Client Alert

pillsbury

Corporate & Securities

Private Equity

Finance

September 8, 2009

Will the FDIC's Relaxed Requirements Entice Private Equity to Invest in Failing Banks?

by Rodney R. Peck, Patricia F. Young, Michael Ouimette and Benjamin A. Wiles

On August 26, 2009, the FDIC adopted a Final Statement of Policy on Qualifications for Failed Bank Acquisitions. While the Final Statement relaxes some of the terms and conditions that private equity investors would be expected to satisfy in order to qualify to bid on a failed depository institution (in part by eliminating the proposed statement's "source of strength" requirement, reducing the minimum capital ratio commitment and relaxing the cross-support requirement), it remains to be seen whether it has gone far enough to encourage significant investments by private equity firms.

The Final Statement provides guidance to private equity investors interested in acquiring or investing in failed banks. It clarifies and, in some respects, revises the FDIC's proposed policy statement that was published for comment on July 9, 2009. For an overview of the FDIC's proposed policy statement and some of the key issues facing prospective private equity investors in financial institutions (including potential transaction structures and certain regulatory considerations), please see our earlier Client Alert of July 9, 2009.

This Client Alert outlines the terms and conditions that private capital investors would be expected to satisfy in order to qualify to bid on a failed institution, as set forth in the Final Statement.

Applicability

The Final Statement applies to the following entities (referred to as "Investors"):

- 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

- Applicants for insurance in the case of *de novo* charters issued in connection with the resolution of failed insured depository institutions.

The Final Statement specifically excludes the following entities and situations from its pronouncements:

- Acquisitions of failed depository institutions completed prior to the Final Statement's approval date;
- Investors in a bank or thrift, or bank or thrift holding company, where the bank or thrift has maintained a composite CAMELS rating of 1 or 2 continuously for seven years (upon application to and approval by the FDIC's Board of Directors);
- Investors in partnerships or similar ventures with bank or thrift holding companies or in such holding companies (excluding shell holding companies) where the holding company has a "strong majority interest" in the acquired bank or thrift and an established record for successful operation of insured banks or thrifts; and
- Investors with five percent or less of the total voting power of an acquired depository institution or its bank or thrift holding company, provided there is no evidence of concerted action by these investors.

Noteworthy is the Final Statement's exemption for private equity investors that partner with existing bank or thrift holding companies in bidding for failed institutions. While allowing Investors to avoid the higher minimum capital requirement and the other terms and conditions of the Final Statement, this structure is unlikely to hold much appeal for many private equity firms which traditionally are unwilling to compromise their investment's control position. The Final Statement does not define what is meant by a "strong majority interest." Implied, however, is significantly more than a 51% interest.

According to expedited procedures to be established, the FDIC Board of Directors may waive one or more provisions of the Final Statement if the Board finds that such exemption is in the best interests of the Deposit Insurance Fund and the goals and objectives of the Final Statement can be accomplished by other means.

The Final Statement, by its terms, applies only in the context of a failed or failing depository institution. It does not address what principles the FDIC will follow regarding private equity investments in insured depository institutions which are not failed or failing institutions.

Capital Commitment

The Final Statement requires an acquired depository institution to maintain a Tier 1 common equity[1] to total assets ratio of at least 10 percent for a period of three years from the time of acquisition. Thereafter, the depository institution is required to remain at least "well capitalized" during the remaining period of ownership by the Investors. This is a departure from the proposed policy statement in several important respects. First, the minimum required capital ratio has been decreased from 15 percent to 10 percent. Second, the FDIC has changed the numerator of the required minimum capital ratio from Tier 1 capital ("leverage") to Tier 1 common equity. The FDIC made this change in consideration of its concerns about the quality of bank capital and the adequacy of the risk-based capital rules. The FDIC adopted Tier 1 common equity as the numerator of the capital ratio required in the Final Statement because the FDIC believes that Tier 1 common equity provides a stronger measure of the capital available to absorb losses than alternative measures. Depending on the nature of the acquiror's capital investment and the balance sheet

[1] Tier 1 common equity is defined as Tier 1 capital minus non-common equity elements. Non-common equity elements are defined as qualifying perpetual preferred stock, plus minority interests and restricted core capital elements not already included.

of the target bank, this could result in an even more stringent minimum capital requirement than was initially proposed. Third, the FDIC deleted a provision in the proposed policy statement that would have allowed the three-year period to be extended.

