

Banking & Financial Services

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Change Creates Opportunity: The Latest Developments in FDIC-Assisted Acquisitions

By Lorraine M. Buerger

“The entrepreneur always searches for change, responds to it, and exploits it as an opportunity.”

— Peter Drucker

Since the Federal Deposit Insurance Corporation (the “FDIC”) began using its receivership and loss-share arrangement for failed banks, veterans of FDIC-assisted acquisitions agree: the only thing constant about the process has been its constant change.

The FDIC continues to modify and refine its protocol for resolving failed banks in a manner consistent with its goal (and statutory mandate¹) of creating in each transaction the least cost solution to the FDIC insurance fund. This drumbeat of continual change has required savvy potential bidders for failing institutions, both first-time bidders or those bidding again after participating in earlier rounds, to ensure they have a complete and up-to-date understanding of the most recent changes to the FDIC’s process. Armed with this knowledge, bidders can evaluate how the changes in the rules affect the economics, execution risk and integration dynamics of these novel and complicated purchase and assumption transactions.

The FDIC’s Pattern of Changes

Consistent with its statutory mandate to resolve failed banks with the least cost to the Deposit Insurance Fund, the FDIC staff has attracted widespread praise for its handling of the record number of bank closures since the beginning of the financial crisis. That praise has been based on the FDIC’s demonstrated ability to close failed financial institutions smoothly and professionally and, importantly, instilling

confidence among depositors and the public that insured deposits are safe and secure, which promotes a stable banking system.

Moreover, the FDIC earns accolades for continually refining the receivership and acquisition process to drive down the price tag of bank failures for taxpayers. The FDIC’s process over the past 24 months has been distinctive for its steady evolution, particularly with regard to the Purchase & Assumption Agreement with Loss Share (the “P&A Agreement”).

Think you are an expert on the P&A Agreement because you mastered its nuances six months ago? Be warned: the FDIC has changed the P&A Agreement multiple times in recent months, and potential bidders proceed at their peril in running economic models on failed bank acquisitions or bidding, while assuming the old P&A Agreement formulas still hold true today.

The New Loss Share Equation

The most significant and noteworthy change to the P&A Agreement is the core economic driver of the majority of these acquisitions: the loss share percentage, which provides the buyer with credit risk protection. The loss share percentage determines that portion of losses, related to the failed bank’s assets assumed from the FDIC, that the assuming institution must bear.

Originally, the P&A Agreement stipulated that losses on all assets of a failed bank, purchased by an assuming institution from the FDIC, were shared between the FDIC and the assuming institution on an 80 percent / 20 percent basis up to a stated threshold, after which losses were shared on a 95 percent / five percent basis. That is, the FDIC would reimburse the assuming institution for up to 80 percent of the losses up to a stated threshold (specific to each individual transaction), after which the FDIC would reimburse the assuming institution for up to 95 percent of the losses.

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The FDIC changed the P&A Agreement early in 2010 to reflect a uniform split that reduced the loss share percentage to 80 percent / 20 percent, eliminating the opportunity for 95 percent coverage for the assuming institution. Significantly, later in the year, the FDIC further refined the formula to eliminate the static 80 percent / 20 percent loss share formula, and invited bidders to bid competitively for the percentage of losses it required the FDIC to assume, up to and not to exceed 80 percent.

Recently the FDIC has further revised its formula, making the process increasingly complex for bidders. As a result of the latest changes, the FDIC now announces three tranches for potential losses. The FDIC determines the loss share percentage (not to exceed 80 percent) for one of the tranches (Tranche #2). The bidding institution bids on the loss share percentage (not to exceed 80 percent) for the remaining two tranches. (Tranches #1 and #3).

In addition, originally the FDIC's loss share percentage was consistent for all assets acquired by the assuming institution. However, the FDIC's bidding process for the loss share percentage is now separate for each of the Single Family (one-to-four family residential real estate) and Commercial asset portfolios.

Thus, there are now 6 tranches. Bidders propose loss share percentages, for each of two tranches, for each of the two portfolios, while the FDIC sets the loss share percentage for one tranche for each of the two portfolios.

A Bidding Example

In a sample bidding scenario, the FDIC may announce a 50 percent / 50 percent loss share percentage for Tranche 2, in each of the Single Family and Commercial portfolios.

