Hunton & Williams

Client Alert

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## Contacts

**Charles E. "Stormy" Greef**
1445 Ross Avenue, Suite 3700
Dallas, Texas 75202
(214) 468-3331
cgreef@hunton.com

**Geoffrey S. Kay**
111 Congress Avenue, Suite 1800
Austin, Texas 78701
(512) 542-5009
gkay@hunton.com

**Peter G. Weinstock**
1445 Ross Avenue, Suite 3700
Dallas, Texas 75202
(214) 468-3395
pweinstock@hunton.com

# FDIC Proposes Policy Statement on Qualifications for Failed Bank Acquisitions by Private Investors

On July 2, 2009, the Federal Deposit Insurance Corporation (FDIC) issued its proposed Statement of Policy on Qualifications for Failed Bank Acquisitions (Policy Statement). The Policy Statement is designed to provide guidance to private investors who are interested in acquiring failed depository institutions with financial assistance from the FDIC. The Policy Statement acknowledges the interest of private investors in failed depository institutions, but also expresses the FDIC's stated concern that some private investment structures present potential safety and soundness issues and risks to the deposit insurance fund (DIF), as well as other important issues. Public comments on the proposal are due in 30 days.

## Applicability of Policy Statement

The proposed Policy Statement is applicable to the following types of investors (referred to herein collectively as "Investors"):

- Private capital investors in a company (other than a bank or thrift holding company that has come into existence or has been acquired by an Investor at least three years prior to the date of the Policy Statement) that is proposing to assume deposit liabilities and/or acquire assets from a failed depository institution in receivership. This would 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.

Although the FDIC specifically points out a number of its concerns with certain private equity structures (i.e., complex opaque ownership structures, separation of ownership and control, decision-making parties not clearly identifiable, etc.), the definition of Investors that are subject to the requirements of the Policy Statement extends far beyond private equity funds and would appear to apply to any inflatable charter or any shelf charter proposal, regardless of how transparent or traditional its ownership structure or how experienced and capable its board of directors or management.

While some of the supplementary information to the Policy Statement suggests that the measures contained in the Policy Statement would not apply to applicants that "accept the responsibilities under existing law to serve as responsible custodians of the public interest that is inherent in insured depository institutions," the text of the Policy Statement itself makes no such distinction. Further, the supplementary information explains that while the structuring issues which present concerns to the FDIC are generally attributable to private equity ownership investments, the FDIC will apply the same standard of review to any prospective proposed acquisition from the FDIC as receiver of a failed bank to ensure parity and to avoid regulatory arbitrage.

## Investment Requirements

The FDIC intends to apply the following requirements to Investors:

### Capital Commitment

Investors would be required to initially capitalize the acquirer from the FDIC as receiver of the failed bank at a minimum 15% leverage capital ratio (Tier 1 capital to average assets) and maintain that leverage capital ratio for a period of at least three years. The Investors would also have to agree to maintain the bank at not less than "well capitalized" levels for the remaining period of their ownership. Failure to remain "well capitalized" would result in the institution being treated as "undercapitalized" for purposes of Prompt Corrective Action, which triggers a number of significant restrictions on operations and other mandates.[1]

We note that Investors who are interested in failed financial institution transactions are already at a significant disadvantage in bidding against existing banks. Shelf charters approved by the FDIC have been required to provide commitments to maintain an 8% leverage capital ratio, a requirement that is not uniformly imposed on existing financial institutions bidding in failed bank transactions. In addition, existing financial institution bidders, unlike inflatable or shelf charter bidders, are able to reflect operational synergies and cost savings in the amount of their bids.

By adopting a requirement to maintain a 15% leverage capital ratio – which is more than twice the practical capital requirement for an existing bank to be deemed to be "well capitalized" – the FDIC would dramatically change the economics of failed bank transactions and thereby reduce the willingness of private capital to participate in the failed bank resolution process. This limitation may reduce bids to the FDIC and could actually increase losses to the DIF.

### Source of Strength

The Investors' organizational structures would be expected to serve as a source of strength for their subsidiary depository institutions. This commitment would be supported by the agreement of the holding company in which the Investors have invested to sell equity or engage in capital qualifying borrowing under appropriate circumstances in support of the depository institution.

The FDIC has asked for comments as to whether the source of strength doctrine set forth in the Policy Statement should be enhanced to include an obligation broader than the commitment referenced above. Any such higher "source of strength" standard for Investors would be beyond what is currently applicable to bank holding companies and could further chill Investor participation in the failed bank resolution process.

### Holding Period

Without FDIC approval, Investors would be prohibited from selling or otherwise transferring their interests in the subject holding company or depository institution for a three-year period. While a three-year holding period may be an impediment for certain private capital structures, the holding period requirement should not have a material adverse effect on the participation in the failed bank resolution process by most Investors.

### Cross Guarantee Liability

Investors whose investments constitute a majority of more than one depository institution would be expected to pledge to the FDIC their proportionate 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.

Although the cross guarantee obligation, by its terms, applies only to the Investor's proportionate ownership in the other depository institution(s), the cross guarantee obligation could have unintended consequences on the healthier financial institution and its minority shareholders, and it could subject the other depository institution(s) to increased risk of failure or undercapitalization. We note that the cross guarantee obligation of the Policy Statement is much broader than the traditional cross guarantee obligation of a bank holding company of wholly-owned depository institution subsidiaries.

### 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 would be 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.

We note that there are already limitations on transactions by depository institutions with insiders and affiliated parties, including those set forth in Regulation W and Regulation O. Each of these

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

regulations was specifically designed to protect depository institutions from disadvantageous transactions with insiders and related parties and to limit the scope of transactions in general. It is unclear why the FDIC now believes that Regulation W and Regulation O are inadequate to address transactions with investors covered by the Policy Statement and why significantly more restrictive provisions are necessary or appropriate.

### Secrecy Law Jurisdictions

Investors utilizing investment vehicles domiciled in bank secrecy jurisdictions would not be eligible 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.

### Bidder Limitation

Investors who hold 10% or more of the equity or debt of the bank or thrift in receivership will not be eligible to bid on that institution through the failed bank resolution process. In addition, "silo" organizational structures would not be eligible Investors.

## Conclusion

The Policy Statement has been proposed by the FDIC to provide guidance to private capital investors interested in participating in the failed bank resolution process. It is purportedly designed to address concerns that the FDIC has had with a number of the private investment structures that the FDIC believes are inconsistent with safety and soundness. The definition of Investor in the Policy Statement, however, appears to apply to a broad range of investor types (including all shelf and inflatable charters), even those that exhibit none of the structural concerns described by the FDIC in the Policy Statement. In so doing, the Policy Statement runs the risk of dramatically limiting or eliminating the interest of private capital investors in participating in the failed bank resolution process, which could lead to the unintended result of limiting, rather than expanding, the number of competing failed bank bids and the FDIC's ability to minimize the expected loss to the DIF.

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