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Re: Proposed Statement of Policy on Qualifications for Failed Bank
Acquisitions

August 10, 2009

Robert E. Feldman, Executive Secretary
Attention: Comments
Federal Deposit Insurance Corporation
550 17th Street, NW
Washington, DC 20429

Sent as a .pdf file via email to:
comments@fdic.gov
RIN No. 3064-AD47

Dear Mr. Feldman:

We appreciate this opportunity to comment on the Federal Deposit Insurance Corporation's (the "FDIC") proposed Statement of Policy on Qualifications for Failed Bank Acquisitions (the "Policy Statement"), 74 *Federal Register* 32931 (July 9, 2009).

Davis Polk & Wardwell LLP represents numerous financial institutions, private equity funds, institutional investors and other entities with a critical interest in the health of our nation's banking system. We have a great appreciation for the difficult tasks the FDIC faces as it deals with the current banking crisis and the resulting insolvencies of insured depository institutions.

We respectfully request that the FDIC consider the following three points as it determines whether to implement the proposed Policy Statement:

First, the FDIC should be encouraging private capital investors into the banking system, not creating artificial barriers to discourage such investment.

Second, the existing statutory framework, crafted over decades, rather than an FDIC policy statement, provides the appropriate mechanism to address such items as cross-guarantee liability, source of strength, transactions with affiliates and related items.

Third, given the chilling effect the proposed Policy Statement has already had on pending transactions, we encourage rapid action by

the FDIC to clarify or withdraw the proposed Policy Statement altogether.¹

The FDIC Should Be Encouraging Private Investors.

At a time when there are over 300 banks on the problem bank list, when hundreds of others are operating under formal or informal enforcement agreements requiring additional capital or the reduction of problem assets, and the cost of bank failures as a percentage of assets is extraordinarily high, we are perplexed that the FDIC would propose requirements that would discourage a potentially significant source of new capital — private capital investors — from investing in the banking system.² Three of the requirements in the proposed Policy Statement are particularly problematic:

Capital ratios should be based on the bank's business plan and management, not its source of funds. The proposed Policy Statement would impose a leverage ratio (15%) that is three times that provided for "well-capitalized" institutions (5%) in the Prompt Corrective Action provisions of the Federal Deposit Insurance Act and implementing regulations of the banking agencies, and almost twice the level normally required for *de novo* banks (8%), with no justification as to why such a higher leverage ratio is necessary or appropriate. There is no recognition given to the strength of any proposed management team, the bank's business plan and model, the quality of the assets or any of the other factors (including any loss-sharing or other credit enhancement provided by the FDIC) that are ordinarily considered when deciding whether higher-than-normal capital ratios are warranted.

Higher capital ratios will simply result in lower-priced bids (or no bids at all) to the FDIC for failed banks, which runs contrary to the FDIC's statutory obligation, as a receiver for failed banks, to resolve the failure at the least cost to the Deposit Insurance Fund. See 12 U.S.C. § 1823(c)(4). Artificially high capital ratios will drive down the returns on equity invested, thus discouraging the attraction of private capital at this critical time.

We would respectfully suggest that the FDIC indicate a range of minimum capital ratios that might be required based upon the business plan, management and asset quality of the institution rather than attempting to promulgate a "one size fits all" rule for banks with private capital investors. If those factors indicated that an enhanced leverage ratio was necessary, we believe that a leverage ratio in the range of 6% to 10% would be more than adequate, with a presumption that something on the order of 8% would be the norm. We

¹ By focusing on these three primary issues, we do not mean to suggest that there are not other specific points that should be addressed. We are confident, however, that others will do so, and we do not wish to detract from the issues we raise.

² The Congressional Budget Office estimates that the costs of probable bank failures could total about \$100 billion by 2014. See Congress of the United States, Congressional Budget Office, *A Preliminary Analysis of the President's Budget and an Update of CBO's Budget and Economic Outlook* (March 2009), available at <http://www.cbo.gov/ftpdocs/100xx/doc10014/03-20-PresidentBudget.pdf>, at 9.

also believe that a three-year period is long enough for the regulators to allow a bank subsequently to comply with existing, ordinary capital requirements.³

Cross-guarantee obligations are inappropriate for non-controlling investors. If a company controls more than one depository institution, the FDIC is already statutorily authorized to impose cross-guarantee liability on the commonly-controlled depository institutions. See 12 U.S.C. § 1815(e)(1). The statute does not authorize the FDIC, and we do not believe the FDIC should attempt, to impose cross-guarantee liability on institutions that are not commonly controlled as their owners are not in a position to control the management or policies of both institutions, and should not be held responsible, directly or indirectly, if a non-controlled depository institution fails. Attempting to expand the statute to situations where at some point in time a majority of the investors in one institution happens to be a majority of the investors in another would also be inappropriate, and would create an unquantifiable and unprotectable risk for a non-controlling investor. A non-controlling investor will generally not be in a position to know in advance whether and when it would be part of such a majority, and thus any such investor faces potential guarantee liability simply by investing in more than one insured depository institution.

