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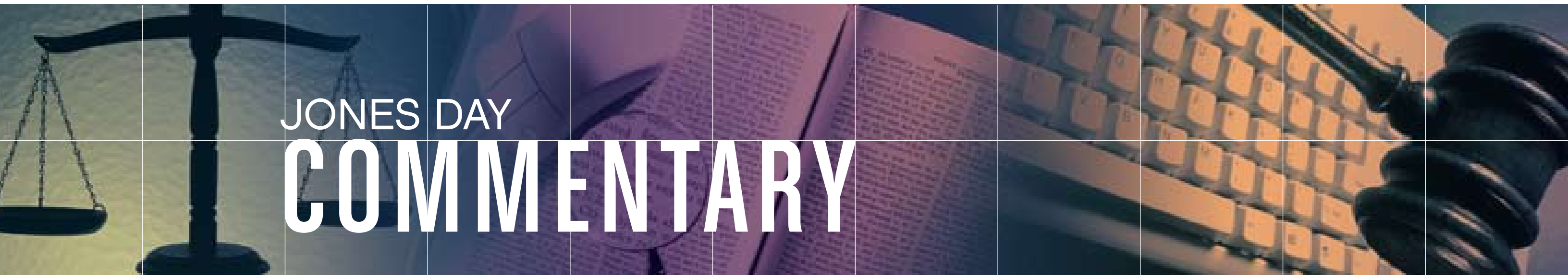

BANK FAILURES IN 2008 AND A LOOK AHEAD TO 2009

During 2008, 25 banks with $373.6 billion in total assets failed in the United States, and several others were strongly encouraged by the regulators to merge with other banks. Only three banks with a total of $2.3 billion in assets failed in 2007, and none failed in 2005 or 2006. Last year was the highest number of bank failures in the U.S. since 1993, when 42 banks with $9.64 billion in assets failed. During the peak years of the S&L crisis in 1988 and 1989, 464 and 533 banks and thrifts failed, with aggregate assets of $309.6 billion and $343.8 billion, respectively. These comparisons are skewed by the failure of Washington Mutual Bank ("WaMu") in 2008, which had $307 billion of assets when it failed, or approximately 82.2 percent of all failed bank assets in 2008. Together, WaMu and IndyMac Bank accounted for almost 91 percent of all failed bank assets in 2008.

The year started with just 76 banks with $22.2 billion in assets on the FDIC's problem bank list at December 31, 2007, and the FDIC's Deposit Insurance Fund ("DIF") had $52.4 billion in assets and a reserve ratio of 1.22 percent. As of September 30, 2008, the FDIC reported 171 "problem banks" with $115.6 billion in aggregate assets, "the first time since the middle of 1994 that assets of 'problem' institutions have exceeded $100 billion," according to the FDIC's latest Quarterly Banking Profile (http://www2.fdic.gov/qbp/2008sep/qbpall.html). As of September 30, 2008, the FDIC's DIF had $34.6 billion in assets and a reserve ratio of 0.76 percent.

FAILURES IN 2008

Below is a summary of last year's bank failures. The types and locations of the failed banks, and the reasons for failure, varied widely. A quick overview follows:

- Five OTS-regulated thrifts failed
- Four national banks failed
- Four Subchapter S banks failed
- One state bank supervised by the Federal Reserve failed

The geographic locations of failed banks by state (more than one failure) follows:

State	Number of Failures
California	5 (excluding Washington Mutual, which had a substantial presence)
Georgia	5
Florida	2
Missouri	2
Nevada	3 (including Washington Mutual)
Texas	2

Among other things, concentrations of real estate loans, especially acquisition, development, and construction commercial real estate ("CRE") loans in formerly "hot" real estate markets were a common theme. When combined with high levels of brokered deposits and other wholesale funding, such lending in overheated markets often proved problematic. Liquidity also was an issue, especially because the FDIC generally declined to give waivers under the prompt corrective action provisions to permit banks that were, or were deemed due to regulatory action to be, less than "well capitalized," to renew or continue using brokered deposits. In some cases, the bank's liquidity became too stressed to continue business due to deposit outflows, and in at least one case, failure was triggered by rapid deposit outflows. Out-of-market lending appeared to be an issue in only a couple of failures. No failures appeared to result from poor or exotic investment portfolio securities. Illiquidity in the mortgage markets, especially for nonconforming, Alt-A, and subprime loans, also was a factor. In various cases, bank capital had been depleted with no realistic prospects for restoration of capital adequacy.

