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BANKING

The 2008-2009 financial crisis continues to have major regulatory compliance repercussions for in-house counsel at financial institutions. The Dodd-Frank Wall Street Reform and Consumer Protection Act, which Congress passed in response to the crisis, imposes stricter regulations on compensation, risk-taking and human resources policies of banks. The impact of continued real estate market weakness also presents major challenges for banks that need to meet tighter capital standards, which regulators have designed to ensure that banks maintain strong balance sheets.

FAR-REACHING EMPLOYMENT REGULATIONS IMPACT BANKS

Of the many new restrictions placed on the banking sector since the financial crisis began in 2008, employment-related regulations have received relatively little attention. But Congress and the U.S. Department of Labor (DOL) have recently implemented two far-reaching changes to the law that reflect aggressive new initiatives directly targeting the workplace in the banking industry.

In July 2010, Congress passed and President Obama signed the Dodd-Frank Wall Street Reform and Consumer Protection Act. Section 342 of the act applies to all private financial institutions doing business with the federal government (in effect, virtually all banks) and requires the establishment of an Office of Minority and Women Inclusion in each of at least 20 banking regulatory agencies. That requirement covers all Treasury Department offices, the Federal Reserve Board and its regional banks, the Comptroller of the Currency, the Federal Deposit Insurance Corporation and the new Consumer Financial Protection Bureau, among others. According to the act, each of the new offices will have its own staff and director and will be charged with "assessing the diversity policies and practices" relating to "the racial, ethnic and gender diversity" of the financial institutions regulated by the agencies, and with encouraging "to the maximum extent possible, the fair inclusion and utilization of minorities, women, and minority-owned and women-owned businesses." These mandates are in addition to existing anti-discrimination statutes. Although specific standards remain to be developed, they will apply to all operations of a bank, and could potentially involve numerical or statistical benchmarks. In-house counsel should closely monitor the establishment of these offices and the exercise of their authority in the upcoming months.

The DOL's recent initiative is more limited in scope but could have an equally significant impact on some banks. On March 24, the agency's Wage and Hour Division issued Administrator's Interpretation No. 2010-1, which overturned two previous DOL opinion letters. The new interpretation holds that mortgage loan officers who exercise typical responsibilities, as described in the document, "have a primary duty of making sales for their employers and, therefore, do not qualify as bona fide administrative employees" who are exempt from the Fair Labor Standards Act (FLSA). In other words, the DOL no longer considers mortgage loan officers to be exempt from the overtime provisions of the FLSA. The (re)interpretation acknowledges that this is a "frequently litigated area of the law." While it is only advisory in nature, courts will likely give the agency's new view a measure of deference in any FLSA lawsuits brought by mortgage brokers, who could seek to recover unpaid overtime, liquidated damages and attorneys' fees. In-house counsel should carefully assess existing loan officer job descriptions to ensure that they (and the actual positions) conform to current DOL interpretations, making job classification and responsibility adjustments if and as appropriate.

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BANKS SEEK REGULATORY FORBEARANCE FOLLOWING GULF OIL SPILL

As environmental damage from the Deepwater Horizon oil spill hammers property values throughout the Gulf Coast region, commercial banks face added financial stress on their already struggling real estate portfolios. Even before the BP rig exploded last April, the substantial decline in the real estate market had hit the Southeast particularly hard. Since the recession began, more than two years ago, many banks have needed to enforce their security interests on residential and commercial properties, and as a result they now hold these foreclosed properties on their books as real estate owned. As assets of the bank, such properties must be regularly assessed for fair market value. The consequences of the oil spill (including potential cleanup costs, declines in tourism and other business activity, and further slides in property value) threaten to compound the problem.

As property values in their asset portfolios have slipped, banks in the Southeast have come under increasing pressure from federal and state regulators to raise capital in order to maintain adequate loss reserves. Banks that are attempting to raise capital under current conditions must do so at deep discounts to book value and are further pressured by regulators' insistence on annual reappraisals of real estate owned. A current fair market value assessment of real estate holdings that may have potentially greater future value means banks must report that value at today's depressed market rates—making more capital a necessity to bolster their balance sheets.

Efforts are under way to secure a temporary halt on requirements to raise capital and to reappraise property within 100 miles of the Gulf of Mexico. In July 2010, the Florida Bankers Association asked the Federal Reserve and the Federal Deposit Insurance Corp. for a 12-month moratorium on higher capital requirements, new appraisals and regulatory sanctions for failure to meet capital standards. Such a request is not without precedent. After Hurricane Katrina, in 2005, regulators granted a three-year moratorium on appraisals, but not on capital standards. For banks, the best scenario would include an 18-month halt in sanctions for failure to meet capital standards and a moratorium for the same period on new appraisals, but such a move is far from assured. For a moratorium to be effective, federal regulators and state bank regulators would need to develop a coordinated approach, particularly regarding capital standards, because of the high number of bank failures in Florida and Georgia as a result of inadequate capital. Corporate counsel for banks with any commercial interests in the Southeast region should remain aware of this regulatory debate as it progresses, and may wish to consider communicating directly with regulators about the value that such a moratorium would have for their institutions.

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CONGRESS IMPLEMENTS NEW EXECUTIVE COMPENSATION RULES FOR BANKS

Compensation for business executives has been a much discussed topic in political and regulatory circles lately. Although it is focused on the financial industry, the Dodd-Frank Wall Street Reform and Consumer Protection Act contains provisions aimed at compensation arrangements at all publicly traded companies. Giving shareholders a voice on executive pay, including so-called golden parachute arrangements, preserving compensation committee independence and disclosing pay for performance standards are key provisions of the act for all publicly traded companies.

In addition, the act also specifically gives federal banking regulators the authority to prohibit incentive compensation arrangements that are "excessive" or encourage inappropriate risks at all "covered financial institutions." These institutions include all banks, bank holding companies, credit unions and other specified financial companies, whether publicly traded or privately owned, that have assets of more than $1 billion—a level that encompasses hundreds of midsized and larger banks. These institutions must disclose all incentive compensation arrangements to applicable federal banking regulators. Under the act, regulators must issue implementing rules regarding compensation by April 2011.

Although corporate counsel for affected financial institutions should carefully monitor the Dodd-Frank rulemaking process over the next nine months, Congress is not the only one to weigh in on the issue. In June 2010, the Federal Reserve, the Office of the Comptroller of the Currency (OCC), the Office of Thrift Supervision and the Federal Deposit Insurance Corp. issued final guidance regarding incentive compensation arrangements at all regulated financial organizations, regardless of size. According to the OCC, the guidance, which was issued in anticipation of the Dodd-Frank Act, "is designed to ensure that incentive compensation arrangements at banking organizations appropriately tie rewards to longer-term performance and do not undermine the safety and soundness of the firm or create undue risks to the financial system." It applies both to top-level managers and to other employees who can materially affect the organization's risk profile.

Many of the provisions in the Dodd-Frank Act—including the say-on-pay and clawback requirements—also reflect the compensation requirements imposed on banks that received federal assistance in 2008 and 2009 as part of the Troubled Asset Relief Program (TARP). Banks still participating in TARP remain subject to compliance; banks that have exited TARP will be familiar with the provisions.

The June 2010 final guidance, when combined with the earlier TARP provisions, offer in-house counsel at any affected financial institution the means to begin assessing compliance with Dodd-Frank even before rules are issued. This is particularly important for publicly owned banks that must make compensation compliance disclosures in 2011 proxy statements.

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