THE FDIC MOVES TO ACCOMMODATE PRIVATE EQUITY BANK INVESTORS — BUT DID IT GO FAR ENOUGH?

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To Our Clients and Friends:

Yesterday, the Federal Deposit Insurance Corporation (the "FDIC") released a Final Statement of Policy on Qualifications for Failed Bank Acquisitions (the "Policy Statement"). The Policy Statement is designed to "provide guidance about the standards for more than *de minimis* investments in acquirers of deposit liabilities and the operations of failed insured depository institutions."

The Policy Statement retreats partially from several of the highly problematic terms in the FDIC's proposal on the same subject, which was the topic of our *Client Alert* of July 6, 2009, but falls short of creating a level playing field between private equity firms and traditional banks seeking to acquire failed bank assets and liabilities. The Policy Statement reflects changes to three aspects of the proposal that drew the most significant private equity industry comment: (i) the capital requirements, (ii) the need for private equity funds to serve as a "source of strength" to the banks in which the funds invest, and (iii) the FDIC's ability to take a pledge of the interests in one commonly owned bank to repay itself for its costs in resolving another commonly owned failed bank (the "cross-guarantee" provision). Other provisions of the Policy Statement remain largely or wholly unchanged. The FDIC has promised to review the operation of the entire Policy Statement within six months and to make such adjustments as necessary then.

SCOPE OF THE POLICY STATEMENT

The Policy Statement establishes qualifications for private investor participation in the acquisition of failed banks and thrifts and is applicable to:

- private investors in a company (including any company acquired to facilitate bidding on failed banks and thrifts) that is proposing to, directly or indirectly, assume the deposit liabilities, or both the liabilities and assets, of a failed insured depository institution; and

- private investors involved in applications for deposit insurance in the case of *de novo* charters issued in connection with the resolution of a failed insured depository institution.

In this regard, the Policy Statement's reach does not differ substantially from what the FDIC proposed. Many of the 61 comment letters submitted in response to the FDIC's proposal

had requested greater clarity as to coverage of the Policy Statement. The FDIC declined to provide it, citing "the relatively new phenomenon of private capital funds joining together to purchase the assets and liabilities of failed banks and thrifts" and the "multiple variations in structures" that the agency has already seen.

In response to comments, the FDIC did identify a few situations in which the Policy Statement does not apply. First, unlike the proposal, the Policy Statement applies only prospectively, and not to acquisitions of failed depository institutions made prior to the adoption of the Policy Statement. Second, the Policy Statement does not apply to investors entering into partnerships with bank or thrift holding companies that have "a strong majority interest" (an undefined term) in the acquired depository institution and an established record of successfully operating insured depository institutions. The FDIC "strongly encourages" such partnerships, thereby hoping to foster private equity minority partnerships with strategic investors. The FDIC's approach in this regard is consistent with its greater comfort with strategic investors rather than private equity firms and may provide a bidding advantage to those private equity firms that focus exclusively on financial services and banking investments and that have, thus, chosen to become bank or thrift holding companies subject to the Bank Holding Company Act or the Savings and Loan Holding Company Act. Third, the Policy Statement does not reach investors owning 5% or less of the total voting power of an acquired depository institution or its holding company, provided there is no evidence of concerted action with other investors.

Disappointingly for many investors, the FDIC declined to provide a sunset period, beyond which the Policy Statement would cease to apply to an investor in an insured depository institution or to the depository institution itself. Thus, once an investor is covered by the Policy Statement, there is no automatic termination of such coverage. Rather, to escape the Policy Statement's application, the investor must apply for and obtain the FDIC Board's approval, and the depository institution in which the investor has invested must have maintained strong supervisory (CAMELS "1" or "2") ratings for seven years.

APPLICABLE STANDARDS

The Policy Statement, like the proposal, places various substantive requirements on private equity investors and the depository institutions that they acquire. Some of the most important of these requirements, as noted above, have been modified in material ways from the proposal, and these changes may be helpful to potential private equity investors. Other requirements have been left largely unchanged.

Capital Commitment. Under the Policy Statement, a "resulting depository institution" (that is formed on the acquisition of deposit liabilities or assets and liabilities from a failed institution) will be required to maintain a minimum ratio of 10% Tier 1 common equity-to-

total assets for a period of three years and, thereafter, be "well capitalized" for the remaining period of ownership by the private equity investors. A failure to meet the required capital levels would expose the depository institution itself to the prompt corrective action requirements of the Federal Deposit Insurance Act.

The capital levels set forth in the Policy Statement should be less onerous than what the FDIC originally proposed. The FDIC originally proposed a three-year 15% Tier 1 leverage ratio. The Policy Statement, however, requires the capital to be Tier 1 common equity, which excludes preferred stock and other non-common stock elements of Tier 1 capital. The Policy Statement also does not depart from the proposal's subsequent requirement that the institution remain well capitalized.

The FDIC's proposal contained language that would have required private investors to "agree" to cause the depository institution to meet its capital requirements and "to immediately facilitate" restoring a depository institution to the required capital standards. That language has been eliminated from the Policy Statement.

Source of Strength. The FDIC's proposal would have required investors in certain organizational structures "to commit" to serve as a source of strength and support the depository institutions being acquired. In response to substantial criticism of this aspect of the proposal, and in recognition of the fact that the nature of private equity funds would make such a requirement impractical to apply, the FDIC has dropped this source of strength commitment.

