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Clients&FriendsMemo

The FDIC's Statement of Policy on Qualifications for Failed Bank Acquisitions

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The Board Of Directors of the Federal Deposit Insurance Corporation ("**FDIC**") has adopted its final Statement of Policy on Qualifications for Failed Bank Acquisitions (the "**Acquisition Policy Statement**") by a 4-1 vote.[1] As adopted, the Acquisition Policy Statement applies to investments by "**private capital investors**," which term appears to be the FDIC's name for private equity funds ("**PEFs**"), albeit the scope of application of the Acquisition Policy Statement remains unclear (as discussed in Section II of this memorandum) and will afford the regulators considerable discretion in its application.[2]

While the Acquisition Policy Statement is not as burdensome to PEFs as would have been the case under the Proposed Guidelines,[3] as discussed in our prior Memorandum of July 15, 2009,[4] it nonetheless imposes burdens on PEFs that will not apply to other investors in banks or thrifts. Accordingly, PEFs should give substantial consideration to structuring an acquisition in a manner that avoids application of the Acquisition Policy Statement. It appears to be possible to

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1 *See Final Statement of Policy on Qualifications for Failed Bank Acquisitions*, available at http://www.fdic.gov/news/board/Aug26no2.pdf. The Acquisition Policy Statement was approved on August 26, 2009.

2 Ordinarily, when a bank fails, the FDIC tries to sell its assets and deposit liabilities – these transactions are generally referred to as "Purchase and Assumption," or "P & A" transactions by the FDIC. *See, e.g.,* Purchase and Assumption Agreement, Whole Bank, Among FDIC, Receiver of Washington Mutual Bank, Henderson, NV, FDIC, and JPMorgan Chase Bank, N.A. (September 25, 2009), *available at* http://www.fdic.gov/about/freedom/Washington_Mutual_P_and_A.pdf. To acquire deposit liabilities, a buyer needs to have a bank or thrift charter authorizing it to take deposits. For those deposits to be insured by the FDIC, the buyer either must be itself a bank or thrift with FDIC insurance or it must apply to the FDIC for deposit insurance. If a parent company will "control" the bank or thrift taking the deposits, the controlling company must receive prior approval from the Board of Governors of the Federal Reserve System (as to a bank) or the Office of Thrift Supervision (as to a thrift). Any non-company (such as an individual) acquiring "control" of a bank or thrift requires the prior approval of the primary federal regulator of the bank or thrift.

3 *See Proposed Statement of Policy on Qualifications for Failed Bank Acquisitions* 74 Fed. Reg. 32932 (July 9, 2009); FDIC Board Approves Proposed Policy Statement on Qualifications for Failed Bank Acquisitions, PR-112-2009 (July 2, 2009), *available at* http://www.fdic.gov/news/news/press/2009/pr09112.html.

4 Our previous Memorandum on Private Equity Investments in Troubled Banks is available at http://www.cadwalader.com/assets/client_friend/071409PEInvestmentsInTroubledBanks.pdf.

avoid application of the policy if a private capital investor partners with an established bank or thrift that has (i) a "strong majority" interest" in the acquisition transaction, and (ii) a "successful history" operating insured depository institutions (which we shall term the "**Experienced Partner Exemption**"). It will be desirable to consult early in acquisition planning with the FDIC and other bank regulators to determine whether the private capital investor will be able to benefit from the Experienced Partner Exemption.

I. Background to the Acquisition Policy Statement: Competing Considerations

The Acquisition Policy Statement was adopted against a background of increasing numbers of banks failures eroding the FDIC's Deposit Insurance Fund ("**DIF**"). As of August 31, 84 banks have failed this year. The DIF has shrunk by 75% from its level in January 2009. In addition, the FDIC is about to collect a special assessment from banks to replenish the DIF, and is already discussing the need for a second special assessment. Thus, on the one hand, the regulators would clearly like to bring new capital into the banking industry; on the other hand, it appears that new capital will not be treated equally with old capital.

