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FDIC-Assisted Asset Sales

Leveraging Opportunities and Minimizing Risks in FDIC Loss-Share Transactions

THURSDAY, JANUARY 6, 2011

1pm Eastern | 12pm Central | 11am Mountain | 10am Pacific

Today's faculty features:

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Failed Bank Bid Process

January 6, 2011

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Bid Process

History

The resolution process

Failed bank deal structures

Legal issues

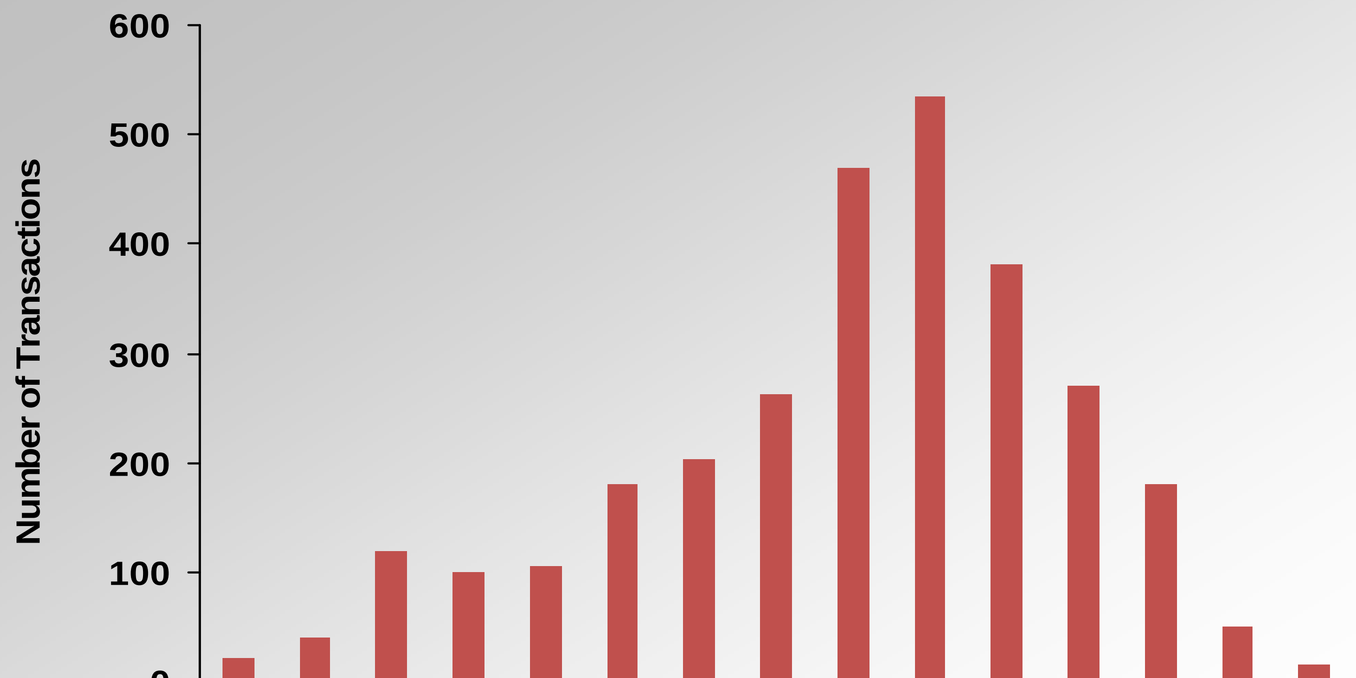
Linked Bids

Post-failure opportunities

A Little History

- Between 1930 & 1933, more than 9,000 of the nation’s 24,000 banks failed
- FDIC created in 1933
- 18,727 banks and thrifts in 1979
- 2,912 banks and thrifts failed from 1980-1994
- 11,070 banks and thrifts in 1995