Cross Support. A cross-guarantee provision permits the FDIC, under certain circumstances, to use interests in a healthy bank to reimburse the FDIC for funds expended to resolve a commonly controlled failed bank. The FDIC had originally proposed an expansive cross-guarantee requirement. The original proposal would have required private equity investors whose investments, *individually or collectively*, constituted a majority of the direct or indirect investments in two or more depository institutions to commit their investment in a bank or thrift to support one or more of these institutions if they failed. Many found this cross-guarantee provision to be highly objectionable since its scope and reach were unclear and since even relatively small investors (who were deemed part of a collective investment group) could be subject to this requirement.

The Policy Statement scales back the proposal's cross-guarantee requirement (which the FDIC has relabeled as "cross support") to a degree. The new cross-support requirement provides that if one or more private investors own at least 80% of multiple insured depository institutions, these investors' interests in commonly owned banks and thrifts would be pledged to the FDIC to cover potential losses sustained by the FDIC from the failure of any one of these institutions. The FDIC can waive the cross-support requirement

if exercising this obligation would not reduce the costs to the insurance funds. It is not clear whether this waiver could be provided on a forward-looking basis.

This "cross-support" requirement, although an improvement from what was originally proposed, still may present issues for private investors. The support obligations could still raise issues for club deals, since it may impose different burdens on the various members of the club, not to mention the structure as a whole, depending on the extent to which each holds other significant bank investments.

Prohibited Structures. The Policy Statement makes express what was implied in the proposal — that "complex structures," including "organizational arrangements involving a single private equity fund that seeks to acquire ownership of a depository institution through creation of multiple investment vehicles, funded and apparently controlled by a parent fund," are inconsistent with the principles outlined in the Policy Statement and will not be permitted. During the FDIC Board's meeting to approve the Policy Statement, Acting Director of the Office of Thrift Supervision ("OTS") John Bowman objected to this position, noting that some of these structures would involve the creation of thrift and bank holding companies that would be subject to supervision and regulation and that there is nothing inherently "opaque" or "complex" about their ownership structures.

Although significant changes were made to the cross support, capital and source of strength obligations described above, other aspects of the proposal have been adopted with no or minimal changes in the Policy Statement. These other requirements could prove problematic for private equity investors.

Secrecy Law Jurisdictions. In its proposal, the FDIC had stated that investors employing ownership structures with entities domiciled in a bank secrecy jurisdiction would not be eligible to own a direct or indirect interest in an insured depository institution unless the investors: (i) were subsidiaries of companies subject to comprehensive consolidated supervision as recognized by the Federal Reserve Board, and (ii) entered into various information sharing and other jurisdictional commitments with the FDIC. The final Policy Statement does not deviate from those proposed requirements.

The proposal was criticized for not defining the phrase "bank secrecy jurisdiction." The Policy Statement defines this term to encompass any 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." The FDIC does not specify which jurisdictions would fall within this definition.

Continuity of Ownership. Under the Policy Statement, as with the proposal, investors are prohibited from selling or otherwise transferring their interests for three years following an acquisition without prior FDIC approval. This provision is consistent with the FDIC's general theme of permitting long-term, committed investors.

In response to comments, the Policy Statement does allow transfers by investors to their affiliates on FDIC approval, which approval will not be "unreasonably withheld" if the affiliate agrees to be bound by the Policy Statement. The FDIC also states that the three-year holding period does not apply to registered, open-end investment companies (mutual funds).

Disclosures. The Policy Statement retains provisions found in the proposal to impose significant information and disclosure requirements on private capital investors and "all entities in the ownership chain." The requirements include information on the size and diversification of funds and their return profile, marketing materials, management team and business model. The requirements would appear to apply to all private capital investors without regard to their percentage ownership.

In response to comments, the FDIC states that confidential business information provided to the agency will be afforded confidential treatment and not disclosed, except as required by law.

Transactions with Affiliates. The Policy Statement prohibits any extension of credit by the insured depository institution to private 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 in which such ownership has been maintained for at least 30 days). The Policy Statement further requires investors to provide regular reports identifying affiliates to the bank to ensure compliance with this restriction. Moreover, extensions of credit existing as of the effective date of the Policy Statement are exempt from its provisions.

The FDIC proposal could have been read to impose these affiliate-transaction limits on any "portfolio company" in which a private investor or an affiliate of a private investor takes a stake, even a *de minimis* stake. This portfolio company language has been eliminated in the Policy Statement, which narrows the reach of the affiliate-transaction limitation.

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

In adopting the Policy Statement, the FDIC eased some of the most problematic provisions of its proposal, but it did not level the playing field between private equity firms and traditional banks seeking to acquire failed bank assets and liabilities. For this reason, in the FDIC Board's meeting yesterday on the Policy Statement, Comptroller of the Currency John Dugan expressed support for the Policy Statement provision that calls for a review of the statement's ramifications within six months of its adoption. Another FDIC Board member, Acting Director of the OTS John Bowman, voted against the Policy Statement (resulting in it being adopted by a 4-1 margin), citing the lack of any showing that private equity investors present greater risks to the banking system than traditional investors and stating that without such evidence he would not support differential treatment of the two groups. FDIC Chairman Sheila Bair acknowledged that the Policy Statement sought a delicate and uncertain balance, but declared it "self-apparent" that private equity firms have a different risk profile than strategic investors like banks. Chairman Bair took the position that the stricter investment terms imposed on private equity investors are warranted.

Whether the Policy Statement encourages significant private equity investment in failed banks should become evident over the coming months. The FDIC today reported that the number of banks on its "problem list" rose to 416 as of June 30 (the highest number since 1994), and the total assets held by these institutions increased to $300 billion (the highest level since 1993). Some analysts expect another 150 to 200 bank failures this year (on top of the 81 to date). If these numbers hold true, they likely will place significant pressure on the deposit insurance fund, which already is at its lowest point since 1992, and that in turn could force the FDIC to reconsider its approach and be more accommodating to private equity investors.

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