During pre-vote consideration of the Acquisition Policy Statement, the FDIC Vice Chairman stated rather bluntly, "we need to attract bidders [for failed banks]" while FDIC Chairman Bair appeared comfortable that PEFs would be willing to bid on failed banks in light of the revisions made to the Proposed Guidelines by the Acquisition Policy Statement. The Acting Director of the Office of Thrift Supervision ("**OTS**"), the only Board member who voted against adoption,[5] stated bluntly, prior to the vote, that the Acquisition Policy Statement essentially singled out non-bank investors as *persona non-grata* in the banking industry without adequate justification or inquiry.[6]

Chairman Bair noted that PEF buyers lacked "a buyer's balance sheet" and suggested that their opacity could put the FDIC at significant risk, especially in light of FDIC loss-sharing arrangements

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5 The Director of OTS, along with the Comptroller of the Currency, who directs the Office of the Comptroller of the Currency ("**OCC**"), sit on the Board of Directors of the FDIC alongside the FDIC Chairman, FDIC Vice Chairman, and FDIC Director. *See generally*, 12 U.S.C. § 1812(a).

6 When disposing of assets in a receivership, the FDIC generally is required to: (i) maximize the net present value obtained in a sale of receivership assets; (ii) minimize the overall loss the pool of receivership assets experiences; (iii) *treat those bidding for receivership assets fairly*; (iv) prevent discrimination against bidders; and (v) maximize the availability of low/middle income housing. The FDIC also must observe certain procedural guidelines that seek to minimize the adverse impact the FDIC's actions may have on individuals or other financial institutions in the community of the failed institution. 12 U.S.C. § 1821(d)(13)(E). It is interesting to consider whether the Acquisition Policy Statement has the effect of violating the FDIC's statutory obligation to "ensure adequate competition and fair and consistent treatment of [bidders]."

See also Section IV.H of this memorandum as to whether certain other aspects of the Acquisition Policy Statement might be in conflict with existing FDIC policy.

with certain buyers.[7] She also asserted that PEFs were notorious for a short-term mindset with respect to their investments, and that such an approach might have an adverse long-term impact on the prospects of the target institution and the banking industry generally. In any event, the general view expressed by those voting in favor of the Acquisition Policy Statement was that the FDIC had struck a proper balance among competing public interests.

II. The Acquisition Policy Statement: Scope and Applicability

The Acquisition Policy Statement technically applies to:

> (a) private investors in a company, including any company acquired to facilitate bidding on failed banks or thrifts that is proposing to, directly or indirectly, (including through a shelf charter) assume deposit liabilities, or such liabilities and assets, from the resolution of a failed insured depository institution; and
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> (b) applicants for insurance in the case of de novo charters issued in connection with the resolution of failed insured depository institutions (hereinafter "Investors"). This covers investors in a company acquired to facilitate bidding and, of course, applies to investors in firms using a shelf charter to acquire liabilities of a failed bank or thrift.

Despite comments requesting greater precision in the definition of "private capital investor," the FDIC left the definition vague, giving the agency greater scope of authority to determine the definition by interpretation. The Acquisition Policy Statement indicates that, "the requirements it imposes on investors only apply to investors that agree to its terms," which would seem to suggest that in practice the application of the Acquisition Policy Statement will be open to discussion on a case-by-case basis with potential investors. Nevertheless, the FDIC may have the view that any "private capital investor" that voluntarily bids on a failed bank or thrift after adoption of the Acquisition Policy Statement is implicitly agreeing to be bound by the terms of the policy.

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[7] Loss sharing is a means for the FDIC essentially to delay payment of the "sweetener" that induces an acquiring institution to take over the failed institution. Loss sharing has been structured variously as: (i) a "put" option permitting the acquirer to return riskier assets to the FDIC within a specified timeframe; and (ii) arrangements whereby the FDIC absorbs a portion of losses on specified pools of assets. *See generally* MANAGING THE CRISIS: THE FDIC AND RTC EXPERIENCE Ch. 7 (FDIC 1997), *available at* http://www.fdic.gov/bank/historical/managing/history1-07.pdf.

A. Club Deals

While the clear intent of the Acquisition Policy Statement is to reach PEFs, its terms apply to "private capital investors," which is broad enough to cover so-called "club deals" in which no single PEF "controls" the bank or thrift.[8]

B. Experienced Partner Exemption

The Acquisition Policy Statement would **not apply** to new investors partnering with existing banks or thrifts that have a "strong majority interest" in the acquired bank or thrift and a history of successful operation. The regulatory concern embodied in the Acquisition Policy Statement is clearly with new entrants to the banking industry. Indeed, the Vice Chairman of the FDIC expressly suggested that PEFs should partner with existing banks and thrifts, and the Acquisition Policy Statement expressly states that "[s]uch partnerships are strongly encouraged." However, the Acquisition Policy Statement is ambiguous as to whether, for instance, a PEF minority investment paired with an existing investor that had a 51% majority interest would be subject to the Acquisition Policy Statement.

