August 2009

Contacts

Charles E. "Stormy" Greef
1445 Ross Avenue
Suite 3700
Dallas, Texas 75202-2799
(214) 468-3331

Peter G. Weinstock
1445 Ross Avenue
Suite 3700
Dallas, Texas 75202-2799
(214) 468-3395

Geoffrey S. Kay
111 Congress Avenue
Suite 1800
Austin, Texas 78701-4068
(512) 542-5009

Retreat but Not Reversal by FDIC on Private Equity

On August 26, 2009, the Federal Deposit Insurance Corporation ("FDIC") issued its Final Statement of Policy on Qualifications for Failed Bank Acquisitions ("Final Rules"). The Final Rules signal a retreat, but not a reversal, of the disparate treatment afforded private equity backed bids on failed bank transactions, as compared to bids from strategic acquirors.

In response to significant comments received by the FDIC following the issuance of the Proposed Statement of Policy ("Proposed Rules"), the FDIC reduced the leverage capital requirement for "private investors" from 15 percent to 10 percent (although the FDIC has limited the type of capital that private investors may use to satisfy that requirement). The Final Rules also remove the "source of strength" requirement and increase the threshold for cross-guarantee liability from 50 percent to 80 percent. These changes were designed to make the failed bank acquisition opportunity more attractive for private capital investors, while retaining many of the other elements from the Proposed Rules designed to address the FDIC's concerns related to private capital investment in failed institutions.

Applicability of Policy Statement

The restrictions set forth in the Final Rules are applicable generally to the following types of investors (referred to herein collectively as "Investors"):

- Private investors in a company, including any company acquired to facilitate bidding on failed banks or thrifts, that is proposing to assume deposit liabilities and/or acquire assets from a failed depository institution in receivership. This vague "definition" is much more expansive than the private equity-sponsored groups that were the primary focus of the Proposed Rules. The Final Rules appear to cover investors in any inflatable charter structure.
- Applicants for insurance in the case of de novo charters (commonly known as "shelf charters") issued in connection with the resolution of failed insured depository institutions. This would appear to cover any shelf charter proposal regardless of whether private equity investors are involved.

The Final Rules do not apply to the following Investors:

- Any Investor who acquired a failed depository institution prior to August 26, 2009.
- Any Investor in a financial institution or holding company, provided the financial institution or holding company has maintained a composite

CAMELS 1 or 2 rating continuously for seven (7) years, upon application to and approval by the FDIC.

- Investors in partnerships or similar ventures with existing bank or thrift holding companies or in bank or thrift holding companies when the holding company has a strong majority interest in the resulting bank or thrift and an established record for successful operation of insured banks or thrifts (i.e., "side-by-side investments").
- Investors with 5 percent or less of the total voting power of the institution, as long as the Investor is not acting in concert with one or more other Investors.

Investment Requirements

The FDIC will apply the following requirements to Investors:

- **Capital Commitment** — Investors generally would be required to initially capitalize the acquiror from the FDIC as receiver of the failed bank at a minimum Tier 1 common equity to average assets ratio of 10 percent and maintain that capital ratio for a period of three years from the time of acquisition. The FDIC has retained the ability to increase the required capital to a level higher than 10 percent if it believes circumstances warrant. The FDIC reduced the capital requirement contained in the Proposed Rules from a minimum Tier 1 capital to average assets ratio of 15 percent.

  Investors must also agree to maintain the bank at "well capitalized" levels for the remaining period of their ownership. Failure to maintain the 10 percent ratio during the first three years or to remain "well capitalized" thereafter will result in the institution being treated as "undercapitalized" for purposes of Prompt Corrective Action, which would trigger a number of significant restrictions on operations and other mandates.[1]

