FDIC PROPOSED POLICY STATEMENT ON PRIVATE CAPITAL INVESTMENTS IN FAILED BANKS

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To Our Clients and Friends:

On July 2, the Federal Deposit Insurance Corporation (the "FDIC") released for public comment a proposed Statement of Policy on Qualifications for Failed Bank Acquisitions to "provide guidance to private capital investors interested in acquiring or investing in failed insured depositary institutions regarding the terms and conditions for such investments and acquisitions." The proposal calls for comments within 30 days from the date of its publication in the Federal Register. Significant comments can be anticipated. Unless materially revised as a result of the comment process, the policy statement would create substantial new hurdles (in addition to existing regulatory hurdles) to private equity, hedge fund and other private capital investing in structures aimed at acquiring failed banks and thrifts.

In the interim, the breadth and ambiguity of many of the provisions in the proposed policy statement will have a chilling effect on pending transactions. Compounding the negative effect of the proposed policy statement, the FDIC has specifically asked for comment on the question of whether various proposed restrictions or requirements in the policy statement should be made even more stringent. As a general matter, a move toward precision in guidance from the regulators is usually a good thing. However, in this case, it appears that each element in the proposed guidance is aimed at greater astringency.

SCOPE OF THE PROPOSED POLICY STATEMENT

The proposed policy statement would establish new qualifications for "private capital investor" participation in the acquisition of failed banks and thrifts. These qualifications would be in addition to the requirements already imposed by the appropriate Federal banking agency for the relevant depository institution or bank or thrift holding company under other federal statutes. Thus, these qualification standards would be in addition to the legal and regulatory requirements imposed by the Federal Reserve Board or the Office of Thrift Supervision under such statutes as the Bank Holding Company Act of 1956, as amended, the Savings and Loan Holding Company Act, and the Change in Bank Control Act.

The proposed policy statement states that "complex and functionally opaque ownership structures," typified by the "silo" organization structure, where beneficial ownership cannot

be ascertained, responsible parties for making decisions are not clearly identified, or ownership and control are separated, would not be considered appropriate by the FDIC for approval for ownership of insured depository institutions.

To address its concerns with complex ownership structures, the FDIC proposes in the policy statement to establish bidder eligibility standards that would be applicable to:

- private capital investors in a company (other than a bank or thrift holding company that came into existence or was acquired by the investors at least 3 years prior to the date of the policy statement) proposing directly or indirectly to acquire a failed insured depository institution, and
- applicants for deposit insurance in the case of de novo charters issued in connection with the resolution of a failed insured depository institution.

The proposed policy statement does not define the term "private capital investor." Moreover, the proposed policy statement does not specify any percentage ownership test for applying the standards to a "private capital investor," suggesting that the standards might apply to any investment other than perhaps a de minimis investment. Such an approach would significantly expand the reach of existing regulatory practice.

PROPOSED STANDARDS

The policy statement contains many requirements which, if adopted in their proposed form, would likely become a roadblock to broad-based investment by private capital in failed depository institutions. Among the most problematic, however, are proposals that could make private equity, hedge funds and other private capital investors potentially responsible for shortfalls in capital at banks or thrifts in which they invest, while requiring those investors whose investments, individually or collectively, constitute a majority of the investments in more than one insured depository institution to pledge to the FDIC their proportionate interest in each such institution to repay losses incurred by the FDIC insurance fund resulting from the failure of or assistance provided to any other such institution.

Capital Commitment. A depository institution acquiring deposit liabilities or assets and liabilities from a failed institution would be required to maintain a minimum 15% Tier 1 leverage ratio for a period of 3 years and thereafter a "well capitalized" level during the remaining period of ownership by the private capital investors. If the depository institution fails to meet these capital tests, the private capital investors would have to "immediately facilitate restoring" the institution to the required capital levels. It is not clear whether the concept of restoring the capital levels is intended to include a direct capital call on the

investors. In addition, the policy statement envisions that a failure to meet the required capital level would expose the depository institution itself to the prompt corrective action requirements of the Federal Deposit Insurance Act.