One also has to ask whether a "private capital investor" in a bank that acquires a failed bank would be caught up in the Acquisition Policy Statement literally as a "private investor in a company proposing to assume liabilities" of a failed bank or whether that investor is exempt as being deemed to have partnered with the bank in which it has invested. It is conceivable that the answer might even turn on whether the acquiring bank in which the investor took a direct interest has an established record for successful operation or has itself had problems.

C. Small Investments

In order to exclude *de minimis* investments from its scope, the Acquisition Policy Statement, by its terms, does not apply to investors with five percent or less of the total "voting power" of the acquired bank or thrift or holding company provided there is no evidence of concerted action. That said, the Acquisition Policy Statement does not set forth what constitutes evidence of concerted action, and leaves uncertainty as to whether the mere existence of an organizer who solicits several less-than-five percent investors would be sufficient to give rise to "concerted action" and loss of the *de minimis* exemption.

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[8] The FDIC is still uncomfortable with PEF bidders, as it continues to express concern with the "relatively new phenomenon of private capital funds joining together to purchase the assets and liabilities of failed banks and thrifts where the investors all are less than 24.9 percent owners but supply almost all of the capital to capitalize the new depository institution."

D. Duration of Requirements

An acquirer subject to the Acquisition Policy Statement may apply, after seven years, to be released from the requirements of the policy if the bank it has acquired has continuously maintained a CAMELS 1 or 2 rating.[9] It would seem unlikely, however, that the successor to a failed bank or thrift would on the acquisition date be awarded the highest ratings immediately (and then could sustain that rating for seven years).[10] In a more likely scenario, it would take some time for the acquired bank to achieve the rating, meaning that the Acquisition Policy Statement could apply to an acquisition for materially longer than seven years after the acquisition date.

III. The Proposed Guidelines Moderated in the Acquisition Policy Statement

The Proposed Guidelines would have imposed eight basic requirements on a PEF buying a failed bank, including the source of strength commitment to maintain the bank's capital levels.[11] These requirements would likely have very materially discouraged investment by PEFs into the banking system. Three aspects of the Proposed Guidelines received the greatest attention from commenters: the heightened capital requirement, the source of strength commitment, and the cross-guarantee provision. These three requirements have been moderated somewhat in the Acquisition Policy Statement, primarily due to the reasons outlined below.

A. Capital

The Proposed Guidelines included a requirement that a failed bank acquired by a PEF maintain a 15% Tier 1 leverage ratio.[12] That would have been triple the high-end range for well-capitalized banks and double the industry average. It would have put such a bank at a competitive disadvantage, reduced returns, and, some argue, encouraged risk-taking.

Historically, the FDIC has treated the acquisition of a failed bank or thrift as the creation of a *de novo* institution – that is, it is as if the bidder acquiring the failed bank was applying to the FDIC to open a new bank. As the FDIC has indicated, *de novo* banks have a higher risk profile than

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9 CAMELS ratings are the confidential composite ratings given by regulators to a bank after they have examined the bank's capital, asset quality, management, earnings, liquidity, and sensitivity to market risk, on a 1 to 5 scale, 1 being highest.

10 See our comment in footnote 13 below regarding the extent to which *de novo* banks are subject to more frequent examination than seasoned banks and required to maintain heightened capital levels.

11 These eight requirements are discussed in greater detail in our earlier memo on Private Equity Investments in Troubled Banks. *See supra* note 4.

12 A leverage ratio requires an amount to be held as a simple flat percentage of a bank's total assets, whereas the common equity ratio is a percentage of risk-based assets. Requiring a high leverage ratio effectively penalizes banks holding large amounts of relatively riskless liquid assets, such as cash or Treasuries.

established banks and are overrepresented on the list of banks that have failed, often exhibiting inadequate controls and risk management. Accordingly, the FDIC is of the view that heightened capital levels at such "new" institutions are warranted.[13]

B. Source Of Strength

The Proposed Guidelines would have required a "private capital investor" to serve as a source of financial and managerial strength to the acquired bank and to require holding companies in which a "private capital investor" had invested to sell equity or issue debt that qualified as capital. This vague requirement could have imposed unlimited liability on a "private capital investor" and made it difficult for it to raise funds. It is instructive to note that a PEF's organizational documents often limit the extent to which the PEF may provide capital support or make follow-on investments in its portfolio companies – thus it often would not have been possible for the PEF to comply with any source of strength requirement. The source of strength commitment has been eliminated from the Acquisition Policy Statement.