Regulatory enforcement actions, including heightened capital requirements under prompt corrective action or otherwise, played a part in some failures. Enforcement actions were not necessarily good indicators of pending failures. In some cases, enforcement actions were only released upon the bank's failure or were never finalized.

Except for the largest failures—WaMu, IndyMac, Downey Savings, and PFF Bank & Trust—the FDIC resolutions for the most part were sales of deposits, without loans. The FDIC generally kept loans from failed banks for separate disposition. *The Wall Street Journal* reported on January 2, 2009, that, excluding IndyMac, the FDIC as receiver holds approximately $15.3 billion of failed bank assets. Loss sharing was used or is expected to be used in Downey, PFF, and IndyMac. In WaMu's case, its assets exceeded its liabilities by about the amount of the credit markdowns made by the acquirer, which facilitated a whole bank transfer without any FDIC assistance.

Open bank assistance was only offered twice, and then only in the case of the largest institutions where the Treasury found, upon recommendation of the FDIC and the Federal Reserve, after consultation with the President, systemic risk that threatened adverse effects on economic conditions or financial stability.

The costs to the FDIC of failed banks ranged from approximately zero to 44.7 percent of the failed bank's assets. In dollars, IndyMac was the most expensive failure in history, with the FDIC currently estimating losses to the FDIC of $8.5 billion to $9.4 billion, up from $4 billion to $8 billion when IndyMac was closed on July 11. Nine failures are expected to result in losses to the FDIC of 30 percent or more of assets. Fortunately, WaMu, the biggest bank to fail, was resolved at no cost to the FDIC's DIF.

More detailed information on each 2008 bank failure and the related resolutions beginning in July 2008 are available from Jones Day upon request to the authors of this *Commentary*.

OUTLOOK FOR FAILED BANKS IN 2009

Continuing increases in the number of problem banks, as well as normal lags in the regulatory examination and enforcement act processes, statements from bank regulators, and economic conditions, indicate that more banks will fail in 2009. A few thoughts:

- The Treasury's Troubled Asset Relief Program's ("TARP") Capital Purchase Program ("CPP") has stabilized and will stabilize many banks that the bank regulators and the Treasury deem "viable."

- Capital will continue to be needed at or above current minimums, especially as regulators, creditors, and counterparties use peer comparisons of banks that have TARP capital versus those that do not.
- Banks that have sought, but do not receive, TARP may be viewed as nonviable and at risk of a forced merger to avoid a possible failure. Acquirers may consider seeking the TARP capital allocable based on the risk-weighted assets to a TARP-ineligible bank as part of the acquisition of the ineligible bank.
- The FDIC's Temporary Liquidity Guarantee Program ("TLG") should improve eligible, participating institutions' liquidity and funding. A bank or holding company that becomes ineligible for TLG, or where the FDIC makes a payment on bank debt guaranteed by the TLG, could fail.
- Asset quality issues, especially CRE loans, will continue to be a risk. New problem asset types may also arise, such as other commercial loan types and commercial mortgage-backed securities, trust preferred securities, and CDOs. Exposures of banks to other financial institutions may raise more concerns.
- Core deposits will be more important to provide a stable funding base and will be encouraged economically by the FDIC's new and proposed deposit insurance assessments.
- Wholesale funding and brokered deposits will be discouraged.
- Further consolidation of the banking industry is highly likely.

