Davis Polk

FDIC PROPOSES CONDITIONS FOR INVESTMENTS IN FAILED BANKS BY PRIVATE CAPITAL INVESTORS

July 6, 2009

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Following a meeting of the Board of Directors of the FDIC on Thursday, July 2, 2009, the FDIC issued a Proposed Statement of Policy on Qualifications for Failed Bank Acquisitions for public comment. The proposed policy statement, if adopted, is intended to provide guidance to "private capital investors" about the terms and conditions they would be expected to satisfy for approval of a proposed acquisition of, or investment in, a failed bank or thrift.

The FDIC's proposal appears to be aimed primarily at "club" deals involving unaffiliated private equity firms investing in a failed insured depository institution on terms and with investment limits (*e.g.*, 24.9% of any class of voting securities) that enable those firms to avoid being deemed to "control" the institution for bank regulatory and other purposes. However, it also reflects the FDIC's discomfort over "silo" transactions, where a private equity firm creates a separate entity for bank investments that is isolated from the other activities of the firm so that the firm is not required to become a bank holding company. The proposed policy statement could, however, also apply to any minority investment by a "private capital investor," a term which is not defined in the statement.

In their memorandum accompanying the release, the FDIC staff acknowledged that the FDIC has a responsibility to ensure that failing institutions are resolved in a manner that will result in the least cost to the Deposit Insurance Fund and minimal disruption to the financial system. But the staff also suggested that the proposed standards are needed to protect the Deposit Insurance Fund and to protect the safety and soundness of insured depository institutions. Comptroller of the Currency, John Dugan, and Acting Director of the Office of Thrift Supervision, John Bowman, each expressed concerns during the FDIC Board meeting that the proposal goes too far in seeking to create safeguards and would threaten to deter private capital investments. In her remarks, even FDIC Chairman Sheila Bair noted that she "is not sure we have it right here."

At the FDIC Board meeting, nearly every member of the Board expressed a keen interest in receiving comments on all aspects of the proposal, and Chairman Bair stated that she remains "very open on many, if not most aspects of this proposal." The FDIC will be holding a roundtable today, Monday, July 6, 2009, for views on the appropriate requirements to impose on private capital investors, and there will be a thirty-day comment period from the date of publication of the proposal in the *Federal Register*.

Some commentators have noted that a clear policy statement could provide certainty to potential private capital investors, thus attracting private capital to failed banks. Unfortunately, the high hurdles and uncertain standards in the proposed policy statement would be highly likely to deter rather than encourage future private capital investments. Examples of the most troubling provisions include the following:

- provisions that would directly affect the economics of any investment (*e.g.*, 15% capital requirements and minimum holding periods);
- provisions that would create large potential liabilities for any investor (*e.g.*, potentially unlimited source of strength obligations and cross-guarantee liability) which could be show-stoppers for many private equity investors unless clearly circumscribed; and
- conditions to FDIC approval that may make it very difficult for private capital investors to move with the speed necessary to submit bids in failed bank transactions unless the FDIC adopts a pre-approval process.

Although the proposed policy statement is not yet effective and will not be adopted, whether in its current or in amended form, until after the thirty-day comment period has expired and comments have been reviewed, it is difficult to imagine that the FDIC will issue approvals for private capital investments in failed banks until action is taken on this proposal.

We are tremendously concerned about the impact of the proposed policy statement, if approved. It strikes us as counterproductive and contrary to both sound public policy and the statutory framework governing financial institutions. We anticipate a vigorous discussion during the comment period and at the roundtable and will continue to monitor all developments in this area.

Scope of Standards in the Policy Statement

The standards enumerated in the proposed policy statement would apply to:

- private capital investors in a company such as a bank or thrift holding company (subject to exceptions noted below), that is proposing to directly or indirectly assume deposit liabilities, or deposit liabilities and assets, from a failed insured depository institution in receivership, and
- applicants for insurance in the case of *de novo* charters issued in connection with the resolution of failed insured depository institutions,

BUT not to:

- investments through a bank or thrift holding company that was formed at least 3 years prior to the date of the policy statement, or that was acquired by a private capital investor at least 3 years prior to the date of the policy statement.

The proposed policy statement does not define “private capital investors,” so the scope of coverage is not clear. In addition to private equity firms, the standards could apply to all manner of “private” investors, possibly including management. Moreover, the FDIC’s questions for comment note, without further elaboration, that the requirements in the proposed policy statement would apply to private capital investors, “including all entities in such an ownership chain.”

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The proposed policy statement avowedly seeks to address concerns raised by ownership structures that “typically involve a shell holding company owned by another entity or other entities that avoid certain of the responsibilities of bank and thrift ownership.” This appears to be an intent-based test for who would be subject to the standards in the policy statement and suggests that any time a private capital investor invests indirectly in a failed insured depository institution, the standards could apply.

No “Silo” Structures

The proposed policy statement asserts that the FDIC would not approve for ownership of insured depository institutions some investment structures, “typified” by so-called “silo” arrangements, because the beneficial ownership and decision makers are too difficult to determine “and/or ownership and control are separated.”

