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A Tale of Two Markets in 2011: Private Equity Investment in Failed and (Increasingly) Live Community Banks

by Gregory J. Lyons and Gregory V. Gooding

Private equity is expected to continue to seek investment opportunities in the struggling US banking industry in 2011, particularly with respect to the over 7,000 community banks with assets of up to $1 billion. At the beginning of the financial crisis, private equity firms focused almost exclusively in failed bank opportunities, as a result of various factors that included uncertainty as to the true condition of targets and the favorable terms available under Federal Deposit Insurance Corporation ("FDIC") loss-sharing agreements. More recently, however, greater comfort with target bank balance sheets, the geographic concentration of most failed bank opportunities, frustration with the uncertainty of the FDIC failed bank process, and more willing sellers have caused private equity firms to show an increasing interest in live banks. This article discusses the current state of these markets, as well as regulatory considerations for private equity firms considering these opportunities in 2011.

Failed Bank Market

Failed banks remain a significant part of the market for bank acquisitions, in the case of both private equity and traditional (so-called "strategic") buyers. The numbers are striking – while only 52 banks failed in total between 2000-2008, there were 140 failures in 2009, and 157 failures in 2010. Moreover, with 860, or over 11%, of all FDIC-insured banks on the troubled bank list as of the FDIC's September 30 quarterly report (the highest number since March, 1993), failed bank opportunities will almost certainly continue in 2011. Approximately 80% of these failed banks since the outset of the crisis had less than $1 billion of assets, and approximately 60% had less than $500 million of assets.

In addition to the continued availability of failed bank targets, FDIC loss-sharing arrangements remain an attractive incentive for private equity firms to pursue failed bank deals. The FDIC has historically protected acquirors of failed banks against 80% of the losses incurred by a defined set of assets up to a maximum loss threshold, and 95% of the losses thereafter. The increase in stock price that often follows the announcement of a failed bank deal by a publicly traded acquiring bank – such as East West Bancorp's 55% increase following its acquisition of failed United Commercial Bank – demonstrate the economic benefits of these arrangements. In addition, serial acquisitions of a number of small banks can allow private equity-backed institutions to grow quite large. For example, Community and Southern in Georgia has primarily used failed bank acquisitions, including three in September 2010, to become the fourth largest bank in Georgia with approximately $2.5 billion of assets.

However, despite several notable successes, private equity firms are increasingly looking beyond the failed bank market. Part of this is borne of regulatory burdens. In September 2009, the FDIC published its Statement of Policy on Failed Bank Acquisitions (the "Failed Bank Policy Statement"). While not quite as harsh as its July 2009 proposal, the Failed Bank Policy Statement imposes a number of

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Letter from the Editor

Welcome to 2011! 2010 saw unprecedented changes in global financial regulation. Debevoise moved to a monthly Financial Institutions Report and hosted a series of conferences and seminars on Dodd-Frank, global insurance M&A, Basel III, and private equity investing in financial institutions. This year promises to be equally eventful, as the Basel Committee continues its global capital, liquidity and governance efforts, the European Union implements Solvency II, US regulators promulgate the numerous regulations and studies called for by Dodd-Frank, and other countries throughout the world also seek to ensure the future stability of their financial systems. In response to these regulatory changes and signs of economic recovery, we are pleased to assist our clients worldwide in raising capital, engaging in strategic acquisitions and dispositions, undergoing internal restructurings and otherwise positioning themselves to succeed.

This year also brings a change to the leadership of the Financial Institutions Report. After superb stewardship, Dick Dunham has decided to turn over the Editor reins to myself and my Co-Editor, Nick Potter. We wish to express sincere gratitude to Dick for his tireless efforts to develop the report into the publication it is today. While filling some very large shoes, Nick and I are committed to continuing the standard of excellence established by Dick. We want to make the report as useful to our readers as possible, and thus welcome any thoughts as to approach, format or topics.

This issue focuses on several topics that promise to be of continuing focus throughout 2011. On the transaction front, we have an article describing a shift in the target of private equity investments in the troubled US banking sector--from an almost exclusive focus on failed bank deals over the past two years to increasing attention to distressed live banks. We also provide an extensive analysis of the recently finalized global banking capital and liquidity rules, more commonly referred to as Basel III. As to the insurance industry, we describe the implications of the IMF's evaluation of US insurance regulation, and detail changes to New York's reinsurance credit rules.

More generally, while challenges remain to cope with new regulation and a new economic environment, we have seen demonstrable evidence of returning strength to virtually all industries in the financial services sector. Through this publication, our conferences and seminars, and our global transactional, litigation and advisory work for clients, we continue to strive to help our clients succeed.

Gregory J. Lyons
Co-Editor-in-Chief

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New York Adopts Important Changes to its Reinsurance Credit Rules for Cessions to Unauthorized Reinsurers

By John Dembeck

By its 10th Amendment to its Regulation 20 (the "Amendment"), the New York Insurance Department (the "Department") has adopted important changes to its reinsurance credit rules for cessions to unauthorized reinsurers, including: (i) imposing new prudent reinsurance credit risk management principles on ceding insurers; (ii) allowing a collateral reduction for a cession to an unauthorized reinsurer or alien group of reinsurers that satisfies certain requirements; and (iii) allowing a reduction in the amount of required trusteed surplus for a single alien reinsurer that uses a multiple beneficiary reinsurance trust and that is also in run-off. These amendments became effective January 1, 2011. Furthermore, the Amendment expressly acknowledges the preemption of non-domestic state reinsurance credit rules by Section 531(a) of the Dodd-Frank Wall Street Reform and Consumer Protection Act, Public Law No. 111-203 ("Dodd-Frank Act"), 11 U.S.C. § 8221(a), which is effective July 21, 2011. This final Amendment follows informal draft proposals released by the Department in October 2007, February 2009 and July 2010 and a formal proposed amendment published in the New York State Register on September 15, 2010, each of which generated substantial public comment. This article summarizes and discusses the new or amended provisions of Regulation 20.

Application of Regulation 20

While the Amendment provides that Regulation 20, as amended, applies to cessions by any insurer authorized to do an insurance business in New York, the Amendment expressly acknowledges the preemptive effect of Dodd-Frank Act Section 531(a) by providing that, where a foreign ceding insurer's domestic state is NAIC-accredited, or has financial solvency requirements substantially similar to the requirements necessary for NAIC accreditation, and that state recognizes credit for reinsurance for the insurer's ceded risk, then the foreign ceding insurer may take credit for the reinsurance without having to comply with Regulation 20, as amended. Hence, the Amendment may only directly impact New York domestic ceding insurers on and after July 21, 2011 due to the preemptive effect of Dodd-Frank Act Section 531(a).

Prudent Reinsurance Credit Risk Management Principles (All Authorized Ceding Insurers)

The Amendment sets out several principles of prudential reinsurance credit risk management which apply to an authorized ceding insurer. These principles include some new affirmative obligations of a ceding insurer to provide notice of certain events to the New York Superintendent of Insurance (the "Superintendent").

Financial Prudence. The ceding insurer must at all times act with financial prudence when entering into any reinsurance arrangement.

Reinsurance Risks. The ceding insurer must properly consider and account for all risks associated with a reinsurance agreement, including (i) compliance with all applicable legal and regulatory requirements; (ii) the net risk to be retained; (iii) concentration of risk on a net and gross basis; (iv) projections as to reasonable future availability and affordability of adequate levels of reinsurance support for the ceding insurer's ongoing operations; (v) the degree to which future reinsurance proceeds for existing and future ceded reserves are likely to be recoverable based upon best available current information; (vi) the way an assuming insurer will be selected, including how to assess its security; (vii) how the reinsurance program will be monitored (i.e., the reporting and internal control systems); and (viii) that the terms of any reinsurance agreement with any affiliated reinsurer are fair and equitable.

Reinsurance Recoverables. Principle. The ceding insurer must take steps to manage its reinsurance recoverables proportionate to its own book of business.

Notice Requirement. The ceding insurer must notify the Superintendent within 30 days after a reinsurance recoverable from any single reinsurer, or group of affiliated reinsurers, exceeds 50% of the ceding insurer's last reported surplus to policyholders, or after it is determined that a reinsurance

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recoverable from any single reinsurer, any alien group of reinsurers, or group of affiliated reinsurers, is likely to exceed the limit. The notice must demonstrate that the exposure is safely managed by the ceding insurer including consideration of the reinsurer's financial strength.

Reinsurance Program Diversification. Principle. A ceding insurer must take steps to diversify its reinsur-ance program.

Notice Requirement. The ceding insurer must notify the Superintendent within 30 days after ceding more than 20% of the ceding insurer's total gross written premium in the prior calendar year to any single reinsurer, or group of affiliated reinsurers, or after it has determined that the reinsurance ceded to any single reinsurer, any alien group of reinsurers, or group of affiliated reinsurers, is likely to exceed the limit. The notice must demonstrate that the exposure is safely managed by the ceding insurer.

Cessions to Affiliated Reinsurers. These principles apply equally to cessions to affiliated reinsurers and unaffiliated reinsurers. Therefore, if a ceding insurer cedes risks to a single affiliated reinsurer or to multiple affiliated reinsurers under a reinsurance pooling agreement, the notice requirements with respect to reinsurance recoverables and reinsurance program diversification apply. If the ceding insurer is a New York domestic insurer and must file the affiliate reinsurance agreement with the Superintendent pursuant to New York Insurance Law Article 15 (New York's holding company statute), the required notice may accompany that filing.

