

## FDIC Issues Policy Statement on Private Equity Investments in Failed Banks

On July 9, 2009, the Federal Deposit Insurance Corporation (FDIC), proposed a new Statement of Policy on Qualifications for Failed Bank Acquisitions (Proposed Policy Statement). On August 26, 2009, the FDIC announced its Final Statement of Policy on Qualifications for Failed Bank Acquisitions (Final Policy Statement). The Final Policy Statement retreated from some of the harsher proposals of the Proposed Policy Statement, but may need to be revised yet again if private investors continue to avoid acquiring troubled commercial banking entities.

The FDIC, facing daunting bank failures not seen since the time of the savings and loan bailout of 25 years ago, must balance the need to attract new private sector capital with the concern that overly aggressive investors will seek to obtain bank charters for a short-term acquire-and-flip strategy to the long-term detriment of the FDIC deposit insurance fund and to the government. It is reasonably clear that the large domestic banks are not significant sources of investment capital due to present economic circumstances, and due to the integration of the large entities that many of them acquired within the last 12-18 months. Sovereign wealth funds also are not likely to have an appetite to acquire more U.S.-based banking entities due to the poor performance of their last round of investment after the housing bubble burst and the investments lost substantial amounts of value. Instead, foreign banks and private equity investors seem to be the best opportunity for the FDIC to attract capital to stabilize the commercial banking entities weakened by the recession.

Against this backdrop, it is surprising that the conditions applied to private equity investors in failed commercial banks remain relatively harsh. While deals likely can be done under these conditions and we would not counsel a potential buyer to wait for better terms, it seems inevitable that in six months or a year's time, the FDIC policy will need to be further liberalized to reflect the reality of

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additional bank failures and the more pressing need for private capital to rescue failed banks.

The policy statement as adopted is less onerous than what was proposed in the following ways.

**Applicability of Final Policy Statement.** The Final Policy Statement applies prospectively to: (a) 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 (b) applicants for insurance in the case of de novo charters issued in connection with the resolution of failed insured depository institutions. The Final Policy Statement does not apply to acquisitions of failed depository institutions completed before its approval date. The Final Policy Statement also does not apply to: (a) 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 thrift and an established record for successful operation of insured banks or thrifts. Such partnerships are strongly encouraged;

or (b) investors with 5 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.

**Capital.** The Proposed Policy Statement would have required investors to maintain a Tier 1 leverage ratio of at least 15 percent because of the FDIC's perceived higher risk profile of the failed institutions investors would be buying, the higher risk appetite of private equity investors, and the financial challenges facing banking institutions today. The FDIC revised this proposal in the final issuance to require investors to provide for a level of initial capitalization sufficient to establish a ratio of Tier 1 common equity to total assets of at least 10 percent throughout the first three years. After the first three years, the depository institution must remain "well capitalized," as that term is defined in FDIC regulations.

**Source of Strength.** The Proposed Policy Statement would have required investors "to agree to serve as a source of strength for their subsidiary depository institutions." The FDIC has dropped this requirement from the Final Policy Statement.

**Prompt Corrective Action (PCA).** The Proposed Policy Statement asked whether there should be a requirement that if capital declines below the required capital level, the institution would be treated as "undercapitalized" for purposes of the FDIC's PCA authority. Under the PCA authority, the failure of an insured depository institution to maintain required capital levels may trigger certain restrictions on activities, and may require the insured depository institution to formulate and implement a capital restoration plan. This proposal worried the industry because of the heightened capital levels that the FDIC had proposed for failed institutions covered by the Policy Statement. Citing the disproportionate number of failed institutions that failed during their first seven years of operation, the FDIC took the view "that the higher capital standards applicable under the Proposed Policy Statement are extremely important in order to preserve the safety and soundness of these de novo institutions and to protect the Deposit Insurance Fund." Because of this concern, the FDIC decided to retain the heightened PCA policy in the final statement.

