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FDIC-Assisted Acquisitions: Seizing Strategic Opportunities In the Midst of the "New Normal"

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FDIC-Assisted Acquisitions:
Seizing Strategic Opportunities
In the Midst of the "New Normal"

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With each passing week, the roster of failed banks continues to grow. In the first three quarters of 2010, more than 125 financial institutions failed, putting the year on-pace to exceed 2009's 140 failures.[2] Since the beginning of the financial crisis in 2007, more than 300 banks have been placed into FDIC receivership, with assets exceeding $634 billion.[3]

The relentless pattern of weekly bank failures is echoed in the increasing number of institutions on the FDIC's list of problem institutions (more than 800 as of the most recent FDIC Quarterly Banking Profile). The size of that inventory of severely distressed institutions means that the "new normal," in which every Friday brings the failure of least one financial institution, is likely to continue into the foreseeable future.

The Strategic Opportunity

A key challenge for the FDIC is balancing its goal of minimizing cost to the insurance fund with the need to ensure a ready supply of eager, willing and qualified buyers for failed depository

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The opinions expressed are those of the author, and do not represent the views of the firm or its partners. This article does not constitute, and should not be treated as, legal advice.

[2] See FDIC website, Failed Bank List, available at http://www.fdic.gov/bank/individual/failed/banklist.html.

institutions. The incentive for healthy banks and other qualified entities to acquire the assets of failed banks in FDIC-assisted acquisitions is the value of the target bank's core deposits and franchise, combined with the opportunity to limit credit loss exposure pursuant to the FDIC's loss-share arrangement. That combination represents what many consider an invaluable strategic opportunity for buyers.

However, over the last twelve months the FDIC, consistent with its statutory mandate and vigilant attention to reducing cost to taxpayers, has made a ongoing series of changes to the loss share arrangement. For those considering an acquisition of a failed bank from the FDIC, staying current on the financial impact of these developments is critical to informed decision-making, more precise estimates of the value of the institution acquired and more successful bidding.

A Unique Counterparty

To prepare effectively for FDIC-assisted transactions, it is essential to understand the unique nature of the transaction and the seller. First, all of the FDIC's activities with regard to failed bank receiverships and asset sales are guided by its statutory mandate to achieve the least cost for the insurance fund.[4]

Second, the FDIC operates with the benefit of statutory insulation from normal contractual restrictions to which other parties are generally bound. For instance, the FDIC has the statutory right to repudiate contracts or agreements to which the failed bank was a party, notwithstanding

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[3] *Id.*

[4] *See* Federal Deposit Corporation Improvement Act of 1991, Pub. L. No. 102-242; 105 Stat. 2236, 12 U.S.C. 1811 note.

any provisions granting rights to the counterparty for early termination or default.[5] Likewise, when the FDIC acts as receiver, contractual restrictions on transfer are moot, generally allowing it to assign contracts and agreements to the assuming institution without restriction.[6]

Lastly, the FDIC requires a smooth, quick and efficient process for closing failed banks in a manner that instills confidence among depositors and the public. As one component to that efficient process, the key provisions of the FDIC's transaction documents (principally the Purchase and Assumption or "P&A Agreement") pursuant to which assets and liabilities are purchased by the assuming institution are generally non-negotiable.

The Loss-Share Process

Another unique aspect of FDIC-assisted acquisitions, and indeed a key to the value proposition in most of these transactions, is the loss-share arrangement with the FDIC. The overwhelming majority of failed bank purchases in the last two years have been pursuant to P&A Agreements with loss share.

The P&A Agreement sets forth detailed conditions that must be satisfied in order for losses and expenses to qualify for reimbursement. Upon acquisition of a failed bank, purchasers must immediately put into place robust business processes to ensure compliance with the myriad deadlines and requirements reflected in the P & A Agreement and ensure that all reporting requirements are made timely and completely. Failure to satisfy those conditions can jeopardize the FDIC financial guarantee. If an asset is covered by loss share and the purchaser fails to

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[5] 12 U.S.C. 1821(e)(13)(A).
[6] 12 U.S.C. 1821(d)(2)(G).

manage that asset properly within the parameters of the FDIC loss-share agreement, a "covered asset" otherwise subject to FDIC coverage can easily become a 100 percent loss.

Ongoing Changes to the Loss Share Protocol

In earlier versions, the P&A Agreement stipulated that losses on all assets of a failed bank purchased by an assuming institution from the FDIC were shared between the FDIC and the assuming institution on an 80% / 20% basis up to a stated threshold, after which losses were shared on a 95% / 5% basis. That is, the FDIC would reimburse the assuming institution for up to 80% of the losses up to the stated threshold (specific to each individual transaction), after which the FDIC would reimburse the assuming institution for up to 95% of the losses.

