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September 1, 2009

Global Finance Group Client Alert

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FDIC Publishes Guidance on Qualifications for Entities Seeking to Acquire Failed Banking Institutions

The Federal Deposit Insurance Corporation (the “FDIC”) issued its final Statement of Policy on the Acquisition of Failed Insured Depository Institutions on August 26, 2009 (the “Statement of Policy”). The final Statement of Policy incorporates numerous comments that the FDIC received to its initial proposal, which it published on July 2, 2009, from members of the private equity industry, banking institutions, law firms, senators, and law professors, both in support of and against the proposal. In response to these comments, the FDIC made several substantial revisions to its initial proposal, which was widely criticized for discouraging private equity investors from injecting new capital into the banking sector. The final policy nevertheless left unchanged aspects of the proposal that the FDIC considered crucial to the safety and soundness of de novo banking institutions and to ensuring the resolution of failed depository institutions at the least cost to the Deposit Insurance Fund. The full text of the FDIC’s final Statement of Policy is available at <http://www.fdic.gov/news/board/Aug26no2.pdf>. The FDIC will review the implementation and impact of the guidelines set forth in its Statement of Policy in six months.

Highlights of the Statement of Policy are the following:

1. *Definition of Private Investors Remains Fuzzy.* The FDIC declined the request of commentators to give further definition to the term “private investors” used in the Statement of Policy. The FDIC’s hesitation to define the term appears to have been motivated by an inability to identify a unifying set of characteristics for such investors and a desire to preserve flexibility in applying the Statement of Policy to a variety of private equity investors.
2. *Private Investors in Bank or Thrift Holding Companies Not Exempt.* In a change from the FDIC’s initial proposal, all private investors will be subject to the restrictions set forth in the Statement of Policy, including those private investors that have already subjected themselves to the provisions of the Bank Holding Company Act as a result of their investments in bank or thrift holding companies in the past three years. Private investors that invest in insured depository institutions through joint ventures with depository institution holding companies, however, are exempt from these restrictions so long as the depository institution holding company with which they invest (i) is not a shell holding company, (ii) holds a “strong majority interest” in the bank or thrift to be acquired, and (iii) has “an established record for successful operation of insured banks or thrifts.”

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3. *De Minimis Exception to Guidelines.* The Statement of Policy excepts from its purview any private investor whose investment in an insured depository institution represents five percent or less of the total voting power of the insured depository institution or its holding company. When calculating the percentage of total voting power represented by any such investment, the FDIC will aggregate it with the investments of any investor found to be working with the investor in “concerted action.”
 4. *Capital Requirements Reduced to 10 Percent Tier One Common Equity.* The Statement of Policy relaxes, from the 15 percent originally proposed, the capital requirement imposed on a depository institution in which a private investor invests to a minimum ratio of Tier 1 common equity to total assets of 10 percent for the first three years of operations. After the three-year period, a private investor must maintain capital levels necessary to keep the depository institution “well capitalized.” Higher or more stringent capital requirements may be imposed on certain investments by private investors, if warranted, although the FDIC does not provide details on the circumstances that would merit increased requirements. Qualifying perpetual preferred stock is excluded from the Statement of Policy’s definition of common equity.
 5. *Source of Strength Requirement Removed.* The Statement of Policy removes the requirement that a private investor serve as a “source of strength” to the insured depository institutions in which it invests. The FDIC cited concerns raised by private investors about the practical difficulties of implementing such a requirement.
 6. *Transfer of Investment Before the End of Three-Year Holding Period.* The final Statement of Policy continues to require a private investor to hold its investments in a depository institution for three years but adds a provision that allows such an investor to apply to the FDIC for prior approval to transfer its investment before the end of the three-year holding period. In the case of a transfer to an affiliate that agrees to be subject to the restrictions set forth in the Statement of Policy, consent by the FDIC is not to be unreasonably withheld.³
 7. *Possibility of Freedom from Guidelines After Seven Years.* The final Statement of Policy provides an end date to the application of its guidelines to private investors. A private investor in a bank, thrift, bank holding company or thrift holding company may ask the FDIC to relieve it of the guidelines set forth in the Statement of Policy after the institution in which it has invested has maintained a Camel rating of 1 or 2 for seven continuous years.
 8. *Waiver of Guidelines Available on a Case-by Case Basis.* The FDIC appears to be willing to relax the restrictions otherwise applicable to private investors in certain circumstances. The FDIC will review requests by investors for waivers of any of the provisions set forth in the Statement of Policy under expedited procedures and may grant a request “if such exemption is in the best interests of the Deposit Insurance Fund and the goals and objectives of [the Statement of Policy] can be accomplished by other means.”
 9. *Confidentiality of Documents Provided Pursuant to Disclosure Requirements.* The Statement of Policy assures investors that all confidential business information provided in connection with the Statement of Policy’s disclosure requirements will be accorded confidential treatment by the FDIC.

The following elements of the FDIC's proposed statement of policy remain unchanged or only slightly modified:

- a. *Two-track prompt corrective action regime.* The FDIC rejected arguments that the failure of a private investor to maintain levels of capital sufficient for a depository institution to remain "well capitalized" should not trigger prompt corrective action. As a result, the threshold for triggering prompt corrective action for a depository institution in which a private investor has invested is lower than the threshold applied to a depository institution that is not subject to the Statement of Policy.
- b. *Cross-support mechanism.* A cross-support mechanism remains in the final Statement of Policy, with the slight modification that this requirement is triggered only with respect to a depository institution that has 80 percent of its investors in common. The cross-support mechanism requires a private investor with investments in more than one depository institution to pledge commonly owned stock in those depository institutions to the FDIC, to be used by the FDIC to recoup losses associated with the failure of any one of the depository institutions.
- c. *Restrictions on transactions with affiliates.* The Statement of Policy retains a strict prohibition on any extension of credit by a depository institution to its private investors, to the investment funds managed by the private investors, or to any affiliate of either. The Statement of Policy makes exceptions for short-term investments and existing extensions of credit.
- d. *Prohibition on use of "silo" structures.* The final Statement of Policy flatly rejects the use of a "silo" structure for any investment by a private investor in depository institutions. The Statement of Policy does not define a "silo" structure but notes that the ownership structures with which the FDIC is concerned are "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."
- e. *Restrictions on investors from jurisdictions with secrecy laws.* The Statement of Policy retains stringent restrictions on investments in depository institutions by entities located in bank secrecy jurisdictions.

For all the attention the Statement of Policy has received in the financial press, it applies only to investors seeking to acquire a depository institution from the FDIC as receiver and does not supplant the existing regulatory regimes imposed by the Federal Reserve under the Bank Holding Company Act on investments by private investors in a bank or bank holding company or imposed by the Office of Thrift Institutions under the Home Owners' Loan Act on private investors in a thrift or savings and loan holding company. That said, the Statement of Policy will undoubtedly influence the FDIC in extracting commitments in other areas in which it retains primary authority, for example, in applications for insurance for de novo depository institutions and notices of change in control of insured non-member banks, including industrial banks.

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