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Distressed Debt

FDIC Issues Final Statement on Private Equity Investments in Failed Banks or Thrifts

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The Federal Deposit Insurance Corporation (FDIC) has recently faced the daunting task of salvaging an ever-increasing number of failed depository institutions. Indeed, 45 insured institution closings occurred in the first two quarters of 2009, nearly double the total for all of 2008. Concomitantly, the FDIC recognized the increased interest from private equity capital in acquiring or investing in the assets and assuming the deposit liabilities of failed depository-insured banks or thrift institutions. In response, on August 26, 2009, the FDIC released a Final Statement of Policy on Qualifications for Failed Bank Acquisitions (the Final Statement) to provide guidance to these interested private capital investors.

The Final Statement offers guidance to private investors, including hedge funds, on the terms and conditions the FDIC will require to obtain bidding eligibility of a failed bank. It does not establish civil or criminal penalties, but rather offers guidance to investors that agree to its terms. The FDIC issued the statement to attract private investment capital for the purpose of purchasing deposit liabilities, or both the liabilities and assets of a failed insured depository institution. The Final Statement reflects changes made in response to public comments on the Proposed Statement of Policy on Qualifications for Failed Bank Acquisitions released by the FDIC on July 2, 2009 (the Proposed Statement). This article summarizes both the terms of the Final Statement and the key differences between the Final Statement and the Proposed Statement.

The Final Statement vs. The Proposed Statement

The Final Statement retains many of the provisions contained in the Proposed Statement. It does, however, make significant changes to the coverage, capital commitment, and cross-guarantee standards, along with other minor changes.

Coverage

The FDIC clarified the definition of the types of investors its Final Policy Statement covers. The Final Statement applies prospectively from August 26, 2009, forward to private investors that make FDIC-assisted acquisitions of failed banks as well as to applicants for insurance in the case of de novo charters issued in connection with the resolution of failed banks (hereinafter Investors). If an acquired bank maintains a Camels 1 or 2 rating continuously for seven years, its Investors may apply to the FDIC to request discharge from the provisions of the Final Statement. The Final Statement also provides certain exemptions. It does not apply to Investors

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in partnerships or similar ventures with bank or thrift holding companies (excluding shell holding companies) where the bank or holding companies have a "strong majority interest" in the acquired bank and an established record for successful operation of insured banks. The Final Statement also does not apply to Investors who individually acquire five percent or less of the total voting power of a failed bank or its holding company; provided, however, that there is no evidence of concerted action by these Investors.

Capital Commitment

Critics strongly condemned a provision of the Proposed Statement which required private equity investors to provide an initial capitalization of a failed depository institution at a minimum 15 percent Tier 1 leverage ratio for a period of three years, that the FDIC could subject to possible extension. The provision would have had the effect of creating a separate, more stringent set of capital standards for depository institutions with private equity ownership that acquire failed banks in FDIC receivership. The 15 percent Tier 1 leverage ratio requirement would have been almost double the 8 percent level imposed by the FDIC in granting deposit insurance for de novo institutions, three times greater than the level required for a "well capitalized" existing depository institution, and nearly four times greater than the minimum level generally required of most depository institutions on an ongoing basis. Recognizing this burden, the FDIC specifically requested comment as to whether this level of initial capital would "mak[e] investments in the assets and liabilities of failed banks and thrifts uncompetitive and uneconomic."

The Final Statement reduced the Tier 1 capital leverage ratio from a 15 percent Tier 1 leverage ratio to a 10 percent Tier 1 common equity to total assets ratio for the first three years following acquisition. However, this would only apply to common equity – preferred stock and other forms of non-common stock of Tier 1 capital would not count for purposes of meeting this requirement. (Tier 1 common equity includes Tier 1 capital minus non-common equity elements. Non-common equity elements include qualifying perpetual preferred stock, plus minority interests and restricted core capital elements not already included.) After the first three years, banks must continue to operate at a "well capitalized" level for the remaining period of ownership by the Investors. ("Well-capitalized" is currently defined in 12 C.F.R. § 325.103(b)(1) as requiring minimum ratios of 6 percent Tier 1 capital and 10 percent Tier 1 and 2 capital to total risk-based assets and a leverage ratio of 5 percent Tier 1 capital to total assets.) If the bank fails to meet these standards, the FDIC may take immediate corrective action (referred to as Prompt Corrective Action) to restore the institution to the 10 percent Tier 1 common equity to total assets ratio or the "well capitalized" standard. Once subject to Prompt Corrective Action, the FDIC can require the bank to take various steps, such as selling securities or prohibiting the payment of subordinated debt, to restore the bank to a "well capitalized" level. The Final Statement also eliminated the provision in the Proposed Statement that would have allowed the FDIC to extend the capital commitment requirement beyond the first three years from the time of the acquisition.

Cross-Guarantee

In the Proposed Statement, private equity investors that individually or collectively purchase a majority interest in two or more insured depository institutions had to pledge "proportionate interests" in each institution to repay the FDIC for losses from either institution. The Final

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Statement reduces the number of circumstances in which this "cross-support" requirement would apply. It requires a cross-support obligation only when a group of common investors own at least 80 percent of two or more depository institutions. The FDIC stated it may waive this cross-support obligation if enforcing the obligation would not reduce the cost of the bank or thrift failure to the Deposit Insurance Fund (DIF). Notably, the FDIC does not address whether and under what terms the FDIC may dispose of the pledged stock of a healthy financial institution as a result of the FDIC exercising the cross-guarantee.

