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## FDIC Issues Final Statement of Policy on Private Investments in Failed Bank Assets

At its August 26 Board meeting, the Federal Deposit Insurance Corporation adopted a Statement of Policy on Qualifications for Failed Bank Acquisitions, which provides guidance on the terms and conditions that the FDIC is likely to require of private investors interested in acquiring or investing in failed insured depository institutions.

After intense lobbying from private equity funds and other investors that would be subject to the Statement, the FDIC eliminated one and relaxed several of the other elements in the policy it proposed on July 9 (the “July Proposal”), but also included several provisions that may have a significant impact on private equity and similar investors in failed bank acquisitions. The final Statement thus sought to balance the need for additional capital in the banking system and the contribution that private capital could make to meeting this need, against concerns raised by ownership structures used by consortia of private equity funds and similar private investors that, in the FDIC’s view, avoided certain of the responsibilities of bank or thrift ownership.

The FDIC will review the policy within six months and make adjustments, if necessary. We summarize the key provisions of the policy below. For the full Statement of Policy, click [here](#).

*Applicability.* The Statement applies *prospectively* to:

- private investors in a company that is proposing to, directly or indirectly, assume deposits, or deposits and assets, from the resolution of a failed insured depository institution and
- applicants for insurance for new charters issued in connection with the resolution of failed insured depository institutions (together, “Investors”).

Because of the numerous and changing variations in structure among such Investors, the FDIC declined to define the term “private investors.” However, it noted that as a statement of policy (as opposed to regulatory action) the Statement will only apply to Investors that agree to its terms. Thus, although the generality of the Statement leaves open many questions about its breadth, prospective Investors will have the ability to clarify its applicability via dialogue with the FDIC.

The Statement by its terms does not apply to 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 resulting bank or

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thrift and an established record for successful operation of insured banks or thrifts. These partnerships are “strongly encouraged” by the FDIC in the Statement (ostensibly because the FDIC has expressed concern that private equity investors do not have a demonstrable record of successful management of depository institutions), but there is no clear guidance on the scope of this exemption, including what constitutes a strong majority interest or an established record of successful operation of insured banks or thrifts. This provision may encourage private equity investors to pursue possible equity investments into existing, successful holding companies, which may then be used as platforms for future failed bank acquisitions.

The Statement also excludes Investors with 5% or less of the total voting power of an acquired depository institution or its holding company (unless there is evidence of concerted action among those investors). The Statement further contemplates that the Board would entertain applications by Investors in a bank or thrift to be released from the Statement of Policy if the bank or thrift has maintained a composite Camels 1 or 2 rating continuously for seven years.

The FDIC’s Board may, under expedited procedures, waive any aspect of the Statement if it would be in the best interests of the Deposit Insurance Fund and the goals and objectives of the Statement can be accomplished by other means. Experience will demonstrate whether this exemptive authority is used regularly or rarely.

*Capital Commitment.* The element in the July Proposal that garnered the most negative reaction from the investing community was its requirement that depository institutions acquired by Investors maintain for three years (or longer if extended by the FDIC) a Tier 1 leverage ratio of at least 15%. The final Statement now calls for the depository institution to maintain a ratio of Tier 1 common equity<sup>1</sup> to total assets of at least 10% for three years, and thereafter to be “well capitalized” during the remaining ownership of the Investors.

If the depository institution fails to meet this standard, the institution must immediately take action to restore capital to the required level. Failure to maintain the required capital level would result in the institution being considered “undercapitalized” for purposes of Prompt Corrective Action, triggering all of the measures that would be available to the institution’s regulator in such a situation. The Statement does not address how Investors may act together with other Investors or shareholders to restore capital immediately as required in the Statement, while avoiding “acting in concert” for purposes of Regulation Y and the policies of the Board of Governors of the Federal Reserve System.<sup>2</sup>

*Cross Support.* Under the Statement, if multiple<sup>3</sup> Investors own 80% or more of two or more banks or thrifts or their holding companies, the stock of the banks or thrifts (or holding companies) must be pledged to the FDIC, which may exercise such pledges to recoup any losses incurred by it if any of the banks or thrifts fails. The purpose of this policy is to require groups of Investors that do not constitute a bank holding company, and are thus not subject to the “cross-guarantee” provisions in the Financial Institutions Reform, Recovery and Enforcement

<sup>1</sup> “Tier 1 common equity” is defined as Tier 1 capital minus non-common equity elements, and “non-common equity elements” is defined as qualifying perpetual preferred stock, plus minority interests and restricted core capital elements not already included. The FDIC had previously proposed a 15% Tier 1 leverage ratio.

<sup>2</sup> See, e.g., Policy Statement on Equity Investments in Banks and Bank Holding Companies. 12 C.F.R. § 225.143.

<sup>3</sup> The Statement says “one or more” Investors, but if one Investor owned 80% of each of two depository institutions or its holding company then it would be a bank holding company and be subject already to the cross-guarantee provisions of FIRREA noted below.

