WHAT PROMPT CORRECTIVE ACTION REALLY MEANS

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There is a tremendous amount of "paper" coming out of the regulatory authorities these days as it relates to community banks. The "paper" is all at varying levels of obnoxiousness.

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I did see one approach by the Office of the Comptroller of the Currency, however, that disturbed me even more than normal. This particular piece of paper was issued under the Prompt Corrective Action provisions of the banking statute. It was a PCA Directive.

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A number of our clients have received PCA Directives over the last two years. A PCA Directive basically requires the bank to raise capital within a very short timeframe. I have learned to understand that PCA in this day and time means "Probably Can't Achieve," as it relates to capital. In connection with a recent matter involving a national bank, I believe OCC has moved PCA from the category of "Probably Can't Achieve" over to the category of "Probably Can't (Even) Attempt."

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As many of you know, the Prompt Corrective Action Rules allow the regulator, basically without due process, to tell the bank to go out and raise capital or come up with a Capital Restoration Plan. Part of that Capital Restoration Plan requires a statement from the bank's holding company that it will guarantee the bank's compliance with the Plan (whatever that means). Having dealt with a number of PCA Directives, and having created a number of Capital Restoration Plans for numerous clients across the country, we have generally assumed that the holding company's "guarantee" meant the holding company would do what it could to support the bank's capital, but could meet its own needs in the interim.

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The OCC, in a recent situation, dusted off a "Guarantee Agreement" from sometime in the last century that required the holding company to downstream into the bank as capital any cash it received from any capital-raising activities at the holding company level.

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That, in and of itself, seemed halfway logical--if you are interested only in the bank's welfare and not in the real world.

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Many of these holding companies that are in financial difficulty also have bank stock loans. A bank stock loan is a loan to the holding company from another financial institution, secured by the holding company's only asset, (in most cases) 100% of the stock of the subsidiary bank.

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OCC's approach with respect to the "ironclad" guarantee by the holding company that any funds the holding company receives as a result of its capital-raising efforts would be downstreamed into the bank, i.e., not used to satisfy the bank's stock lender, will result in no equity being sold at the holding company.

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Or, let me rephrase that: "No equity being sold by the holding company to anyone who has a brain."

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Why would any investor buy stock in the holding company, generate cash for the holding company, have the cash downstreamed into the subsidiary bank as capital, only to allow the bank stock lender, who has 100% of the bank stock as collateral (which, after the downstreaming of the funds, is much more valuable), and whose note is still in default, to foreclose? A foreclosure on the bank stock would leave the investor with a nice equity investment in a company with no assets!

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The result of all this is that the Prompt Corrective Action Directive will be issued, the Guarantee will be signed, and the holding company will have one further impediment with respect to generating any capital for the subsidiary bank. It simply makes the investment by the typical investor in the holding company unjustifiable (if not insane).

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The only exception to this would be if the holding company could leverage the bank stock lender into an equity position, i.e. "Lender, if you do not convert your bank stock to equity, the bank will close and you will get nothing."

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- It would be nice if the regulators took a realistic approach as to how to solve the community banks' problems, which includes its debt structure at the holding company, instead of simply dealing with their own issue of "we have to have capital in the bank."

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