FDIC Adopts Final Statement of Policy on Private Investor Purchases of Failed Banks

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On August 26, 2009, the Federal Deposit Insurance Corporation ("FDIC") adopted a final Statement of Policy (the "Final Policy Statement") setting forth the terms and conditions under which the FDIC will evaluate transactions by private investors seeking to acquire failed depository institutions, or their deposit liabilities, from the FDIC. Release of the Final Policy Statement followed substantial public and industry comment on a proposed policy statement that the FDIC issued in early July.[1] The Final Policy Statement substantially eases or eliminates some of the most significant restrictions that the FDIC had proposed, but it retains several requirements that may make it less likely that private investors will participate in acquisitions of failed depository institutions, or that will cause them to submit lower bids than they otherwise would have submitted. The FDIC board stated that it will review the Final Policy Statement's "operation and impact" within six months and make any adjustments it deems necessary. The FDIC also retained the discretion to waive one or more provisions of the Final Policy Statement if it determines that an exemption is in the "best interests of the Deposit Insurance Fund" and the goals and objectives of the Final Policy Statement can be achieved by other means.

Key aspects of the Final Policy Statement include:

Covered Investors. The Final Policy Statement does not cover all potential investors in a failed depository institution. Rather, it applies only to:

- private investors in a company, including any company acquired to facilitate bidding on a failed depository institution, that is proposing to, directly or indirectly, including through a shelf charter, assume deposits, or deposits and assets, from a failed depository institution; and
- applicants for deposit insurance for a *de novo* depository institution chartered to acquire a failed institution.

Significantly, the Final Policy Statement excludes from its reach:

- acquisitions completed prior to the FDIC's approval of the Final Policy Statement;
- upon application and approval by the FDIC, investors in a depository institution (or depository institution holding company) after the institution has maintained a Camels 1 or 2 rating continuously for seven years;

[1] For background on the FDIC's proposed policy statement, 74 Fed. Reg. 32931 (July 9, 2009), please see the Firm's memorandum dated July 10, 2009, available at http://www.simpsonthacher.com/content/publications/pub851.pdf

- investors in partnerships or similar ventures with depository institution holding companies or in such holding companies (excluding shell holding companies) where the holding company has a "strong majority interest" in the resulting depository institution and an "established record for successful operation" of insured depository institutions; and
- investors holding 5% or less of the total voting power of an acquired depository institution (or its holding company), absent any evidence of such investors acting in concert.

Investors that are subject to the Final Policy Statement are referred to in this memorandum as "Covered Investors."

Capital Commitment. Under the Final Policy Statement, depository institutions acquired by Covered Investors will be required to be initially capitalized at a minimum 10% common equity to total assets ratio for at least three years and at a "well capitalized" capital adequacy level thereafter. This requirement has been substantially eased from the initial proposal in several ways.

First, the 10% level is substantially lower than the original proposal of at least a 15% Tier 1 leverage ratio for at least three years. Although the Final Policy Statement did revise the test from a Tier 1 leverage test, which permits the inclusion of cumulative perpetual preferred stock, to a common equity test, which does not, the 10% common equity leverage test is at least comparable to the 8% Tier 1 leverage ratio that newly chartered depository institutions and those that are subject to a change in ownership are typically required by the FDIC to maintain.

Second, in contrast to the proposed policy, the FDIC did not retain in the Final Policy Statement the authority to extend the term of this requirement beyond three years (and potentially indefinitely).

Third, where the proposed policy statement provided that the investors would have to agree to maintain the capital of the depository institution at this level, the Final Policy Statement merely provides that the acquired depository institution must maintain the required capital ratio. As in the proposed policy statement, if the depository institution fails to maintain the required capital levels, it would be deemed "undercapitalized" for purposes of the Prompt Corrective Action rules. In that case, the depository institution would be required to submit a plan to restore its capital to the required level and, in order for that plan to be accepted by the regulators, the holding company for the depository institution would be required to guarantee the plan in an amount not to exceed 5% of the assets of the depository institution. (The holding company cannot be required to provide such a guarantee, although the regulators may take other actions against a depository institution that does not submit a capital plan that includes such a guarantee.) However, it is important to note that the Final Policy Statement does not contemplate that either the holding company or Covered Investors will be required to enter into agreements with the FDIC in which they are legally bound to maintain the capital of the depository institution at a particular level.

