A GUIDE TO INVESTMENTS IN FAILED BANKS

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Although the worse of the recession may be behind us, chronic undercapitalization and the specter of the collapse of the commercial real estate market threatens small and medium sized banks throughout the nation, including several in Florida. The number of banks and other insured institutions on the "Problem List" of the Federal Deposit Insurance Corporation (**FDIC**) ballooned to 702 at the end of December 2009, representing nearly $403 billion in total assets. The "Problem List" further grew to 775 by the end of March 2010, or almost 10% of total FDIC-insured institutions. In 2009, 140 federally insured institutions failed and were shut down by regulators. In the first quarter of 2010, the pace of bank failures has accelerated with 72 banks failing.

The resources of the FDIC have been stretched and heightened capital requirements and restrictions have limited the ability of all but the best capitalized banks to acquire failed bank assets. Although the number of qualified banks and bank holding companies (**BHCs**) may be limited, one source has ample capital ready for investment – private equity funds and other private investors.

Why Participate in FDIC-Assisted Transactions?

An investment in the assets of failed banks is attractive to both banks and private investors for a number of reasons, primarily related to the values at which such assets can be acquired and the limitation on downside risk provided by participating in transactions where the FDIC has entered into a loss sharing agreement (**LSA**) with the buyer. Opportunities can vary based on a number of variables, including the location and size of the banking organization, and will likely be fewer as time passes. However, they are still available, albeit the valuations are higher than in 2009 and the LSA's protection has narrowed recently from 95% down to not more than 80% of losses (relating to acquired assets) from 95%, and could trend lower or vanish altogether (in one case in the second quarter of 2010 the LSA covered only 50% of losses).

FDIC transactions occur quickly, much more quickly than a typical business acquisition. Generally there is a two-week window between the time when the FDIC notifies approved bidders of a bidding opportunity and the date when the transaction closes. Generally, only superficial due diligence is possible. After closing, purchasers of operating bank assets need to quickly integrate the systems, records and operations of the failed bank.

Regulatory Hurdles

Acquiring a bank is not for sissies. Neither is it a typical investment for private investors. Generally, the regulatory hurdles have discouraged private investors from acquiring bank assets. However, in an effort to increase bidders for the assets of failed banks and thus reduce the loss covered by FDIC insurance, the FDIC has issued interpretive guidance (**FDIC Guidance**) concerning the standards that it will apply to bids made by private equity funds and other private investors.

In addition to the requirements of the FDIC, the Federal Reserve Board (the **Federal Reserve**) reviews investments to determine whether the investment constitutes "control" for purposes of the Bank Holding Company Act (**BHCA**). Under the BHCA, "control" is defined as (i) ownership, direct or beneficial, of twenty five percent (25%) or more of any class of voting securities of a bank or BHC, (ii) the ability to control the election of a majority of the board of directors of a bank or BHC or (iii) the determination by the Federal Reserve that a person directly or indirectly exercises a controlling influence over the management or policies of a bank or BHC.

In September 2008, the Federal Reserve issued a policy statement (the **FR Policy Statement**) that provided guidelines that effectively increased permitted ownership levels and board membership slots for investors, evidencing new flexibility in permitting investment by private investors under the third leg of the three criteria for determining "control" under the BHCA. The FR Policy Statement is discussed below as it relates to the various ownership structures for investing in banks and BHCs.

The Office of Thrift Supervision (**OTS**) also has regulatory authority over investment in savings banks and thrifts. The OTS has established a "pre-clearance" program to facilitate bids for banks and savings associations. Under this program, the OTS can grant preliminary approval to bid on troubled institutions through a bid process operated by the FDIC. The OTS reviews the investor's character, integrity, financial and managerial resources and general business plan. After the investor receives preliminary approval, the OTS contacts savings and loan associations requiring capital to initiate a due diligence process. If the prospective investor is interested in participating in the FDIC bid process, the OTS notifies the FDIC to include the investor on the bidders list. Final approval is subject to formal application and the FDIC approval considerations.

Other regulators, including state financial regulators, have other requirements that complicate the process for private investors seeking to acquire banks and banking assets.

A Roadmap for Investing

How can private investors take advantage of the opportunities presented in acquiring distressed banks without becoming ensnarled in the trap of continuing regulatory requirements? What are the requirements for banks wishing to grow by taking advantage of current market values and government assistance? What are the pros and cons of the different possible structures for such transactions?

Banks and private investors must meet certain criteria to get on the approved list to bid on FDIC sales. For banks the following criteria must be satisfied:

- Total risk-based capital ratio must be 10 percent or greater
- Tier 1 risk-based capital ratio must be 6 percent or greater

- Tier 1 leverage capital ratio must be 4 percent or greater
- CAMELS composite rating of 1 or 2
- CAMELS management rating of 1 or 2
- Compliance rating of 1 or 2
- Bank holding company composite (RFI/C) rating of 1 or 2
- Community Reinvestment Act rating of at least satisfactory
- Satisfactory anti-money laundering record

Meeting this criteria allows a bank to bid on FDIC sales but does not assure that the bank's bid will be accepted. Final approval must be obtained from the bank's primary federal regulator (**PFR**), the FDIC's Division of Supervision and Consumer Protection, and the Federal Reserve if a bank holding company is involved in the acquisition. The PFR for state-chartered banks that are members of the Federal Reserve System is a regional Federal Reserve Bank in the area where the bank is located. The FDIC regulates state-chartered banks that are not members of the Federal Reserve System, the Office of the Comptroller of the Currency (**OCC**) regulates nationally chartered banks and the OTS regulates savings and loan associations.