Alternative "Risk-Based" Credit for Cessions to Unauthorized Reinsurers

The Amendment adds an alternative "risk-based" credit for cessions to unauthorized reinsurers that is based largely on the collateral reduction proposal adopted by the National Association of Insurance Commissioners ("NAIC") for cessions to highly-rated unauthorized reinsurers and contained in the Reinsurance Regulatory Modernization Act of 2009, a federal legislative proposal put forward by the NAIC, and which are also included in the "Reinsurance Collateral Reduction & Accreditation Recommendations" adopted by the NAIC in October 2010. While required collateral could be reduced and possibly eliminated under this alternative credit provision, nothing in Regulation 20, as amended, precludes a ceding insurer from negotiating a collateral requirement in its reinsurance agreements.

With the Amendment, New York becomes the second state to implement an alternative "risk-based" credit rule. Florida was the first state to do so, enacting Fla. Stat. Ann. § 624.610(3)(e) in 2007 and promulgating a companion regulation, Fla. Admin. Code Rule 69O-144.007, in 2008. In February 2010, the Florida Office of Insurance Regulation reached an agreement with Hannover Ruckversicherung AG ("Hannover Re") to qualify as the state's first reinsurer to capitalize on the Florida alternative "risk-based" credit provisions.[1] In June 2010, the Florida Office of Insurance Regulation reached an agreement with XL Re Ltd. to do the same "under modified regulatory terms."[2] In October 2010, Hannover Re announced that its subsidiary, Hannover Re (Bermuda) Ltd., acquired eligible reinsurer status in Florida.[3] In November 2010, the Florida Office of Insurance Regulation also reached an agreement with three Bermuda reinsurers, Ace Tempest Reinsurance Ltd., Hiscox Insurance Company (Bermuda) Limited, and Partner Reinsurance Company Ltd., each "under modified regulatory terms."[4]

Applicability. This New York alternative credit applies to: (i) either reinsurance ceded to a single unauthorized alien reinsurer or an alien group of reinsurers that secures its assumed risks with a multiple beneficiary reinsurance trust or an unauthorized reinsurer that secures its reinsurance recoverables using permitted amounts withheld (letter of credit, single beneficiary reinsurance trust or funds withheld); (ii) cessions of both non-life and life risks (although ceded life risks can be secured under Regulation 20 using permitted funds withheld and not a multiple beneficiary reinsurance trust); and (iii) reinsurance agreements entered into or renewed on or after January 1, 2011. Hence, this alternative credit only applies prospectively and not to reinsurance agreements that are in-force or have outstanding liabilities as of January 1, 2011 – these reinsurance agreements will remain subject to the existing New York reinsurance credit rules that require 100% collateral funding. Unlike the New York alternative credit provision, the Florida alternative credit provisions only

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apply to collateral funding under multiple beneficiary reinsurance trusts and cessions of non-life risks.

Existing Multiple Beneficiary Reinsurance Trust Agreements. The terms of an existing multiple beneficiary reinsurance trust agreement will have to be supplemented when the single unauthorized alien reinsurer or alien group of reinsurers that already has a multiple beneficiary reinsurance trust seeks a reduction in collateral for reinsurance agreements entered into or renewed on or after the date the Superintendent approves it for collateral reduction (the "Reduction Effective Date"). In this case, risks ceded on pre-Reduction Effective Date reinsurance agreements will continue to be collateralized at the 100% level but risks ceded to a "Secure-3" rated reinsurer on post-Reduction Effective Date reinsurance agreements may be collateralized at a 20% level (thus affording an 80% collateral reduction). As part of its submission to qualify under the Florida alternative credit provisions, Hannover Re (which was accorded an 80% reduction in required collateral) entered into an amended Deed of Trust as well as a new Supplemental Deed of Trust[5] to segregate the collateral pools – the pre-Reduction Effective Date reinsurance agreements are collateralized at a 100% level under the amended Deed of Trust while the post-Reduction Effective Date reinsurance agreements will be collateralized at a 20% level under the new Supplemental Deed of Trust. Fla. Admin. Code Rule 69O-144.007(6) expressly allows such a supplemental trust. In response to public comments on an earlier draft of the Amendment, the Department stated that a change to Section 125.4(c)(1) of Regulation 20 (relating to multiple beneficiary reinsurance trusts) was not required in order to establish a supplemental trust for a reinsurer that already has a multiple beneficiary reinsurance trust.

Superintendent Approval. For the New York alternative credit to apply to a ceding insurer, the Superintendent must approve the reduced collateral for reinsurance recoverables, including incurred but not reported loss reserves and unearned premium reserves. In doing so, the unauthorized reinsurer or alien group of reinsurers must meet the general requirements set out below and the reduced collateral will be determined in accordance with collateral reduction determination standards set forth below.

General Requirements (All Unauthorized Reinsurers).

General Qualifications. For this alternative credit, a ceding insurer may take credit only if the unauthorized reinsurer (i) maintains, on a stand-alone basis separate from its parent or any affiliates, an interactive financial strength rating from at least two of the following rating agencies: S&P, Moody's, Fitch, A.M. Best or any other rating agency acceptable to the Superintendent; (ii) meets the standards of solvency, including standards for capital adequacy, established by its domiciliary regulator; (iii) is authorized in its domiciliary jurisdiction to assume the kind or kinds of reinsurance ceded by the ceding insurer; and (iv) maintains a policyholders' surplus or equivalent in excess of $250 million, which is calculated on the basis of U.S. GAAP or U.S. statutory accounting principles; or in the case of a group including incorporated and individual unincorporated underwriters, the group has minimum capital and surplus or equivalents (net of liabilities) of at least $250 million and a central fund containing a balance of at least $250 million.

Initial Rating Application. The unauthorized reinsurer must file an application for a rating with the Superintendent on such forms and supplements as prescribed by the Superintendent. The application must be accompanied by a non-refundable fee of $10,000.

Notice of Changes. The unauthorized reinsurer must give notice to the Superintendent, within 30 days, of any change in domiciliary license status or change in its rating status.

Annual Filing and Renewal Rating Application. The unauthorized reinsurer must annually file with the Superintendent the following: (i) audited financial statements, from inception or for the last three years, whichever is less, and an actuarial opinion filed with its domiciliary regulator (the statements should include U.S. GAAP basis if available, or audited International Financial Reporting Standards basis that includes an audited footnote reconciling equity and net income to U.S. GAAP basis); (ii) a report in the form similar to the applicable NAIC Annual Filing Blank (Schedule F (non-life) or Schedule S (life)); (iii) a

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list of all disputed or overdue recoverables, regardless of whether the claims are in litigation or arbitration; and (iv) a certification from its domiciliary regulator that it is in good standing and that the regulator will provide financial and operational information to the Superintendent. The unauthorized reinsurer must also annually file a renewal application for the rating with the Superintendent on such forms and supplements as prescribed by the Superintendent. The renewal application must be accompanied by a non-refundable fee of $5,000.

Special Requirements (Unauthorized Alien Reinsurers).
MOU. The Superintendent and the domiciliary regulator of the unauthorized alien reinsurer must have executed a memorandum of understanding that addresses matters that the Superintendent deems relevant for proper oversight of reinsurance transactions.

Market Access. The domiciliary jurisdiction of the unauthorized alien assuming insurer must allow U.S. reinsurers access to the market of the domiciliary jurisdiction on terms and conditions that are at least as favorable as those provided by New York laws for unauthorized alien reinsurers.

Required Contract Terms. The reinsurance agreement between the ceding insurer and the unauthorized alien reinsurer must:
1. include an insolvency clause as provided for in New York Insurance Law Section 1308(a)(2)(A);
2. require the unauthorized alien reinsurer to designate a person in New York state or the ceding insurer's state of domicile as its true and lawful agent upon whom may be served any lawful process in a dispute, action, suit, or proceeding instituted by, or on behalf of, the ceding insurer;
3. provide that if, pursuant to New York Insurance Law Article 74 (the New York insurance insolvency law) or the equivalent law of another state, an order of rehabilitation, liquidation or conservation against the ceding insurer is entered, the unauthorized alien reinsurer must, within 30 days of entry of the order, fund the entire amount for which the ceding insurer has taken credit as an asset or deduction from its reserves for reinsurance recoverable from the unauthorized alien reinsurer; and
4. include certain prescribed provisions relating to submission to personal jurisdiction in the U.S. and governing law in relation to any dispute under the reinsurance agreement.

Failure to Comply. An unauthorized alien reinsurer that fails to comply on a timely basis with the funding requirement in Item 3, and any member of its holding company system, will not "meet the standards for any ceding insurer to qualify for credit with respect to any reinsurance contracts entered into or renewed by the unauthorized alien reinsurer" on or after the first day of such failure to comply, unless the Superintendent determines that it is in the public interest to allow the credit in whole or in part.

Collateral Reduction Determination.
Rating Assignment. The Superintendent must assign the reinsurer one of five ratings – Secure-1, Secure-2, Secure-3, Secure-4 or Vulnerable-5. Based on that rating, the minimum amount of reinsurance collateral that will be required for full reinsurance credit will be as follows:

Ratings	Minimum Amount of Collateral
Secure-1	0%
Secure-2	10%
Secure-3	20%
Secure-4	75%
Vulnerable-5	100%

Maximum Assignable Rating. The maximum rating that an unauthorized reinsurer may be assigned must correspond to the reinsurer's financial strength rating as set forth in the table on the following page. The Superintendent is required to use the lowest financial strength rating received from an approved rating agency in establishing the maximum rating.