C. Cross-Guarantee

The Proposed Guidelines also would have required a PEF that has majority interests in more than one bank or thrift to pledge to the FDIC its interest in each bank or thrift to guarantee the FDIC against loss caused by the failure of any such bank or thrift. This would have imposed a risk that most PEF investors would have declined to accept. The cross-guarantee provision has been reduced in scope to a cross-support provision, as described in Section IV.C below.

IV. Specific Requirements of PEFs in the Acquisition Policy Statement

A. Capital

The Acquisition Policy Statement requires a Tier 1 common equity[14] ratio of ten percent for the first three years with a requirement thereafter that the bank remain well capitalized.[15] However, the

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[13] The FDIC has recently issued new guidance that extends from three years to seven years the "*de novo* period" during which a newly chartered banking institution must maintain heightened capital levels. *See Enhanced Supervisory Procedures for Newly Insured FDIC- Supervised Institutions* FIL-50-2009 (August 28, 2009), *available at* http://www.fdic.gov/news/news/financial/2009/fil09050.html.

[14] Tier 1 common equity is Tier 1 capital minus perpetual preferred stock, minority interests, and certain restricted core capital elements. *See* 12 C.F.R. § 325.2(v).

[15] The term "well capitalized" is defined at 12 C.F.R. § 325.103(b)(1) to mean having (1) a total risk-based capital ratio of ten percent (10%) or more, (2) a Tier 1 risk-based capital ratio of six percent (6%) or more, (3) a leverage ratio of five percent (5%) or more, and (4) no capital directive from the regulators. The remaining four capitalization categories are: adequately capitalized; undercapitalized; significantly undercapitalized; and critically undercapitalized. 12 U.S.C. § 1831o(b).

FDIC retains the flexibility to impose a higher capital requirement on a case by base basis depending on the business plan and experience of the acquirer. As in the Proposed Guidelines, a failure to maintain the heightened capital levels required under the Acquisition Policy Statement would require the FDIC to treat the institution as "undercapitalized" for purposes of Prompt Corrective Action ("**PCA**").[16]

B. Source Of Strength

As indicated, the Acquisition Policy Statement drops the source of strength commitment.

C. Cross-Support

The cross-support provision of the Acquisition Policy Statement only applies if the "private capital investor" owns eighty percent or more of multiple banks or thrifts. Where such common ownership is present, the "private capital investor" must pledge to the FDIC its interest in the shares of commonly owned institutions as security against any losses the FDIC might suffer as a result of the failure of any of the commonly-controlled institutions.[17]

D. Transactions with Affiliates

Extensions of credit[18] by the bank to its investors and to "affiliates"[19] of those investors would be prohibited.[20] "Private capital investors" must regularly report to the bank the identity of all such affiliates to enable the bank or thrift to identify those affiliates and avoid extensions of credit to them.

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[16] 12 U.S.C. § 1831o(b); 12 C.F.R. § 325.103. *See supra* note 4. The Federal Deposit Insurance Corporation Improvement Act of 1991 ("**FDICIA**"), Pub. L. No. 102-242, 105 Stat. 2236, mandated that banking regulators take "prompt corrective action" when an institution's capitalization rating falls below the top two capitalization categories. PCA may include an increase in the monitoring of the institution, requiring the institution to raise more capital, requiring the institution to merge with a more highly capitalized institution, or closure of the institution. The PCA provisions are intended to bring about the resolution of a depository institution at the lowest possible overall cost to the DIF.

[17] The cross-support requirement derives from the FDIC's authority to assess commonly controlled insured financial institutions for a failure within the group. 12 U.S.C. § 1815(c)(5). Such assessments are intended to recover from affiliated institutions the cost to the DIF of the failure of an affiliated bank. This authority is meant to deter a bank from shifting assets among affiliates in anticipation of the failure of an institution within a single group. Ironically, the FDIC's exercise of cross-guaranty authority has in the past itself caused the failure of banks – e.g., Southeast Bank of West Florida, a sister bank of Southeast Bank, N.A. (closed on September 19, 1991), was assessed for the failure of Southeast Bank, N.A., and thereafter failed.

[18] The term "extension of credit" is defined as in Federal Reserve Regulation W, 12 C.F.R. 223.3(o).