Source of strength obligations are not appropriate for non-controlling investors. It is one thing for the Federal Reserve Board and the Office of Thrift Supervision (the "OTS") to evaluate whether a holding company has the capacity to serve as a source of strength to one or more subsidiary depository institutions. That is a proper consequence of controlling such an institution. It is quite another to create a situation where a non-controlling investor is potentially obligated to contribute more capital to an institution. Most private investors are incapable of making such open-ended commitments, and any such requirement will merely preclude them from investing in the first instance.

The FDIC should not discourage particular types of investments, particularly where the Federal Reserve Board or the OTS has approved the investment structure. The proposed Policy Statement indicates a displeasure with so-called "silo" structures and the use of entities in the investment chain located in "secrecy" jurisdictions. There appears to be an implication that so-called "club" deals, where several investors each take significant ownership interests, each below the threshold of being or becoming a bank or savings and loan holding company, may be inappropriate.

The Federal Reserve Board and the OTS have the responsibility for vetting such structures, for determining whether or not the entities and the investors meet the requisite financial and managerial standards for controlling a bank or thrift, respectively, and whether or not the structures and relationships created cause the investors themselves to be or

³ We also believe it would be unduly punitive and restrictive to automatically treat institutions that fall below these higher capital levels as "undercapitalized." Such a rigid policy could immediately create liquidity problems, as undercapitalized institutions are precluded from certain types of funding. It would likely require any institution to hold capital at levels significantly above even the enhanced requirements. This policy, combined with the Prompt Corrective Action remedies required for undercapitalized institutions, could further discourage private investors from participating in a bank's recapitalization. Finally, we believe it would interfere with the normal supervisory process for banking organizations, as regulators and banking organizations carefully evaluate how best to ensure safe and sound operations without triggering automatic regulatory responses

become bank or thrift holding companies. In the silo structure, the investors typically create an entity that can be regulated as a holding company, subject to all of the obligations resulting from such status. For club transactions, the regulators will evaluate the ownership interest and typically impose passivity and other commitments to ensure that the investment does not result in a controlling influence. Again, we believe that for the FDIC to attempt to expand its mandate by discouraging or prohibiting structures that the Federal Reserve Board and the OTS are comfortable with will discourage investors from taking the time, effort, energy and funds to recapitalize a failed institution.⁴

The Existing Statutory Framework Should Be Followed and Respected.

The FDIC plays two important roles when dealing with a failed bank. It is, of course, the receiver, and as such has important statutory duties and obligations, including satisfying its "least cost" responsibility. It is also a supervisor, but in that capacity is only one of several supervisors given responsibility for open, operating financial institutions.

We believe it is perfectly appropriate for the FDIC to evaluate the business plan of any proposed acquirer of a failed bank, whether the acquirer is an existing financial institution or a newly-formed holding company. Similarly, it is important to ensure that the acquirer has qualified management with the experience and character necessary to carry out the business plan in a safe and sound fashion. Again, this evaluation is just as important for an existing financial institution as it is for a new entrant in the banking system. It is equally appropriate for the FDIC to assure itself that the acquirer of a failed bank, whether it is an existing or new financial institution, can contribute sufficient capital to the bank.

But the proposed Policy Statement seems to go beyond these legitimate areas of FDIC inquiry by presuming that there should be enhanced scrutiny and special requirements imposed by the FDIC whenever an acquirer of a failed bank has private capital investors. We respectfully submit that the existing statutory and regulatory framework makes this both unnecessary and inappropriate.

The existing statutory and regulatory framework has crafted a careful balance between the needs and responsibilities of the government and the regulatory agencies, on the one hand, and the development of a vigorous and vibrant private financial sector on the other. Supervision of depository institutions is split among the FDIC, the Office of the Comptroller of the Currency (the "OCC"), the OTS and the Federal Reserve Board. Supervision of holding companies is allocated to the Federal Reserve Board and the OTS. Change in Bank Control Act filings are made with the primary federal regulator of the depository institution in question or, if a holding company is the target institution, with either the Federal Reserve Board or the OTS. Bank Merger Act applications are filed with the federal banking agency with responsibility for the surviving institution. Applications for new

⁴ We believe it would be perfectly appropriate for the FDIC to require private capital bidders for failed banks to do so through a holding company structure to ensure that these issues are evaluated in a consistent fashion by the agencies charged with doing so, and to assure that the holding company meets the obligations imposed on it by the existing statutory and regulatory framework (e.g., regulation, examination, source of strength).

depository institutions are filed with the chartering authority, and the application for deposit insurance is filed with the FDIC.