Source of Strength

According to the Proposed Statement, private equity firms had to provide a "source of strength," or financial backstop if a bank, after its acquisition, fails again. (The term "source of strength" came from a Federal Reserve Board policy applicable to its supervision of and regulation of bank holding companies, which requires a bank holding company to serve as a source of "financial and managerial strength" to its subsidiary banks. The Federal Reserve Board expects that a bank holding company, in serving as a source of strength to its subsidiary banks, would stand ready to use available resources to provide adequate capital funds to its subsidiary banks during periods of financial stress or adversity and maintain the financial flexibility and capital-raising capacity to obtain additional resources for assisting its subsidiary banks.) Critics argued that this requirement would have required Investors to put up more capital if their banks faltered. As a result, the Final Statement removed this "source of strength" requirement in an effort to make it easier for failing institutions to attract private equity buyers.

Restricting Transactions With Affiliates

The Final Statement maintained the original restrictions on affiliate transactions in the Proposed Statement. It prohibits "all extensions of credit to Investors, their investment funds if any, any affiliates and any portfolio companies (i.e., companies in which the Investors or affiliates invest) by an insured depository institution acquired or controlled by such Investors under this policy statement." The Final Statement only modifies the definition of "affiliate" to mean "any company in which the Investor owns, directly or indirectly, at least 10 percent of the equity of such company and has maintained such ownership for at least 30 days." This change makes compliance easier and demonstrates the FDIC's recognition that very short term investments in a failing bank do not provide a reason for limiting the investors' ability to obtain extensions of credit. The Final Statement also requires Investors to provide regular reports to the bank identifying all affiliates.

Silo Structures

Notwithstanding strong criticism against the policy, the Final Statement continues to prohibit bids to acquire ownership of an insured depository institution by ownership structures that involve a private equity firm (or its sponsor) using multiple investment vehicles funded and apparently controlled by the private equity firm (or its sponsor). Hence, just as in the Proposed Statement, investment vehicles featuring "silo" structures remain ineligible to acquire failed banks. Neither the Proposed nor the Final Statement define the term "silo structure." However, in connection with private equity investments in depository institutions, the term "silo structure" commonly refers to an acquisition structure designed to allow an investing private

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equity organization to make a controlling investment in the institution without becoming (and without the private equity organization's other funds and their portfolio investments becoming) subject to the nonbanking prohibitions and other regulatory restrictions and requirements of the Bank Holding Company Act. (Typically, in this type of structure, the private equity organization creates a mirror fund with its own new general partner that would acquire up to 100 percent of the voting equity of a depository institution or its holding company.) The FDIC specifically indicated its concern that these "silo" structures would artificially separate the non-financial activities of the firm from its banking activities to keep the private equity from regulatory oversight.

Special Owner Bidding Limitations

The Final Statement did not change its original proposed guideline prohibiting private equity investors who directly or indirectly hold 10 percent or more of a failed bank's total equity from bidding on and taking over that bank's deposit liabilities or both its liabilities and assets. This provision avoids the natural incentive Investors may have to take advantage of any loss sharing arrangements that might be entered into by the FDIC as part of the resolution of the failed institution.

Secrecy Law Jurisdictions

The Final Statement maintains the prohibition on bidding by private equity investors with ownership structures domiciled in "bank secrecy jurisdictions." It clarifies the definition of a "bank secrecy jurisdiction" to include "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, or does not provide for a minimum standard of transparency for financial activities."

Continuity of Ownership

The Final Statement kept the Proposed Statement's requirement that Investors hold their investment for at least three years. (This three-year policy is apparently based on the requirement commonly contained in FDIC Deposit Insurance Orders for de novo depository institutions to obtain prior FDIC approval to make a change in their business plan during their first three years of operations.) The Final Statement does authorize, however, transfers to affiliates, provided the affiliate agrees to the terms applicable to the transferring Investor. Moreover, the Final Statement clarifies that the three-year holding period does not apply to open-end investment companies registered under the Investment Company Act of 1940.

Additional Disclosures

The Final Statement retains the Proposed Statement's requirement that Investors provide additional disclosure of their financials, investors and business plans, even when purchasing a non-controlling interest. However, unlike the Proposed Statement, the Final Statement provides that the FDIC will treat confidential business information as such and not disclose it except in

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accordance with applicable law. As such, Investors must still provide the FDIC with information regarding the size of the fund or funds, its diversification, the return profile, the marketing documents, the management team and the business model.

Finally, the FDIC retains the right to waive one or more of the provisions of the Final Statement if the exemption "is in the best interests" of the DIF and the "goals and objectives" of the Final Policy Statement "can be accomplished by other means." This is primarily because the FDIC aims to mitigate the risk to the DIF posed by the possibility of banks acquired by Investors failing a second time. The Final Statement will be reviewed by the FDIC within six months.

To view the FDIC's final statement, click here. All private equity sponsors interested in bidding for failed depository institutions should carefully review the full text of the Final Statement to determine whether such investments are still feasible from both an economic and regulatory perspective.

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