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FDIC Final Statement of Policy on Qualifications for Failed Bank Acquisitions

August 2009

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- [Financial Services Law]

Summary

The FDIC published a proposed new Statement of Policy on the Acquisition of Failed Insured Depository Institutions on July 9, 2009 (the "Proposed Policy Statement"), that would have imposed significant restrictions on the ability of private investors, including private equity funds, to invest in failed banks in the FDIC receivership process. After receiving and reviewing public comments pointing out the negative impact the Proposed Policy Statement would have on the ability to raise capital to invest in failed banks, on August 26, 2009, the FDIC Board adopted a final Statement of Policy (the "Policy Statement") that lessens the negative impact of the new restrictions but does not eliminate them completely.

This Policy Statement provides guidance to "private investors" interested in acquiring or investing in the deposit liabilities of failed banks or thrifts including applicants for insurance in the case of *de novo* banks in connection with resolution of a failed depository institution ("Investors") about the standards they will be expected to meet in order to qualify to bid on failed institutions. The Policy Statement does not define the term "private investor" and therefore, it is unclear if the Policy Statement is intended to apply to investors beyond the traditional private equity investors to include funds or wealthy individuals. The Policy Statement does not apply to Investors with 5% or less of the total voting power of an acquired depository institution or its bank or thrift holding company, provided there is no evidence of concerted action by these Investors

As noted, while the new rules still impose significant restrictions on private-equity ownership of banks, the FDIC has incorporated a number of significant changes into the Policy Statement. The changes include, for example, changing the capital standard to one that is a better measure of the capital available to absorb losses, specifically replacing the 15% leverage ratio as set forth in the Proposed Policy Statement with a 10% leverage ratio for the first three years following an acquisition, and clarifying the circumstances in which the cross support obligation would apply. The FDIC Board of Directors may waive one or more provisions of the Policy Statement if such exemption is in the best interests of the Deposit Insurance Fund (the "DIF") and the goals and objectives of the Policy Statement can be accomplished by other means.

The Policy Statement

Applicability
The Proposed Policy Statement would not have applied to Investors in depository institutions after three years. The final Policy Statement eliminated this blanket exclusion and instead requires an Investor in a bank or thrift, or bank or thrift holding company of an insured institution otherwise covered by the Policy Statement to apply to the FDIC for an exemption from the Policy Statement, if the bank or thrift has maintained a CAMELS 1 or 2 rating continuously for seven years. The Policy Statement also would not apply to investors in partnerships or similar ventures with depository institution holding companies (excluding shell holding companies) where the latter have a strong majority interest in the acquired bank or thrift and an established record for successful operation of insured banks or thrifts. Additionally, the Policy Statement would not apply to Investors with 5% or less of the total voting power of an acquired depository institution or its bank or thrift holding company, provided there is no evidence of concerted action by these Investors.

Minimum Capital
The Policy Statement requires that any depository institution subject to the Policy Statement (a "Covered Institution") maintain capital sufficient to establish a ratio of Tier 1 common equity to total assets of at least 10% for the first three years following an acquisition; this replaces the 15% leverage ratio in the Proposed Policy Statement. The FDIC is mandating a capital ratio based on Tier 1 common equity, since it provides a stronger measure of the capital available to absorb losses than alternative measures.

In the Proposed Policy Statement, the FDIC had requested comment on whether, if capital declines below the required capital level, a Covered Institution should be treated as "undercapitalized" for purposes of Prompt Corrective Action. The Policy Statement retains the Prompt Corrective Action requirements based on the FDIC's view that the higher capital standards are extremely important in order to preserve the safety and soundness of acquired institutions and to protect the DIF.

Affiliate Transactions
Limited changes were made to the scope of this provision in the Policy Statement. All extensions of credit other than existing extensions of credit to Investors, their investment funds and affiliates would be prohibited. The Policy Statement defines the term "affiliate" to mean "any company in which the Investor owns, directly or indirectly, at least 10% of the equity of such company and has maintained such ownership for at least 30 days." Additionally, there is an expectation that Investors will provide regular reports to the insured depository institution identifying all affiliates.

