

FDIC EXTENDS CAUTIOUS WELCOME TO PRIVATE CAPITAL INVESTMENTS IN FAILED BANKS

August 31, 2009

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At a meeting of the Board of Directors of the FDIC on August 26, 2009, the FDIC adopted a [Final Statement of Policy on Qualifications for Failed Bank Acquisitions](#). The final policy statement establishes standards and requirements for private investors acquiring or investing in failed insured depository institutions, including through holding companies formed for that purpose. While the final policy statement is a substantial improvement over [the proposed policy statement](#) issued on July 2, 2009, it nevertheless subjects private investors to more onerous requirements than those applicable to existing banks, thrifts and their respective holding companies, which explicitly remain the FDIC’s preferred buyers of failed insured depository institutions. Just how onerous these requirements will be is unclear, as the final policy statement leaves a number of terms and concepts undefined and thus subject to the discretionary interpretation of the FDIC. The FDIC Board of Directors has not only reserved the right to modify the policy statement in specific situations, but also agreed to revisit the policy statement in six months.

Highlights

Scope. The policy statement will not apply to private investors with 5% or less of total voting power; nor will it apply to pre-existing investments in failed depository institutions.

Term. Upon application to the FDIC, investors may seek relief from the policy statement if the institution invested in has maintained a composite CAMELS rating of 1 or 2 continuously for seven years.

Capital. The FDIC backed off its proposed 15% Tier 1 leverage requirement, but instead imposed a minimum 10% ratio of Tier 1 common equity to total assets. While the 10% requirement probably will not eliminate private capital bids for failed banks, at least in the near term, it represents a financial penalty that will reduce any potential bid, thus hindering private investors.

Cross Guarantee. The FDIC backed off its initial proposal to impose cross-guarantee liability where there is majority common ownership, increasing the common ownership threshold to 80% and clarifying the intent to impose that liability on common owners directly. While the 80% test is a significant improvement, it still represents a deterrent for prospective private investors.

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Source of Strength. The FDIC completely eliminated the proposed source of strength requirement, but underlined the source of strength obligations of a depository institution's holding company by deeming an insured depository institution "undercapitalized" for purposes of prompt corrective action if its Tier 1 common equity ratio drops below 10%.

Transactions with Affiliates. The final policy statement goes well beyond Section 23A of the Federal Reserve Act by flatly prohibiting transactions with private investors, their investment funds and any of their respective affiliates and by defining affiliates by reference to a 10% level of ownership.

Bank Secrecy Jurisdictions. The FDIC retained the ability to refuse to allow investors from so-called bank secrecy jurisdictions to participate.

Holding Period. The FDIC retained the minimum three-year ownership requirement, although it will permit transfers to affiliates that agree to the provisions of the policy statement, subject to FDIC consent, and it excluded mutual funds from this minimum holding period requirement.

Prohibited Structures. The FDIC retained the ability to preclude ownership structures that the FDIC determines to be "complex and functionally opaque."

Precluded Investors. The policy statement retains a prohibition on investors that hold 10% or more of the equity of an institution in receivership from bidding on that institution.

Disclosures. Investors subject to the policy statement are required to provide substantial information to the FDIC in connection with any proposed bid.

Despite the compromises reflected in the final policy statement, the FDIC Board was unable to achieve unanimity, with the final policy statement being approved by a 4-1 vote. John Bowman, Acting Director of the Office of Thrift Supervision, cast the opposing vote, stating that the lack of empirical data supporting the policy statement made it impossible to evaluate its benefits.

We analyze the final policy statement in greater detail below. Because of the ambiguities in the final policy statement and the FDIC's discretion to interpret and apply the statement, it will be more important than ever for prospective investors to engage the FDIC very early on in the process of any proposal to acquire a failed insured depository institution.

US Bank Failures*

- In 2009, there have been 84 US bank failures to date
- In 2008, there were 25 US bank failures
- In 1993, there were 50 US bank failures
- In 1992, there were 179 US bank failures

*Source, FDIC

Applicability of the Final Policy Statement

As an initial matter, the FDIC clarified that the final policy statement applies only prospectively, not to acquisitions of failed depository institutions completed prior to its approval date.