Source of Strength. The proposed policy statement adopts and applies the source of strength doctrine to "investors organizational structures" that are subject to the policy statement. The proposed policy statement states that "investors organizational structures" would be expected "to agree" to serve as a source of strength. These commitments would be "supported" by an agreement of the depository institution holding company in which the private capital investors have invested to sell additional equity or engage in a capital qualifying borrowing. It is not clear whether the intent of these provisions would be merely to dilute the ownership stake of a private capital investor or would be to require the private capital investor to contribute additional equity. The FDIC has specifically asked for comment on the question of whether a broader obligation than merely a commitment to raise new capital should be imposed on the holding company and the private capital investors.

Cross Guarantee. The proposed policy statement indicates that private capital investors whose investments, *individually or collectively*, constitute a majority of the direct or indirect investments in more than one insured depository institution would be expected to pledge to the FDIC their proportionate interests in each such institution to cover potential losses sustained by the FDIC resulting from the failure of any other such institution. This requirement would represent a significant expansion of the cross-guarantee provision contained in the Federal Deposit Insurance Act. It is not clear whether there would be any percentage test for an individual private capital investor, meaning that even relatively small investors could become subject to the requirement. Nor is it clear how private capital investors will be determined collectively to be subject to the ownership test. Such a cross-guarantee requirement raises a serious issue for many club deals – a structure commonly used by alternative asset managers to avoid subjecting the assets which they manage to Bank Holding Company Act regulation – since it may create different obligations for the various members of the club depending upon the extent to which each holds other majority-owned bank investments.

In addition to the capital support and cross-guarantee obligations described above, the proposed policy statement contains other requirements that could prove problematic for private equity, hedge fund and other similar investors.

Secrecy Law Jurisdictions. Under the proposed policy statement, investors employing ownership structures with entities domiciled in a bank secrecy jurisdiction would not be eligible to own a direct or indirect interest in a insured depository institution unless the

investors are subsidiaries of companies that are subject to comprehensive consolidated supervision as recognized by the Federal Reserve Board and unless they enter into various information sharing and other jurisdictional commitments with the FDIC. The proposed policy statement gives no indication of the intended scope of the phrase "bank secrecy jurisdiction." It is therefore unclear whether jurisdictions such as the Cayman Islands and other jurisdictions in which private equity and hedge funds are commonly organized would be covered by this requirement, potentially another significant impediment to participation in the banking sector by such investors.

Continuity of Ownership. Investors would be prohibited from selling or otherwise transferring their securities in the holding company or depository institution for 3 years following the acquisition without prior FDIC approval. The FDIC would not expect to approve any sale to a private capital investor during the 3-year period unless the buyer agrees to be subject to the same restrictions under the policy statement as the original private capital investor.

Disclosure. The proposed policy statement would impose significant information and disclosure requirements on private capital investors and "all entities in the ownership chain." The requirements would include information on the size and diversification of funds, return profile, marketing materials, management team and business model. Again, these requirements would appear to apply to all private capital investors without regard to their percentage ownership. This represents another significant expansion of current regulatory requirements.

Transactions with Affiliates. The proposed policy statement would prohibit any extension of credit by the insured depository institution to the private capital investors, their investment funds or any other affiliates (defined to mean any company in which the investor owns 10% or more of the equity), and *any* portfolio companies in which the private capital investor or its affiliates invest. Similar to the other requirements under the proposed policy statement, it appears that the requirement would apply to a private capital investor without regard to its percentage ownership in the depository institution or holding company. It also appears to apply to an extension of credit to any portfolio company without regard to the percentage ownership of the private capital investor in the portfolio company.

Special Owner Bid Limitation. Investors that directly or indirectly hold 10% or more of the equity of a bank or thrift in receivership would be ineligible to be an investor in a bidder for that failed depository institution.

CONCLUSION

The policy statement is likely to receive substantial comment from both the public and the private sector. The breadth and ambiguity of many of the provisions in the policy statement invite obvious comment. On a more fundamental level, however, the proposed policy statement reflects the continuing divide between those who support easier access to private capital for the banking system and those who support a regime of highly integrated regulation of all substantial providers of equity to the banking system. These fundamental differences in approach will be reflected in the debate over the policy statement.

Please feel free to contact us with any questions.

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