Other Factors. The Superintendent may also consider the following factors in determining the appropriate rating of a reinsurer:
1. the reinsurer's compliance with reinsurance contractual terms and obligations (including mandatory contractual clauses);
2. the reinsurer's business practices in dealing with its ceding insurers;
3. a report similar to the reinsurer's most recent applicable NAIC Filing Blank (Schedule F (non-life) or Schedule S (life));
4. the reinsurer's reputation for prompt payment of claims under reinsurance agreements, including the proportion of the reinsurer's obligations that are more than 90 days past due or are in dispute, with particular attention to receivable

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payables to reinsurers that are under administrative supervision or in receivership;
5. regulatory actions against the reinsurer;
6. the reinsurer's annual financial statement together with an opinion thereon of an independent certified public accountant, regulatory filings and actuarial opinions;
7. the liquidation preference of obligations to a ceding insurer in the reinsurer's domiciliary jurisdiction in the context of an insolvency proceeding;
8. a reinsurer's participation in any solvent scheme of arrangement or similar procedure that involves U.S. cedents. Entrance into such an arrangement or procedure that involves one or more U.S. cedents will result in an assignment of a Vulnerable-5 rating by the Superintendent; and
9. any other information deemed relevant by the Superintendent.

Unauthorized Reinsurer Assigned Rating Reduction; Required Adjustment. If an unauthorized reinsurer's rating assigned by the Superintendent is reduced or withdrawn (e.g., the Superintendent's rating is reduced from Secure-1 to Secure-2), the existing credit to the ceding insurer must be "adjusted accordingly" unless the reduced credit is funded using amounts withheld. Nonetheless, the Superintendent may, in the interest of ensuring market stability and the solvency of the ceding insurer, on request of the ceding insurer, authorize the ceding insurer to continue to take credit, in whole or in part, for the reinsurance recoverable relating to the rating change or withdrawal for some specified period of time unless the reinsurance recoverable is deemed uncollectible.

Experience in Collecting Reinsurance Recoverables. If the ceding insurer's experience in collecting recoverables from any unauthorized reinsurer indicates that the credit to the ceding insurer should be lower, the ceding insurer is required to "adjust the credit accordingly." In response to public comments on an earlier draft of the Amendment, the Department stated that this determination would be based on the ceding insurer's judgment regarding its ability to collect.

Ceded Short-Tail Claims for Catastrophic Loss. Where the reinsurance ceded by an authorized property/casualty insurer is for short-tailed lines due to a catastrophic loss, the Superintendent may approve that any collateral required to be posted may be subject to no more than a one-year deferral from the date of the first instance of a liability reserve entry as a result of a catastrophic loss. This one-year deferral period is contingent on the reinsurer continuing to pay claims in a timely manner. A "catastrophic loss" is defined to mean an event designated as a catastrophe by the Property Claims Service, or an equivalent organization, as determined by the Superintendent, or any successor organization, and covering losses related to a natural event including wind, hail, hurricane, earthquake, winter storms (snow, ice, freezing), fire, tsunami or flood.

Alien Reinsurers in Run-Off (With Multiple Beneficiary Reinsurance Trusts)

Under Regulation 20, credit for reinsurance is allowed for a cession of non-life risks to an alien reinsurer that establishes a multiple beneficiary reinsurance trust and maintains a trusteed surplus of at least $20 million. The Amendment allows for a reduced minimum trusteed surplus

Ratings	A.M. Best	S&P	Moody's	Fitch
Secure-1	A++	AAA	Aaa	AAA
Secure-2	A+	AA+, AA, AA-	Aa1, Aa2, Aa3	AA+, AA, AA-
Secure-3	A, A-	A+, A, A-	A1, A2, A3	A+, A, A-
Secure-4	B++, B+	BBB+, BBB, BBB-	Baa1, Baa2, Baa3	BBB+, BBB, BBB-
Vulnerable-5	B, B-, C++, C+, C, C-, D, E, F	BB+, BB, B-,B+, B, B-, CCC, CC, C, D, R, NR	Ba1, Ba2, Ba3, B1, B2, B3, Caa, Ca, C	BB+, BB, BB-, B+, B, B-, CCC+, CCC, CCC-, DD

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for an alien reinsurer in run-off provided that the Superintendent approves the reduction.

Reduction Allowed. Under the Amendment, the Superintendent may approve a reduction in the minimum trusteed surplus amount if (i) the reinsurer has permanently discontinued underwriting new business secured by the trust for at least three full years, and (ii) the Superintendent finds, based on an assessment of the risk, that the new required surplus level is adequate for the protection of U.S. ceding insurers, policyholders and claimants in light of reasonably foreseeable adverse loss development.

Risk Assessment. The Superintendent's risk assessment may involve an actuarial review, including an independent analysis of reserves and cash flows, and must consider all material risk factors, including when applicable the lines of business involved, the stability of the incurred loss estimates and the effect of the surplus requirements on the reinsurer's liquidity or solvency.

Minimum Required Trusteed Surplus. The minimum required trusteed surplus for such an alien reinsurer in run-off may not be reduced to an amount less than 30% of the reinsurer's liabilities attributable to reinsurance ceded by U.S. ceding insurers. ■

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1. Florida Office of Insurance Regulation, *Florida Office of Insurance Regulation Reaches Agreement with Hannover Re to be the First to Qualify as an Eligible Reinsurer Under New Terms* (Feb. 24, 2010) (available at www.floir.com/PressReleases/viewmediarelease.aspx?ID=3437).
2. Florida Office of Insurance Regulation, *Florida Office of Insurance Regulation Reaches Agreement with XL RE LTD to be the First Bermuda Reinsurer to Qualify under Modified Terms* (June 22, 2010) (available at www.floir.com/PressReleases/viewmediarelease.aspx?ID=3610).
3. Press Release, Insurance regulator in *Florida reduces collateral requirements for Hannover Re (Bermuda) Ltd.* (Sept. 28,. 2010) (available at http://www.hannover-re.com/media/press/pr100928/index.html).
4. Florida Office of Insurance Regulation, Florida Office of Insurance Regulation Reaches Agreement with Three Bermuda Reinsurers for New Collateral Requirements (Nov. 8, 2010) (available at http://www.floir.com/PressReleases/viewmediarelease.aspx?ID=3734).
5. Florida Office of Insurance Regulation, Case No.: 108275-09-CO, Consent Order (filed Feb. 24, 2010) (available at www.floir.com/pdf/HannoverRe108875-09-CO.pdf). The author also reviewed the Hannover Re forms of Deed of Trust and Supplemental Deed of Trust filed with the Florida Office of Insurance Regulation.

Basel III—An Initial Piece of the Global Puzzle

by Gregory J. Lyons and Chan E. Casey

The Basel Committee on Banking Supervision (the "Basel Committee"), an international committee consisting of representatives of central banks and other agencies, issued its final Basel III framework on December 16, 2010, along with the results of the quantitative impact study (the "QIS") it conducted to ascertain the impact of the new requirements. Then, on January 13, 2011, the Basel Committee expanded on the Basel III capital rules with additional requirements (the "January 13 Annex") applicable to the non-common Tier 1 or Tier 2 instruments issued by internationally active banks. The Basel III framework is intended to reform the international financial system and improve the banking sector's resiliency in times of financial and economic stress by instituting higher global capital and new liquidity standards on a more or less uniform basis globally.

The Basel Committee's actions are not themselves binding but rather must be adopted and implemented by each jurisdiction, which can create variation. For example, on December 22, Switzerland published proposed rules that would impose capital requirements on the largest Swiss banks much higher than required by Basel III, and more generally the European Parliament has stated that the framework may be modified to address the "individual circumstances" of each country.

The framework text is set forth in "*Basel III: A global regulatory framework for more resilient banks and banking systems*," which together with the January 13 Annex, sets forth higher minimum capital requirements and new conservation and countercyclical buffers, revised risk-based capital measures, and a new leverage ratio, and "*Basel III: International framework for liquidity risk measurement, standards and monitoring*" (together, "Basel III"), which details two new and controversial global liquidity standards. In response to concerns raised by the banking industry and some governments after the proposal was published last December,

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the final rules will be phased in gradually in an effort to mitigate their burden on the banks and thus their potential damage to national economies. On December 17, 2010, a Macroeconomic Assessment Group established by the Basel Committee and the Financial Stability Board issued a final report (the "Final Report") analyzing the macroeconomic impact of the Basel III reforms over the transition period, which concludes that the Basel III capital standards are likely to have "a relatively modest impact on growth."[1]

This article details the Basel III framework's capital and liquidity requirements, as well as the contemplated timing and ramifications on banks and on the global economy. However, the completion of this framework is just an initial piece of a global puzzle that ultimately will determine the post-crisis regulatory framework for the banking industry. In addition to Basel III, Dodd-Frank and its myriad still-to-be-proposed regulations will profoundly impact affected banks (as referenced herein), as will analogous initiatives in Europe and Asia. Thus, while Basel III itself will certainly impose material burdens on the banking industry, it is the cumulative, purposeful or inadvertent, "highest common denominator" impact of all these global initiatives that presents the greatest challenge, particularly to large international banking institutions. Vigilance in responding to and commenting upon diverse government initiatives and their ramifications is necessary, and hopefully sufficient, to enable the banking industry to prosper and continue its vital role in the world economy.

Basel III Capital Provisions

The Introduction to Basel III asserts that the financial crisis became so severe, in large part, because banking institutions in many countries had incurred excessive on- and off-balance sheet leverage while holding an insufficient level of high-quality capital and inadequate liquidity buffers. As a result, banks could not withstand their systemic trading or credit losses or address the migration of off-balance sheet exposures onto their balance sheets. These problems were exacerbated by the pro-cyclical de-leveraging process after the crisis began, and by the interdependency of financial institutions.