Since bank or thrift investments by private capital investors are generally designed to prevent any of the firms from being deemed to control the bank or thrift for bank regulatory and other purposes, it is unclear what range of ownership structures could be deemed to be silo structures or structures in which “ownership” does not constitute “control” and therefore prohibited under the policy statement.

Silo structures were used in the IndyMac Bank, FSB recapitalization, the MatlinPatterson recapitalization of Flagstar Bancorp, Inc., and the acquisition by JLL Partners of a series of banks in Texas. Arguably a silo structure was used in connection with J.C. Flowers’ acquisition of the First National Bank of Cainesville. The Office of Thrift Supervision Acting Director expressed concern with the proposed policy statement’s use of terms such as silo, which he characterized as opaque.

Proposed Policy Statement Standards for Private Capital Investors

Capitalization Requirements

Under the proposal, private capital investors would have to agree to cause the depository institution acquiring deposit liabilities, or such deposit liabilities and assets, from a failed institution in receivership to be initially capitalized at a Tier 1 leverage ratio of at least 15% and to maintain this minimum ratio for at least 3 years. In her statement accompanying the proposed policy statement, Chairman Bair acknowledged that the 15% Tier 1 leverage ratio proposal would be contentious and stated that the FDIC was “opening high.” The 15% Tier 1 leverage ratio is higher than the minimum 8% Tier 1 leverage ratio that the FDIC requires for new banks to qualify for deposit insurance. Moreover, the 3-year period would be subject to extension by the FDIC, and therefore the capital impact on an acquiring bank could extend for an indefinite period of time.

US Bank Failures*

- **In 2009, there have been 52 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*

After this period expires, private capital investors would need to maintain the depository institution at “well capitalized” levels, which is higher than otherwise required for bank holding companies that are not financial holding companies, for the duration of their investment. If the required standards are not met at any time, private capital investors would have to immediately “facilitate” the restoration of the institution to well capitalized standards or become subject to the “Prompt Corrective Action” provisions of the Federal Deposit Insurance Corporation Improvement Act. It is unclear what would be required to “facilitate” a restoration.

As the request for public comments acknowledges, commentators have suggested that the result of these super-capital requirements may be to make such investments uncompetitive and uneconomic, thereby deterring

investments in failed banks and thrifts. In addition, the super-capital requirements would be likely to deter active lending by an insured depository institution subject to these requirements. The proposal has been criticized for recommending more burdensome capital requirements for private capital investors in failed banks than for other, similarly situated, potential investors in failed banks. At the FDIC Board meeting, Chairman Bair singled out the initial capitalization proposal as an area where "there is a legitimate issue" and on which she was particularly interested in comment.

> [C]ommentators have suggested that the result of these super-capital requirements may be to make such investments uncompetitive and uneconomic

Source of Strength

The proposal does not define the term "investors organizational structures," but nevertheless notes that they would be expected to serve as a "source of strength" for their subsidiary depository institutions. This portion of the proposed policy statement raises numerous issues. The statement applies to "subsidiary" depository institutions, which suggests that the requirement would not apply to an investor that does not control the bank. However, nothing in the proposed policy statement provides guidance on when a private capital investor would be deemed to control a depository institution, and, as noted above, there is at least an implicit suggestion that the policy statement could apply to any private capital investment in which "ownership" does not constitute "control." This is an area which is typically within the province of the Board of Governors of the Federal Reserve System, which has not yet provided any guidance specifically applicable to private capital investors or so-called "club" deals. If the requirement did extend to private capital investors, it is not clear what would be required of private investors in this context. In addition, to the extent the source of strength requirement would apply to a private capital investor, it could apparently apply to all entities in such an investor's ownership chain.

> [N]othing in the proposed policy statement provides guidance on when a private capital investor would be deemed to control a depository institution

The FDIC has recently required acquirers of trust banks, credit card banks and industrial banks to enter into source of strength commitments. However, in each of these instances, the acquirer was not subject to the Bank Holding Company Act. In IndyMac Bank, FSB and BankUnited, FSB, the major transactions that have been announced to date involving private equity investors, the acquirers formed regulated holding companies. Similarly, in the JLL Partners investment, the investing fund actually became a bank holding company and as such the Federal Reserve Board implicitly found

the silo structure to provide sufficient financial and managerial support to the banks.

To "support" the source of strength commitments, the depository institution holding company in which the investor is invested would have to agree to sell equity or engage in capital qualifying borrowing. The FDIC has asked for public comments on whether the obligation should be broader than this. This requirement would be problematic on several levels, as it may present certain "Catch 22" risks for a private capital investor. If the FDIC expects a private capital investor to be able to cause the holding company to fulfill this obligation, this would imply that the investor controls the holding company and, indirectly, the relevant depository institution. However, indirect control would generally be contrary to how such private capital investments are structured and could potentially impede the ability of a private capital investor to obtain a non-control determination from the Federal Reserve Board. If the private capital investor is not able to cause the holding company to fulfill this obligation because its investment is non-controlling, on the other hand, it is unclear whether the private capital investor could satisfy the proposed source of strength requirement.