[19] While affiliate transaction statutes and regulations to which most banks are subject define the term "affiliate" to mean 25% or more ownership of a class of voting securities, the Final Policy Statement defines "affiliate" to include any firm in which the investor directly or indirectly owns 10% of the equity and has maintained that ownership for at least 30 days.

E. "Silo" Structures

The Acquisition Policy Statement indicates that the FDIC would not approve ownership structures in which a "private capital investor" (or its sponsor) establishes multiple investment vehicles funded and apparently controlled by the "private capital investors" (or their sponsors) to acquire a bank or thrift. Apparently, the FDIC considers such structures to be evasions of bank holding company laws and regulations and is concerned that they separate ownership from control.

F. Secrecy Law Jurisdictions

Generally, "private capital investors" from "secrecy law jurisdictions" are not permitted to bid for a failed bank. A "secrecy law jurisdiction" is one that, *inter alia*, precludes U.S. bank regulators (i) from garnering sufficient information to ensure compliance with U.S. laws or (ii) from obtaining information on the competence, experience, and financial condition of the investors and related parties.[21] A country that permits off shore entities to operate shell companies would also be considered a "secrecy law jurisdiction." This could affect a PEF with a large base of non-U.S. investors. An exception is provided for the case of an investor from a secrecy law jurisdiction that is a subsidiary of a company that is subject to comprehensive consolidated supervision recognized by the Federal Reserve Board that consents to a number of promises of cooperation.

G. Continuity of Ownership

Ownership in the failed bank must be maintained for three years, as in the Proposed Guidelines. A new exception in the Acquisition Policy Statement permits the "private capital investor" to sell its interest in the acquired institution before the end of the three year commitment period where the "private capital investor" is a mutual fund.[22] The three year requirement would seem to bar acquiring a failed bank, turning it around, and taking it public to raise capital within three years.

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[20] Conventional restrictions on transactions between banks and their affiliates do not completely prohibit such transactions, but rather limit them, impose special collateral requirements, and require them to be on non-preferential terms and conditions.

[21] The Acquisition Policy Statement defines a "secrecy law jurisdiction" as a "country that applies a bank secrecy law that limits U.S. bank regulators from determining compliance with U.S. laws or prevents them from obtaining information on the competence, experience and financial condition of applicants and related parties, lacks authorization for exchange of information with U.S. regulatory authorities, does not provide for a minimum standard of transparency for financial activities, or permits off shore companies to operate shell companies without substantial activities within the host country."

[22] The carve out of an exception for mutual funds is a clear acknowledgement of the broad scope of the definition of "private capital investor." The mutual fund carve-out is available to open-ended investment companies registered under the Investment Company Act of 1940 that issue redeemable securities that allow investors to redeem on demand.

H. Special Owner Bid Limitation

Investors that directly or indirectly own ten percent or more of a failed bank or thrift would not be allowed to bid on the assets or liabilities of that bank or thrift, even if such investors were not at fault for the bank's failure. Ironically, the FDIC has a statutory duty to pursue the "least cost resolution" of a failed bank or thrift, and it is conceivable that this aspect of the policy could, at least in a rare case, place the FDIC in violation of that statutory duty.[23] Also ironically, a manager that caused a bank to fail would not be precluded by the Acquisition Policy Statement from bidding if he or she owned less than ten percent of the bank.[24]

I. Disclosures

"Private capital investors," and their investors as well, would be required to disclose information to the FDIC as the FDIC deems necessary. Such information would include information about the size of the capital funds, diversification, return profile, marketing documents, management team, and business model. Such disclosures would remain confidential.

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Please feel free to contact any of the following if you have any questions about this Memorandum:

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[23] 12 U.S.C. § 1823(c)(4); 12 C.F.R. 360.1. FDICIA amended the Federal Deposit Insurance Act ("**FDIA**"), Pub. L. No. 81-797, 64 Stat. 873, to require least cost resolution. The only exception to the "least cost resolution" requirement is where a systemic risk to the financial system exists. 12 U.S.C. § 1821(c)(4)(G). Of course, it would be a stretch for the FDIC to argue that permitting PEF entry into the banking industry would cause a "systemic risk," and thus that excluding PEFs from bidding on failed institutions is justifiable regardless of the increased cost to the DIF.

[24] *Cf.* 12 U.S.C. § 1823(k)(5), which prohibits the FDIC from providing assistance to a failing depository institution when management of the institution (i) has failed to manage the institution in compliance with rules and regulations and (ii) has engaged in certain abusive practices with respect to the institution.