It is advisable to have early and regular conversations with the relevant regulators and it is important to remember that certain PFR's have different requirements and that some state regulators have additional requirements.

In the case of private investors holding more than five percent (5%) of the total voting power of the acquired bank (including those deemed to be acting "in concert"), under the FDIC Guidance certain significant limitations, restrictions and requirements not applicable to banks apply in order for the investor group to be eligible to bid. These include the following:

- Higher capital requirements for the acquired bank;
- "cross support" by the investor for the acquired bank where such private investor owns eighty percent (80%) or more of two or more U.S. depository institutions;
- prohibitions on the extension of credit to the investor or its affiliates;
- prohibitions on the uses of entities domiciled in "bank secrecy jurisdictions" as part of their ownership structure; and
- provision of information about all entities in the "ownership chain" of the investor.

Private investors who have not yet affiliated with a bank or bank management team can use "shelf charters" or "inflatable charters" to acquire assets of failed banks, tools that allow them to act quickly when an acquisition opportunity arises. In January 2009, the OCC approved the initial use of a "shelf charter" to facilitate the purchase of Premier American Bank, a state-chartered bank closed by the Florida Department of Financial Services. The OCC had granted a private investor group preliminary approval in October 2009 to obtain a national bank charter and the FDIC had granted preliminary approval to receive deposit insurance for the charter. This status enabled the investors to be notified by the FDIC and enter a pool of potential bidders for the failed bank.

Under the FDIC Guidance, the FDIC has indicated that it will consider abbreviated information submissions and applications and may issue conditional approval for deposit insurance in order to qualify interested parties for the FDIC's failing institution bidders list. Investors that are interested in acquiring the deposits of failing institutions must have conditional approval for a charter from the applicable PFR and meet the bid criteria established by the FDIC. The basic areas of consideration include a business plan compliant with the Community Reinvestment Act (**CRA**), readily available capital, and an identified management team subject to financial and biographical review.

However, in each case, the process has several downsides. Among other things, the investor group would likely need to "lock-up" well-qualified senior bank executive officers potentially for a long period and without knowing much about the type of banking institution that they might potentially run. In addition, such *de novo* organizations sometimes are subject to stringent operating requirements. And, in any case, private investors are subject to the FDIC Guidance or may be required to register as a bank or thrift holding company.

An "inflatable charter" is similar to a shelf charter. In this structure, the private investor group would acquire a relatively small depository institution with the expectation that it will be recapitalized when an opportunity arises to acquire a significantly larger open or failed institution. The OTS has a similar, but less formalized procedure for preliminary approval for a federal thrift charter, which was briefly described above.

Set forth below is a description of some of the requirements applicable to specific structures that may be used by banks and private investors that wish to participate in the acquisition of banks and bank assets, including mortgages and other loans. As you will note, the degree of involvement that an investor may have in a transaction and the degree of restrictions and regulatory requirements correlate and vary based on the structure employed. Structures where a bank or BHC leads the investor group minimizes the regulatory impact on the private investor. Acquiring a bank and bank assets is a complex transaction and involves numerous accounting, tax, operational, legal, regulatory and other considerations. The following discussion is not intended to be comprehensive, but only illustrative, of the universe of possible structures or what is involved in a particular structure.

Some alternative structures are:

1. ***Investment partnerships between private investors and a bank or BHC to acquire banks and bank assets.***

2. ***Club deals among private equity firms and other private investors to acquire banks and bank assets.***

3. ***Small investments by private investors of less than 5% in a bank or BHC to acquire banks and bank assets.***

4. ***Investment partnerships between private investors and a bank or BHC where the bank would acquire the bank branches and deposits and the private investors would acquire loans or the underlying collateral for the loans.***

Each of these structures are discussed below.

Investment Partnership with a Bank

In this structure one or more individual private investors each make a "noncontrolling" investment generally representing more than five percent (5%) of the total voting power in a bank or BHC or in a partnership with a bank or BHC, but in any case less than twenty five percent (25%) of any class of voting securities. Most importantly, the partnership must include a BHC with an established record for successful operation of insured banks or thrifts holding a "strong majority interest" in the bank or BHC, or partnership. Although the term "strong majority interest" is not completely defined, it includes at least two-thirds of the total equity and voting equity of the acquired bank and should be understood to mean that the BHC controls all day-to-day operations of the bank, as well as most other significant actions and that the private investors have no special rights.

An investment in a partnership by individual private investors with a BHC is, in effect, an investment in a BHC. This means that the partnership may be subject to supervision by the Federal Reserve and the myriad of regulations that are applicable to BHCs, including capital requirements and limitations on non-banking activities, absent the application of the FR Policy Statement.

