

# Discussion Memo

December 18, 2007

## Bank Holding Company Challenges for Board Members

This memo has been prepared as a follow-up to our October 30, 2007 discussion memo, "New Challenges for Bank Directors". It is hoped this memo helps provide bank regulators with additional insight concerning current challenges at the holding company level from the viewpoint of the institution's directors.

- **Significant Increase in Community Banks**

During the past fifteen years over 1,800 new bank charters have been approved and even though the total number of financial institutions has decreased by 38% from 13,853 to 8,615, the number of community banks (\$100M to \$1B) has increased by 31% - with over 850 more community banks.

- **Holding Company Leverage**

The availability of Trust Preferred 'Pools' for community banks has increased bank capital at the expense of additional holding company leverage. As a result many community banks have accessed the capital markets to support growth or finance bank acquisitions.

- **Holding Company Governance**

Most community banks have minimal activity at the holding company level and, although bank board meetings may be held monthly, holding company board meetings are frequently held quarterly. As a practical matter, in good times only infrequent board action is required for holding company matters.

- **Changing Credit Market Conditions**

Community banks have experienced fifteen years of solid earnings based on real estate related loan growth. Credit problems surfacing in the residential mortgage markets and declining home values are well publicized. Today's headlines focus on the national institutions but declining real estate values are also impacting community banks.

Few new community bank board members have experience in dealing with significant asset quality issues. In addition, few CEO's and bank examiners have experience in dealing with significant loan problems and declining real estate loan values in their current capacities.

- **Regulatory Action at Community Banks**

Bank regulators generally prohibit dividends from the bank to the holding company for debt service when a bank encounters significant asset quality problems.

- **Accounting Risk**

Newly organized banks may not have a sufficient amount of retained earnings to absorb significant loan losses and bank dividends for debt service cannot be paid from a retained earnings account with a negative balance.

Community banks also have significantly increased the amount of goodwill as a result of purchase accounting for acquisition activity. Goodwill impairment charges could also impact retained earnings and limit bank dividend payments to the holding company.

- **Bank Holding Company Liquidity**

Many institutions do not maintain cash or liquid assets at the holding company level and pay bank dividends to the holding company only when needed to service holding company debt. As a consequence, the holding company of a bank experiencing asset quality problems will be unable to service its obligations if (when) bank regulators prohibit bank dividends to the holding company.

- **Financing Alternatives**

In such circumstances holding company boards are faced with limited choices for raising additional capital to service holding company obligations.

Trust preferred obligations permit the deferral of interest payments, however, a deferral is just 'capitalized interest' that harms the institution's future access to capital and it creates additional 'reputation risk' in the local market.

History indicates that bank regulators do not approve increased debt to service the institution's existing obligations. Therefore, the addition of equity capital at the holding company level is required. However, there are only limited sources of equity capital for troubled community banking institutions.

- ✓ 'Private' institutions frequently must rely on board members and large shareholders to add capital as they fall below the radar of most institutional investors.
- ✓ 'Public' institutions frequently utilize a 'rights offering' to existing shareholders with the offering assured with 'back-up commitments' from institutional investors.

Needless to say, the publication of a Cease & Desist order combined with the securities disclosures required for a troubled institution to raise additional capital create additional 'reputation risk' in the bank's local market.

- **Regulatory Actions & Economic Consequences**

Our experience in the early 1990's indicates bank boards tend to overreact to regulatory concerns about real estate related lending and, as a consequence, banks actually stop lending – even to solid credits. We see signs that similar behavior is occurring today and such behavior obviously adds downward pressure to economic activity and delays recovery.

## **Conclusion**

These observations do not necessarily reflect the views of the AABD or its individual members. Obviously, other bank directors may feel other issues are more important or differ with some of the preceding observations.

Respectfully submitted,

Charles J Thayer, Chairman  
American Association of Bank Directors