Definition of Investors

The FDIC has stated that the final policy statement applies to

- private investors in a company, including any company acquired to facilitate bidding on failed banks or thrifts, that is proposing to, directly or indirectly, (including through a shelf charter) assume deposit liabilities, or such liabilities and assets, from the resolution of a failed insured depository institution; and
- applicants for insurance in the case of *de novo* charters issued in connection with the resolution of failed insured depository institutions.

These private investors and applicants are referred to in the final policy statement as “Investors.”

The FDIC declined to supply a more precise definition of “private investor” on the grounds that the policy statement is not a statutory provision and only applies to investors that agree to its terms. The FDIC cited as justification for its reluctance to be more precise the difficulty posed by “private capital funds” joining together in structures which are intended to provide almost all of the capital to a newly formed depository institution and in which no one investor has an ownership interest of more than 24.9% (the traditional threshold above which control of a depository institution or its holding company is found). The FDIC also referred to the multiple types of structures “private capital firms” have used to own banks and thrifts. Consequently, it seems clear that the FDIC intends to retain the discretion to determine which types of entities (and perhaps even individuals, although the release accompanying the final policy statement referred to “types of firms”) fall within the scope of the term “Investors.”

The final policy statement does not apply to

- investors in partnerships or similar ventures with bank or thrift holding companies or in bank or thrift holding companies (excluding shell holding companies) where the holding company has a strong majority interest in the resulting bank or thrift and an established record for successful operation of insured banks or thrifts; or

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- 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 investors.

In the policy statement, and at the FDIC Board meeting, the FDIC “strongly encouraged” investments by private investors alongside existing banks or thrifts and their respective holding companies.

Period of Applicability

Upon application by an Investor, the FDIC Board may, after taking into consideration whether the ownership structure of the bank, thrift or holding company in question is consistent with the objectives of the final policy statement, determine that the policy statement will not apply to an Investor in a bank, thrift, or bank or thrift holding company, that has maintained a composite CAMELS rating of 1 or 2 continuously for seven years. This period was included by the FDIC in response to comments that the policy statement should specify a date after which it would no longer apply.

The final policy statement does not clarify how the seven-year period would be measured. If the starting point is the date of acquisition of a failed insured depository institution by a bank or its holding company, does that mean that a new seven-year period would be triggered upon any subsequent acquisition of an additional failed depository institution by the same bank or its holding company? In the case of a private capital investment in a solvent bank or its holding company which, four years later, acquires a failed depository institution, would the seven-year period start from the date of the investment in the solvent bank or holding company or from the date of acquisition of the failed entity?

Although, in its commentary to the capital requirements section of the final policy statement, the FDIC specifically noted that depository institutions insured for less than seven years have accounted for a disproportionate number of failures in 2008 and 2009, it also referred to the higher risk profile of “what are de novo institutions being acquired.” This at least leaves open the argument that an existing bank or its holding company that acquires a failed depository institution and merges it into its existing bank should be allowed to measure its seven-year period from the date of the original private capital investment in the existing bank or holding company because the latter is not a *de novo* institution.

After the final policy statement was released, the FDIC also issued a Financial Institution Letter ([FIL-50-2009](#)) announcing that it is extending the *de novo* period for state non-member institutions from the current three-year period to seven years for examinations, capital, and other requirements. Although this rule may be viewed as harmonizing to some degree the requirements imposed on failed institutions acquired by private investors and those imposed upon *de novo* institutions, higher regulatory hurdles

FDIC Deposit Insurance Fund*

The "Problem List."

- At June 30, 2009, there were 416 institutions with \$299.8 billion in assets on the FDIC's "Problem List."
- This is the largest number of problem institutions since June 30, 1994 and the largest amount of assets on the list since December 31, 1993.

DIF Balance and Reserve Ratio.

- At June 30, 2009, the Combined Deposit Insurance Fund (DIF) had a balance of \$10.4 billion to cover insured deposits of approximately \$4.8 trillion.
- The DIF's reserve ratio was 0.22% on June 30, 2009.
- This compares to a reserve ratio of 0.27% at March 31, 2009 and 1.01% at June 30, 2008.
- This is the lowest reserve ratio for the combined bank and thrift insurance fund since March 30, 1993, when the reserve ratio was 0.06%.

*Source, FDIC

continue to be in place for private investors, who must maintain a composite CAMELS rating of 1 or 2 for the seven-year period and, even then, are released from the policy statement only in the FDIC Board's discretion.