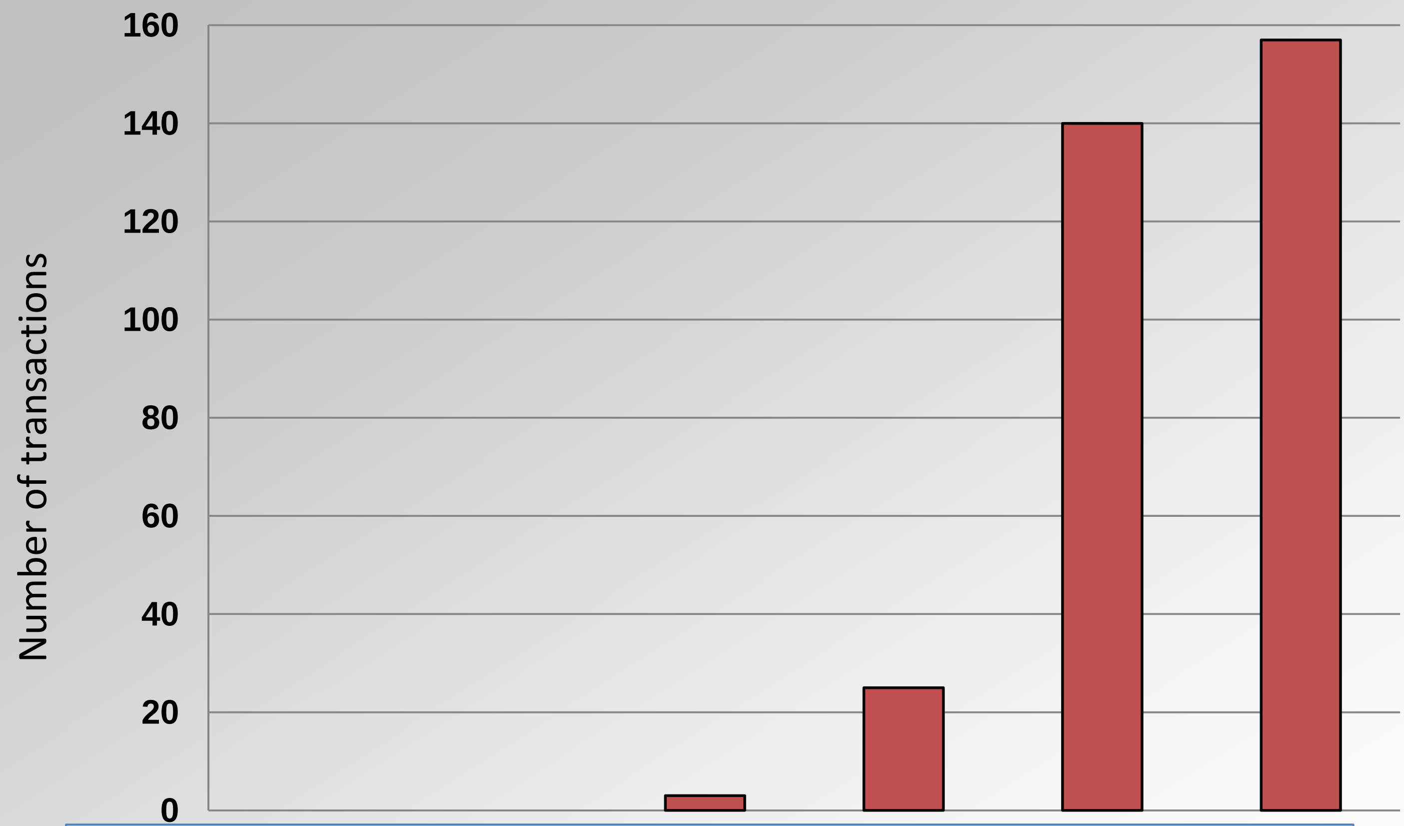
Total Failures (Banks and S&L's) 1980 - 1994



	1980	1981	1982	1983	1984	1985	1986	1987	1988	1989	1990	1991	1992	1993	1994
Totals	22	40	119	99	106	180	204	262	470	534	382	271	181	50	15

Source: FDIC Failures and Assistance Transactions.

Total Failures (Banks and S&L's) 2005 - 2010



	2005	2006	2007	2008	2009	2010
Totals	0	0	3	25	140	157

Source: FDIC Failures and Assistance Transactions.