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Minimum Investment Period

The proposal would require investors to maintain ownership of the failed institution for a period of 3 years, absent the FDIC's consent. The FDIC has indicated that it would likely withhold its approval for a sale or transfer unless the buyer from the private capital investor agreed to be subject to the policy statement's conditions. The FDIC should clarify whether such buyer would be subject to the remainder of the 3-year period or an additional 3 years. Also, currently there are no exceptions to the minimum investment period for sales through public or otherwise widely dispersed offerings.

Cross-Guarantee

Where private capital investors, individually or collectively, constitute a majority of the investments in more than one depository institution, they would be expected to enter into a contractual cross-guarantee. Under the cross-guarantee, investors would pledge their proportionate interest in each institution to the FDIC to cover losses to the Deposit Insurance Fund from the failure of, or assistance to, each other such institution.

If imposed, this condition is likely to cause significant issues for private capital investors invested in more than one depository institution. A non-

controlling investment in one bank could be exposed to a non-controlling investment in another bank if there are other common co-investors which together make a majority of the investment in each bank, despite the fact that the fund investors behind any one private capital investment could be different than the fund investors behind another investment by the same private capital investor. Moreover, this could potentially limit the number of investments private capital investors would make generally because of the challenge of avoiding this liability.

Finally, it would likely discourage minority investors in private-capital led transactions. While the cross-guarantee liability would apparently be imposed only upon the majority investors, the imposition of liability could have a disastrous impact on the institution itself. The requirement could deter private capital investors from participating in "club" deals where this exposure may apply and may cause private capital investors to demand covenants to prohibit this risk from materializing by virtue of future bank investments by any other "club" deal investor. This would further limit the pool of available private capital for future failed banks.

Limitations on Certain Bidders

The proposed policy statement would bar private capital investors holding 10% or more of the equity of a bank or thrift in receivership from bidding for the deposit liabilities, or such deposit liabilities and assets, of that institution.

Prohibition on Credit Extensions to Affiliates

Banks acquired or controlled by private capital investors would be prohibited from extending credit to those investors, their investment funds, any affiliates of either, and any portfolio companies of the investor or its affiliates. An affiliate is defined as any company in which the investor owns 10% or more of the equity of that company, which is broader than the current statutory and regulatory standard. Moreover, a "portfolio company" is defined as any company in which the investor or an affiliate invests. Aside from a hornet's nest of logistical issues in identifying the universe of entities to which such a prohibition would apply, this condition could also result in a private capital investor having to disclose certain of its investors and investments to the insured depository institution and potentially other investors.

Since Section 23A and 23B of the Federal Reserve Act and the Federal Reserve Board's Regulation W already limit, both quantitatively and qualitatively, transactions between an insured depository institution and its non-banking affiliates, it is not at all clear what purpose would be served by, or what the basis is for, the FDIC's proposed outright prohibition of these transactions, other than to extend the restrictions to a larger group of institutions.

Bank Secrecy Law Jurisdictions

The proposed policy statement would prohibit private capital investors with entities domiciled in "bank secrecy jurisdictions" anywhere in their ownership structure from owning 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 the investors agree to certain recordkeeping, disclosure and jurisdictional requirements, including the maintenance of their original or duplicate books and records in the United States. The proposed policy statement does not define "bank secrecy jurisdiction" and does not acknowledge legitimate business, legal or tax-related reasons for an entity to be domiciled in such a jurisdiction.

Disclosure

The proposed policy statement suggests wholesale disclosure of information by private capital investors to the FDIC, including information about the investors and *all entities* in the ownership chain. This information would include the size of the capital fund(s), its diversification, the return profile, marketing documents, the management team, the business model and any other information deemed necessary by the FDIC. There is no commitment in the proposed policy statement that the FDIC would keep the information confidential. For otherwise unregulated entities, this could be a significant hurdle to investing in a failed bank or thrift.

There is no commitment in the proposed policy statement that the FDIC would keep the information confidential

Not Exclusive Authority

The proposed policy statement would not relieve investors of any requirements imposed by applicable federal banking regulators and would 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.

The proposed policy statement raises a host of issues because of its breadth, on the one hand, and its lack of specifics and definitions, on the other hand. In practice, it could take a considerable amount of time to sort through these issues, and the FDIC has not historically had a culture of transparency in the administration of its statutory authority. If the proposed policy statement is adopted, interpreting its requirements may prove to be more problematic than the FDIC may have first anticipated. Further, until

the proposal is resolved, it is likely to have a significant chilling effect on the participation of private capital in assisting the FDIC to satisfy its statutory mandate of finding the least cost resolution for failed insured depository institutions at a time when more and more banks appear to be at risk of failure.

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- FDIC Staff Memorandum, Proposed Statement of Policy on Qualifications for Failed Bank Acquisitions
- FDIC Board Meeting (July 2, 2009)

This is a summary that we believe may be of interest to you for general information. It is not a full analysis of the matters presented and should not be relied upon as legal advice.

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