To address these concerns and strengthen the regulatory capital framework, Basel III (i) increases the required quality and quantity of the capital base (the numerator of the regulatory capital ratios); (ii) creates a capital conservation buffer to promote the build-up of capital that can be used in times of stress and encourage market discipline; (iii) creates a countercyclical buffer to be implemented when regulators perceive signs that credit has grown to excessive levels; (iv) increases risk-weighted asset assessment for certain types of activities (the denominator of the risk capital ratios); (v) introduces a leverage ratio as an addition to the risk-capital ratios that historically have been the exclusive capital measure in Basel II; and (vi) addresses systemically important financial institutions, but leaves specific rule-making on systemic risk for mid-2011. The Basel III capital rules likely will force many banking institutions in North America, Europe and Japan to raise significant amounts of common equity, the most expensive form of capital, and may force many of them to exit, or at least significantly reduce, their exposure to certain trading, derivatives, securities finance and securitization operations.

Risk-Capital Ratios. Basel III seeks to simplify and harmonize the capital standards (and eliminate subtiers of capital) across jurisdictions by establishing separate capital requirements for (i) common equity Tier 1 ("Common Equity Tier 1") capital (a new regulatory metric of capital), (ii) total Tier 1 capital, consisting of the sum of Common Equity Tier 1 and additional Tier 1 ("Additional Tier 1") capital, and (iii) total capital ("Total Capital"), consisting of the sum of Common Equity Tier 1, Additional Tier 1 and Tier 2 capital. Basel III will require banks to maintain: (i) a minimum Common Equity Tier 1 capital ratio of 4.5%; (ii) a minimum Tier 1 capital ratio of 6%; and (iii) a minimum Total Capital ratio of 8%. Broadly speaking, Tier 1 capital consists only of capital that can absorb losses on a going concern basis, while Tier 2 capital consists only of capital able to absorb losses on a "gone" concern basis. Tier 3 capital (which supports market risk) is eliminated, as the Basel Committee believes that capital to support market losses is no less significant than other sources of capital.

The minimum Common Equity Tier 1 ratio of 4.5% will ensure that banks maintain more core capital, consisting predominantly of common shares and retained earnings, than most currently do. The concept of a Common Equity Tier 1 metric arose from a general Basel Committee concern that the "hybrid" instruments allowed in Tier 1 historically did not provide

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significant support to banks during the financial crisis,[2] and many banks, particularly in Europe, had relatively little common equity capital. The new standard is thus designed to ensure that banks have a minimum amount of the highest grade, highest support-providing capital, which generally will be common stock. To be included in Common Equity Tier 1 capital, a bank's common shares must, among other things: (i) represent the most subordinated claim in a bank's liquidation; (ii) have perpetual principal that is never repaid outside of liquidation; (iii) do nothing to create an expectation that the instrument will be bought back, redeemed or cancelled; and (iv) not be secured or guaranteed by the issuer or any related entity. The volatility of this capital also may be heightened as Basel III retained the principle in the proposal that unrealized gains and losses recognized on the balance sheet (e.g., with securities) for accounting purposes also will be incorporated for regulatory purposes.

Nonetheless, despite creating a separate common equity-focused metric, the Basel Committee remained convinced that the historical Tier 1 definition was too permissive of hybrid capital instruments. As a result, to be included in Additional Tier 1 capital, an instrument must, among other things: (i) be subordinated to depositors, general creditors and subordinated debt of the bank; (ii) not be secured or guaranteed by the issuer or any related entity; (iii) be perpetual, without any maturity date or any incentive to redeem (such as step-ups); (iv) be callable only after at least 5 years, and only then with regulatory approval; and (v) provide the issuer with the ability to cancel distributions at any time, with no restrictions imposed on the bank. Thus, Basel III more expressly provides that current Tier 1 capital instruments with step-ups, dividend pushers or similar "innovative" or "exotic" traits will be phased out pursuant to the timing discussed below. This phase-out is expected to disqualify, for example, U.S. trust preferred securities from Tier 1 capital, as well as many types of European hybrid capital. Stated differently, non-cumulative perpetual preferred is the only type of existing widely distributed security clearly able to qualify under this category.[3]

> Vigilance in responding to and commenting upon diverse government initiatives and their ramifications is necessary, and hopefully sufficient, to enable the banking industry to prosper and continue its vital role in the world economy.

Minority interests, currently generally included in Tier 1, will be included to a specified extent in Common Equity Tier 1 only if (i) the instrument giving rise to the minority interest would, if issued by the bank, meet the criteria for common shares, and (ii) the subsidiary that issues the instrument is itself an institution subject to the same minimum prudential standards and level of supervision as a bank. This nonetheless represents an improvement from the December 2009 Basel III proposals, which had excluded minority interests entirely from Common Equity Tier 1. Similarly, other Tier 1 capital issued by consolidated subsidiaries of a bank may be recognized as Additional Tier 1 capital only if the instruments would, if issued by the bank, meet the qualifications to be classified as Tier 1 capital. Capital that has been issued to third parties out of a special purpose vehicle cannot be included in Common Equity Tier 1. The limits on the inclusion of minority interests are expected to be particularly burdensome to European banks, which often engage in cross-border operations through a joint venture with a local partner.

Further emphasizing the importance of maintaining a strong common equity base, regulatory adjustments to capital will be made for the most part at the Common Equity Tier 1, rather than the more general Tier 1 capital, level. Notably, goodwill and other intangibles (except mortgage servicing rights), as well as deferred tax assets that would be realized only upon future profitability of the bank, will be deducted from Common Equity Tier 1. The deduction of goodwill from Common Equity Tier 1 capital could be a significant consideration in certain acquisitions.

Mortgage servicing rights, significant investments in the common shares of banks, insurance and other financial entities that are outside the scope of regulatory consolidation, and deferred tax assets arising from temporary differences may all to a limited degree be recognized as Common Equity Tier 1 capital, with recognition of each capped at 10% of the bank's Common Equity Tier 1 capital level. However,

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banks must deduct from Common Equity Tier 1 the amount by which the aggregate of these items exceeds 15% of Common Equity Tier 1. Although the Basel III proposals had not specified a risk-weighting for that portion of these items included in Common Equity Tier 1, the final framework provides that the amount not deducted in almost all circumstances will be risk weighted at 250%,[4] further discouraging banks from holding such assets.

Tier 2 capital is also tightened by establishing a single set of criteria to qualify, including that the instrument (i) be subordinate to depositors and general creditors of the bank, (ii) not be secured or covered by a guaranty of the issuer or a related party, (iii) have an original maturity of at least 5 years, with no incentive to redeem (including step-ups), (iv) provide the investor no right to accelerate the payment, except in bankruptcy or liquidation and (v) not have a credit-sensitive dividend feature. Loan-loss reserves held against future unidentified losses qualify as Tier 2 capital, but only to a maximum of 1.25% of credit risk-weighted assets.

The January 13 Annex imposes further requirements on Additional Tier 1 and Tier 2 capital instruments issued by internationally active banks, to address the Basel Committee's concern that during the financial crisis certain non-common instruments did not absorb losses incurred by banks that benefited from public bail-outs. To be included in Additional Tier 1 or Tier 2 capital, the new Annex requires an instrument issued by an internationally active bank to have a provision that gives regulators the authority to require it to either be written off or converted to common equity upon a "trigger event," unless the relevant jurisdiction gives regulators unilateral authority to require full loss absorption by such instruments in the absence of such a provision and the instruments disclose the potential for loss. A "trigger event" is the earlier of: (i) a decision that a write-off, without which the banking institution would become non-viable, is necessary, as determined by the relevant authority; and (ii) the decision to make a public sector injection of capital, or equivalent support, without which the institution would have become non-viable, as determined by such authority. These additional requirements apply to all instruments issued after January 1, 2013; otherwise-qualifying instruments issued prior to that date will be phased out over a ten year horizon beginning in 2013, as described below. Still, the release did not provide as much detail about the exact triggers as hoped, and so creating appropriate capital instruments is still anticipated to be an iterative process with regulatory agencies.

As to disclosure, under Basel III banks will be required to make public their various capital components (as described above), including separate disclosure of all regulatory adjustments, as well as capital requirements and levels. During the transition period (described below), banks will be required to disclose the specific components of capital that are benefiting from the transitional provisions. The Basel Committee has stated that it will issue more detailed disclosure requirements in 2011.

As to timing, the three basic minimum capital requirements will be phased in first, with a longer period for compliance with the capital conservation buffer and other requirements. Under the new standards, by January 1, 2013, banks would need to meet a 3.5% common equity capital ratio, which will increase in annual fifty basis point increments to 4.5% by the beginning of 2015; Tier 1 capital requirements will increase from 4.5% to 6% over the same period. The minimum total capital ratio remains unchanged at 8%. Beginning January 1, 2016, the capital conservation buffer (described below) will add 0.625% to the three basic ratios, and then increase by 0.625% each year until it reaches the maximum of 2.5% in January 2019. The phase-in of deductions from capital that qualifies as common equity (e.g., for investments in financial institutions, mortgage servicing rights and deferred tax assets) will proceed by 20% annual increments beginning in January 2014. Moreover, while the definition of common equity will be set as of January 2013, the removal of instruments under Basel III that no longer qualify as non-common equity-based Tier 1 or Tier 2 capital will be phased in over a ten year period beginning in 2013 via capping the amount outstanding at 90% on 2013 and a 10% lower amount each year thereafter. Notably, the deduction also applies to existing instruments outstanding as of 2013. As noted in footnote 3, for large US banks the Collins Amendment to Dodd-Frank will result in a more rapid deduction of certain non-qualifying instruments.

