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FDIC Provides Further Clarification on Qualifications and Process for Failed Bank Acquisitions

Following the controversial release by the Federal Deposit Insurance Corporation (“FDIC”) of its final Statement of Policy on qualifications for private investor acquisitions of failed banks (the “Acquisition Policy Statement”), on August 26, 2009, the FDIC staff recently provided additional guidance on the marketing process to be utilized by the FDIC and the standards that potential investors will be expected to meet in order to qualify to bid on a failed institution. The guidance appears to further confirm the advantage that bank bidders have over private investors.

The guidance is in the form of a presentation accompanied by a written outline (the “Presentation”). The staff of the FDIC Division of Resolutions and Receiverships (“DRR”) addressed various issues that are of interest to bidders. The guidance they gave addressing those issues heretofore has been generally unavailable to the public. The Presentation contained valuable insights into the FDIC receivership and resolution process for inexperienced bidders. It covered such topics as the marketing of failed institutions, the structure of FDIC financial assistance to bidders, and a number of other related matters. The subject matter of the Presentation and the staff’s views are described in more detail below.

Marketing a Failed Institution

Bid List Criteria

The DRR initiates the marketing process by preparing a marketing plan, creating a secure website (“Intralink”) and uploading the failing institution’s financial, legal and regulatory information. The DRR then compiles a list of banks to be invited to evaluate the possible acquisition of a failing institution (the “Bid List”). The criteria used to develop the Bid List considers the potential bidder’s supervisory ratings, capital position and geographic location. Significantly, a potential bidder must be a chartered financial institution or have a shelf charter

approval. Thus, the Bid List may include qualified private investors, provided that they have attained a shelf charter from the OCC or other appropriate charter issuing authority. (For more information regarding the FDIC expansion of potential bidders, see the FDIC release dated November 26, 2008).

An invitation to bid is not considered an approval to bid. All potential bidders must obtain final approval to bid from their primary federal regulator, the FDIC Divisions of Supervision and Consumer Protection, and Federal Reserve Bank (if a bank holding company is involved in the acquisition).

The factors that the FDIC considers in compiling the approved bidders fall into two general categories: (i) Supervisory Criteria; and (ii) Total Asset Size and Geographic Criteria.

With respect to Supervisory Criteria, the requirements for a potential bidder are as follows: (i) total risk based capital ratio of 10 percent or higher; (ii) tier 1 risk based capital ratio of 6 percent or higher; (iii) tier 1 leverage capital ratio of 4 percent or higher; (iv) CAMELS composite rating of 1 or 2; (v) CAMELS management component rating of 1 or 2; (vi) compliance rating of 1 or 2; (vii) RFI/C rating of 1 or 2; (viii) CRA rating of satisfactory or outstanding; and (ix) satisfactory anti-money laundering record. Nonetheless, private investors are subject to a tier 1 risk based capital ratio of 10 percent or higher, as per the Acquisition Policy Statement.

With respect to Total Asset Size and Geographic Criteria, the requirements of a potential bidder are as follows: (i) a total asset size that is roughly double the core deposits of the failing bank when the bidder is in geographic proximity to the failing bank; and (ii) larger total asset size requirements are required when the bidder is located in other states. It would appear these criteria will be difficult to meet for any private investor group with a shelf charter.

Bidder Contacts and Intralink

Potential bidders may participate in the bidding process by notifying the FDIC through "FDIC Connect," which can be accessed through the FDIC's website (www.fdicconnect.gov). Potential bidders may complete a survey to record their areas of geographic interest, however, submitting such geographic preference does not mean that an institution will be notified of all potential failing institutions in that state.

For a specific failing institution, the marketing process starts with an email to all prospective bidders, inviting them to Intralink to review the information available. Prospective bidders are required to execute a Confidentially Agreement. If interested, prospective bidders may then request access to the data room set up for a particular failing institution to review information and transaction terms. While on-site due diligence visits to a failing institution are possible, such opportunities are not always available due to resolution timeline concerns, disruption of bank operations, secrecy and the number of interested bidders.

