SIMPSON THACHER

MEMORANDUM

FDIC Proposed Policy Statement on Private Investor Purchases of Failed Banks

July 10, 2009

On July 2, the FDIC released a proposed policy statement that would impose a number of new requirements on private investors seeking to acquire a failed depository institution from the FDIC. The proposed policy statement will be subject to public comment through August 10, and the FDIC has indicated that it expects a high level of debate on the draft provisions (particularly on its proposal to require a 15% Tier 1 leverage ratio for all depository institutions covered by the policy statement), which may result in significant changes to the final version of the policy statement. As currently proposed, the policy statement would likely have a dampening effect on private investor interest in acquiring failed banks and thrifts.

Key provisions of the proposed policy statement include:

Covered Entities. The policy statement states that it establishes "bidder eligibility" standards for

- private capital investors in a company that is proposing to acquire a failed depository institution, unless the bidding company has been in existence or was acquired by the investors at least three years prior to the date of the FDIC's policy statement, and
- applicants for a de novo charter to be used to acquire a failed depository institution.

By including within the policy statement's coverage existing companies unless acquired by investors at least three years prior to the policy statement, it would apply to situations in which investors purchase or invest in an existing small bank or thrift to use as a vehicle to bid for failed depository institutions (sometimes referred to as an "inflatable charter"). The policy statement does not specify what level of "private capital" investment would subject a company to the rules: clearly a shell company formed by one or several investors to acquire failed banks and thrifts would be covered while a minority, non-controlling investment by a single investor in an existing banking organization would not. The draft policy statement does not address intermediate situations, however, such as where a banking organization has been recapitalized through the issuance of new shares to a number of private, non-controlling investors that in total represent a majority of the outstanding shares. As proposed, the policy statement would apply to all investors in a covered company, regardless of their ownership percentage in that company.

The policy statement also states that:

- it will not be applied to individuals, partnerships, limited liability companies or corporations "that accept the responsibilities under existing law to serve as responsible custodians of the public interest that is inherent in insured depository institutions." Potentially, that means that entities which receive approval as, and will be subject to ongoing regulation as, new holding companies under the Bank Holding Company Act or the Savings and Loan Holding Company Act will be exempted from the policy statement's restrictions.

- "Silo" and similar ownership structures, which involve "complex and functionally opaque ownership structures", will not be acceptable for ownership of a depository institution.[1]

Capital Commitment. A depository institution subject to the policy statement would need to be capitalized at a minimum 15% Tier 1 leverage ratio for a period of three years (or longer if extended by the FDIC), and thereafter at a "well capitalized" level (which is 5%) or higher. The FDIC's current practice for newly formed depository institutions is to require an 8% Tier 1 leverage ratio for the first three years. Failure to maintain the required capital levels would trigger potential enforcement actions under the prompt corrective action rules. This of course presents the question whether depository institutions capitalized by private investors can be competitive if they are required to maintain up to three times as much capital as other depository institutions. In addition, the policy statement would require the investors to "immediately facilitate" the restoration of the institution to necessary capital levels if it fell below them. As discussed below, the policy statement suggests that this is not intended to create a direct obligation of investors to provide more capital, but in the release accompanying

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[1] The term "silo structure" typically refers to a private equity structure in which the individual principals of the sponsor firm set up a new investment fund with a new general partner, obtain approval from their existing fund investors to assign a portion of the investors' unused commitments to the new fund, and then use the new fund to pursue acquisitions of depository institutions. Because the only common ownership is at the level of the individual principals, the new fund can in theory own a bank or thrift without the ownership being attributed to the sponsor's existing, non-financial fund (although the Federal Reserve has at least temporarily suspended consideration of such structures). Silo structures of this type would not be expected to have any different ownership or management characteristics than a typical private equity fund. The FDIC policy statement, however, proscribes "functionally opaque" structures where "the beneficial ownership cannot be ascertained, the responsible parties for making decisions are not clearly identified, and/or ownership and control are separated." Given the subjective element in this standard, a determination as to whether a particular ownership structure is impermissibly complex would therefore have to be made on a case-by-case basis based on discussions with the FDIC staff.

the proposed policy statement the FDIC requested public comments on whether a "broader obligation" from investors would be appropriate.