**Cross Support.** The Proposed Policy Statement provided that investors that owned two or more depository institutions, including one covered by the Policy

Statement, would have an obligation to commit their bank or thrift investments to support one of more of these institutions if they failed, provided there was sufficient ownership as provided in the Proposed Policy Statement. Under the Final Policy Statement, the cross support obligation would apply if two or more depository institutions are owned by a group of investors covered by the Final Policy Statement if both depository institutions are at least 80 percent owned by common investors. The FDIC retained the authority to waive the cross support obligation if enforcing the obligation would not reduce the cost of the bank or thrift failure to the deposit insurance fund.

**Transactions with Affiliates.** The Proposed Policy Statement proposed a prohibition of certain extensions of credit by an insured depository institution to affiliates. The restriction under this provision reads: "All extensions of credit to investors, their investment funds if any, and any affiliates of either, by an insured depository institution acquired by such investors under this [Policy Statement] would be prohibited." Several commenters suggested that the existing provisions in Sections 23A and 23B of the Federal Reserve Act, as well as Regulation W and Regulation O, provide sufficient protections against the potential abuses of transactions between a bank and its affiliates. In the Final Policy Statement, the FDIC took the view "that a special situation is presented with respect to transactions with affiliates by private capital investors who are not subject to the activities restrictions of the Bank Holding Company Act with a resultant temptation to cause the de novo bank they have purchased to lend to companies in which they have invested." The Final Policy Statement retains the prohibition offered in the Proposed Policy Statement, and defines the term "affiliate" to mean "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." The Final Policy Statement's restriction on transactions with affiliates goes far beyond the existing quantitative and qualitative restrictions under current law.

**'Silo' Structures.** The FDIC rejected calls by many in the industry to permit private equity investments under so-called "silo" structures, arguing that prohibiting silo structures would eliminate many investors who would be willing to meet the FDIC's disclosure and transparency requirements. The FDIC declined to remove this prohibition, stating that "the purpose of [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.” According to the FDIC, this type of structure “raises serious concerns about the sufficiency of the financial and managerial support to the acquired institution, even in those instances where the investing fund(s) agrees to be regulated as a bank or savings and loan holding company.”

**Secrecy Law Jurisdictions.** The Proposed Policy Statement prohibited investors in entities domiciled in bank secrecy jurisdictions from making a direct or indirect investment in an insured depository institution unless the investors are subsidiaries of companies subject to comprehensive consolidated supervision, as recognized by the Federal Reserve Board. The Final Policy Statement continued this prohibition, while clarifying the meaning of “bank secrecy jurisdiction” to mean “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, or does not provide for a minimum standard of transparency for financial activities.”

**Continuity of Ownership.** The Proposed Policy Statement prohibited covered investors from selling or transferring securities of their holding company or insured depository institution for three years following acquisition absent FDIC approval. The Final Policy Statement has left this provision largely unchanged, but has added a statement that in the case of transfers to affiliates, FDIC approval shall not be unreasonably withheld provided the affiliate agrees to be subject to the same requirements that are applicable under the Final Policy Statement to the transferring investor. In the Final Policy Statement, the three-year holding period does not apply to mutual funds 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.

**Disclosures.** The Proposed Policy Statement provided for disclosures of certain specified information from investors and other entities in the investors’ ownership chain. Such information included the size of the capital fund or funds, its diversification, the return profile, the marketing documents, the management team and the business model, as well as such other information as the FDIC may require.

The Final Policy Statement retains these provisions, and provides that business information will be accorded confidential treatment as requested and as permitted by applicable law.

### Pepper Points

In the current banking environment, private equity firms are quickly becoming the “investors of last resort.” The FDIC’s Final Policy Statement represents an attempt by the agency to respond to this reality, while acknowledging the different risk appetite that private equity firms bring. In the Final Policy Statement the FDIC has retreated from some of the more harsh aspects of its proposal. In the final version, the FDIC eased the capital requirements and avoided a source of strength requirement. The FDIC declined, however, to permit private equity investors to invest through a “silo” structure.

Above all, the FDIC’s Final Policy Statement provides some much-needed structure and predictability to guide the agency and potential investors. It remains to be seen what effect the Final Policy Statement will have on attracting new investment, however the FDIC, the Administration, and certainly the market will be watching in the coming months to determine whether private equity continues to be interested in purchasing failed banks. If not, the FDIC likely will need to revisit this policy.

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