May 16, 2008

FINANCIAL INSTITUTIONS DEVELOPMENTS

Acquisitions of Troubled Financial Institutions and Assisted Transactions

The continuing slide in the credit and housing markets have resulted in significant losses for some financial institutions. These credit-related losses have exacerbated liquidity, asset valuation and accounting difficulties caused by the effective closure of secondary markets for certain asset classes. Against this backdrop, a number of regulated financial institutions have raised substantial amounts of capital only to soon thereafter find themselves needing to raise substantially more. Federal and state regulators have played increasingly prominent (and, in the case of Bear Stearns, unprecedented) roles in efforts to monitor and shore up the capital and liquidity situations of struggling institutions. For example, regulators reportedly played key roles in the recent large capital raise by National City, anchored by Corsair Capital, and in CapitalSource's agreement to acquire Fremont General's retail banking business.

Even with these regulatory interventions, there appears to be a widespread perception of meaningful risk of an acceleration in financial institution failures, with particular concern about small-to-medium sized non-diversified banks that are over-exposed to the riskier portions of the real estate market like residential development construction loans (an example being the recent failure of Arkansas-based ANB Financial). Any such increase will be particularly jarring because it follows years of markedly low numbers of bank failures. Regulators are girding to meet the challenge: the FDIC is reportedly seeking to increase the size of its failure resolution staff by up to 60% and is reportedly seeking to rehire retirees with experience dealing with past waves of failures.

In light of the circumstances, some potential acquirors are studying the FDIC's historical approach to addressing failures. When confronted with an insured depository institution on the brink of failure, the FDIC is required by law to guarantee insured deposits and dispose of the failed institution's assets in the manner least costly to the FDIC's deposit insurance fund. Generally, upon receipt of a "failing bank" letter from a troubled bank's chartering authority, the FDIC starts its formal resolution process and assesses the value of the bank's assets, assembles an information package for potential acquirors and develops a strategy for marketing the bank or its assets. The FDIC also has independent authority to close an insured institution under certain circumstances, through its right to terminate deposit insurance, where an institution is operating in an unsafe or unsound manner or has engaged in other misconduct. In the context of bank holding companies with multiple banking subsidiaries, the FDIC may exercise its authority to assert cross-guarantee claims and pull all of the banking subsidiaries, including otherwise healthy ones, into the resolution process.

Through the resolution process, the FDIC works to maximize its recovery by marketing some or all of the failed bank's assets and deposits and liquidating any residual assets. Historically, the FDIC has managed auctions to dispose of failed bank franchises. These regulatory auctions resemble organized private auctions, with interested parties executing confidentiality agreements and conducting limited due diligence. In the past, the FDIC has structured the auction process by packaging pieces of broader banking franchises in separate

groups in an attempt to maximize auction proceeds. For example, when the FDIC oversaw the resolution of seven failed New Hampshire banks, it bundled the three savings banks together into one block and the four commercial banks together into another block. The FDIC solicited bids on each block separately, ultimately selling one block to an investor group and the other to the U.S. subsidiary of a foreign bank. Similarly, when First City Bancorporation of Texas failed, the FDIC sold off the banking subsidiaries to 12 different financial institutions via 20 separate "bridge banks" (national banks with temporary charters from the Office of the Comptroller of the Currency formed to continue the operations of the failed bank).

After a bank has been declared insolvent, the FDIC has a number of options:

- The FDIC can arrange for another bank to purchase all or part of the failed bank and to assume it liabilities.
- The FDIC can pay off insured depositors and then sell the bank's assets.
- The FDIC can establish a bridge bank, which is eventually sold.

To encourage buyers to take as much of the failed bank's asset base as possible, the FDIC has sometimes entered into loss sharing agreements with the buyer whereby the FDIC agrees to bear much of the further credit loss associated with the failed bank's assets. In such instances, the FDIC has insisted that the buyers continue to bear some of the loss to align the incentives of the buyers and the FDIC to continue to vigorously service nonperforming assets to mitigate losses. Loss sharing has proved particularly useful with large asset portfolios, where the underwriting standards of the failed bank were poor or suspect, and where the underlying collateral values were uncertain.

At the moment, it is difficult to predict the extent to which we will see bank failures in the near-term. One factor distinguishing today from prior troubled times is the availability of private funds from alternative investment vehicles including hedge funds, sovereign wealth funds and private equity firms. A number of recent bail-out transactions (e.g. E*TRADE, Washington Mutual, National City) have been led by private investment funds, which have also figured prominently in more conventional recent capital raises by financial institutions. Regulators have taken notice of these important transactions and, in a capital- and liquidity-constrained market, the potential significant benefits offered by the vast financial resources of private investment funds. This can be expected to translate into a more receptive regulatory climate for private investments into banks and thrifts. Properly structuring transactions, in response to regulatory restrictions on ownership and control of banks and thrifts, is key to facilitating a private equity acquisition of all or parts of a regulated financial institution—though in a context of increasing failures we may see a push for increased regulatory flexibility on governance rights and other indicia of control by the acquiring firm.

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