Generally, the FDIC Guidance would not apply to this type of investment structure. Under the FR Policy Statement, "non-controlling" investments by private investors is possible and an individual private investor may be able to acquire up to thirty three percent (33%) of the total equity of a bank so long as the investor does not hold or vote more than fourteen and nine tenth percent (14.9%) of any class of voting stock of the bank. Moreover, under the FR Policy Statement private investors may have up to two representatives on the board of the bank in most cases. However, in some cases, private investors may be required to make or offer to make "passivity" commitments limiting their involvement in management of the bank.

It is important to note that if the investor were to acquire a direct five percent (5%) or greater voting interest in the failed bank, the investment by the private investor will be subject to the FDIC Guidance including its requirement that such investors hold their investment for a minimum of three years.

In a recent set of FAQs, the FDIC has clarified that there is no requirement that private investors must hold their ownership interests in an established bank for any specific time prior to the acquisition of a failed bank or thrift. Nonetheless, if a significant portion of the total equity held by private investors in an established bank prior to the acquisition of a failed bank or thrift were acquired recently as part of a recapitalization, the FDIC will review the timing and purpose of the recap, including whether the investment was conditioned on completion of the acquisition of the failed bank, as well as the number of failed bank acquisitions following the recap. The FDIC Guidance will apply if any acquisition of a failed bank or series of acquisitions exceed 100% of the recapitalized bank's total assets within an 18 month period after the recap.

Club Deals with Private Equity Firms with Participation by a Leading Bank Manager

In this structure one or more individual private investors each make an investment in a newly-formed entity without a bank charter. The investment of each investor in this structure will represent more than five percent (5%) of the total voting power of the resulting bank (but less than twenty five percent (25%) of a class of voting securities of the bank). Although this structure appeared viable initially, the FDIC Guidance has called into question this structure. Under the FDIC Guidance it is clear that "silo" ownership structures, that is, a structure where a private equity firm (or its sponsor) creates multiple investment vehicles each with a "non-controlling" interest in the bank, but funded and apparently controlled by the private equity firm, the private investment vehicle will not be considered as an individual investor but rather as a group comprised of the other private investment vehicles and collectively constitute a BHC. In the view of the FDIC this structure is an attempt to circumvent BHC status and raises concerns about the financial and managerial support that the investor groups will provide to the bank.

If the private investor groups are aggregated and deemed a BHC, the FDIC Guidance is not applicable and the Federal Reserve will require the investors to provide information about themselves and information will be required about each entity and individual in the ownership chain, including information on the amount of capital, capital diversification, return profile, management team and business model contemplated, as well as comply with the other requirements applicable to a BHC.

In addition to securing approval from the FDIC (to participate in the bid process and in many cases acquire deposit insurance for the resulting bank), the private investor groups will also need approval from the Federal Reserve to either (or both) (i) acquire "control" of the resulting bank and become a BHC and/or (ii) receive confirmation that the relationship between one or more individual private investors and the bank do not constitute "control."

Small Investments by Private Investors in Banks or BHCs

In this structure, private investors purchase stock directly in the distressed bank as part of a plan to recapitalize and restructure the bank and infuse additional tier capital, generally in the form of common stock. No investment by any individual private investor should represent more than five percent (5%) of the total voting power of the bank, an amount that is considered individually for each private investor provided that there is no evidence of "concerted action" among investors in the bank. What constitutes "concerted action" is not defined. Generally, the FDIC Guidance does not apply to this type of investment. Private investors are not typically required to make "passivity commitments" but nonetheless may have representation on the board of the bank of up to two directors provided that the majority of board members are not appointees of a private investor or group of private investors.

<u>Investment Partnerships between Private Investors and Banks or BHCs</u>

In this structure, a bank or BHC teams with one or more real estate investment companies (**RICs**) to acquire from the FDIC the branches and deposits of the failed bank and some or all of the failed bank's real estate assets, whether as mortgages, real estate securities or real estate owned assets (**REO**). In this structure, the bank acquires the bank assets and forms a joint venture company (**JVC**) with the RIC as the majority investor and the acquiring bank as a minority owner. The JVC then acquires some or all of the real estate assets from the bank, while the bank retains the branches and deposits and other assets relating to banking operations. As part of the arrangement with the FDIC, the FDIC agrees to extend its LSA to the JVC with respect to the real estate assets acquired from the bank. The bank and the RIC share in the profits of the JVC in accordance with their respective equity percentages.

Conclusion

Opportunities continue to exist to acquire banks, both by strategic and financial acquirers, at attractive price points compared to valuations applicable prior to the financial crisis. Although some of the most attractive potential acquisitions relate to failed financial institutions purchased from the FDIC in its capacity as receiver, there are other opportunities to acquire banks outside of the FDIC bid process that omit some of the drawbacks of the FDIC bid process, including the inability to conduct due diligence. Acquisitions of banking assets, particularly by private investors, whether or not as part of the FDIC bid process, involve a through analysis of the legal, accounting and business considerations and should be undertaken only by a well capitalized purchaser with the assistance of competent legal and other advisors.

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