Within this allocation of regulatory responsibilities, there are thresholds of ownership and control that trigger enhanced inquiry. For example, both the Bank Holding Company Act and the Change in Bank Control Act provide that control will exist whenever a person owns or controls 25% or more of any class of voting stock of a holding company or a bank. The regulations under the Change in Bank Control Act, however, will presume that control exists at the 10% ownership level under certain circumstances, and the Federal Reserve Board has developed, through over twenty years of interpretations, guidelines that would also presume control at such ownership levels for companies investing in bank holding companies. Holdings at lower levels do not trigger the requirements and obligations that arise above these thresholds, unless special control factors exist.

When parties seek to charter new banks, obtain deposit insurance or form bank holding companies, the bank supervisory agencies inquire into the proposed officers, directors and major shareholders of the new institution. "Major," for the purposes of this inquiry, means any holder of 10% or more of the bank's or bank holding company's voting shares. Shareholders at lower ownership levels are not subject to enhanced scrutiny, unless they are determined to have a controlling influence over the institution based on other factors. These are appropriate cut-off points, for shareholders at these lower levels generally do not have the power to direct or control the management or policies of the institution; attention is properly focused at higher ownership levels.

Cross-guarantee obligations arise when more than a single depository institution is controlled by a single company or a group of companies acting in concert. Source of strength obligations are imposed on bank holding companies. Limitations on transactions with affiliates arise whenever non-banking entities are affiliated with depository institutions, with precise definitions of what constitutes an affiliate.

The proposed Policy Statement attempts to expand these concepts far beyond the existing statutory framework, seeking to impose cross-guarantee liability, source of strength obligations, outright prohibitions (instead of limitations) on transactions with affiliates, and enhanced disclosure requirements to individuals and entities seeking to recapitalize failed financial institutions. Without an articulated factual basis or statutory authority, the proposed Policy Statement takes concepts and principles that apply to parties in a position to exercise a controlling influence over management or policies of a banking organization, and seeks to apply them to parties who lack such power. We respectfully suggest that not only is it inappropriate to do so, but also that the only consequence will be to drive private capital investors away from the essential recapitalization of our banking system.

Instead of imposing discriminatory new requirements on private capital investors as a separate class of investors in a failed bank, we believe that the FDIC should continue its traditional focus on the quality of the new management, business plan and asset quality (taking into account any loss-sharing or other credit enhancement provided by the FDIC) of the failed bank being acquired, and formulate appropriate capital levels in light of that

management, business plan and asset quality to the extent the existing statutory framework grants the FDIC such authority.

We respectfully submit that the existing statutory and regulatory framework is fully adequate to address the vetting of potential acquirers of failed banks. If any potential holder of 10% or more of the voting shares of a failed bank or its holding company has been fully vetted and cleared by another bank supervisory agency as part of its regulatory processes (e.g., the Federal Reserve Board as part of a Bank Holding Company Act application), it is inappropriate and unnecessary for the FDIC to impose greater or stricter scrutiny.

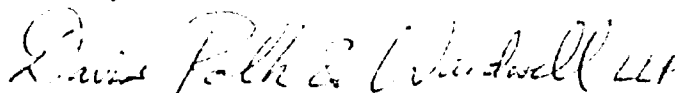
The FDIC Should Act Quickly to Clarify the Proposed Policy Statement.

We have been working with private equity firms, institutional and individual investors, weakened banks and healthy banks. All have an interest in a healthy and sound banking system, and many are interested in and willing to risk private capital to help in the recapitalization effort. The uncertainty created by the proposed Policy Statement has caused many of these parties to reconsider or put proposed investments on hold. The investors are unwilling to invest in the absence of legal certainty about the applicable rules and requirements. Weak banks are unable to obtain necessary capital for the same reasons, as they are looking to private capital for help. The proposed Policy Statement inadvertently casts doubt on the requirements associated with private capital investments in failed banks that have already been completed, raising questions as to whether the investors in those banks can rely on the agreements entered into in connection with their investments, or whether they would be subject to a retroactive application of the proposed Policy Statement.

The needs of our financial system are currently too great for continued uncertainty. There are simply too many banks that need capital, and too many banks still at risk of failing. We respectfully submit that the FDIC should act promptly to eliminate the uncertainty caused by the requirements of the proposed Policy Statement. Absent that clarity, we fear that private capital will focus on other investment opportunities, saddling the Deposit Insurance Fund with costs that are higher than the otherwise available least-cost alternatives.

We would be pleased to discuss our comments or any questions that the FDIC or its staff may have with respect these comments. If you would like to discuss these matters, please do not hesitate to contact Randall D. Guynn at 212-450-4239 or John L. Douglas at 202-962-7126.

Sincerely,



DAVIS POLK & WARDWELL LLP