FDIC FINAL STATEMENT OF POLICY ON QUALIFICATIONS FOR FAILED BANK ACQUISITIONS

On August 26, 2009, the Federal Deposit Insurance Corporation (FDIC) adopted a Final Statement of Policy on Qualifications for Failed Bank Acquisitions (Final Policy Statement). The Final Policy Statement differs significantly in several respects from the FDIC's July 2, 2009, Proposed Statement of Policy on Qualifications for Failed Bank Acquisitions (Proposed Policy Statement), which we discussed in our advisory "FDIC Proposed Guidance on Private Equity Investments on Failed Depository Institutions."[1] Particularly, the Final Policy Statement sets less stringent capital and cross guarantee requirements than the Proposed Policy Statement. The new requirements are, however, more stringent than those applicable under prior policy.

I. Investors Subject to the Final Policy Statement

The Final Policy Statement will apply prospectively to the following "Covered Investors":

- Private investors in a company that is proposing to assume, through an operating depository institution or a shelf charter, deposit liabilities, or both deposit liabilities and assets, of a failed insured depository institution; and
- Private investors that apply for deposit insurance for a *de novo* depository institution established in connection with the assumption of deposit liabilities, or both deposit liabilities and assets, of a failed insured depository institution.

The Final Policy Statement specifically excludes:

- Private investors in partnerships or similar ventures with bank or savings and loan 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; or
- Private investors with 5% or less of the total voting power of a depository institution or its holding company, if there is no evidence of concerted action with other investors.

As is clear from the above description, the Final Policy Statement is imprecise about its applicability. The FDIC acknowledges this but notes that such imprecision is appropriate to a policy statement, and that it is "exceedingly difficult" to be precise in this

1 *Available at:* http://www.arnoldporter.com/resources/documents/Advisory_FDICProposedGuidanceOnPrivateEquity_070809.pdf

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context. It appears that the FDIC would like to retain discretion as to the applicability of the Final Policy Statement.

The Final Policy Statement will become inapplicable to a private investor in a depository institution or its holding company, subject to approval by the FDIC Board of Directors, if the depository institution has maintained a composite CAMELS rating of one or two for seven consecutive years.

II. Requirements for Private Investors

Covered Investors would be subject to the following requirements, *unless* the FDIC Board of Directors provides an exemption on the grounds that such an exemption is in the best interests of the Deposit Insurance Fund and that the goals and objectives of the Final Policy Statement can be accomplished by other means.

- **Capital Commitment:** The resulting depository institution must maintain a ratio of Tier 1 common equity to total assets of at least 10% for the first three years from the time of acquisition, and remain "well capitalized" thereafter as long as the Covered Investors retain ownership in the institution. If the institution fails to maintain the required capital level, it will be treated as "undercapitalized" for purposes of the Prompt Corrective Action statute. In comparison, the Proposed Policy Statement would have required a Tier 1 leverage ratio of 15%. Tier 1 capital that is not common equity may not be included in calculating the ratio required under the Final Policy Statement, but this does not appear to raise much concern among investors that are prepared to capitalize depository institutions with high-quality common equity. To these investors, the reduction in the required capital ratio is welcome. Nevertheless, Covered Investors are still at a competitive disadvantage compared with the depository institution subsidiaries of existing bank or savings and loan holding companies, which would only need to attain a 5% Tier 1 leverage ratio to be considered well capitalized, even if such subsidiaries should also acquire failed banks or thrifts. Furthermore, Covered Investors are at a disadvantage compared with investors in a *de novo* institution that acquires a healthy bank or builds its entire operations from scratch, because such a *de novo* institution generally need only maintain a Tier 1 leverage ratio of not less than 8% for the first three years.
- **Cross Guarantee Obligations:** If one or more Covered Investors own 80% or more of the stock of two or more depository institutions, the Covered Investors will be required to pledge their stock in these depository institutions to the FDIC. Additionally, if one of the institutions fails, the FDIC may foreclose on the pledged stock to recoup any loss that it incurs as a result of the failure. In comparison, the Proposed Policy Statement would have set the ownership threshold at 50% for such cross guarantee to apply. Even though the Final Policy Statement provides for a less stringent cross guarantee requirement, it could still subject investors that have an interest in only one depository institution to cross guarantee liability. For example, a private equity firm may sponsor two funds, each investing in one depository institution, and each fund may have a different group of investors. Yet once the 80% threshold is crossed, investors in both funds are subject to cross guarantee liability.
- **Transactions with Affiliates:** The resulting depository institution will be prohibited from extending any credit to the Covered Investors, any of their investment funds, or any company in which any of the Covered Investors owns 10% or more of the equity and has maintained such ownership for at least 30 days (which company will be considered an affiliate of an investor). This prohibition does not apply to pre-existing extensions of credit. In addition, the Covered Investors are required to provide regular reports to the depository institution identifying all their affiliates. Such restrictions would appear workable to private equity investors, as many of them have offered to comply with such restrictions in connection with their proposed investments in depository institutions.
- **Secrecy Law Jurisdictions:** Covered Investors will not be able to use an entity domiciled in a bank secrecy jurisdiction (which is defined as a jurisdiction that has a bank secrecy law that limits US bank regulators' ability to obtain certain information necessary for supervision) to invest in the resulting insured depository institution, unless the Covered Investors are subsidiaries of companies that