Early in 2010, the FDIC changed the P&A Agreement to reflect a uniform split that reduced the loss share percentage to 80% / 20%, eliminating the opportunity for 95% coverage for the assuming institution after the specified threshold had been exceeded. Significantly, later in the year, the FDIC further refined the formula to eliminate the static 80% / 20% loss share formula, and invited bidders to bid competitively for the percentage of losses it required the FDIC to assume, up to a maximum FDIC loss coverage of 80%.

Recently the FDIC has further revised its formula, making the overall process increasingly complex for bidders. As a result of the latest changes, the FDIC now announces three tranches for potential losses. These tranches vary in size and are specific to each transaction. For instance, Tranche #1 might be all losses from zero to ten million dollars, Tranche #2 might be all losses over ten million dollars up to $40 million, and Tranche #3 might be all losses exceeding $40 million.

For one of the three tranches (Tranche #2), the FDIC determines the loss share percentage (not to exceed 80%). The FDIC announces this percentage of loss share coverage for Tranche #2 approximately one week prior to the bidding deadline. For the remaining two tranches (Tranches #1 and #3), the bidders each bid on the loss share percentage (not to exceed 80% as the FDIC's share).

In addition, originally the FDIC's loss share percentage was consistent with respect to all types of assets acquired by the assuming institution. However, the FDIC's bidding process now requires potentially different loss share percentages for each of the single family (one-to-four family residential real estate) and commercial asset portfolios. Bidders may propose different loss share percentages, for two of the three tranches, for each of the two portfolios. Also, loss share coverage has been eliminated entirely for consumer loans (defined generally as loans to individuals for household, family and other personal expenditures, not secured by real estate).

Each of the changes described above are evidence of the FDIC's ongoing commitment to its central statutory mandate, that is, reducing cost to the insurance fund. Obviously, the FDIC's efforts to reduce potential cost to taxpayers makes the process more complex and challenging for potential bidders. Each bidding team is now faced with the challenge of constructing bids that not only incorporate a discount (or premium) on the assets, a premium (if any) on the deposits, but also a loss share percentage for four separate asset tranches (that is, Tranches #1 and #3 for each of the single family and commercial portfolios). As a result, now more than ever, competitive advantage in the bidding process will go to those bidders who are well-prepared.

The Impact of Recent Bidding Protocol Changes

The FDIC's use of the new bidding protocol described above has been noteworthy for the aggressive approach it reflects to loss share percentages for the Tranche #2 losses.

For instance, for the first transactions to close under the newest bidding protocol, the FDIC set the Tranche #2 loss share percentages at 0% in most instances, and at 20% or 30% in a few cases.

<u>September 10</u>:
Horizon Bank, Bradenton, FL (Single Family **30%**, Commercial **0%)**

<u>September 17</u>:
First Commerce Community Bank, Douglasville, GA (Single Family **0%**, Commercial **0%**)
People's Bank, Winder, GA (Single Family **20%**, Commercial **30%**)
Bank of Ellijay, Ellijay, GA (Single Family **0%**, Commercial **0%**)

<u>September 24</u>:
North County Bank, Arlington, WA (Single Family **0%**, Commercial **0%**)
Haven Trust Bank, Ponte Vedra Beach, FL (Single Family **0%**, Commercial **0%**)

Multiple Bids

In recognition of the increasingly competitive bidding environment, the FDIC encourages bidders to submit multiple bids. For instance, bidders may submit multiple bids with varying loss share percentages for the four tranches on which they can bid. For the same target, however, they can also submit variations on that bid, including different loss share percentages or deposit premiums. In addition, the FDIC allows bidders to make bids with and without loss share coverage, on the same failed bank target.

Other P&A Changes

The latest versions of the P&A Agreement also include other changes that merit review by potential bidders and their professional advisors, including:

- Bidders will now bid the asset premium (or discount) as a set dollar amount, rather than a percentage.

- Conversely, the premium on deposits, if any, continues to be bid as a percentage amount.

- Mortgage servicing rights <u>are no longer included</u> in those assets to be acquired by the assuming institution.

- The P&A Agreement has revised its treatment of letters of credit. Newly-added language now clarifies the circumstances in which assumption of liability can be limited to the market value of the assets securing assumed letters of credit.

Conclusion

Serious potential bidders must be close observers of the FDIC's evolving resolution process. The FDIC makes recent institution-specific P&A Agreements publicly-available on its web site approximately one week after each bank closing. Bidders should become familiar with those P&A Agreements as they are published, and watch the process closely for meaningful new developments.

There are likely to be hundreds of bank failures over the next several years. For well-prepared bidders willing to accept risk, failed bank acquisitions with loss-share protection will continue to offer excellent strategic growth opportunities.