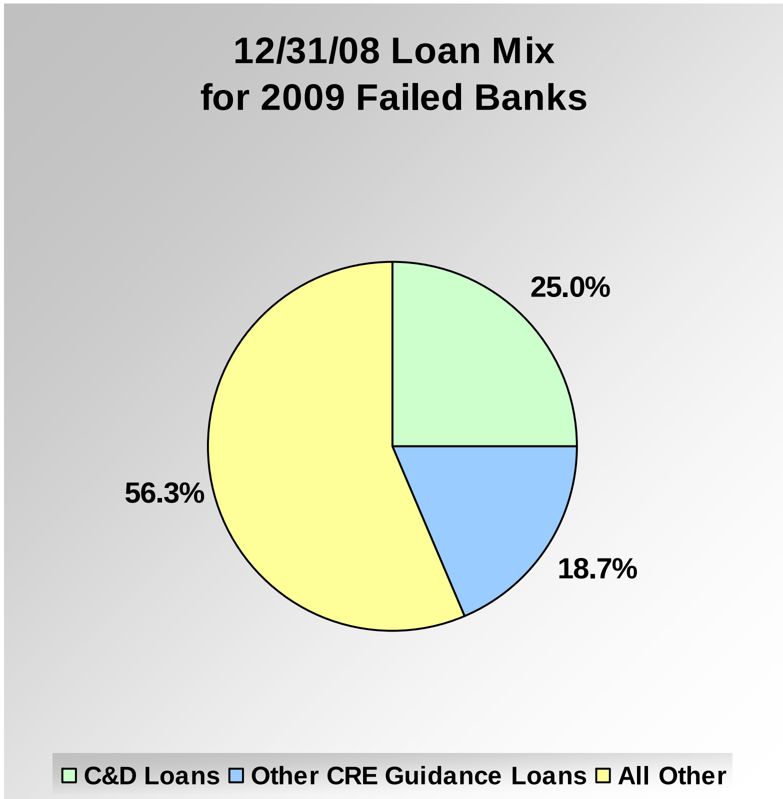
Source: FDIC Failures and Assistance Transactions

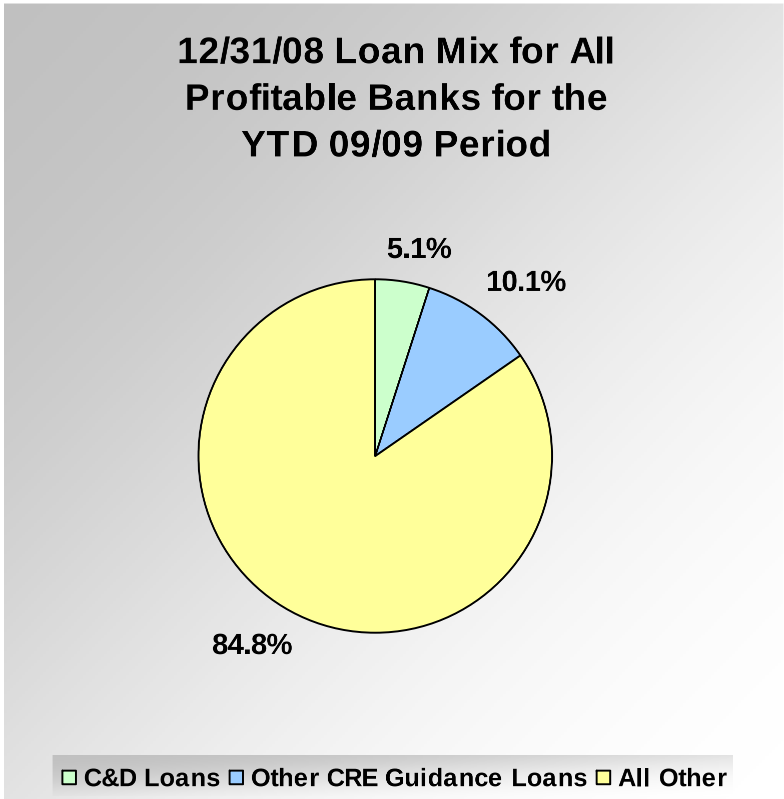
2009 data through December 4, 2009.