Capital Conservation and Countercyclical Buffers. The introduction to Basel III expresses concern that, during the financial crisis, because reductions in distributions could

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be perceived as sending a signal of weakness, banks continued to pay dividends and make other "discretionary" expenditures of their capital, including bonuses, even after their capital position deteriorated. In response to this market failure, Basel III establishes a "capital conservation buffer" of 2.5% above the regulatory minimum capital requirements, which must consist entirely of Common Equity Tier 1 capital. As a result, if a bank does not have common equity, Tier 1 and total capital ratios of at least 7%, 8.5% and 10.5%, respectively, its ability to pay dividends and discretionary bonuses or engage in share repurchases will be restricted. When a bank's capital levels fall within the buffer, a capital conservation ratio will be imposed on the bank, and in the following year the bank will be required to conserve a percentage of its earnings, with only the remainder available for distributions.

The capital conservation buffer is divided into a series of five bands between the minimum capital level required and the maximum at which no limitations apply. The closer a bank's capital falls toward the minimum capital levels, the more constrained its ability to make discretionary payments will be. For example, if a bank's capital falls to 50% of the buffer above the minimum capital ratios, the bank's capital conservation ratio would be 60%, meaning that in the subsequent year the bank could pay out, in the aggregate, no more than 40% of its earnings through dividends, share buybacks or discretionary bonus payments. A bank will have the option of raising capital in the private sector if it wants to make distributions in excess of any applicable capital conservation restraint. Capital conservation above the regulatory minimum is described as a "best practice," and the Basel Committee provides that it "does not wish to impose constraints for entering the range [between the minimum and the buffer] that would be so restrictive as to result in the range being viewed as establishing a new minimum capital requirement," but the capital conservation buffer will likely provide a very significant incentive to conserve capital in excess of the regulatory minimum. The regulators also are expected to use their prudential authority to enforce that incentive, with Federal Reserve Board Governor Tarullo recently stating: "Realistically, both regulators and markets will expect firms generally to maintain their common equity ratios above 7%."[5]

In addition to the capital conservation buffer, Basel III provides each national regulator discretion to institute a "countercyclical buffer" if it perceives a greater system-wide risk to the banking system as the result of a build-up of excess credit growth in its jurisdiction. The Basel Committee expects the countercyclical buffer to be implemented on only an infrequent basis, and national regulators are supposed to announce the decision to institute a countercyclical buffer up to twelve months in advance. If implemented, the countercyclical buffer would (like the capital conservation buffer) restrict discretionary distributions, and incentivize retention of up to an additional 2.5% of risk weighted assets, resulting in minimum common equity, Tier 1 and total capital ratios of up to 9.5%, 11% and 13%, respectively. Internationally active banks would be subject to a bank-specific countercyclical buffer that represents the weighted average of the countercyclical buffers that are being applied in jurisdictions to which they have exposure. The Basel Committee is considering whether other fully loss absorbing capital beyond Common Equity Tier 1 capital could be used to satisfy the countercyclical buffer, but in the absence of further guidance the buffer is to be satisfied with Common Equity Tier 1 only.

> In perhaps the sharpest departure from the Basel II capital standards, Basel III introduces a global leverage ratio as a "backstop" to the risk-based capital requirements, to prevent the building of excessive on-and-off balance sheet leverage and the associated economic damage resulting from de-leveraging during difficult economic periods.

The capital conservation buffer will be phased in beginning January 1, 2016, beginning at 0.625% of risk-weighted assets and increasing by that amount each year until it becomes fully effective on January 1, 2019. The discretion to institute a countercyclical buffer will be phased in at the same rate in tandem with the capital conservation buffer over the same period, unless individual countries experiencing excessive credit growth accelerate implementation. If individual countries choose to accelerate implementation

of the countercyclical buffer, or to implement a countercyclical buffer greater than 2.5%, internationally active banks will not be required to incorporate such excess or accelerated buffers in the calculation of their bank-specific buffers.

Risk-Weighted Assets. In July 2009, the Basel Committee finalized rules that significantly raised the capital requirements for a bank's trading book exposures and the Basel Committee is expected to consider raising trading book charges even higher in 2011. Basel III meanwhile focuses on counterparty credit risk ("CCR"), which is the risk that a counterparty to a transaction could default before the final settlement of the transaction's cash flows. (CCR transactions, unlike typical loans, create a bilateral risk of loss.) Derivatives, securities finance and securitization activities are a particular focus of Basel III's CCR-related amendments. Basel III reflects the Basel Committee's determination that during the financial crisis several risks were not properly captured in the capital components of Basel II, including that: (i) the creditworthiness of trading counterparties was adversely correlated with volatility and exposure to the counterparty (i.e., "wrong way risk"); (ii) approximately two-thirds of CCR losses resulted from mark-to-market losses due to credit valuation adjustments ("CVAs"), and the current rules account for default risk but not market value losses short of default; (iii) securitizations were treated as having the same risk as similarly rated corporate debt instruments; (iv) the close-out period for large or illiquid netting sets often extended beyond the calculation period; and (v) large financial institutions were more interconnected and interdependent, and thus subject to greater risk in times of crisis, than is currently reflected in Basel II.

Basel III contains several specific modifications to Basel II to address these concerns and others identified by the Basel Committee. For example, to address wrong-way risk, Basel III will require (consistent with the revised trading book rules) that a stressed effective positive exposure ("EPE") be used to calculate exposure at default ("EAD"). For potential CVA losses, Basel III treats the counterparty exposure as the equivalent of a bond, resulting in a capital add-on using a bond equivalent as a proxy for CVA risk (with the notional amount of the bond being the counterparty EAD and its maturity being the longest dated netting set involved). Certain transactions are excluded in calculating this capital charge: (i) transactions with a central counterparty ("CCP"); and (ii) securities financing transactions, unless a regulator determines associated CVA loss exposures are material.

Other technical Basel III changes that increase required capital under the Basel II formulae in response to perceived shortcomings in evaluating CCR in the context of certain risks include: (i) the application of a 1.25 multiplier to the asset value correlation (a) of certain regulated financial firms (defined to include banks, broker-dealers and insurance companies and their parents and subsidiaries) with consolidated assets exceeding $100 billion (to address the interconnected risk), and (b) of all unregulated financial firms (broadly defined to include firms whose main business includes managing financial assets, lending, investments, CCP services, proprietary trading, and other financial services as determined by regulators), regardless of size; and (ii) to ensure the suitability and sufficiency of collateral under the Internal Model Method ("IMM"), the extension of the minimum margin period of risk to 20 days for over-the-counter ("OTC") derivatives (typically having a minimum margin period of 10 days) and securities financing (typically 5 days) netting sets if trades exceed 5,000 at any point during a quarter or if the netting sets contain illiquid collateral or hard-to-replace (e.g., bespoke or exotic) derivatives.

Basel III, by increasing the assessed capital requirements against bilateral OTC derivatives exposures, materially enhances banks' incentives to use CCPs for OTC derivatives transactions, because exposures to CCPs generally attract a zero EAD. The Basel Committee has indicated that the capitalization of bank exposures to CCPs will be based on the compliance of the CCP with standards currently being developed by the Committee on Payments and Settlement Systems and the International Organization of Securities Commissions, and has proposed that exposures to compliant CCPs should be subject to a 2% risk weight. The Basel Committee expects to finalize rules on the capitalization of banks' exposures to CCPs in 2011.

Basel III also imposes specific additional bank compliance and risk management requirements on these types of CCR transactions in lieu of Basel II standards that provided substantial discretion to the banks. For example, Basel III expands and makes more detailed the quantitative requirements in Annex 4 of Basel II for

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stress testing by banks using the IMM, requiring, for example, monthly exposure stress testing of principal market factors, and at least quarterly testing of multifactor stress testing scenarios. In addition, Basel III imposes more detailed back testing requirements (not allowing value-at-risk ("VaR") -based back testing to substitute for CCR back testing). Basel III also devotes particular attention to the collateral management units of banks using the IMM, specifically prescribing the need for such a unit and the substance of necessary reports, as well as audit, staffing and regulatory requirements. Finally, Basel III provides incentives to ensure that banks do not rely on external credit ratings for exposures without conducting their own diligence on their counterparties. Nonetheless, Basel III continues extensive references to those ratings, which will be problematic for US banks given the prohibition on the use of such ratings for certain regulatory purposes in Section 939A of Dodd-Frank.[6]

Leverage Ratio. In perhaps the sharpest departure from the Basel II capital standards, Basel III introduces a global leverage ratio as a "backstop" to the risk-based capital requirements, to prevent the building of excessive on-and-off balance sheet leverage and the associated economic damage resulting from de-leveraging during difficult economic periods. To ensure "consistent" implementation internationally, the leverage ratio will be implemented in a manner that takes into account different accounting principles in various jurisdictions.

The numerator of the leverage ratio likely will be based on Tier 1 Capital, although the Basel Committee "also will collect data during the transition period to track the impact of using total regulatory capital and Common Equity Tier 1." As to the denominator, the measure of exposure for the leverage ratio will follow accounting principles, (i) applying on-balance sheet, non-derivative exposures net of credit valuation adjustments; (ii) not allowing the netting of loans and deposits; and (iii) not allowing physical or financial collateral, guarantees or credit risk mitigation purchased to reduce on-balance sheet exposures.

The exposure measure includes both on- and off-balance sheet exposures. As to on-balance sheet, Basel III contemplates that banks will include items on their accounting balance sheet, and will (i) calculate exposure from securities financing transactions by applying the accounting measure of exposure, and (ii) calculate derivatives exposure by applying an accounting measure of exposure plus an add-on for potential future exposure (as expressed in the Current Exposure Method in Basel II), in each case applying Basel II regulatory netting rules (with the exception of cross-product netting). Of positive note for banks, Basel III allows Basel II regulatory netting rules, except for cross-product netting, to apply to repurchase agreements and other securities financing transactions (as well as derivatives). The Basel III proposals (including the July 2010 amendments to the proposals, which only specifically addressed netting of derivatives exposures) had failed to fully address the issue.

