

ClientAlert

Financial Markets Developments

Bank Advisory/Mergers and Acquisitions
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FDIC Adopts Final Policy on Private Equity Investments in Failed Banks

Final Policy Statement Reflects Liberalizations from Original Proposal

At a meeting on August 26, 2009, the Board of Directors of the Federal Deposit Insurance Corporation (the "FDIC") adopted a final Statement of Policy on the Acquisition of Failed Insured Depository Institutions (the "Policy Statement"). The Policy Statement is targeted at, and establishes standards for bidder eligibility for, private equity investors and similar nonbank investors seeking to acquire or invest in the deposit liabilities and operations of failed insured depository institutions through the FDIC resolution process.

The Policy Statement as adopted reflects a number of liberalizations and clarifications to certain of the key provisions of the original proposal (the "Proposal"), which was issued by the FDIC for public comment on July 2, 2009. See our Client Alert of that date ([FDIC Proposes Stringent New Rules For Private Equity Investors in Failed Depository Institutions](#)) for a full analysis of the Proposal. As we noted in our July 2 Client Alert, various provisions of the Proposal—which sought to impose requirements and standards for private equity investors seeking to acquire or invest in failed depository institutions that would have been more burdensome than those applicable to depository institutions owned by traditional holding companies and that would have gone well beyond the requirements imposed by applicable law—threatened to cause many private equity investors to reconsider their strategy of investing in failed insured depository institutions.

The key changes to the Proposal that are made by the Policy Statement are:

- A reduction of the minimum capital level required to be maintained by the resulting depository institution involved in an acquisition of the failed bank or thrift for the first three years after the acquisition from a 15 percent Tier 1 leverage ratio to a 10 percent ratio of Tier 1 common equity to total assets;
- Elimination of the proposed "source of strength" requirement for private equity investors in failed banks or thrifts;
- Scaling back the circumstances under which a cross-guaranty obligation to the FDIC would be imposed upon a private equity investor owning stakes in two or more depository institutions with other investors (and where at least one such institution was acquired in receivership from the FDIC) by increasing the common ownership threshold required to trigger the obligation from a majority to 80 percent; and



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- Certain clarifications as to the investors and investor ownership structures covered by the Policy Statement, some of which are intended to encourage private equity investors to co-invest with traditional bank or thrift holding companies that have large controlling stakes in their depository institution subsidiaries.

Impact of Policy Statement on Private Equity Investment in Failed Banks and Thrifts Remains Unclear

The FDIC received over 60 comment letters on the Proposal, with private equity firm commenters largely unanimous in their opposition to the Proposal's most controversial requirements, including the extraordinary capitalization requirements for covered depository institutions and the source of strength obligations and cross-guarantee liability for non-controlling investor organizations. The comment letter to the FDIC on the Proposal by WL Ross & Co. LLC, which was a member of the private equity consortium that acquired the operations of BankUnited, FSB from the FDIC in a high-profile transaction earlier this year, reflected at least some private equity firms' sentiments in stating that "the substance of the financial proposals is to impose such discriminatory burdens that private capital will no longer bid in the FDIC auctions of failed banks... I assure you that my firm will never again bid if the proposed policy statement is adopted in its present form."¹

In liberalizing or eliminating some of those provisions, the Policy Statement represents the FDIC's current thinking as to the proper balance between, on the one hand, accommodating investments in depository institutions from non-traditional sources in order to assist the FDIC in resolving the large number of failed and troubled depository institutions, and imposing new prudential requirements intended to address the perceived risks associated with ownership in depository institutions by largely unregulated investors, on the other. The fact that the FDIC Board of Directors (the "FDIC Board") acted on the Policy Statement roughly two weeks after the close of the public comment period indicates that the FDIC considers this an important policy area and one for which a clearer statement of agency policy was urgently needed.