- Basel III

- 84-90 real troubled banks today

2009 Failures by Loan Mix





Loan Mix information based on median loan mix data as of 12/31/2008.

C&D Loans = Construction & Development.
Other CRE Guidance Loans = Non-Owner Occupied CRE Loans + Multifamily + Unsecured CRE Loans.

Warning: Pay Attention to the "Texas" Ratio

- Early warning signal for bank failure risk
- Texas Ratio = NPA's/Capital (tangible equity + ALLL)
- Texas Ratio > 100% = elevated risk of failure
- The 165 bank failures in 2008 and 2009 reported a median Texas ratio of 51% four quarters prior to failure
- Follow the ratio to find a target

Source: SNL

Interested in Becoming a Bidder for a Failed Bank

- Register with FDIC (www2.fdicconnect.gov)
- Establish your own failed bank team
- Determine what you want (size, product mix and geography for a target, etc.)
- Meet with your primary regulators to determine if you are approvable
- Know supervisory criteria to become a bidder (e.g., CAMELS 1 or 2, CAMELS 3 case-by-case, CRA rating, BSA rating, etc.)
- Know total asset size and geographic criteria (e.g., you must have double core deposits of failing bank or higher if not in your market, etc.)
- Be ready and able to react quickly

Private Equity Acquirers

- Goal to attract non-traditional investors, with appropriate safeguards FRB issues 5-9.9%

- Regulations require adequate capital, stability in management, prudent lending and business strategies
  - Capital support – 10% leverage ratio first three years
  - Cross guarantees – apply if 80% owned by common investors
  - Transactions with affiliates – new extension of credit prohibited for 10%+ investor
  - Continuity of investment – three-year holding period requirement (may be more)

Failed Bank Acquisition Opportunities

Recommendations

- Your Failed Bank Team Needs to Be Prepared
  —Due diligence (deposits, credit and litigation)
  — Integration (technology; marketing and PR; human resources)
  — Legal
  — Financial advisory
  — Accounting

- Identify Target Banks
  —Texas ratio
  — Tangible common equity/Tier 1 leverage ratio
  —NPAs/Assets
  — Pre-provision net revenue/average assets

Resolutions Timeline (1-2 Months)

Action	Timing
1. Interested acquirers register with FDIC	Before process
2. Primary regulator sends FDIC a failing notice	Day 1
3. FDIC assembles information/transaction structure	1-2 weeks
4. FDIC e-mails potential bidders (interested acquirers sign confidentiality agreement)	1-2 weeks
5. Due diligence (learn how to use IntraLinks) team allowed 2-3 days	2-8 weeks
6. Bidder Board must adopt resolutions	When bid is submitted
7. File regulatory application	With bid
8. Bids due	Monday/Tuesday
9. Winning bidder signs documents	Wednesday/Thursday
10. Closing date	Friday

The Resolution Process

- FDIC has "virtually complete responsibility for resolving failed federally insured depository institutions" with "expansive powers to ensure the efficiency of the process"
- Least cost test
- We won – now what?
- Assemble your team (public relations component of team very important now)
- Employment Agency
- Sign P&AAgreement
- Be ready to assemble your team on site for Black Friday

FDIC Action on "Black Friday"

- Assumes control of premises, records, loans and other assets
- Posts notices
- Changes locks
- Counts the cash
- Resolution team may number 50-100 people for a "typical" community bank

Failed Bank Deal Structures

- P&A (Purchase of Assets and Assumption of Liabilities)
- Deposit Payoff
- Open Bank Assistance ("OBA")
- 2009 Failed Bank Structures

• P&A All Deposits with Loss Share	90
• P&A All Deposits without Loss Share	36
• P&A Insured Deposits Only without Loss Share	2
• Deposit Payout	11
• Insured Deposit Transfer	1

Failed Bank Deal Structures

- Linked Bids (i. e., 4 banks at once)
- Small Bank buys bigger bank
- 2 banks win bid with one buying assets with loss share and the other buying loans and assuming deposits

