

Torys on Private Equity

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U.S. FDIC Issues Guidance for Private Equity Investments in Banks

By [Jay Romagnoli](#), [Amy Johnson-Spina](#) and [Mayah Judovits](#)

The U.S. Federal Deposit Insurance Corporation (FDIC) recently adopted the “Final Statement of Policy on Qualifications for Failed Bank Acquisitions” (the Policy). The Policy provides guidance on the standards that private investors will be expected to meet to qualify to bid on a failed banking institution. Typically, the FDIC sells failed banks to other banking institutions, which are already subject to strict federal rules on leverage and dealings with affiliates. However, struggling with a surge in the number of failed banks and thrifts, the FDIC has recently sought to attract more private equity investment in failed banks. Failed bank IndyMac and the Florida lender Bank United have been sold by the FDIC to private investors in the past few months. In adopting a formal policy, the FDIC seeks to lure private equity money while minimizing risks to the Deposit Insurance Fund and discouraging excessive risk-taking by private equity investors.

The FDIC notes that the Policy is not a statutory one imposing civil or criminal penalties, and the requirements it imposes on investors apply only to investors that agree to its terms. The Policy, which was adopted on August 26, 2009, is effective immediately, and the FDIC’s board of directors will review its impact within six months and make adjustments, as deemed necessary.

Applicability to Private Equity Investors

The Policy states that it will apply, prospectively, to the following:¹

- “private investors in a company, including any company acquired to facilitate bidding on failed banks or thrifts that is proposing to, directly or indirectly, assume deposit liabilities, or such liabilities and assets, from the resolution of a failed insured bank or thrift; and
- applicants for insurance in the case of *de novo* charters issued in connection with the resolution of failed insured bank or thrift.”

To encourage private equity investors to partner with existing banks to make acquisitions rather than submit the bids themselves, the Policy does not apply to investors in partnerships or similar ventures with historically successful bank or thrift holding companies in which the holding company has a majority interest in the

To discuss these issues, please contact the authors.

For media calls, please contact [Stuart Wood](#), Chief Marketing Officer, 416.865.8205.

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¹ The Policy does not apply to acquisitions of failed banks completed prior to its adoption. The Policy will no longer apply upon application and approval by the FDIC’s board of directors to an investor in a bank or thrift, or its holding company, if it has maintained a Camels 1 or 2 rating (a supervisory rating of the bank’s overall condition used by the government to classify the nation’s banks) continuously for seven years.

acquired bank. The Policy does also not apply to investors holding less than 5% voting power in an acquired institution.

Finally, the FDIC's board of directors may waive Policy provisions when an exemption is in the best interests of the Deposit Insurance Fund and the Policy's goals can be accomplished by other means.

Policy Provisions

- **Capital commitment.** A bank will have to maintain a minimum capital requirement (the so-called tier 1 common equity equivalent) of 10% of the bank's assets for three years following its acquisition by an investor.
 - After the three-year period, the bank must maintain no lower level of capital adequacy than "well capitalized" (as defined in the FDIC Rules and Regulations, Section 325.103(b)(1)) during the remaining period of ownership of the investors. If at any time the bank fails to meet this standard, the institution would have to immediately take action to restore capital to the 10% tier 1 common equity ratio or the well-capitalized standards. If the bank fails to maintain the required capital level it will be treated as "undercapitalized" for purposes of prompt corrective action triggering all of the measures that would be available to the institution's regulator in such a situation.
- **Cross-support.** If one or more investors own 80% or more of two or more banks or thrifts, the investors will be obligated to pledge to the FDIC the commonly owned stock of such banks or thrifts, and if any one of those owned banks or thrifts fails, the FDIC may exercise such pledges to the extent necessary to recoup any losses incurred by the FDIC as a result of the bank failure.
- **Transactions with affiliates.** The Policy prevents a bank from extending credit to investors, their investment funds or any "affiliates" (as defined in the Policy) of either who acquired the bank. However, extending credit under existing credit facilities would be permitted.
- **Secrecy law jurisdictions.** Investors with ownership structures utilizing entities that are domiciled in bank secrecy jurisdictions would not be eligible to own a direct or indirect interest in an insured bank or thrift, absent, among other things, the existence of comprehensive consolidated supervision for the investor group in question; consent to provide information to federal banking regulators; consent to jurisdiction in the United States and to be bound by the requirements of the appropriate U.S. federal banking agencies.
- **Continuity of ownership.** Without the FDIC's approval, investors may not sell or transfer their securities in failed banks for three years following their acquisition.
- **Prohibited structures.** The FDIC will not approve for ownership of insured banks or thrifts buyers with complex ownership structures in which the beneficial ownership is difficult to determine, the decision makers are not clearly identified, and ownership and control are separated. For example, a single private equity fund that seeks to acquire ownership of a bank or thrift through creation of multiple investment vehicles, funded and apparently controlled by the parent fund, would be a prohibited structure. The FDIC's concern is that the purpose of this structure would be to artificially separate the non-financial activities of the private equity fund from its banking activities so that the private equity fund would not be required to become a bank or savings and loan holding company and that even if the private equity fund submitted to such regulation, it would not provide sufficient financial and managerial support to the acquired bank.
- **Special owner bid limitation.** An investor that directly or indirectly holds 10% or more of the equity of a bank or thrift in receivership will not be eligible to bid to become an investor in the deposit liabilities or assets of that institution.

- **Disclosure.** Investors would be expected to submit information to the FDIC about the investors and all entities in the ownership chain, including the size of the capital fund, its diversification, the return profile, the marketing documents, the management team, the business model and any other information needed to assure compliance with the Policy. Confidential business information submitted will be treated as confidential and will be disclosed only as required by law. 