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Bank Failures Create Attractive Opportunities[1]

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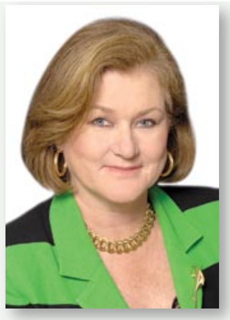

The closure of Metropolitan Savings Bank on Feb. 2, 2007 ended the unprecedented two-and-a-half year period without a U.S. bank failure. This failure was followed by another two failures in 2007 and eight additional failures through Aug. 14, 2008, including the recent collapse of IndyMac Bancorp, which is expected to be the costliest bank collapse in U.S. history.[2] While analysts do not anticipate bank failures at the levels seen in the early 1990s, some predict that another 300 banks could collapse in the next three years.[3]

The opportunity for a distressed investor commences well before a bank's seizure by the Federal Deposit Insurance Company ("FDIC"). There may be advantages to acting in the early stages of developing distress at a bank, regardless of whether it survives or fails.

Regulatory Overview. Each quarter, the FDIC creates a list of "problem" banks ranked on a one to five rating scale—"one" being least problematic and "five" being significantly troubled—based on capital adequacy, asset quality, management, earnings, liquidity and sensitivity to market risk (a "CAMELS Rating"). While the identities of the listed banks are not disclosed, for reasons demonstrated by the results of Senator Schumer's comments on IndyMac's condition, the FDIC does list the total assets of these institutions. There are currently 90 institutions with collective assets totaling $26.3 billion on this "problem" bank list, up from 76 banks in the last quarter of 2007, but still lower than levels seen during previous economic downturns. Statistically, 13 percent of banks on this list will eventually fail.[4] Interestingly, IndyMac was not on this list when it collapsed, revealing just how quickly financial institutions can fail.

When the Office of the Comptroller of the Currency ("OCC") determines to close a national bank, it appoints the FDIC as receiver.[5] Recently, the OCC has been particularly aggressive in failing banks to stem further losses and to prevent banks from unfairly shifting losses to the FDIC by offering insured deposits at lucrative terms.[6] Swift action is also necessary to minimize, if not prevent, disruption to the local community and economy. The FDIC usually closes the failing bank on a Friday and reopens it on the following Monday, allowing FDIC personnel the intervening weekend period to evaluate the bank's positions and initiate the FDIC's role as receiver. For instance, IndyMac was closed on a Friday, with insured deposit accounts being available to depositors the following Monday.[7] Generally, asset values can be best preserved and costs minimized when failing banks are resolved quickly.[8] Furthermore, prompt resolution can minimize the negative impact of the bank failure on the industry in general.[9] Recent failures indicate that buyers have substantial opportunities to acquire deposits without troubled assets as bargain prices from the FDIC, as receiver.

"Open Bank" Assistance is no longer favored. The last wave of bank failures occurred in the significantly different economy of the early 1990s. In that era, resolution was often premised upon purchase and assumption transactions. In a purchase and assumption transaction, another bank purchases from the FDIC, as receiver, some or all of the assets of the failed bank and assumes some or all of the liabilities. At times, however, the FDIC relied upon deposit payoffs, especially when no acquirer could be found. In that case the FDIC liquidates all of the bank's assets and either distributes insured amounts to depositors or transfers such deposits to another bank to assume future account servicing duties. In the late 1980s through 1992, the FDIC used open bank assistance with mixed success. In 1987 and 1988 there were 98 open bank assistance transactions, but only seven open bank assistance transactions during 1989-1992. The Federal Deposit Insurance Corporation Improvement Act of 1991 and its requirements for "least-cost" resolutions make open bank assistance more difficult, and often impractical.[10]

Another approach that has been used in the past is dividing the bank into two separate entities, thus segregating the performing assets from the non-performing assets.[11] By so doing, the "good bank" can be recapitalized and can more efficiently focus on its core businesses, while the "bad bank" can manage the non-performing assets. This approach has its limitations, however, as the parent bank holding company may be held responsible if an FDIC-insured "bad bank" fails. This approach, using an actual bank charter, has only been used once under current law. We believe that it is more feasible to use a non-bank entity to resolve "bad" assets. And, more significantly, such a division usually requires some form of capital infusion, which can be difficult to obtain for troubled banks.

"Least Cost Resolution" mandated. With limited exceptions, the FDIC is required to choose the resolution alternative that is least costly to the deposit insurance fund of all possible methods for resolving the failed institution. With the most recent bank collapses expected to drain up to 16 percent of the $53 billion of reserves, such a policy is certainly sound. Following IndyMac, the FDIC's reserve ratio fell below the minimum 1.15 percent of insured deposits, and the FDIC is expected to increase insurance premiums to prevent further depletion of its insurance fund.[12] Regulators and other government authorities may attempt to be flexible to help prevent additional bank failures and more actively seek pre-closing solutions. The expense of resolving failed banks or forestalling the failure of a troubled bank is not insignificant and regulators may increasingly rely on private investors to shoulder this burden. Private investors that are "qualified" and have demonstrated capacity to service loan assets will have a decided advantage. While large institutions benefiting from federal bailouts, such as Bear Stearns, Fannie Mae, and Freddie Mac, are exceptions, the preference for participation from qualified private sector participants seems to be growing. Importantly, the universe of private sector participants should not be limited to large national banks and, increasingly, the approach should be before, rather than after seizure by the FDIC.

