulted in payment of $1.4 million to the debtor. Before the sale could be closed, Pacific First Federal succeeded to the interests of the original lender and refused to close the sale.

The debtor sued, asserting five theories of recovery derived from these facts:

1. Breach of contract based on an implied duty to market the property.
2. Breach of an implied duty of good faith.
3. Tortious breach of fiduciary duty.
4. Breach of fiduciary duty arising from the duties of a partner or joint venturer.

5. Intentional infliction of emotional distress.

All of these theories were rejected as a matter of law, except that the allegation of bad faith (number 2 above) was sufficient to overcome a motion to dismiss.

The court rejected outright the argument that the contract created an implied duty to market the mall, noting that the contract language refuted this view. The court specifically rejected the use of extrinsic evidence regarding the circumstances surrounding execution of the agreement: "[I]f the language of a written contract is unambiguous, we will not consider extrinsic evidence." This recognition of the rule of law is significant, in an era when some courts have seemed eager to rewrite private contracts.

Similarly, the court rejected arguments that the lender assumed a fiduciary duty as a result of entering the contract, either in the sense of an independent tort duty outside the contract or as a partner or joint venturer with the debtor. Rather, the lender's "obligations were those of the ordinary party to an arm's length business transaction. That does not give rise to a fiduciary duty." Regarding infliction of emotional distress, the court noted that breach of contract, without more, is not the "extraordinary transgression of contemporaneous standards of civilized conduct" contemplated by an action for outrageous conduct.

Of the plaintiff's five theories of recovery, only the issue of bad faith breach was deemed legally sufficient to survive a motion to dismiss. This issue remains something of a problem in commercial and consumer contracts nationwide. While every contract embodies a duty of good faith, the proper limits of this duty have often proved elusive to the courts. Nonetheless there seems to be a clear trend of authority toward limiting the duty to its traditional, common law boundaries.

Oregon has its own famous good faith case, decided during the heyday of the 1980s expansion of the good faith concept. This case effectively precluded a motion to dismiss on the allegation of bad faith breach. Nonetheless, the \textit{Susina} court's sound treatment of the plaintiff's other arguments provides a basis for hope that a sound approach can be expected on this issue as well.

\footnotesize{\textsuperscript{2} The contract provided that the lender had "the right, but not the obligation, to market the property ... at its sole discretion" Id. at 440, n. 1.}

\footnotesize{\textsuperscript{3} 846 P.2d at 440.}

\footnotesize{\textsuperscript{4} Id. At, the contract refused allegations of joint ownership. Id. at 441 and n. 3.}

\footnotesize{\textsuperscript{5} M. at 441, quoting McWherter v. First Interstate Bank, 679 P.2d 766, rev. den., 683 P.2d 92 (Or. 1984).}

\footnotesize{\textsuperscript{6} See, e.g., Carolyn S. Smith, Affidavit: Our Luck: The United States Supreme Court Rejects Tort Liability for Breach of Good Faith, 43 Commer. Law. J. Q. Reg. 258 (1989).}

\footnotesize{\textsuperscript{7} Id. Warren L. Dowitt and John R. Spanel, Monitoring the Risk of Lender Liability: Understanding the Relationship Between Lender and Borrower, 47 Commer. Law. J. Q. Reg. 682 (1993).

\footnotesize{\textsuperscript{8} see v. U.S. National Bank, 739 P.2d 554 (Or. 1987).}

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prudent and collectible loan."\textsuperscript{14} While this seems obvious, the result is that loan-to-value ratios in excess of those prescribed will trigger a heavy burden of persuasion when the examiners arrive.

The Interagency Guidelines do not specify a maximum loan-to-value ratio for permanent mortgage loans on owner-occupied one-to-four family residential dwellings or for home equity loans; however, to the extent that such a loan exceeds 90 percent of the collateral value it must be protected by mortgage insurance or some other "appropriate credit enhancement."\textsuperscript{15}

\footnotesize{\textsuperscript{14} At 62892.}

\footnotesize{\textsuperscript{15} At the outset, it is important to distinguish the former OTS rule requiring mortgage insurance in certain circumstances. However, OTS did not specify risk-based capital requirements as a result, in order to qualify for the 90% risk-weighted category the loan must have mortgage insurance for any amount in excess of the 80% loan-to-value ratio. Id. at note 2.}