  Although the reduction from 15 percent to 10 percent may be seen as an attractive feature for many Investors, we note that the FDIC's elimination of an Investor's ability to utilize Tier 1 noncommon equity elements to satisfy the capital requirement may partially offset the attractiveness of the reduced capital threshold. In light of the Federal Reserve Board's more flexible treatment of nonvoting equity[2], the emphasis in the Final Rules on equity capital may serve to diminish the overall size of investment by private investors. Alternatively, such an emphasis will enhance the benefits to seeking bank holding company status.
- **Source of Strength** — The Final Rules eliminated the requirement from the Proposed Rules that an Investor's organizational structure would be expected to serve as a source of strength for its subsidiary depository institutions.
- **Holding Period** — Investors are prohibited from selling or otherwise transferring their interests in the subject holding company or depository institution (other than to affiliates subject to the Final Rules) for a three-year period, without FDIC approval. Open-ended mutual funds generally are not subject to this requirement.
- **Cross-Support Liability** — Investors whose investments constitute 80 percent or more (up from 50 percent in the Proposed Rules) of more than one depository institution would be expected to pledge to the FDIC their interests in each such institution to pay for any losses to the Deposit Insurance Fund that result from the failure of, or assistance provided to, any other such depository institution. The FDIC may waive this pledge requirement if enforcing the cross-support obligation would not reduce the cost to the Deposit Insurance Fund.
- **Transactions With Affiliates** — All extensions of credit by the acquired depository institution to the Investors, their investment funds, their respective affiliates and their portfolio companies are prohibited. For purposes of the Policy Statement, an "affiliate" is any company in which an investor owns 10 percent or more of the equity of that company for at least 30 days. Existing extensions of credit by an FDIC-insured institution acquired by such Investors are grandfathered. Investors will be required to provide regular reports to the insured depository

---

[1] Please see our February 2009 Client Alert titled "Prompt Corrective Action."

[2] The Federal Reserve has indicated that a passive owner of 15 percent of any class of voting security and 33 percent of the overall equity would not be deemed to be "in control" of a bank or bank holding company. Please see our January 2009 Client Alert titled "Private Equity Investments in Financial Institutions."

institution identifying all affiliates presumably by review during examinations.

- **Secrecy Law Jurisdictions** — Investors utilizing investment vehicles domiciled in bank secrecy jurisdictions are ineligible to own a direct or indirect interest in an insured depository institution unless the Investors are subsidiaries of companies that are subject to comprehensive consolidated supervision and agree to certain additional conditions. The FDIC will continue to define a bank secrecy jurisdiction as a country that applies a bank secrecy law that limits bank regulators from determining compliance with U.S. laws or prevents the regulators from obtaining information or otherwise does not provide for the exchange of information with U.S. regulatory authorities.

- **Bidder Limitation** — Investors who held 10 percent or more of the equity or debt of a bank or thrift that goes through receivership are not be eligible to bid on that institution through the failed bank resolution process.

- **Other Prohibited Structures** — Complex and functionally opaque ownership structures in which the beneficial ownership is difficult to ascertain with certainty, the decision-making parties are not clearly identifiable, and ownership and control are separated, are prohibited. This would likely apply to any private equity "silo" ownership structure.

- **Miscellaneous** — The FDIC may waive provisions of the Final Rules on a case-by-case basis. The FDIC has advised that it will revisit the Final Rules in six months to assess whether the rules are still deterring investment or if other features need to be altered.

Conclusion

While a number of the substantive changes from the Proposed Rules signal the FDIC's interest in broadening Investor participation in the failed bank resolution process, the Final Rules nonetheless continue to reflect the FDIC's concern that private capital acquirors of failed financial institutions present heightened regulatory risks, as compared to strategic acquirors, so as to justify the disparate treatment afforded by the Final Rules.

Although the changes to the Proposed Rules may be expected to increase the attractiveness to Investors of participating in the failed bank resolution process at the margins, the Final Rules — by restricting viable private capital bidders — nonetheless run the risk of artificially limiting Investor interest in the failed bank resolution process. The Final Rules, because they did not level the playing field, could prove to be counterproductive by limiting, rather than expanding, the number of competing failed bank bids and the FDIC's ability to minimize the expected loss to the Deposit Insurance Fund.