Failed Bank Deal Structures

- Deposit payoff
  - No bidders, or
  - Discount on assets is so great that a payoff is the “least cost alternative”
  - FDIC pays off depositors directly
- Open bank assistance
  - Technically still available, but not used anymore
  - FDI Act of 1993 prohibited FDIC from using insurance money to benefit any shareholder of an institution that had failed or was in danger of failing
- Bridge bank
  - Temporary bank created by FDIC to facilitate a resolution

Failed Bank Deal Structures

Practically speaking . . . there are 2 basic structures to acquire a failed bank…

…and both are P&A transactions

- Straight P&A with no loss sharing
  - 36% of 2009 bank failures
- P&A with loss sharing
  - 64% of 2009 bank failures

Straight P&A

- Assume deposits (all or insured deposits only)
- Purchase assets (optional loan pools)
- Bid Amount:
  - Deposit Premium
  - Discount Bid for Loans/Assets
  - Depending on deal structure, bid form may ask for a combined Bid Amount
- Reconcile cash at closing
- Option to purchase banking premises at “fair market value”

Settlement Statement

Deposits assumed	$100,000
Loans/Assets purchased	($40,000)
Deposit premium	($1,000)
Loan/Asset discount	$5,000
Cash due to purchaser	**$64,000**

Option to purchase premises at "fair market value" is a post-closing transaction

P&A Transaction - The Legal Document

- P&A Agreement
  - Generally not negotiable
  - Key legal terms
  - Key legal risks
- New versions issued frequently

Key Terms in P&A

- Know what you are buying
- Excluded assets (non-performing loans, OREO, quick rate, FHLB advances, litigation)
- Puts of assets to receiver (3.4)
- Assets not purchased (3.5)
- Correction of errors (8.2)
- Claims and suits (9.3)
- Indemnification (Article XII)

Legal Issues

- Anti-Injunction 12 USC 1821(j)
- Stay of remedies 12 USC 1821(e)(13)(C)(i)
- Side agreements 12 USC 1823(e)
- Contract repudiation/enforcement 12 USC 1821(e)(1)
- Removal 12 USC 1819(b)(2)(B)
- Exemptions 12 USC 1821(b)
  - State and local taxes levy, garnishment, attachment or foreclosure
  - Penalties or fines
- Improperly documented agreements unenforceable 12 USC 1821(e)

P&A with Loss Sharing Agreement

Loss Sharing Framework

- "First Loss Tranche" – typically zero – not applicable any longer
- "Stated Threshold" – a specified dollar amount by FDIC (has tended to equal about 25% of loans purchased). Mostly not in play now.
- 80% of losses covered up to the assets minus expected loss
- Loss share typically extends for 5 years on non-single family loans and 10 years on single family loans

Key Terms in P&A/LSA

- Commercial Intrinsic loss estimate
- Commercial Tranche 1 (80-20)
- Commercial Tranche 2 (30-70)
- Commercial Tranche 3 (80-20)
- Assignment – LS (6.2)
- Fraud
- Litigation

Loss Share Rationale

- Regulator Benefits
  - Less costly than assuming a failed bank's assets and liquidating them over time
  - Keeps troubled assets in private sector
  - Accelerates resolution
- Acquirer Benefits
  - Credit loss exposure is limited
  - Infrastructure already in place to service & manage assets
  - Projected IRR at very high levels
  - Potential increase in capital through creation of negative goodwill

Accounting Considerations

- Statement of Financial Accounting Standards No. 141R, Business Combinations (SFAS 141R)
- Acquisition date and post-acquisition date issues
- Acquirer must record purchased loans, other assets and liabilities at “fair value” or the amount that would be received upon sale in a market transaction
- Fair value of loss share indemnification accounted for separately
- Interagency Guidance issued June 7, 2010 – Bargain purchase accounting

Post Failure Opportunities

- Purchase loans/REO directly from FDIC
- Purchase branch real property
- Acquire subsidiary of failed bank
- Hire key employees of failed bank (consider restrictions in confidentiality agreement)
- Pursue loan and deposit customers of failed bank (consider restrictions in confidentiality agreement)