Even with the changes from the Proposal, however, the Policy Statement still subjects private equity investors seeking to acquire or invest in failed depository institutions to more burdensome requirements and standards than are applicable to depository institutions owned by traditional holding companies. It remains to be seen whether the liberalizations reflected in the final version of the Policy Statement will be sufficient to avoid deterring private equity interest in acquiring failed depository

institutions from the FDIC, which is a matter of considerable importance to the FDIC in light of the ever-increasing number of failed or failing depository institutions. Early published reports discussing the reaction of the private equity industry to the Policy Statement suggest that the required minimum capital level of a 10 percent ratio of Tier 1 common equity to total assets may still have at least somewhat of a negative effect on private equity firms' bidding on failed banks and thrifts in FDIC receivership. The uncertainty as to the impact of the Policy Statement on private equity participation in the FDIC resolution process, and consequently on the FDIC's Deposit Insurance Fund, was reflected in the less than unanimous support for the Policy Statement by the members of the FDIC Board, with Acting Director of the Office of Thrift Supervision John E. Bowman voting to disapprove based largely on the lack of evidence to support a conclusion that the Policy Statement would reduce bank resolution costs for the FDIC. Acknowledging this uncertainty, the Policy Statement provides that the FDIC Board "will review the operation and impact of [the Policy Statement] within 6 months of its approval date and shall make adjustments, as it deems necessary."

Provisions of the Policy Statement Reflecting Substantial Change from the Proposal

Investors Covered

The Policy Statement provides that it applies to:

- "Private investors" in a company, including any company acquired to facilitate bidding on failed banks or thrifts that is proposing to, directly or indirectly (including through a shelf charter), assume deposit liabilities, or deposit liabilities and assets, from the resolution of a failed insured depository institution; and
- Applicants for FDIC deposit insurance in the case of de novo bank or thrift charters issued in connection with the resolution of failed insured depository institutions.

This scope provision is largely the same as in the Proposal, but subject to the changes noted below. The FDIC declined the request from numerous commenters for more precise terminology as to the types of investors covered by the Policy Statement, noting that the agency "finds it exceedingly difficult to use precisely defined terms to deal with the relatively new phenomenon of private capital funds joining together to purchase the assets and liabilities of failed banks and thrifts where the investors all are less than 24.9 percent owners but supply almost all of the capital to capitalize the new depository institution." It is clear, however, that the FDIC will apply the Policy Statement

¹ Comment Letter to FDIC of WL Ross & Co.

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to, among other things, private equity investors and consortia of such investors (commonly referred to as “club deals”) seeking to participate in the FDIC bidding process for failed depository institutions through newly-formed holding companies or newly-chartered or recently-acquired depository institutions, in which the private equity investors have not taken controlling equity stakes so as to avoid becoming subject to regulation as bank holding companies or thrift holding companies under applicable federal banking laws. The Policy Statement is silent as to whether one or more individuals acquiring or chartering a depository institution to acquire a failed bank in the FDIC receivership process would be covered, but the logic of the Policy Statement suggests that they would be.

The Policy Statement makes the following clarifications and other changes to the scope provision of the Proposal:

- The Proposal’s exclusion for private capital investors in bank or thrift holding companies that were created or acquired by the investor at least three years prior to the date of the Policy Statement has been deleted, with the effect that even a holding company that has been owned by a private equity investor for longer than three years would be subject to the Policy Statement (unless the FDIC Board grants an application seeking an exemption from the Policy Statement based upon the examination ratings maintained by the bank or thrift involved for a continuous seven-year period, as discussed below).
- The Policy Statement excludes from its coverage “investors in partnerships or similar ventures with bank or thrift holding companies or in such holding companies (excluding shell holding companies) where the holding company has a strong majority interest in the resulting bank or thrift and an established record for successful operation of insured banks or thrifts.” No further guidance is provided as to what type of equity ownership stake would constitute a “strong majority interest” for purposes of this exclusion. The Policy Statement notes that the FDIC “strongly encourages” these types of arrangements, however.
- In place of the Proposal’s exclusion for ownership structures involving “de minimis investments” by private equity investors, with the de minimis threshold being undefined, the Policy Statement makes clear that investors with five percent or less of the total voting power of an acquired depository institution or its bank or thrift holding company are not covered by the Policy Statement, provided there is no evidence of concerted action by such investors with other investors. Presumably the Policy Statement is intended to apply to an ownership structure involving two or more private equity investors in which each such investor’s voting equity stake is no higher than five percent but the combined stake of all private equity investors exceeds that threshold, although this is not completely clear. The Policy Statement also applies if there is only one private equity investor

involved in a transaction as long as the investor’s voting equity stake exceeds the five percent threshold, unless another investor is a holding company with a “strong majority interest” and an “established record for successful operation of insured banks or thrifts,” as noted above. Although the term “concerted action” is not defined, the FDIC most likely will look to the treatment of that concept in the agency’s Change in Bank Control regulations, and possibly also to the criteria applied by the Federal Reserve Board in determining whether or not to aggregate the ownership stakes of various investors for purposes of the control provisions of the Bank Holding Company Act.