In terms of off-balance sheet items, the leverage ratio also will include among other things, commitments (including liquidity facilities), direct credit substitutes, letters of credit, failed transactions and unsettled securities. The final rules also make clear that a 100% credit conversion factor will apply to off-balance sheet items, with the exception of a 10% credit conversion factor for commitments that are unconditionally cancellable by the bank at any time without prior notice. The Basel Committee plans to conduct further review to ensure that a 10% credit conversion factor is appropriately conservative.

Systemically Important Financial Institutions. Notably absent from Basel III is discussion of the treatment of the largest international banking institutions. Rather, both the Basel Committee and U.S. regulators still are developing rules to address risks posed to the financial system and the economy as a whole by systemically important financial institutions. Basel III indicates that the Basel Committee will continue its work to determine (i) qualitative and quantitative factors to assess the systemic importance of financial institutions at a global level, and (ii) how best to mitigate systemic risk. Measures the Basel Committee is considering with respect to systemically important financial institutions include additional capital surcharges, contingent capital and bail-in debt. The Basel Committee has indicated that "[i]t will continue its work on these issues in the first half of 2011;" meanwhile, governmental authorities in individual jurisdictions are moving ahead with their own measures to control systemic risk. In the United States, for instance, the Dodd-Frank Act tasks the Financial Stability Oversight Council and the Federal Reserve with identifying and

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imposing heightened prudential standards on systemically important financial institutions.

Basel III Liquidity Standards

As recently as September 2008 the Basel Committee addressed liquidity extensively, albeit on a principles-driven basis, by publishing its "Principles for Sound Liquidity Risk Management and Supervision" (the "Principles"). However, given the Basel Committee's perception that poor liquidity risk management was a significant contributor to the financial crisis, and further evidencing the change to a more exacting regulation-predominant environment, Basel III complements the Principles with specific short-term ("Liquidity Coverage Ratio") and longer-term ("Net Stable Funding Ratio") concrete liquidity standards for banking institutions. These liquidity standards are expected by many to impose perhaps an even greater burden on banking institutions than the capital burdens discussed above.[7]

Liquidity Coverage Ratio. The Liquidity Coverage Ratio seeks to ensure that banks will have a sufficient level of unencumbered high quality assets (i.e., assets easily converted to cash at no material loss of value, and ideally eligible as collateral at central banks) over a stressed 30-day period by mandating that, on a continuous basis, the value of such assets held by a bank (the numerator) be at least equal to 100% of the bank's estimated net cash outflows (the denominator) during that period. The basic premise is that a 30-day liquidity reserve will provide the bank and the regulators time to respond before the bank's condition becomes critical, or to enable it to be resolved in an orderly manner.

The Liquidity Coverage Ratio will require affected banks to maintain sufficient high-quality liquid assets to cover 100% of the net cash outflows that could be encountered under an acute stress scenario assuming: (i) a significant downgrade of the bank's credit rating; (ii) a partial loss of deposits; (iii) a loss of unsecured wholesale funding; (iv) a significant increase in secured funding haircuts; and (v) increases in derivative collateral calls and substantial calls on off-balance sheet exposures. The numerator will include two categories of high-quality assets: "Level 1" and "Level 2" assets. Level 1 assets are included without limit; Level 2 assets are capped at 40% of the stock of high-quality assets. Level 1 assets include cash, central bank reserves, and (if they are assigned a 0% risk-weight under the Basel II Standardized Approach to credit risk) marketable securities representing claims on or guaranteed by sovereigns and multi-national quasi-governmental organizations. Level 2 assets are subject to a minimum 15% haircut, and are limited to high grade, plain vanilla non-financial corporate bonds, covered bonds (i.e., bonds issued by a bank and subject to special supervision designed to protect bond holders), and marketable securities representing claims on or guaranteed by sovereigns and multi-national quasi-governmental organizations that are assigned a 20% risk-weight under the Basel II Standardized Approach for credit risk.

As indicated above, the denominator of the Liquidity Coverage Ratio is equal to cumulative expected cash outflows minus cumulative expected cash inflows over a 30 day period. For expected cash outflows, Basel III details various potential sources of liquidity, and prescribes various levels of expected run-off or other outflows that banks must include in their calculation. For example, certain stable deposits only have a 5% (minimum) "run-off factor," unsecured wholesale funding by non-financial corporate customers has a 75% run-off factor, committed credit and liquidity facilities are expected to cause liquidity outflows of between 5% and 100% of the credit line and asset-backed commercial paper, conduits, and securities finance and derivative transactions also have detailed rules which generally assume significant outflows. Notably, at the discretion of the local supervisor, the denominator also potentially involves off-balance sheet contingent funding liabilities, such as guarantees and letters of credit, as well as non-contractual obligations that may create material reputational risk. As to cash inflows, the Liquidity Coverage Ratio also proposes specific percentages for expected retail and wholesale contractual inflows, reverse repos and secured lending, and other potential sources. Expected inflows eligible for netting against outflows will be capped at a maximum of 75% of expected outflows. In other words, banks will be required to maintain high-quality liquid assets equal to 25% of their expected cash outflows, regardless of the amount of their expected inflows; this is a significant new requirement that had not been announced in the Basel III proposals.

Net Stable Funding Ratio. Whereas the Liquidity Coverage Ratio focuses

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on short-term stressed conditions, the Net Stable Funding Ratio ("NSFR") seeks to establish a minimum amount of funding based on the liquidity of a bank's assets and activities over a one-year time horizon. In other words, the NSFR seeks more fundamentally to restructure the components of a bank's balance sheet. Like the July 2009 trading rules and much of the risk-weighted asset provisions of Basel III, much of the focus of the NSFR is on non-traditional bank activities. As with the Liquidity Coverage Ratio, the numerator (available amount of stable funding, or "ASF") must be equal to at least 100% of the denominator (assets and off-balance sheet exposures). In arriving at the result, the components of the numerator are multiplied by percentages depending on their category in a table, ranging from 100% for very stable funding (e.g., Tier 1 and 2 capital), to 0% for any liability or equity category not specified in the table.

The denominator of the NSFR operates in a corresponding manner using a table with very liquid assets (e.g., cash, securities with a maturity of less than 1 year) having a 0% multiplier, gold having a 50% multiplier, loans to retail clients with a maturity of less than 1 year having an 85% multiplier, and all non-designated assets having a 100% multiplier. As is the case with the Liquidity Coverage Ratio, the denominator also includes off-balance sheet assets at the discretion of the local regulator.

Timing. Basel III provides for an observation period to begin in 2011, during which the Basel Committee will monitor the implications of the standards for financial markets, credit extension and economic growth, addressing unintended consequences as necessary, including by revising specific components of the standards. It is contemplated that the Liquidity Coverage Ratio and the Net Stable Funding Ratio, including any revisions, will be introduced as minimum standards beginning January 1, 2015, and January 1, 2018, respectively.

> By remaining actively engaged in the process, financial institutions may be able to shift the debate sufficiently to avoid some of the most challenging intended and unintended consequences of the new landscape.

Monitoring. In addition to the ratios set forth above, Basel III also imposes additional monitoring requirements on affected banking institutions. The specified monitoring includes metrics to identify contractual maturity mismatches, concentration of funding, and available unencumbered assets. Basel III provides that the metrics "should be used on an ongoing basis to help monitor and control liquidity risk."

The Quantitative Impact Study and the Final Report

As to the impact of the foregoing, the QIS assessed year-end 2009 data gathered from a total of 263 banks from 23 jurisdictions, including 94 "Group 1 banks" (well-diversified, internationally active banks with more than €3 billion of Tier 1 Capital) assuming full implementation of Basel III, without accounting for transitional periods. The QIS states that Group 1 banks, on average, will have a 23% increase in risk-weighted assets, with the largest component of the change resulting from increases for CCR exposures. Due largely to deductions, Basel III also reduces Group 1 banks' Common Equity Tier 1 capital by an average of 41.3%. As a result, the 87 banks involved[8] are expected to have, in aggregate, a €165 billion shortfall to satisfy the base 4.5% required Common Equity Tier 1 ratio, and a €577 billion shortfall to satisfy the 7.0% common equity Tier 1 ratio (which includes the 2.5% capital conservation buffer).

The Group 1 banks' average Liquidity Coverage and Net Stable Funding Ratios (again, based on year-end 2009 data) were 83% and 93%, respectively. Across all banks in the sample (including both Group 1 and Group 2 banks), the results showed a shortfall in liquid assets of €1.73 trillion and a shortfall in stable funding of €2.89 trillion as of the end of 2009.

The Final Report of the Macroeconomic Assessment Group (the "MAG") examines the macroeconomic impact of Basel III's increased bank capital requirements, assuming a transition period of eight years. The MAG estimates that "bringing the global common equity capital ratio to 7% (the minimum common equity capital ratio plus the capital conservation buffer) would result in a maximum decline in GDP, relative to baseline forecasts, of 0.22%" after 35 quarters, and that annual growth

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would be 0.03% below the baseline level during that time.

Implementation of the Basel III Standards

As stated above, the fact that the Basel Committee has completed its work does not mean that banks now have final rules with which they must immediately comply. The Basel III directives are not self-effectuating but, rather, must be adopted by legislation or regulation to be imposed on any particular country's home banks.