are subject to comprehensive consolidated supervision as recognized by the Federal Reserve Board. Furthermore, the Covered Investors would be required to essentially forgo the bank secrecy protection afforded by the entity's jurisdiction of domicile. Investors have argued that they have a legitimate business purpose, including tax planning, in investing through an entity domiciled in a secrecy law jurisdiction, but the FDIC imposed the restriction nonetheless.

- **Continuity of Ownership:** A Covered Investor will not be able to transfer its investment in a failed depository institution for three years after the acquisition, unless it obtains FDIC approval. The FDIC generally will approve transfers to affiliates of the Covered Investor, if the affiliates agree to comply with the Final Policy Statement. The three-year holding period requirement does not apply to open-ended mutual funds. Generally, there is no holding period requirement for an investor whose investment in the banking industry does not involve a failed depository institution.
- **Prohibited Structures:** The FDIC would not approve "silo" ownership structures that typically involve a private equity firm that creates multiple investment vehicles funded and apparently controlled by the private equity firm, and uses one or more of the investment vehicles to acquire ownership of an insured depository institution. The FDIC expressed concern in the preamble to the Final Policy Statement that the purpose of such structures is to artificially separate banking from commerce, and that sufficient financial and managerial support might not be provided to an insured depository institution acquired through such a structure. Essentially, even though the FDIC does not use the term "silo structures" in the text of the Final Policy Statement, which it did in the Proposed Policy Statement, the FDIC still considers such structures "complex and functionally opaque" and remains unwilling to approve them.
- **Special Owner Bid Limitation:** Covered Investors that hold 10% or more of the equity of a bank or savings institution when it fails will not be allowed to bid on that failed bank or savings institution.
- **Disclosure:** A Covered Investor will be required to provide the FDIC with information about itself and all the entities in the ownership chain, including information regarding the size of the investment fund, its diversification, the return profile, the marketing documents, the management team, and the business model. The FDIC may also require other information. The confidentiality of confidential business information will be protected in accordance with law. These disclosure requirements seem consistent with what is already required of investors in the banking industry.

The FDIC emphasized that the Final Policy Statement does not replace any applicable requirements under existing banking statutes or regulations. Therefore, the factors that the bank regulators consider in acting on a deposit insurance application, holding company application, Change in Bank Control Act notice, or Bank Merger Act application will continue to be considered in addition to the requirements of the Final Policy Statement. In other words, the Final Policy Statement does not relax existing requirements, but instead imposes new requirements that are in addition to existing bank and holding company regulatory requirements.

The Final Policy Statement has not elicited as much criticism from investors as the Proposed Policy Statement, and some investors have indicated that they would explore opportunities to make investments covered by the Final Policy Statement, even though they were uncertain about the prospects for such investments. The Final Policy Statement would impose various restrictions on an investor with a 5% or more voting interest in a depository institution that proposes to acquire the banking operations of a failed depository institution, even though the current statutory scheme generally would not subject an investor in the banking industry to regulatory restrictions unless the investor acquires a 10% or more voting interest in a depository institution. Furthermore, the Final Policy Statement would impose certain restrictions that currently do not even apply to investors that propose to acquire a 10% or more voting interest in a depository institution. For example, the Office of Thrift Supervision has approved private equity investments in savings institutions or their holding companies where the institutions were not required to maintain higher capital ratios than are generally applicable. Nor did the Federal Reserve Board indicate in its September 2008 policy statement that it would require a higher capital ratio for banks or bank holding companies in which private equity investors propose to acquire a non-controlling interest, even though the Federal Reserve Board has appeared to be hesitant to approve controlling investments by private equity investors.

Arnold & Porter LLP has been assisting numerous private equity firms and individual investors interested in navigating through the shelf charter process initiated by the Office of the Comptroller of the Currency and the Office of Thrift Supervision, and in using the non-controlling investment policy statement issued by the Federal Reserve in September 2008. We would be pleased to assist you in considering implications of this Final Policy Statement for specific situations. If you have questions or need further information, please contact your Arnold & Porter attorney or:

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