The Final Statement provides that failure to maintain the required minimum capital level will result in an institution being treated as "undercapitalized" for purposes of Prompt Corrective Action, which would trigger all of the measures that would be available to the institution's regulator in such a situation.

Under the Prompt Corrective Action provisions of the FDIC Act,[2] an undercapitalized bank can be required to submit a capital restoration plan to its primary Federal banking agency regulator. This plan would specify the steps the institution will take to become adequately capitalized, the levels of capital to be attained during each year in which the plan will be in effect and how the institution will comply with the restrictions or requirements then in effect. A capital restoration plan will not be accepted by the undercapitalized bank's regulator unless each company having control of the institution has guaranteed (subject to a statutory limit of the lesser of five percent of the institution's total assets at the time the institution became undercapitalized or the amount which is necessary to bring the institution into compliance with all capital standards) that the institution will comply with the plan until the institution has been adequately capitalized on average during each of four consecutive calendar quarters, and provided appropriate assurances of performance. Undercapitalized institutions may also be subject to asset growth restrictions, and prior approval requirements in order to make acquisitions, establish or acquire any additional branch office, or engage in any new line of business.

Additional discretionary safeguards will be imposed if the institution is deemed to be "significantly undercapitalized." Such measures may include requiring the institution's recapitalization, restricting transactions with affiliates and/or the interest rates paid on deposits, and restricting asset growth and any bank activity that the regulator determines poses excessive risk to the institution. The bank's regulator may also require that action be taken to improve its board and senior executive officer management. A bank holding company having control of the significantly undercapitalized institution may also be prohibited from making any capital distribution without the prior approval of the Federal Reserve Board. In addition, any company having control of the institution may be required to divest itself of the institution if the appropriate Federal banking agency for that company determines that divestiture would improve the institution's financial condition and future prospects.

Source of Strength

The proposed policy statement provided that Investors must agree to serve as a "source of strength" for subsidiary depository institutions. However, private equity firms typically have stringent restrictions on their ability to put other investments at risk, so a "source of strength" requirement could make impractical any bank deals subject to such requirement. In response to comments to this effect, the FDIC decided to delete the "source of strength" provision in the Final Statement. As noted above, however, the Prompt Corrective Action provisions of the FDIC Act will continue to apply. Moreover, the Final Statement makes clear that other federal statutes, such as the Bank Holding Company Act (the "BHCA"), may continue to apply to private equity investors. Thus, an Investor which becomes subject to the BHCA may find itself subject to the "source of strength" doctrine under the policies of the Federal Reserve Board. Generally speaking, the BHCA applies to any company that controls a bank or bank holding company. The Federal

[2] *See* 12 U.S.C. §1831(o).

Reserve Board in its September 22, 2008 policy statement clarified its position on what constitutes "control" of a banking organization.[3]

Cross Support

If one or more Investors own 80 percent or more of two or more banks or thrifts, the stock of the banks or thrifts commonly owned by these Investors must be pledged to the FDIC, and if any one of those owned depository institutions fails, the FDIC may exercise such pledges to the extent necessary to recoup any losses incurred by the FDIC as a result of the bank or thrift failure. This is a slight relaxation from the proposed policy statement, which required Investors whose investments constitute a majority of the investments in more than one insured depository institution to pledge to the FDIC their proportionate interests in each such institution to pay for losses resulting from the failure of, or assistance provided to, any other such institution. The Final Statement allows the FDIC (in its discretion) to waive this pledge requirement where the exercise of the pledge would not result in a decrease in the cost of the bank or thrift failure to the Deposit Insurance Fund.

Transactions with Affiliates

In the Final Statement, the FDIC expresses the view that private capital investors who are not subject to the activities restrictions of the BHCA may be tempted to cause the bank they have purchased to lend to companies in which they have invested. Moreover, the FDIC notes that the prohibitions on insider lending are among the most crucial requirements for maintaining a safe and sound banking system and for protecting the Deposit Insurance Fund. As a result, the Final Statement prohibits all extensions of credit to Investors, their investment funds (if any), and any affiliates[4] of either, by an insured depository institution acquired by such Investors. However, existing extensions of credit by an insured depository institution acquired by such Investors are exempted from the foregoing prohibitions. The Final Statement further requires each Investor to disclose to the insured depository institution all affiliates of such Investor.