In the United States. As to the United States, it is worth remembering that U.S. banking regulators promoted the development of Basel II before proceeding to only partially implement those final rules (compelling only the largest and most internationally active U.S. banks to adopt the Basel II advanced approach). This past September, U.S. bank regulators issued a joint statement specifically stating support for the Basel Committee's efforts "to strengthen the position of large and internationally active banks." That statement, combined with the fact that historically Basel Committee capital directives often have applied more broadly to European banks than U.S. banks, raises a question as to whether, like Basel II, only a subset of the largest U.S. banks will be subject to Basel III. There has been, however, some informal indication by the Federal Reserve that Basel III, at least in some form, will apply more broadly to U.S. depository institutions. The U.S. bank regulators will propose regulations to implement Basel III. The regulations will ulitimately determine the scope of Basel III's applicability in the U.S.

In Europe. As part of the implementation of Basel III into EU law across all 27 EU Member States, the European commission has proposed amendments to the EU Capital Requirements Directive ("CRD IV"). This will be the third amendment to the Capital Requirements Directive in two years, reflecting the fast pace of legislative developments at the EU level as European legislators and regulators try to ensure that the recent financial crisis is not repeated. In order to become law across the 27 Member States of the EU, the EU Commission's proposed amendments will not only have to be agreed by the Council of the EU and the European Parliament but will also have to be implemented into national law by the EU Member States. Of concern as to that effort, in October, the European Parliament raised several issues with a number of elements of the Basel Committee proposals, including that a "'one size fits all approach' could stifle economic recovery." UK banks have historically maintained higher minimum capital ratios than other European banks and are therefore likely to be well placed to ensure compliance with Basel III.

Conclusion

Financial institutions are entering a new era with substantial imbalance between regulatory and market forces. If government action and discourse to date is any guide, financial institutions likely will not be able to prevent this change. However, by remaining actively engaged in the process, they may be able to shift the debate sufficiently to avoid some of the most challenging intended and unintended consequences of the new landscape. The window to influence the discussion, however, may be relatively short. ■

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1. Macroeconomic Assessment Group, "Final Report: Assessing the macroeconomic impact of the transition to stronger capital and liquidity requirements" (Dec. 2010, available at http://www.bis.org/press/p101217.htm.)
2. For example, the FDIC recently published a report asserting that trust preferred securities provided inadequate capital support during the financial crisis. "Trust Preferred Securities and the Capital Strength of Banking Organizations," FDIC Supervisory Insights--Winter 2010.
3. The so-called "Collins Amendment" of the Dodd-Frank Wall Street Reform Act (Section 171), imposes more stringent requirements upon large US banks. These banking institutions will need to deduct certain hybrid instruments, such as trust preferred securities and cumulative perpetual preferred stock, that do not count as capital at the bank level from holding company capital over a three year period beginning in 2013.
4. If a bank's total holdings of "insignificant" investments in financial entities (i.e., holdings of 10% or less of their common stock) constitute in excess of 10% of its Common Equity Tier 1 capital, then (unlike with other capped instruments hereunder) the amount above 10% is not subject to the 250% risk-weighting. Securities held for less than 5 business days in connection with an underwriting also are excluded.
5. Speech of FRB Governor Tarullo, "Next Steps in Financial Regulatory Reform," at the George Washington University Center for Law, Economics, and Finance Conference on the Dodd-Frank Act, Washington, D.C. Nov. 12, 2010.
6. This provision of Dodd-Frank also is problematic for the U.S. bank regulators, as evidenced by the request for approaches they published in response to this statute.
7. See, e.g., "Basel reveals liquidity gap for biggest banks," Financial Times (Dec. 16, 2010), noting that "the liquidity gap, particularly sensitive given the currently malfunctioning interbank markets in the eurozone, is a shock."
8. The QIS notes that "not all banks provided data on all parts of the Basel III framework."

The NAIC's Response to the IMF's Evaluation of U.S. Insurance Regulation

by Michael K. McDonnell and Amit Kataria

During the past year, the NAIC has been actively working on a variety of regulatory reform proposals that may have significant consequences for insurers operating in the United States. The NAIC is coordinating its work on many of its more noteworthy proposals through its "solvency modernization initiative." In the words of the NAIC, the solvency modernization initiative is "a critical self-examination to update the United States' insurance solvency regulation framework and includes a review of international developments regarding insurance supervision, banking supervision, and international accounting standards and their potential use in U.S. insurance regulation." The initiative includes a variety of important reform proposals, including, among others, the proposed adoption of principles-based reserves for U.S. life insurers, possible recalibration of U.S. risk-based capital requirements, and the potential introduction of a new regulatory reporting requirement inspired by the Own Risk and Solvency Assessment, or ORSA, that is part of the Solvency II Framework currently being implemented by the European Union.

In a broad sense, the initiative and its components can be understood as the NAIC's effort to generate a comprehensive response to the recent global financial crisis. The NAIC is keen to demonstrate the continued effectiveness of the state-based regulatory system in the United States, particularly in light of continuing calls by some interested parties to replace the state-based system with an optional federal charter. A special focus, in this regard, is a Financial Sector Assessment Program Report, published (the "FSAP Report") by the International Monetary Fund (the "IMF") in May of 2010, regarding the efficacy of the U.S. system of insurance regulation. Over the past year, the NAIC has used a variety of criticisms contained in this report to help direct its efforts to improve the existing insurance regulatory regime. At recent in-person meetings of the NAIC, for example, the IMF's findings have been discussed in detail, with particular NAIC committees and working groups assigned responsibility for analyzing and potentially generating reform proposals in response to the FSAP Report. Understanding the FSAP Report, therefore, can help shed light on the NAIC's current posture toward reform and likely next steps. To that end, this article provides a brief overview of the FSAP Report, and highlights a few reform proposals that the NAIC has offered to address some of the IMF's findings.

Background on the IMF's Financial Sector Assessment Program

Launched jointly by the IMF and the World Bank in 1999, the IMF's Financial Sector Assessment Program is comprehensive in geographical and topical scope, providing for periodic in-depth evaluations of the effectiveness of banking, securities, insurance and other financial regulators throughout the world. Although the Financial Sector Assessment Program began its life as a voluntary program, the IMF determined this past fall that participating jurisdictions with "systemically important" financial sectors should undergo stability assessments every five years. The U.S., given its size and the interconnectedness of its financial sector, is subject to required stability assessments.

Summary of the FSAP Report Regarding U.S. Insurance Regulation

The May 2010 FSAP Report regarding U.S. insurance regulation was published by the IMF following an assessment of the adequacy of compliance by the U.S. with a set of "core principles" of effective insurance regulation promulgated by the International Association of Insurance Supervisors (the "IAIS"). The IAIS is a multinational, non-governmental organization that represents the principal insurance regulators of some 190 jurisdictions around the world. Although insurance regulation in the United States is primarily the responsibility of the individual fifty states rather than the federal government, the IMF reviewed insurance regulation at a national level. The IMF relied on the model insurance laws and regulations developed by the NAIC as its principal documentary resource, analyzing individual state laws and regulations only selectively.

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In the report, the IMF noted that the U.S. insurance market is the largest in the world and concluded that insurance regulation in the U.S. is "generally thorough and effective." However, the IMF identified certain areas where "significant development" is needed. More specifically, the report graded the observance by U.S. insurance regulators of the 28 core principles of insurance regulation articulated by the IAIS, finding 11 core principles to be "observed," 14 to be "largely observed," and the remaining 3 to be "partly observed." The report included an in-depth discussion of these grading determinations, setting out qualitative evaluations that cover all of the core principles, and as a whole makes for interesting reading for those with an interest in the insurance regulatory system in the U.S.[1]

In some cases, even though the IMF assigned a grading of "observed" or "largely observed," the qualitative evaluations embedded in the report reveal criticisms that have prompted potentially significant proposals for reform at the NAIC. For example, the IMF noted as a failing the general lack of attention by state insurance regulators to issues involving the corporate governance of insurers. Among other things, in this regard, the IMF cited the absence of regulatory power to levy personal fines against insurance company directors and managers. Since publication of the report, and possibly in part as a result of it, the corporate governance working group that is part of the NAIC's solvency modernization initiative has been working actively to develop a set of reform proposals that could, if ultimately agreed and enacted, require a much more active role for state insurance regulators in the oversight of insurance company corporate governance.

The most significant concern highlighted by the IMF in the report was the absence of "group-wide" regulatory supervision in the U.S.

Concerns identified outside of those areas that were graded only as "partly observed" included, among several others, scope for improvement in the disclosure of information to policyholders, excessive prior approval requirements for reinsurance transactions, the absence of clear statements by state regulators and legislatures of the primary objectives of insurance regulation, and the need to update state laws to ensure the protection of information shared with state insurance regulators by international regulators. In the remainder of this article, we will focus our summary on those IAIS core principles that the IMF found to be only "partly observed."

Supervision of Groups

The most significant concern highlighted by the IMF in the report was the absence of "group-wide" regulatory supervision in the U.S., meaning regulatory supervision that focuses on the entirety of insurance organizations rather than the specific legal entities domiciled or licensed in a particular state. The IMF noted, in particular, that at the time of examination, U.S. insurance regulators did not typically make an assessment of the financial condition of the whole company group of which a particular regulated insurance company is a member. This particular finding is perhaps not surprising in the wake of the collapse of AIG, where the unregulated derivatives business housed outside of the U.S.-regulated insurance entities caused significant financial strain for the group as a whole.

In the report, the IMF recommended a collection of reforms to the current regulatory system, including provisions for:

• regular comprehensive assessments of the financial condition of all entities in an insurance holding company system, including from the perspective of the entire group;

• an extension of the state insurance regulatory system of "risk-focused" financial examinations to the entire group;

• the establishment and participation of state insurance regulators in colleges of supervisors, including, for cross-border groups, on an international basis;

• granting additional powers to insurance regulators, including (1) licensing authority over insurance holding companies, (2) group-wide minimum capital requirements, and (3) regulatory authority to require holding companies to take remedial actions at the group level in order to correct regulatory problems.