No Source of Strength Requirement. The Final Policy Statement does not contain a requirement that Covered Investors agree to serve as a "source of strength" to any failed depository institutions in which they invest—a vague but potentially unlimited obligation to support the depository institution. Under current law, the "source of strength" obligation only applies to companies that acquire control of a depository institution. The FDIC had proposed that such a requirement would generally apply to investors' organizational structures, but eliminated it in recognition of the fact that private equity funds generally would be prohibited by their fund documents from making an investment on such terms.

Cross Support Liability. The Final Policy Statement requires Covered Investors holding an 80% or greater interest (as opposed to a majority interest, as contemplated in the proposed policy) in two or more depository institutions to pledge their interests in each of the institutions to cover any losses to the FDIC's Deposit Insurance Fund as a result of a failure by either institution. This provision, which allows the FDIC to seize shares pledged by Covered Investors in a healthy depository institution if the FDIC incurred costs assisting a commonly owned depository institution, differs from the statutory commonly controlled liability rule, which allows the FDIC to assess a healthy depository institution (not its owners) for the costs of assisting a commonly controlled depository institution. In the Final Policy Statement the FDIC retains the discretion to waive the pledge requirement if it determines that exercising the pledge would not result in a decrease in the cost of the failed depository institution to the fund. While the Final Policy Statement does not indicate when a waiver would be given, we would expect that a waiver would occur at the time bids are submitted so that a determination of whether or not a pledge will be made can be factored into affected bidders' financial proposals.

Transactions with Affiliates. Under the Final Policy Statement, a depository institution acquired by Covered Investors is prohibited from making extensions of credit (as defined in Regulation W) to such investors, their investment funds, if any, and any affiliates (defined as any company in which a Covered Investor owns, directly or indirectly, 10% or more of the equity for a period of at least 30 days) of either. Covered Investors will be expected to make regular reports to the depository institution identifying all of their affiliates. Existing extensions of credit made by an insured depository institution prior to its acquisition are exempt from the prohibition.

Bank Secrecy. The FDIC will deem Covered Investors ineligible to own a direct or indirect interest in an insured depository institution if they employ ownership structures "utilizing entities that are domiciled in bank secrecy jurisdictions," unless they are part of a group subject to comprehensive consolidated supervision, as recognized by the Federal Reserve Board, and satisfy certain other requirements. Private equity investors are not subject to comprehensive consolidated supervision and the definition of "secrecy law jurisdiction" in the Policy Statement is extremely broad. Under the Final Policy Statement, a secrecy law jurisdiction would 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, does not provide for a minimum standard of transparency for financial activities, or permits off shore companies to operate shell companies without substantial activities within the host country.

The Final Policy Statement does not list or provide examples of countries that would satisfy the FDIC's definition and this restriction would appear to implicate a range of tax and other issues for potential bidders that frequently use common off-shore jurisdictions at some level of their ownership structures.

Minimum Term of Ownership. Unless the FDIC gives its prior approval, Covered Investors that have acquired a failed depository institution are restricted from selling or otherwise transferring their securities for at least three years. The Final Policy Statement provides that the FDIC will not unreasonably withhold its consent to a sale or transfer to an affiliate if the affiliate also agrees to be subject to the same conditions applicable to the selling or transferring investor under the Final Policy Statement. The Final Policy Statement also provides that the holding period requirement does not apply to open-end mutual funds registered under the Investment Company Act of 1940 that issue redeemable securities capable of being redeemed by investors on demand.

Prohibited Ownership Structures. The Final Policy Statement also considers "complex and functionally opaque ownership structures" to be ineligible bidders for failed depository institutions. Such structures exist where "beneficial ownership is difficult to ascertain with certainty, the responsible parties for making decisions are not clearly identified, and ownership and control are separated." The Final Policy Statement describes structures of this type as typified by "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." Thus, the prohibition appears to apply to so-called "silo" structures in which private capital sponsors form new funds to make investments in failed depository institutions without causing their existing funds to be subject to regulation applicable to depository institution holding companies. Although reasonable persons may differ on the virtues of "silo" structures, the Final Policy Statement is nonetheless an improvement over the proposed policy in that the Final Policy Statement more clearly describes what structures would raise objections from the FDIC.

Special Owner Bid Limitation. A 10% or greater shareholder of a depository institution that fails would not be permitted to bid for the assets or deposits of that institution.

Required Disclosures. Covered Investors in a failed depository institution are expected to provide the FDIC with information about themselves and all entities in the ownership chain, including the size of their funds, diversification, return profile, marketing documents, management team and the business model, as well as other information that the FDIC may request. Any such information would be submitted on a confidential basis.

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