What does it take to be a qualified investor/purchaser? The current market conditions reveal a growing opportunity for distressed investors. To avoid seizure by the FDIC, banks may employ a number of different tactics to improve their condition. Unlike the last period of systematic bank failures, alternative investment vehicles, including private equity and hedge funds, have acquired critical financial servicing capabilities and demonstrated their ability to fund and recover upon financial assets. Non-industry investors will have to carefully navigate the many complex banking regulations and risks to determine if they are able to

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aid a troubled bank or, alternatively, acquire bank deposits or assets from the FDIC in a receivership. Investment opportunities in "open" banks are subject to regulatory oversight, particularly by the Federal Reserve under the Bank Holding Company Act of 1956 and the Change in Bank Control Act, and possibly state regulators. Using properly structured transactions, private equity firms, are able to invest large amounts of money into banks to resolve problem assets and capital issues.[13] Banks needing capital should seek it early, as it becomes more difficult and expensive as the bank moves down the regulatory enforcement path to "troubled" or "problem" status.

Prospective purchasers of failed institutions' assets must be eligible to purchase such assets and attest to such a fact by signing a purchaser eligibility certification form.[14] This form requires, among other things, that the prospective purchaser not have obligations owing to the FDIC in excess of $50,000 that is over 60 days past due, that the prospective purchaser is not an employee of the FDIC, and that the prospective purchaser has never been an officer or director of a failed institution. If a prospective purchaser wishes to assume bank deposits, it may be required to obtain approval for a bank or thrift charter to create a new institution, if they do not already have such a charter.

Alternatives—Pre-Bank Closing. In an effort to avoid seizure by the FDIC, a troubled banking institution has several rehabilitation options available to it, each giving rise to investment opportunities by distressed investors. Often the simplest strategy involves the sale of problem assets, often at a steep discount. However, under GAAP, the loss realized on these sales must be booked immediately, likely adding to the institution's capital confidence crises. These losses, however, may have significant tax advantages to the banking institution and offer the distressed investor the opportunity to buy potentially salvageable assets at significant discounts.

Portfolio sales, such as the one recently completed by Merrill Lynch & Co., may be an option. Yet asset sales at such distressed prices may cause capital deficits. Ironically it may be too expensive for a bank to sell troubled asset classes having uncertain values. The resulting write-offs may crystallize capital shortfalls. While outside the bank regulatory regime, the Merrill transaction nevertheless serves to illustrate not only the investor economics that may be available, but also the loss likely to be realized upon sale. In that instance, Merrill Lynch agreed to sell $30.6 billion in so-called "super senior" CDOs for $6.7 billion, or approximately 22 cents on the dollar, when it was on Merrill's books at an amount in excess of $11 billion. Merrill will finance approximately 75 percent of Lone Star Funds' $6.7 billion investment in the transaction, limiting recourse to the purchased assets. While Lone Star has assumed the risk for the first loss of $1.7 billion, it can potentially profit if the portfolio performs in excess of its 22 percent of the purchase price. Meanwhile, Merrill has sustained an additional loss, which required a concurrent sale of approximately $8.5 billion of capital. In today's world of "fair value" accounting, distressed sales can force other institutions to write down similar assets in unpredictable ways.[15] It is not clear that an isolated transaction such as the Merrill/Lone Star transaction defines a market. Yet it is also not surprising that some banks may be unwilling to sell their distressed assets at such steep discounts, especially if the loss creates a capital issue. Banks without access to new capital will be pressed if such transactions continue to develop, leaving these institutions with portfolios of assets of uncertain value and higher capital barriers to overcome to effect a sale.[16]

Additional capital is an alternative or concurrent strategy. It may however involve an "exploding" or variable ownership dilution. Private equity firms led by Texas Pacific Group ("TPG"), for example, recently invested $7 billion in Washington Mutual by purchasing stock at $8.75 per share. That deal also includes a price protection mechanism which requires Washington Mutual to compensate TPG if their stock sells below a certain price within 18 months of the deal.

The failure of a bank and its subsequent entry into FDIC receivership creates a host of attractive investment opportunities for distressed investors. While the risks are inherently high in such situations, prices and competition appear low, and the opportunity for reward is elevated, also.