For example, a potential bidder, following due diligence on the assets, might determine that Commercial losses are likely to be high, but that Single Family losses are unlikely to exceed Tranche 2, thus allowing him to be more aggressive in his bidding. In that instance, the bidder might bid as follows:

Commercial

80 percent / 20 percent for Tranche 1;

50 percent / 50 percent for Tranche 2 (as determined by the FDIC);

80 percent / 20 percent for Tranche 3.

Single Family

80 percent / 20 percent for Tranche 1;

50 percent / 50 percent for Tranche 2 (as determined by the FDIC);

Zero percent / 100 percent for Tranche 3.

Conversely, a bidder that expects heavy losses in both the Single Family and Commercial portfolios might bid 80 percent / 20 percent across the board, in all categories.

Likewise, a bidder eager to reduce complexity in loss share administration might bid a consistent percentage across all categories, opting to mirror whatever loss share percentage the FDIC announces for Tranche 2 in each of the two portfolios, and adjusting the discount it bids on the assets accordingly.

In summary, the bidding process has become tremendously more complex for potential bidders. As a result, now more than ever, competitive advantage in the bidding process will go to those bidders who are well-prepared.

Multiple Bids

In recognition of the increasingly competitive bidding environment, the FDIC encourages bidders to submit multiple bids.

For instance, bidders may submit multiple bids with varying loss share percentages for the four tranches on which they can bid. For the same target, however, they can also submit variations on that bid, including different loss share percentages, asset discounts or deposit premiums.

In addition, the FDIC allows bidders to make bids with and without loss share coverage, on the same failed bank target.

Other P&A Changes

The latest versions of the P&A Agreement also include other changes that merit review by potential bidders and their professional advisors, including:

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- Bidders now bid the asset premium (or discount) as a set dollar amount, rather than a percentage.
 - Conversely, the premium on deposits, if any, continues to be bid as a percentage amount.
 - Consumer Loans (defined generally as loans to individuals for household, family and other personal expenditures, not secured by real estate) are not included in those assets for which loss share protection is available.
 - Mortgage servicing rights are no longer included in those assets to be acquired by the assuming institution.
 - The P&A Agreement has revised its treatment of letters of credit and standby letters of credit. Newly-added language now clarifies the circumstances in which assumption of liability can be limited to the market value of the assets securing assumed letters of credit.
 - The Schedules to the P&A Agreement have been revised, with previous schedules (*e.g.*, Schedule 2.1 Certain Liabilities Assumed and Schedule 3.1 Certain Assets Purchased) eliminated and others added (*e.g.*, Schedule 6.3 Data Retention Catalog). Veterans of previous FDIC-assisted transactions recognize that the elimination of Schedules 2.1 and 3.1 reflect: (a) the FDIC's actual practice regarding Schedule 2.1 and 3.1, in which such information is generally not produced in Schedule form, and (b) the FDIC's growing emphasis upon and attention to the data retention practices of assuming institutions.

How to Remain Current and Bid Intelligently and Successfully

Serious potential bidders are close observers of the FDIC's evolving resolution process and have

protocols in place, internally, to monitor meaningful developments. The FDIC makes recent institution-specific P&A Agreements publicly-available on its web site approximately one week after each bank closing. Serious potential bidders should institute protocols that promote familiarity with the details of recent successful bids, in real time.

Moreover, every bidding team should include a specialist focused on understanding the P&A Agreement, remaining current with recent P&A Agreement changes and the ramifications of those changes on bidding strategies – particularly with respect to how P & A changes affect the economics of these acquisitions.

Conclusion

The FDIC's evolving bid process for failed banks offers opportunities to those potential bidders who are alert and thinking critically about the effects of these changes on the economics of the deal and bidding strategy. The process has become so complicated and the nuances so many that potential bidders who take a casual approach risk making mistakes in the bidding process or missing out on great acquisitive opportunities.

There are likely to be hundreds of bank failures forthcoming over the next several years and those failures are likely to run in waves. For well-prepared bidders willing to accept risk, failed bank acquisitions with loss-share protection will continue to offer excellent strategic growth opportunities.

Note

1. See Federal Deposit Corporation Improvement Act of 1991, *Pub. L. No. 102-242; 105 Stat. 2236, 12 U.S.C. 1811.*