Exemption

The FDIC Board may waive one or more provisions of the final policy statement if an exemption is determined to be in the best interests of the Deposit Insurance Fund and the goals and objectives of the final policy statement can be accomplished by other means. It is unclear how this exemptive authority will be exercised, including whether the exemptions will be publicly available.

Standards for Private Capital Investors

Capital Commitment

A strongly disputed aspect of the proposed policy statement was the proposal to require a 15% Tier 1 leverage ratio for insured depository institutions covered by the policy statement. The final policy statement scales back from that proposal somewhat, requiring instead a minimum 10% ratio of Tier 1 common equity to total assets. The FDIC has stated that the capital requirement may be increased above 10% if warranted. The minimum Tier 1 common equity requirement would be in place for three years from the time of acquisition, after which the depository institution would be required to be "well-capitalized" for the remaining period of ownership by the Investors.

The final policy statement requires a minimum 10% ratio of Tier 1 common equity to total assets

If the depository institution failed to meet the required capital levels, it would be treated as "undercapitalized" for purposes of the prompt corrective action provisions of the Federal Deposit Insurance Act, and would trigger the measures available to the regulator under those provisions, including the ability to require the depository institution to adopt a capital restoration plan guaranteed by its holding company.

At 10%, the minimum capital requirement is still substantially in excess of the current minimum required to meet "well-capitalized" standards, especially since the FDIC's requirement can be satisfied only by common equity and not other securities that qualify as Tier 1 capital under existing capital adequacy regulations. In her statement at the FDIC Board meeting, FDIC Chairman Sheila Bair acknowledged that the heightened capital requirement for private investors could have an impact on pricing, and therefore on bids, for failed insured depository institutions. She argued that

FDIC Borrowing

- In May 2009, Congress voted to increase the FDIC's borrowing line with Treasury to \$100 billion from \$30 billion, with borrowings of up to \$500 billion possible with the consent of both the Federal Reserve Board and the Treasury Department.

these short-term concerns needed to be balanced against the long-term concerns raised by investors with no track record of managing banks. Comptroller of the Currency John Dugan said that he viewed the 10% requirement as potentially too high and, although he voted in favor of the policy statement, he strongly supported review of the capital requirement in six months to assess its impact.

Cross-Guarantee Liability

Under the final policy statement, cross-guarantee liability will exist where one or more Investors own 80% or more of two or more banks or thrifts. These Investors will be required to pledge their stock in the banks and thrifts to the FDIC, and if any of them fails, the FDIC would be able to enforce its security interest to the extent necessary to recoup losses incurred by the FDIC as a result of the failure. The FDIC may waive this requirement if enforcing it would not reduce the cost of the depository institution's failure to the Deposit Insurance Fund.

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Although the FDIC did not back away from cross-guarantee liability for non-controlling investors entirely, it did raise the threshold at which cross-guarantee liability would be triggered from a majority of the common ownership in the proposed policy statement to 80% in the final policy statement. However, the same criticisms that applied at the majority ownership level apply at the 80% level, including that fund investors behind a private capital firm's investment in one bank or thrift could be different from the fund investors behind an investment in another bank or thrift made by the same private capital firm. This requirement continues to represent a departure from existing and well-tried statutory and regulatory concepts of "control" to impose liability based solely on commonality of identity.

The final policy statement is unclear about how the 80% threshold will be calculated. Since the policy statement is not intended to apply to investors holding 5% or less of the voting shares of an insured depository institution, the 80% threshold presumably applies only to Investors holding more than 5% of the voting shares of each of the insured depository institutions in question, but the cross-guarantee section of the final policy statement is not expressly limited in this way. In any event, it is difficult to see how in practice a non-controlling Investor owning, for example, 6% of the voting shares of two different depository institutions could protect itself from this cross-guarantee liability unless it could persuade the requisite number of other over-5% Investors not to invest in another depository institution in which the same Investors would hold more than 5% of the voting shares.

The overall impact of this requirement may be to create a disincentive to own a non-controlling stake of more than 5% of the voting shares of a bank, thrift or holding company that acquires a failed insured depository institution. If that is the case, the final policy statement would effectively rewrite the existing regulations defining what constitutes control of an insured depository institution or its holding company, notwithstanding the FDIC's statement that the policy statement is not intended to interfere with or supplant the pre-existing regulation of bank or thrift holding companies.