Source of Strength. The policy statement states that "Investors organizational structures" subject to the policy statement must agree to serve as a source of strength to their subsidiary depository institutions. The policy statement seems to contemplate that the depository institution holding company will be required to issue capital securities or engage in capital qualifying borrowing if the depository institution needs additional capital but that individual non-controlling investors will not have a financial obligation to contribute more capital themselves. That is already the current position of the bank regulators. As noted above, however, the FDIC is at least considering the possibility of imposing a direct source-of-strength obligation on individual non-controlling investors. Such an obligation would be a very significant issue for most investors, and would raise a number of complicated implementation issues such as how long the commitment continues (e.g. whether it continues after the company becomes publicly traded), whether it applies to new investors as well as the original investors and whether the obligation is joint and several among all investors, regardless of the size of their investments. In addition, it is unclear how private equity investors would be able to make such a commitment, given that limited partners in the investing private equity funds have fixed capital commitment obligations.

Cross Guarantees. The policy statement indicates that if investors holding a majority interest in one depository institution also own, in the aggregate, a majority of the shares in another depository institution, the investors' investments in the two depository institutions must be pledged to the FDIC to pay for losses the FDIC may incur if it has to provide financial assistance to either institution. The proposed policy statement does not provide any details on what the FDIC would do with the pledged interests if it forecloses on them. Absent further detail, it appears that upon such foreclosure the FDIC would succeed to the rights of a majority stockholder in the banking organization but would not have any power to override the contractual terms of any investment agreements to which the previous majority stockholders were subject. This would be a significant departure from the cross-guarantee liability provision of the Federal Deposit Insurance Act, which is not triggered unless two depository institutions are "controlled" by the same company, and then the liability is assessed against the commonly controlled depository institutions themselves. As is the case with the application of the policy statement overall, there is no indication that this obligation would only apply to investors that exceed a certain ownership threshold, suggesting that it would impact even small investors who happen to be part of the overlap group. In addition, the statement does not indicate whether this cross-guarantee obligation would apply across various private equity funds controlled by the same sponsor or only where there is substantial overlap of investors across the various funds.

Transactions with Affiliates. The policy statement would prohibit extensions of credit by a depository institution to all investors in that institution (or its holding company), their investment funds, affiliates (defined as ownership of 10% or more of the equity), and portfolio companies (defined simply as “companies in which the investors or [their] affiliates invest”). Currently, major investors in a depository institution or its holding company would be subject to similar restrictions under existing laws or pursuant to rebuttal of control or similar agreements with bank regulators. The policy statement appears to broaden those restrictions by, among other things, covering all investors, regardless of the size of their investment, and applying them to any entity in which an investor or its affiliates invest, regardless of the size of that ownership interest.

Secrecy Law Jurisdictions. Investors would not be permitted to employ ownership structures “utilizing entities that are domiciled in bank secrecy jurisdictions”. The proposed policy statement does not indicate which jurisdictions the FDIC considers “bank secrecy jurisdictions.” The policy statement says that this prohibition would not apply to investors which (1) are subsidiaries of a company that is subject to comprehensive consolidated supervision (i.e., bank holding companies) and (2) agree to provide information to bank regulators about their non-domestic operations.

Continuity of Ownership. Investors would be prohibited from selling their interests in the acquired depository institution for three years without prior FDIC approval. As proposed, this restriction would also prohibit the completion of an initial public offering during this time without FDIC consent. Note that in the recent sale by the FDIC of the failed BankUnited to investors, the FDIC imposed an 18 month transfer restriction, subject to various de minimis and other exceptions, on the investors as part of the loss-sharing agreement.

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.

Disclosure. Investors would be required 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. The policy statement does not limit this information requirement to the largest investors (which would typically need to provide at least some of this information in order to comply with the Change in Bank Control Act or similar regulations).

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