Bids

The FDIC will establish a deadline for all bid packages to be submitted. A bid package will include: (i) the bid (on a standard form); (ii) a purchaser eligibility certificate; (iii) a board resolution; and (iv) reaffirmation of the Confidentially Agreement. The FDIC will select the winning bid using the "Least Cost Test," which requires the FDIC to use the resolution method that is least costly to the FDIC.

Resolution Transaction Structures

There are three basic resolution methods employed by the FDIC to structure the resolution of a failing institution: (i) the Purchase and Assumption Method ("P&A"); (ii) the Payout Method; and (iii) open bank assistance transactions. Of the three, P&A is the most common.

The P&A is a resolution transaction in which some or all deposits (liabilities) are assumed by a healthy institution, which also purchases some or all of the failed bank's loans (assets). There are four types of P&A transactions: (i) Whole Bank; (ii) Whole Bank with Loss Share; (iii) P&A with Option Loan Pools; and (iv) Clean P&A (which covers deposits and cash, but not the loan portfolio).

Some categories of assets never pass to the acquirer in a P&A, they remain with the FDIC. These include claims against former directors and officers, the failing institution premises, prepaid regulatory assessments, tax receivables, loss reserves, and private label asset backed securities. However, if it is not specifically excluded in the P&A, most assets will be transferred to the assuming institution.

Loss Share

A P&A structured as a Loss Share transaction uses the basic P&A structure except for the provision regarding transferred assets. Instead of selling some or all of the assets to the acquirer at a discounted price, the FDIC agrees to share in future loss experienced by the acquirer on a fixed pool of assets. A loss sharing P&A limits the downside risk associated with acquiring large loan portfolios. The FDIC absorbs a significant portion of credit loss on commercial loans and commercial real estate loans, typically 80 percent, and acquiring institutions assume the remaining 20 percent of loss.

A Loss Share transaction applicable to a single family loan asset carries a 10-year term and for commercial loan assets, a five-year term with three years for recovery. An acquiring institution cannot currently obtain loss share without a deposit franchise.

Loss sharing is also structured to include a "stated threshold" so that if losses exceed a projected amount, the sharing percentages would be changed so that

the FDIC would absorb a higher percentage of the losses beyond the projected amount, resulting in a 95 percent to 5 percent ratio.

From the FDIC's perspective, a Loss Share transaction is consistent with their least cost objective and designed to address the problems associated with marketing large institutions with sizeable commercial loan and commercial real estate loan portfolios. This, in turn, encourages more bidders, provides for better long-term returns by managing assets in the local and private sectors, and allows for better asset pricing. From the bidder's perspective, a Loss Share transaction provides a level of confidence to bid for assets, with limited due diligence, lower risk to own impaired assets, and favorable economic terms.

Despite the advantages of a Loss Share transaction for both the FDIC and a bidder, it does require both the FDIC and the acquirer to take on additional administrative duties and costs in managing the shared loss assets throughout the life of the agreement, which some acquirers may find overly burdensome, resulting in a diminished interest in bidding.

Loss Share Bids

Bids for a whole bank with a Loss Share transaction are submitted in two components: (i) deposit premium bid, which is stated as a percentage of adjusted, assumed deposits (i.e. all deposits, less brokered, CDARS and listing service deposits); and (ii) asset premium/(discount) bid (stated in the amount bidder is willing to pay for the assets).

At closing, the FDIC prepares a pro-forma balance sheet for the assuming bank ("AB") listing the book values of acquired assets and assumed liabilities of the failing institution, with the net result resulting in a sum called the transactional equity ("TE"). Then, the FDIC nets the TE with asset discount bid and

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deposit premium bid. If the results are positive, the AB will absorb 100 percent of credit losses until this sum is reached (the "First Loss Tranche"), and thereafter loss sharing begins. If the result is negative, the FDIC pays the AB the resulting amount and loss sharing begins on the first day following bank closing.

Conclusion

The Presentation answered many questions which interested bidders have posed and provided further structure and predictability to guide potential bidders. However, the detail provided does appear to support the belief by many private investors that unless they partner with an existing bank that meets the bidder qualifications, they will not be able to participate in bidding except in the most difficult situations for the FDIC to resolve. As these transactions become more frequent and increasingly complex, the FDIC will likely need to issue more guidance.

About the Authors

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