Another tactic a struggling bank may employ is entering into a joint venture with distressed investors. Such a joint venture often requires that a new entity be formed, subject to any necessary regulatory approvals.[17] Such joint ventures can be valuable in that they combine the expertise and resources of the joint venture partners, spread the risk of future losses, facilitate increased tax refunds if taken soon enough, and allow the bank and the joint venture partners to share in future appreciation and recovery on the assets to the extent of their interest in the joint venture. More importantly, it allows the bank to share the losses and alleviate its capital concerns. A joint venture may also have the advantage of avoiding the immediate recognition of all losses (that occurs with an outright sale), while providing some equity capital from the joint venture partners to cover some of the losses that are recognized. Given that the capital markets for these institutions is essentially non-existent, many banks may need to seek investors with a high tolerance for risk.

The failure of a bank and its subsequent entry into FDIC receivership creates a host of attractive alternative investment opportunities for distressed investors. While the risks are inherently high in such situations, prices and competition appear low, and the opportunity for reward is elevated, also. There is little doubt that savvy distressed investors are positioning themselves to be "qualified" in the technical, as well as practical sense to buy assets from the FDIC. Instances where investors have acquired infrastructure through acquiring financial services businesses or expertise serve to confirm the strategy, such as the acquisition, among others, of American Home Mortgage by Wilbur Ross, Greentree by Centerbridge Partners and CBass by Goldman Sachs. This article has focused on preliminary pre-closing tactics; a review of post closing procedures used by the FDIC will follow in the next installment of this column.

1. This is the first article in a multipart series addressing the opportunities and risks presented by the expected near-term increase in bank failures.
2. FDIC, Failed Bank List, http://www.fdic.gov/bank/individual/failed/banklist.html (listing U.S. banks which have failed since October 2001); "American Banks: Fear of Failure," The Economist, July 17, 2008, available at http://www.economist.com/finance/displaystory.cfm?story_id=11751195.
3. "American Banks: Fear of Failure," The Economist.
4. Alison Vekshin, "FDIC Fund Strained by Bank Failures May Lift Premiums," Bloomberg, Aug. 11, 2008, available at http://www.bloomberg.com/apps/news?pid=20601109&sid=aOER9jYL5AqA&refer=news.
5. See 12 U.S.C. §191(a) (OCC to appoint FDIC as receiver); 12 U.S.C. §1821(c)(5) (basis for closing an FDIC-insured bank).
6. The Federal Deposit Insurance Corporation Improvement Act of 1991 section 143 encourages early resolution of troubled banks.
7. IndyMac is only the second time the FDIC has been appointed as "conservator" as opposed to a "receiver" for a failed bank.
8. Rosalind L. Bennett, Failure Resolution and Asset Liquidation: Results of an International Survey of Deposit Insurers, FDIC, available at http://www.fdic.gov/bank/analytical/banking/2001sep/article1.html ("not resolving failed banks promptly will…undermine the market mechanism—and may, in addition, substantially increase the costs of a resolution"); FDIC Resolutions Handbook, available at http://www.fdic.gov/bank/historical/reshandbook/ch8other.pdf ("Experience suggests that failing financial institutions should be resolved as quickly as possible. Asset and franchise values are preserved and maximized, making them more desirable to healthy institutions.").
9. Bennett, "Failure Resolution and Asset Liquidation: Results of an International Survey of Deposit Insurers," supra.
10. See 12 U.S.C. §1823(c). The FDIC adopted a complex "Statement of Policy on Assistance to Operating Insured Depository Institutions," 57 Fed. Reg. 60203 (Dec. 18, 1992). This policy statement was rescinded in 1997 and replaced by the statutory test on a case-by-case basis, including least cost resolution, management competence and no benefit to former shareholders. FDIC Resolutions Handbook at pp. 50-51.
11. "McKinsey & Company, Managing Successful Bank Restructuring: The Mellon Bank Story," November 2003, available at http://info.worldbank.org/etools/docs/library/156393/stateowned2004/pdf/wilson_managing.pdf.
12. See 12 U.S.C. §1817(b)(3). The FDIC also may borrow up to $30 billion from the U.S. Treasury, together with other borrowings permitted by 12 U.S.C. §§1824 and 1825.
13. See, e.g., 12 C.F.R. §§5.34-5.36.
14. Federal Deposit Insurance Regulation 12 C.F.R. §340.7.
15. Recent reports indicate that the significant write down on this suspect asset class through a sale transaction by Merrill Lynch prompted the National Australia Bank to write off 90 percent of its senior, as opposed to Merrill's "super senior," interest in the CDO. Its larger write-down than Merrill (90 percent vs. 78 percent) reflects its lower ranking of security.
16. "Merrill's Bitter Pill May Be a Sweet Deal for Lone Star," New York Times, June 29, 2008, available at http://dealbook.blogs.nytimes.com/2008/07/29/merills-bitter-pill-may-be-a-sweet-deal-for-lone-star/?scp=6& sq=merrill%20lynch%20lone%20star&st=cse.
17. See, e.g., OCC Reg. §§5.34-5.36 (applicable to national bank subsidiaries).