Transactions With Affiliates

Under the final policy statement, all extensions of credit (as defined in the Federal Reserve Board's Regulation W) to Investors, their investment funds, and any of their respective affiliates, by an insured depository institution acquired by such Investors are prohibited. The prohibition does not include existing

Affiliate is defined as any company in which the Investor owns, directly or indirectly, 10% of the equity of such company

extensions of credits to such Investors. Affiliate, for this purpose, is defined as any company in which the Investor owns, directly or indirectly, 10% of the equity of such company, and has maintained such ownership for at least 30 days.

The FDIC acknowledged that Sections 23A and 23B of the Federal Reserve Act, and the Federal Reserve Board's Regulation W and Regulation O, restrict affiliate and insider transactions, but expressed a concern that Investors that are not subject to the activities restrictions applicable to bank holding companies and thrift holding companies would not be subject to these prohibitions, and that the limitations provided crucial protection to the banking system and the Deposit Insurance Fund. Since the FDIC's stated concern could apply to any investor that is not itself a bank holding company or thrift holding company, it remains unclear why Investors covered by the final policy statement should be subject to this prohibition when similarly placed investors in other insured depository institutions are not.

Investors will be required to provide a list of all such affiliates to the insured depository institution for monitoring compliance with the prohibition.

Bank Secrecy Law Jurisdictions

The final policy statement retains the previously proposed approach to Investors with entities domiciled in bank secrecy jurisdictions. In response to concerns about the ambiguity of the term "bank secrecy jurisdiction," the final policy statement defines the term 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, does not provide for a minimum standard of transparency for financial activities, or permits off shore companies to operate shell companies without substantial activities within the host country.”

Investors with ownership structures utilizing entities domiciled in such bank secrecy jurisdictions will not be eligible to own an interest in an insured depository institution unless the Investors are subsidiaries of companies subject to comprehensive consolidated supervision as recognized by the Federal Reserve Board and agree to certain record-keeping, disclosure and jurisdictional requirements, including the provision of information to the insured depository institution’s primary federal regulator about the Investor’s non-domestic activities, the maintenance of original or duplicate records in the United States, and consent to be bound by US statutes and regulations administered by appropriate US federal banking agencies.

In adopting the final policy statement, the FDIC acknowledged concerns that this prohibition could restrict private capital investors from using traditional funding structures that provide business, tax and other efficiencies. The FDIC argued, however, that such concerns were outweighed by the FDIC’s need for adequate assurances that it will have access to reliable information on the operations or activities of the Investor and its affiliates, and that “investors can organize efficient and functional ownership structures in the U.S.”

Continuity of Ownership

The final policy statement preserves, with some slight modifications, the proposed policy statement’s minimum investment period of three years.

The final policy statement prohibits Investors from selling or transferring their securities for a period of three years, absent the FDIC’s consent. The FDIC explained that it retained the minimum

The final policy statement prohibits Investors from selling or transferring their securities for a period of three years, absent the FDIC’s consent

investment period requirement in order to encourage long-term investment to promote the stability of the previously failed bank or thrift, particularly the stability of the management.

The FDIC has introduced two new carve-outs to the continuity of ownership requirement. First, the FDIC will not unreasonably withhold its consent for transfers to affiliates, where the affiliate agrees to be subject to the same conditions as the transferor. The final policy statement does not clarify whether a sale or transfer, if approved, would trigger an additional minimum investment period of three years or whether the affiliate would be free to sell at the end of the original Investor’s three-year period. Second, the

continuity of ownership requirement will not apply to any mutual fund, defined as an open-ended investment company registered under the Investment Company Act of 1940 that issues redeemable securities and allows investors to redeem on demand.

There is no carve-out for sales or transfers pursuant to widely dispersed offerings, including initial public offerings. The final policy statement is also silent on whether a sale to an unaffiliated third party would be allowed even if that party agreed to be bound by the restrictions applicable to the selling Investor. The FDIC's commentary to the final policy statement justifies the requirement by referring to the FDIC's need for stability of management with respect to any applicable loss-sharing agreements relating to the acquisition of the failed depository institution, which implies that the FDIC would treat a proposed sale to an unaffiliated third party as requiring a *de novo* change in control review.