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Handling of Loans

- *What happens to loans the FDIC retains*

- *Handling a failed bank's portfolio to assist the assuming bank's staff and to assist in compliance with loss share*

Evolving Issues for Acquirers of Failed Banks

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Avoiding Potential Problems

- Enact proper loss share policies and procedures
- Allocate resources as necessary
- Produce certificates as mandated by FDIC for reimbursement of loss events
- Implement sustainable accounting
- Prepare for inevitable audit
- Maintain solid working relationship with FDIC loss share administrator

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Proper Policies and Procedures

- Document loss share administration policies and procedures
- Highlight key and secondary controls and incorporate into existing regulatory control environment
- Ensure ongoing compliance with FDIC reporting requirements
- Reconcile FDIC mandated reporting with existing financial reporting & control structure

Resource Allocation

- Convert and integrate loss share assets (“covered assets”)
  - Data integrity
  - Process integration
  - Operational integration
- Effectiveness of management and workout programs
- Assess existing resources and need for additional resources to ensure compliance with terms of loss share agreement

Certificate Production

- Certificates must be produced and submitted to the FDIC monthly/quarterly
- Amount of data required by the FDIC is voluminous
- Monetary and non-monetary data required to be transmitted to the FDIC
  - Monetary – actual losses incurred
  - Non-monetary – asset performance information (i.e., 30, 60, 90 days past due)
- In order to receive payment for loss events, certificates must balance in terms of total dollar amount and total number of covered assets

Sustainable Accounting (Day 1 & 2)

- Address differences between contractual cash flows and cash flows expected to be collected
- Conservative approach is to minimize Day 1 gains
- Limit the yield that may be accreted (accretable yield) to the excess of the bank's estimate of undiscounted expected principal, interest, and other cash flows over the purchase price
- Excess of contractual cash flows over expected cash flows (the non-accretable difference) not be recognized as an adjustment of yield, loss accrual, or allowance
- Subsequent increases in cash flows expected to be collected generally should be recognized prospectively through adjustment of the loan's yield over its remaining life. Decreases in cash flows expected to be collected should be recognized as an impairment

Loss Share Audits

- Develop audit self assessment plan to ensure process and transaction compliance
- Contractors typically perform audits of loss share transactions on behalf of the FDIC to ensure compliance with P&A agreement
- Unfavorable audit finding can result in disallowance of previously claimed losses

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Loss Share Strategies

- Subsidiary LLC Structures (to hold loss share assets)
  - Goal to shield bank from bad asset liability
  - Other practical benefits (collection; market perception; etc)
  - Regulatory issues
  - Practical issues
- Outsourcing
  - Third party servicing of loans
  - Third party asset management

Managing Expectations

- Regulatory considerations
  - Impact on business plan
  - Management expertise / depth
  - Long-term strategy; footprint and integration issues
- Bidding frequency / Exam timing
- Investor expectations
  - Financial performance

Evolving Bid Process

- Linked Bids – greater FDIC willingness to group smaller banks together
- Modified Bids – non-conforming bids
- Excluded Assets – for example, performing commercial loans that are securitized through the FDIC's facilities

Other Issues

- Employees / personnel matters
  - Coordination with the FDIC
- IT Systems / Processor
  - Repudiation / Transition services
  - De-Conversion
  - Fees
- Appraisals of bank branches
  - Fair value measurements and disputes
  - Carrying costs

Other Issues *(continued)*

- Inheriting multiple legal relationships
  - Managing and tracking asset resolution costs
- Customer perception
  - Local markets
  - Re-pricing of deposits / excess liquidity
  - Lending
- Role of former management
- Contract repudiation process

What's Next?

- Bidding continues to be competitive
  - Many sophisticated, serial bidders
  - Execution risk / pricing risk are high
- Number of failures – when will it slow down?
  - S&L experience
- Open bank consolidation opportunities will be robust
  - Role of loss-share acquirers in new M&A environment

For More Information – Contact Alston+Bird LLP

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