Act (FIRREA), to be subject to an equivalent financial mechanism for the benefit of the FDIC. The Statement does not state whether the FDIC would expect to be able to recoup from each Investor up to the total amount of its losses from any bank or thrift failure, or only a pro rata portion based on that Investor's pro rata interest in the relevant depository institution.

The cross support requirement also may result in the aggregation of cross-supported investments for purposes of calculating compliance with concentration limitations that are common under the governing documents of private equity funds. For this and other reasons, many Investor groups are likely to seek to avoid being subject to the cross-support requirements by avoiding an 80% overlap in Investor ownership.

*Continuity of Ownership.* In response to concerns that private equity investors have an overly short-term investment horizon to be dependable acquirers of failed banks or thrifts, the Statement restricts Investors from selling or otherwise transferring their securities in the depository institution for three years without the FDIC's prior approval. The Statement also provides that approval will not be unreasonably withheld for transfers to affiliates that agree to be subject to the Statement to the same extent as the transferring Investor. Experience will tell whether the FDIC will approve other types of transfers that would seem consistent with the FDIC's interests, such as transfers among Investors, to a regulated bank holding company or open market sales after an initial public offering. The Statement excludes open-ended registered investment companies from the holding period requirement, presumably out of concern for mutual funds' liquidity requirements.

*Prohibited Structures.* The Statement expresses the FDIC's policy against Investors' use of "complex and functionally opaque ownership structures", such as when "a private equity firm or its sponsor ... create[s] multiple investment vehicles funded and apparently controlled by the private equity firm (or its sponsor) to acquire ownership of an insured depository institution." These types of structures, sometimes referred to as "silo" structures, are typically designed to allow a private equity fund to invest in a bank or thrift holding company without causing the main fund to be a bank holding company. Silo structures have not to date found favor with either the FDIC or the Federal Reserve.

*Disclosure.* Investors must submit to the FDIC information about the Investors and all entities in the ownership chain, including information as to the size of the capital fund or funds, their diversification, their return profile, marketing documents, management teams, business models and any other information that the FDIC determines is necessary.

*Secrecy Law Jurisdictions.* Consistent with the FDIC's stress on transparency, the Statement prohibits Investors that are domiciled in "bank secrecy jurisdictions"<sup>4</sup> from owning a direct or indirect interest in an insured depository institution unless the Investor is a subsidiary of a company that is subject to comprehensive consolidated supervision as recognized by the Federal Reserve Board and agrees to provide information to the applicable primary federal regulator about any non-domestic Investors' operations and activities; maintain their business books and records in the U.S.; consent to the disclosure of information that might be covered by

<sup>4</sup> "Secrecy law jurisdiction" is defined 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 a minimum standard of transparency for financial activities or permits offshore companies to operate shell companies without substantial activities within the host country.

confidentiality or privacy laws; agree to cooperate with the FDIC in obtaining information maintained by foreign government entities; consent to jurisdiction and designation of an agent for service of process and consent to be bound by the statutes and regulations administered by the appropriate U.S. federal banking agencies.

The applicability of this provision to fund vehicles organized under the laws of the Cayman Islands, Luxembourg or Bermuda, to name a few relevant jurisdictions, will only become clear through time. None of these jurisdictions have laws that would impair their ability to disclose the required information to the FDIC, but all could be alleged to be caught by the definition of secrecy law jurisdiction.

*Restrictions on Affiliate Transactions.* Insured depository institutions acquired by Investors may not make any extensions of credit (as defined in 12 C.F.R. § 223.3(o)) to such Investors, their investment funds or affiliates of either. “Affiliates” is defined as any company in which the Investor owns, directly or indirectly, at least 10% of the equity and has maintained such ownership for at least 30 days. Investors will be required to provide regular reports to the insured depository institution identifying all of its covered affiliates. This provision has been usefully clarified in comparison with the July Proposal, which includes the ambiguous term “portfolio companies” within the prohibition.

*Special Owner Bid Limitation.* Investors that directly or indirectly hold 10% or more of the equity of a bank or thrift in receivership is prohibited from bidding to become an investor in the deposits, or both deposits and assets, of that failed depository institution.

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The final Statement of Policy is likely to be viewed by most prospective Investors as a major improvement over the July Proposal. Many of the provisions in the July Proposal have been usefully clarified, and in many cases narrowed. Although the FDIC had originally proposed including a requirement that Investors serve as a “source of strength” for their acquired depository institutions, such requirement was eliminated from the final Statement. In addition, the Statement is, as the FDIC itself has emphasized, only a policy, and its practical implication will in many cases only become clear in the context of specific acquisitions. The first few transactions subject to the Statement may set important precedents for future deals.

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This memorandum is not intended to provide legal advice, and no legal or business decision should be based on its content.