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Since the publication of the IMF's report, the NAIC has promulgated and adopted a revised version of its model insurance holding company law and regulation. Once enacted into law in a particular state, the revisions to the model law will give that state's insurance regulator additional powers to oversee group-level activities that affect insurers. Among other things, the new model will require the ultimate controlling person of an insurer to file an annual enterprise risk report, will permit state insurance regulators to request filing of consolidated financial statements at the holding company level, and will permit state insurance regulators to participate in supervisory colleges with other regulators in order to share information and cooperate across borders in the oversight of insurance company groups.

Regulatory Independence from Political Influence

In its report, the IMF noted that the U.S. should consider reforms to its regulatory system in order to enhance the independence of state insurance regulators from undue political influence. Among other things, the report noted that the operational independence of an insurance regulator is compromised if a state governor can dismiss the regulator without a public statement of reasons. The IMF noted that in some states, the electoral cycle puts significant pressures on regulators. The IMF also voiced concerns regarding regulatory dependence on fickle state legislatures for budgetary resources.

The report suggested recommended courses of action to address these issues, including, among others, the following:

- amending state laws, where necessary, to provide for fixed terms for state insurance regulators, with dismissal of the regulator being permitted only for prescribed causes and on publication of reasons; and

- changing budgetary mechanisms to make state insurance departments fully self-funding.

> As the NAIC continues to develop and implement its solvency modernization initiative, the IMF's FSAP Report regarding U.S. insurance regulation will likely continue to play a prominent role in the policy debate.

Anti-Money Laundering and Related Regulation

The IMF's report also raised concerns regarding delays in bringing insurance businesses within the scope of anti-money laundering and related regulatory requirements that apply to other financial institutions in the United States. Among other things, the IMF cited limited resources available for oversight of insurance businesses at the U.S. Internal Revenue Service and limited effectiveness in efforts between state and federal regulators to cooperate in the area of anti-money laundering regulation.

In its report, the IMF recommended establishing a timetable for the agreement and implementation of new arrangements between state insurance regulators and federal authorities providing for increased supervision and information exchange.

Conclusion

As the NAIC continues to develop and implement its solvency modernization initiative, the IMF's FSAP Report regarding U.S. insurance regulation will likely continue to play a prominent role in the policy debate. Those with an interest in the outcome of the solvency modernization initiative should consider reading the report in its entirety. Because the IMF's assessments will occur every five years, they may also become an important impetus for critical evaluation and reform of the regulatory system on an ongoing basis. ■

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1. The report can be downloaded at http://www.imf.org/external/pubs/ft/scr/2010/cr10126.pdf.

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requirements, including heightened bank capital requirements and three-year investment holding periods, on private equity acquirors. Similar requirements are not imposed on strategic buyers. Moreover, the FDIC has published two sets of Q&As since the Failed Bank Policy Statement (all available at http://fdic.gov/regulations/laws/faqfbqual.html), which have not eased the burdens for these investments.

In addition, a number of private equity bidders perceive themselves at a disadvantage to strategic bidders in the failed bank market, believing that if a fully qualified consortium of private equity buyers and a strategic buyer are bidding on the same failed bank, the FDIC will likely favor the strategic buyer. Given the substantial cost, effort and urgency involved in these bids, the prospect – and in some cases the experience – of consistently losing auctions has discouraged some private equity firms. Despite these perceptions, though, it should be noted that private equity firms have had greater success more recently and may be expected to win a larger percentage of these bids in 2011, as failed banks continue to be located within a limited range of states (approximately 60% of all recent failures have occurred in Florida, Georgia, Illinois, California or Washington) and strategic buyers seem to be showing declining interest in seeking market share via acquisitions of failed community banks in these markets.

Moreover, as bidders for failed banks have increased, the attractiveness of failed bank acquisitions has decreased: bids have become higher and FDIC protections have decreased. Until this past spring, for example, winning bids for failed banks rarely had a deposit premium, and FDIC loss-sharing agreements almost invariably were set at the 80%/95% levels described above. However, starting with TD Bank's acquisition of three failed banks in Florida in April, including $3.4 billion asset Riverside National Bank, leverage has increasingly shifted to the FDIC, with TD Bank agreeing to assume 50% of the losses on the assets as part of its winning bid. While most winning bids since that deal have maintained an 80% initial FDIC loss protection, 95% protection for greater losses generally is no longer available. Moreover, winning bidders are more often paying premiums for deposits of the failed institutions.

Live Bank Market

While failed bank deals will undoubtedly remain in the bank merger headlines during 2011, acquisitions of "live," often distressed, community banks should be the focus of bank M&A activity. Indeed, even in 2010 almost 90% of all (i.e., live and failed) bank deals involved targets with assets of less than $1 billion. Given the need for large banks to increase capital over the coming years in light of the Dodd-Frank Wall Street Reform legislation of last year and Basel Committee proposals to be implemented in 2013, among other things, community banks are likely to be the predominant merger parties in 2011.

In addition to the lessened attractiveness of failed banks deals noted above, several supply side factors can be expected to drive significant acquisitions of live community banks in 2011. Community banks generally are struggling to find areas to generate returns. Loan demand is not significant given the continued lull in the markets that have been the historical focus of much community bank lending activity, the commercial real estate and construction markets. Indeed, the *Financial Times* recently reported that over half of the $1.5 trillion commercial real estate loans coming due over the next four years have mortgages in excess of property values and community banks hold the lion's share of property loans. Because community banks also tend to have fewer fee generating operations than larger institutions, this inability to deploy capital has had an increasingly adverse impact on income statements. The poor asset quality and weak growth prospects in turn make it very difficult for many of these banks to raise capital.

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Moreover, Dodd-Frank, while focusing on the "too big to fail" banks, will also adversely affect community banks. Trust preferred securities have been eliminated as a source of new Tier 1 capital. The new Consumer Financial Protection Bureau is expected to make residential and consumer loans more costly to originate. The sheer compliance requirements of Dodd-Frank and its anticipated 5,000 pages of regulations will place significant

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demands on their limited compliance staffs. Finally, at a personal level, directors and management of distressed banks are increasingly realizing the risks presented by a bank failure. The FDIC recently announced 50 criminal investigations of former employees and directors at failed US banks, and the filing of lawsuits against more than 100 of the same to recover approximately $2.5 billion. Both numbers are expected to increase.

These factors have led a number of private equity firms across the country over the past year to focus on acquiring and/or recapitalizing distressed live community banks. For example, in the Northeast, Lazares & Company completed the acquisition of $235 million of the assets of Domestic Bank, and FHB Formation LLC acquired 60 percent of the stock of $612 million Northwest Bancorp. On the West Coast, Grandpoint Capital first acquired $25 million Santa Ana Bank and then acquired $336 million First Commerce Bancorp at year-end. Bay Cities National Bank was recapitalized with $460 million. In the Midwest, Texas-based Carlile Bancshares raised $325 million and entered into deals with $120 million Treaty Oak Bancorp and $32 million Community State Bank. More recently, Cascade Bancorp, a Northwest bank, received a $177 million private equity recapitalization. Moreover, in a new structure designed to avoid the historical impediment to private equity investment posed by a distressed bank having a holding company with trust preferred securities outstanding, a group of private equity investors recently utilized a bankruptcy proceeding to acquire AmericanWest bank.

The pricing of live community bank deals depends in large part on the health of the bank and the desirability of its marketplace. With distressed live banks, deals can still be priced around, or even at a discount to, book. In the Northeast, where community banks generally have been healthier, the American Banker has reported deals occurring at premiums (125%–165%) to book. The current buyer's market is driven, in part, by the recognition that target prices are likely to increase in 2011.

Structuring the Deals

Investors must be cognizant of the significant regulatory hurdles that accompany any failed or live bank initiative. While larger investments, up to 24.9%, allow benefits such as warrants, reimbursement of fees and expenses and board representation, the burdens of such a voting stock investment also are more significant. A less than 5% investment generally avoids regulatory burdens. A 5% to 9.9% investment will subject an investor to the Failed Bank Policy Statement. Above 9.9%, the investor often also is subject to the federal Change in Bank Control Act, which imposes materially higher disclosure requirements on the investor (including biographical and financial reports, and fingerprint cards). Because the general focus of the banking laws is acquisition of voting stock, an investor wanting somewhat greater economics while maintaining more modest bank regulatory burdens often may be able to bridge the difference by acquiring non-voting stock. Care also must be taken to ensure investors are not deemed to be "acting in concert", which can result in the holdings of separate investors being aggregated for purposes of these thresholds.

In addition to the investment structure, regulators also focus intensively on the business plan of the target bank. The regulators prefer a business plan that demonstrates that the target community bank (whether live or failed) has retained its fundamental character as a community bank, and offers products and services typical for such a bank. As to overall asset growth, the regulators are focused on ensuring that organic growth occurs consistent with the market in which the bank resides, resulting in reasonably slow growth, particularly if the target is under any type of regulatory order. Greater growth can occur through live or failed community bank acquisitions, as those are generally deemed to be less risky market extensions. In all events, the regulators wish to see the targets populated to a significant extent at the board and management levels by seasoned bankers with community bank experience.

Despite these regulatory hurdles – which show no sign of moderating in the near future – both demand and supply side factors can be expected to continue to present private equity investors with significant bank acquisition opportunities. While failed bank deals are by no means going away, we expect an increasing focus of this activity in 2011 will be in the live community bank market. ■

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