The FDIC will use more tools to facilitate resolutions, and a greater variety of buyers will have opportunities to expand through failed bank acquisitions. Among other things:

- The FDIC apparently had few bidders for many failed banks in 2008.
- Deposit premiums on failed bank acquisitions have been very low, often reflecting a lack of bidder interest.
- Bidders in 2008 sought only deposits, and in certain cases only insured, local, nonbrokered core deposits.
- Many markets where banks have become overextended and failed in 2008, and where more failures may occur in 2009, have attractive long-term demographics.
- The FDIC and the other bank regulators are working to expand opportunities for potential buyers of failed banks, including "shelf charters" for entities that have capital and have experienced bank management, but do not have an existing bank that can participate as a bidder to the FDIC for failed banks; "inflatable" charters whereby capable persons or entities may buy a small bank with a view to upgrading its management, systems, and capital to expand by failed bank and other acquisitions; and "pre-clearances" of nondepository institution bidders on failed banks to obtain a depository institution charter to acquire a failed bank from the FDIC, as conservator or receiver.
- The FDIC has indicated that it does not expect to approve applications for deposit insurance for *de novo* bank charters in the Southeast and West. Those wanting to enter the market will need to acquire, rather than start, a bank.
- Loss sharing will become a more important tool of failed bank resolutions, as a means of decreasing the FDIC's costs of failed banks.
- Open bank assistance could be used if the FDIC develops ways, in addition to cases of systemic risk, to use it within its existing statutory limitations, or if the law is changed.
- The FDIC, working with the Treasury, could use TARP to facilitate open bank assistance, beyond the two examples in 2008. TARP also could be used to purchase assets from a failing bank as part of a coordinated effort with the FDIC and the bank regulators in the case of failing documents.
- Banks with TARP capital may become active acquirers of other banks. Banks and bank holding companies that are issuers of private TARP capital may be especially interesting to public company acquirors.
- Recent *de novo* banks, SPACs that have acquired banks, and private equity investors may become more interested in failed bank acquisitions.
- As asset prices stabilize with the effects of various Treasury, Federal Reserve, and other government programs, bidders' interest in credits should increase because spreads on these assets are historically wide compared to yields on Treasury obligations.
- Joint bids and partnerships are likely to increase. These will reflect different investors' goals, expertise, time horizons, and risk/return goals.

In addition, the FDIC in PFF, Downey, and IndyMac has required that the FDIC's residential loan modification program announced for IndyMac on August 20, 2008, be adopted by the buyer. The salient points of this program are:

Loans Are Eligible for Modification. This applies to first mortgage loans owned or securitized and serviced by failed bank where the borrower is seriously delinquent or in default.

Modification Measures. Modifications are designed to achieve sustainable payments at a 38 percent housing debt-to-income ("DTI") ratio of principal, interest, taxes, and insurance. To reach this metric for affordable payments, modifications could include a combination of interest rate reductions, extended amortization, and/or principal forbearance.

Interest Rates. Eligible mortgages are modified into sustainable mortgages permanently capped at the current Freddie Mac survey rate for conforming mortgages. Interest rate reductions below the current Freddie Mac survey rate may be made for a period of five years where such reductions are necessary to achieve a 38 percent DTI, and where the reduced rate is consistent with maximizing net present value. For these loans, after five years, the interest rate would increase by no more than 1 percent per year until it is capped at the Freddie Mac survey rate, where it would remain for the balance of the loan term. Other modification features could be combined with an interest rate reduction, as necessary and consistent with maximizing the value of the mortgage, to achieve sustainable payments.

CONCLUSIONS

The bank failures in 2008 offer insights into how and why banks fail during the current economic conditions. They also demonstrate the opportunities for buyers to expand cheaply and at low risk. These opportunities are likely to be expanded in 2009 for buyers, potential buyers, and nontraditional buyers of failed bank assets.

LAWYER CONTACTS

For further information or to receive any of Jones Day's failed bank summaries or a summary of all 2008 bank failures, please contact your principal Firm representative or one of the lawyers listed below. General email messages may be sent using our "Contact Us" form, which can be found at www.jonesday.com.

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