Secrecy Law Jurisdictions

The Final Statement provides that Investors employing ownership structures utilizing entities that are domiciled in secrecy law jurisdictions[5] would not be eligible to own a direct or indirect interest in an insured depository institution unless the following conditions are met:

[3] The BHCA provides that a company has control over a banking organization if (i) the company directly or indirectly or acting through one or more other persons owns, controls, or has power to vote 25 percent or more of any class of voting securities of the banking organization; (ii) the company controls in any manner the election of a majority of the directors or trustees of the banking organization; or (iii) the Federal Reserve Board determines, after notice and opportunity for hearing, that the company directly or indirectly exercises a controlling influence over the management or policies of the banking organization. 12 U.S.C. § 1841(a)(2) The Federal Reserve Board stated that the determination of "control" is a case by case inquiry, and indicated that an investor would be deemed to "control" a banking organization if that investor owned one third or more of the total equity and 15 percent or more of any class of voting securities in the organization. For a further discussion of the Federal Reserve Board's policy statement and guidelines for determining "control," see our Client Alert of July 9, 2009, at pg. 2 ("Control Standards" Under the BHCA).

[4] "Affiliate" is defined as 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 definition is designed to make compliance easier and is based on the assumption that very short-term investments do not provide a reason for extensions of credit.

[5] The Final Statement defines "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 offshore companies to operate shell companies without substantial activities within the host country.

- the Investors must be subsidiaries of companies that are subject to comprehensive consolidated supervision as recognized by the Federal Reserve Board;
- the Investors must execute agreements on the provision of information to the primary Federal regulator about the non-domestic Investors' operations and activities;
- the Investors must maintain their business books and records (or a duplicate) in the United States;
- the Investors must consent to the disclosure of information that might be covered by confidentiality or privacy laws and agree to cooperate with the FDIC, if necessary, in obtaining information maintained by foreign governmental entities;
- the Investors must consent to jurisdiction and designation of an agent for service of process; and
- the Investors must consent to be bound by the statutes and regulations administered by the appropriate United States Federal banking agencies.

The FDIC notes in the Final Statement that it must have adequate assurances that it will have access to reliable information on the operations or activities of an Investor and its affiliates in order to evaluate a proposal involving an investment in an insured depository institution. The Final Statement's provisions requiring transparent ownership and full disclosure are designed to address such concerns, while still allowing Investors to organize efficient and functional ownership structures in the United States.

Continuity of Ownership

Investors subject to the Final Statement are prohibited, without the FDIC's prior approval, from selling or otherwise transferring their securities in an acquired depository institution for three years following the acquisition. Such approval will not be unreasonably withheld by the FDIC for transfers to affiliates, provided the affiliate agrees to be subject to the conditions which were applicable under the Final Statement to the transferring Investor. The Final Statement provides an exemption from this requirement for any mutual fund defined as an open-ended investment company registered under the Investment Company Act of 1940 that issues redeemable securities that allow investors to redeem on demand.

In the Final Statement, the FDIC notes the importance of encouraging long-term investment to promote the stability of a previously failed bank or thrift. The FDIC stresses its interest in stability of management, on which it depends for appropriate management of any agreements it may have with a bank or thrift concerning losses at that bank or thrift. For these reasons, the continuity of ownership provisions in the proposed policy statement were left largely unchanged.

Disfavored Structures ("Silo" Structures)

The FDIC expressed concern in the proposed policy statement and the Final Statement regarding complex and functionally opaque ownership structures in which the beneficial ownership is difficult to ascertain with certainty, the responsible parties for making decisions are not clearly identified, and ownership and control are separated. While the Final Statement does not specifically prohibit such "silo" structures, it strongly discourages organizational arrangements involving a single private equity fund that seeks to acquire ownership of a depository institution through creation of multiple investment vehicles, funded and apparently controlled by the parent fund.

In the Final Statement, the FDIC expresses concern that the purpose of such "silo" structures is to artificially separate the non-financial activities of the firm from its banking activities so that the private equity firm is not required to become a bank or savings and loan holding company. In the FDIC's opinion, this type of structure raises concerns about the sufficiency of the financial and managerial support to the acquired institution, even in those instances where the Investor agrees to be regulated as a bank or savings and loan holding company.

Special Owner Bid Limitation

Investors that directly or indirectly hold 10 percent or more of the equity of a bank or thrift in receivership will not, under any circumstances, be considered eligible to be a bidder to become an investor in the deposit liabilities, or both such liabilities and assets, of any failed depository institution in which they were Investors.