Cross Support
The Proposed Policy Statement included a cross guarantee provision, whereby Investors owning two or more depository institutions, including a Covered Institution, would have an obligation to commit such other depository institution(s) to support the Covered Institution. Commenters stated that this would be a deterrent to private capital investment because it would place legally separate investments at risk.

The Policy Statement scales back the circumstances in which what is now referred to as "cross support" would be required. A cross support obligation, whereby the stock of the commonly owned institutions would be pledged to the FDIC, will apply if two or more depository institutions are owned by a group of Investors covered by the Policy Statement but only if both depository institutions are at least 80% owned by common investors. Further, the FDIC may waive the cross support obligation if enforcing the obligation would not reduce the cost of the bank or thrift failure to the DIF.

Continuity of Ownership
The Policy Statement prohibits Investors from selling their investment for a minimum of three years, except with prior approval from the FDIC. This was part of the proposal as well.

Prohibited Structures
Although the Policy Statement does not make reference to "silo" structures, it has retained the general prohibition on investment by funds that are part of a group. The FDIC clarified that it would not approve "complex and functionally opaque" ownership structures. In particular, the FDIC identified a structure involving a private equity firm (or its sponsor) that creates multiple investment vehicles funded and apparently controlled by the private equity firm (or its sponsor) to acquire ownership of an insured

depository institution as a type of structure that would not be appropriate for approval. The FDIC is concerned that the purpose of these structures is to artificially separate the non-financial investments of the group of funds from the bank investments of the group so that the non-banking funds are not subject to the prohibitions on non-financial investments that apply to a bank or savings and loan holding company.

Source of Strength

The Federal Reserve has for many years required that a bank holding company serve as a source of financial and managerial strength for financial institutions it controls. This "source of strength" doctrine appeared in the FDIC Proposed Policy Statement, but it was not clear what specific obligations it would have imposed on Investors. In response to comments that a source of strength provision would be difficult for Investors to apply as a practical matter, the FDIC deleted that requirement in the Policy Statement.

Secrecy Law Jurisdictions

Under the Policy Statement, Investors may not invest through entities organized in a jurisdiction that is considered a "secrecy jurisdiction" unless the Investors are subsidiaries of companies that are subject to comprehensive consolidated supervision by internationally recognized and respected financial services regulators, and certain other reporting, recordkeeping and jurisdictional conditions are met. "Bank secrecy jurisdiction" is defined as "a country that applies a bank secrecy law that limits U.S. bank regulators from determining compliance with U.S. laws or prevents them from obtaining information on the competence, experience and financial condition of applicants and related parties, lacks authorization for exchange of information with U.S. regulatory authorities, or does not provide for a minimum standard of transparency for financial activities." This essentially means that Investors from bank secrecy jurisdictions will not be able to invest in failed institutions unless they are foreign banks that have been approved by the Federal Reserve to engage in banking in the United States.

Special Owner Bid Limitation

Any current owner of 10% or more of a failed institution would be prohibited from bidding on that failed institution in receivership. This is unchanged from the Proposed Policy Statement.

Disclosure

Investors would be expected to make substantial disclosures, including disclosures about all entities in the chain of ownership, such as amount of capital, diversification, business model and management team. Confidential offering memoranda and other solicitation materials that were used by the bidding organization to raise capital would need to be disclosed to the FDIC. In an effort to address commenters' concerns about confidentiality, the Policy Statement provides that confidential business information will be treated as such and not disclosed, except in accordance with applicable law.

If you have any questions pertaining to this alert, please feel free to call Barbara R. Mendelson at (212) 468-8118, Oliver I. Ireland at (202) 778-1614, Henry M. Fields at (213) 892-5275 or Mark T. Gillett at (213) 892-5289.