Prohibited Structures

The final policy statement prohibits certain ownership structures from being approved for ownership of failed insured depository institutions. The prohibited structures, which are deemed "substantially inconsistent with the principles" of insured depository institution ownership, are identified as "[c]omplex and functionally opaque" structures in which beneficial ownership is difficult to ascertain, the decision-making parties are not clearly identifiable, and ownership and control are separated.

While the FDIC has removed any explicit reference to "silo structures" from the final policy statement, the section identifies the prohibited structures as typified by arrangements whereby a single private equity fund seeks to acquire ownership of a depository institution through creation of multiple investment vehicles, funded and "apparently" controlled by the parent fund. The FDIC expressed a concern that the purpose of such structures is to artificially separate the non-financial activities of the firm

Prohibited structures are typified by arrangements whereby a single private equity fund seeks to acquire ownership of a depository institution through creation of multiple investment vehicles, funded and "apparently" controlled by the parent fund

from its banking activities so as to prevent the private equity firm from becoming a bank or thrift holding company. The FDIC has also stated that even if an investing fund agrees to be regulated as a bank or thrift holding company, such a structure raises concerns about the sufficiency of the financial and managerial support to the acquired institution.

The final policy statement, like the proposed policy statement, remains unclear on which types of ownership structures would be prohibited from

acquiring failed depository institutions. Nor does the FDIC explain, in either the final policy statement or its accompanying commentary, what it means by “apparently controlled” and whether it intends to apply criteria different from those applied by, for example, the Federal Reserve Board and the Office of Thrift Supervision in making determinations under their respective regulations about whether an entity or individual controls a bank holding company or thrift holding company. It would be helpful if this lack of clarity could be addressed not just by the FDIC, but by the other relevant bank supervisory authorities as well.

Special Owner Bid Limitation

The final policy statement leaves unchanged the limitation in the proposed policy statement that bars Investors that hold 10% or more of the equity of a bank or thrift in receivership from bidding on the deposit liabilities, or deposit liabilities and assets, of that bank or thrift.

Disclosure

The FDIC left unchanged the wholesale information disclosure requirements, originally put forward in the proposed policy statement. These broad requirements will mandate disclosure of information about the Investors and all entities in the ownership chain. Because no minimum threshold is specified, these requirements could, in theory, be exercised with respect to every limited partner in a private equity fund, making compliance by Investors administratively burdensome. The required information includes the size of the capital fund(s), its diversification, the return profile, marketing documents, the management team, the business model and any other information requested by the FDIC as necessary.

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The FDIC has stated that any confidential business information submitted under the disclosure requirements will be treated as confidential and will not be disclosed by the FDIC except in accordance with law. Information provided to the FDIC as confidential business information may become the subject of requests under the Freedom of Information Act. If such a request is made, the confidentiality of such information may turn on the willingness of the FDIC to expend the significant resources required to vigorously argue that the information is, in fact, able to be withheld from requesters. Furthermore, the recent decision of a US federal district court to compel the Federal Reserve Board to provide, pursuant to Freedom of Information Act requests by Bloomberg, information about extraordinary actions taken by the Federal Reserve Board in early 2008 casts some doubt over the

protection afforded to information even where the relevant bank supervisory agency has determined that the information may be withheld pursuant to exemptions to the Freedom of Information Act.

Limitations

As in the proposed policy statement, the final policy statement explicitly specifies that the policy statement requirements will not relieve Investors of any requirements imposed by applicable federal banking regulators and will not affect any supervisory determinations or requirements that may be made relating to the reasonableness of proposed business plans, the fitness of proposed management or whether corporate governance structures are satisfactory.

If you have any questions regarding the matters covered in this publication, please contact any of the lawyers listed below or your regular Davis Polk contact.

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- [FDIC Press Release, FDIC Board Approves Final Statement of Policy on the Acquisition of Failed Depository Institutions](#) (August 26, 2009)
- [FDIC Draft Release, Final Statement of Policy on Qualifications for Failed Bank Acquisitions](#) (August 26, 2009)
- [FDIC Staff Memorandum, Statement of Policy on the Acquisition of Failed Insured Depository Institutions](#) (August 26, 2009)
- [FDIC Board Meeting](#) (August 26, 2009)
- [FDIC Financial Institution Letter on Enhanced Supervisory Procedures for Newly Insured FDIC-Supervised Depository Institutions](#) (August 28, 2009)



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