Disclosure

Investors subject to the Final Statement will be required to submit to the FDIC information about the Investors and all entities in the ownership chain. Such information includes the size of the capital fund or funds, its diversification, return profile, marketing documents, management team and business model, as well as any other information the FDIC may require. In an effort to address commenters' concerns about confidentiality, the Final Statement provides that confidential business information will be treated as such and not disclosed except in accordance with applicable law.

Six-Month Review Period

The FDIC Board of Directors will review the operation and impact of the Final Statement within six months of its approval date and will make adjustments as it may deem necessary.

Limitation

As mentioned above, the Final Statement does not limit or replace the applicability of other statutes relating to banks or thrifts or their holding companies. Thus, the BHCA or the Savings and Loan Holding Company Act may apply to private equity investors in banks or thrifts depending on the circumstances.

Conclusion

Bank failures have reached a 17-year high, with 84 failed banks to date in 2009 (110 failed banks since January 1, 2008).[6] In addition, there were 416 insured institutions on the FDIC's "Problem List" at June 30, 2009 (up from 305 at March 31, 2009); the largest number of institutions on the list since June 30, 1994.[7] Facing a dearth of traditional bank buyers, and with the FDIC on the hook through loss-share agreements for billions of dollars in bank losses if the economy doesn't improve, the banking industry is in critical need of additional capital.

[6] FDIC Failed Bank List (as of August 31, 2009), available at *www.fdic.gov/bank/individual/failed/banklist.html*.

[7] FDIC Press Release**,** ***FDIC-Insured Institutions Lost $3.7 Billion in the Second Quarter of 2009; Total Reserves of the Deposit Insurance Fund Stood at $42 Billion***, August 27, 2009, available at *www.fdic.gov/news/news/press/2009/pr09153.html*.

The Private Equity Council estimates that roughly 2,000 private equity firms in the United States have around $450 billion in capital to invest.[6] According to FDIC Chairman Sheila Bair, the Final Statement seeks to strike a thoughtful balance to attract these "non-traditional investors" in insured depository institutions, while maintaining necessary safeguards to ensure that acquired institutions will have adequate capital, stable management, and protections to ensure objective and independent lending decisions.

While the Final Statement relaxes some of the terms and conditions that private equity investors would be expected to satisfy in order to qualify to bid on a failed institution, it may not, however, have gone far enough to encourage significant investments by private equity firms.

While an exemption in the Final Statement encourages private equity investors to partner with existing bank or thrift holding companies in bidding for failed institutions (allowing Investors to avoid the higher minimum capital requirement and the other terms and conditions of the Final Statement), this structure is unlikely to hold much appeal for many private equity firms which traditionally are unwilling to compromise their investment's control position. The elimination of the "source of strength" requirement, the reduction in the minimum capital ratio commitment and the relaxation of the cross-support requirement are clearly favorable to potential private equity investors; however, it remains to be seen whether private equity firms will view investments in failed financial institutions under the conditions outlined in the Final Statement as attractive (particularly in light of the three-year continuity of ownership requirement, the threat of Prompt Corrective Action measures in the event the acquired bank becomes "undercapitalized" or "significantly undercapitalized," and other requirements).

If you have any questions about the content of this alert, please contact the Pillsbury attorney with whom you regularly work, or the authors of this alert.

Rodney R. Peck (bio)
San Francisco
+1.415.983.1516
rodney.peck@pillsburylaw.com

Michael Ouimette (bio)
San Francisco
+1.415.983.1163
michael.ouimette@pillsburylaw.com

Patricia F. Young (bio)
San Francisco
+1.415.983.1845
patricia.young@pillsburylaw.com

Benjamin A. Wiles (bio)
San Francisco
+1.415.983.1426
benjamin.wiles@pillsburylaw.com

[6] Marcy Gordon, *FDIC Eases Rules for Private Buys of Failed Banks*, The Associated Press, August 26, 2009, available at *www.usatoday.com/money/industries/banking/2009-08-26-fdic-rules-failed-banks_N.htm*.

This publication is issued periodically to keep Pillsbury Winthrop Shaw Pittman LLP clients and other interested parties informed of current legal developments that may affect or otherwise be of interest to them. The comments contained herein do not constitute legal opinion and should not be regarded as a substitute for legal advice.
© 2009 Pillsbury Winthrop Shaw Pittman LLP. All Rights Reserved.