- Unlike the Proposal, the Policy Statement is explicit that it applies only prospectively to acquisitions of failed depository institutions completed after its approval date.
- The Policy Statement provides that the FDIC Board, upon application, may determine not to apply the Policy Statement to an investor in a bank or thrift or a holding company of either where the bank or thrift has maintained a composite examination rating in one of the two highest rating categories continuously for seven years, “taking into consideration whether the ownership structure of such bank, thrift or holding company is consistent with the objectives” of the Policy Statement.
- Similarly, the Policy Statement provides that the FDIC Board may waive one or more provisions of the Policy Statement using expedited procedures to be established by the FDIC Chairman “if such exemption is in the best interests of the Deposit Insurance Fund and the goals and objectives of this [Policy Statement] can be accomplished by other means.”

Capital Commitment

The provision in the Proposal that was the source of greatest concern to many private equity investors interested in bidding on failed depository institutions, and which was the subject of extensive comment, was the proposed requirement that covered investors commit to the FDIC to cause the depository institution acquiring the banking operations of a failed depository institution in receivership to be initially capitalized at a minimum 15 percent Tier 1 leverage ratio² for a period of three years, subject to possible extension by the FDIC. The 15 percent Tier 1 leverage ratio requirement—which would have been almost double the 8 percent level imposed by the FDIC in granting deposit insurance for de novo institutions generally, three times greater than the level required for an existing depository institution to be considered well capitalized and nearly four times greater than the minimum level generally required of most depository institutions on an ongoing basis—was perceived by many private equity firms as making investments in banks and thrifts uneconomic.

² The Tier 1 leverage ratio is the ratio of the depository institution’s Tier 1 capital to its average total (i.e., not risk-weighted) consolidated assets.

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The Policy Statement replaces the 15 percent Tier 1 leverage ratio requirement with a new requirement that the resulting depository institution involved in the acquisition of the failed bank or thrift maintain a ratio of Tier 1 common equity to total assets of at least 10 percent for a period of three years from the time of acquisition. However, in adopting this change, the FDIC also revised the numerator of the fraction from Tier 1 capital generally to Tier 1 common equity, thereby excluding from the calculation of the numerator other items includible in Tier 1 capital such as qualifying perpetual preferred stock and minority interests. This focus on common equity is consistent with the federal bank regulators' evolving views on capital adequacy in light of the financial crisis and the governmental efforts to stabilize the banking industry. The Policy Statement eliminates the provision in the Proposal that the three-year period during which the higher capitalization requirement applies would be subject to possible extension by the FDIC, but the FDIC Staff Memorandum accompanying the Policy Statement (the "Staff Memorandum") makes clear that capital requirements may be increased by the FDIC above the minimum 10 percent Tier 1 common equity to total assets ratio if deemed warranted.

The other capitalization requirements from the Proposal were adopted unchanged in the Policy Statement. After the initial three-year period during which the 10 percent Tier 1 common equity to total assets ratio applies, covered investors are required to maintain the depository institution at a level of capital adequacy no lower than "well capitalized"³ throughout the remainder of their ownership. If at any time the depository institution fails to meet the then-applicable capital requirement, the institution would have to immediately take action to restore capital to the 10 percent Tier 1 common equity ratio or the well capitalized standards, as applicable. Any failure to maintain the required capital level would result in the institution being treated as "undercapitalized" for purposes of the federal Prompt Corrective Action regulations, which would (among other things) trigger restrictions on the payment of dividends and management fees by the institution and on the growth of the institution's assets, require the submission to the institution's primary federal regulator of a capital restoration plan, and impose prior regulatory approval requirements on certain expansion proposals by the institution. This treatment of an insured depository institution that fails to meet the well-capitalized standard as being "undercapitalized" (rather than adequately capitalized, which may in fact be the case depending upon its

capital ratios) conflicts with the definition of "undercapitalized" in the other federal banking agencies' Prompt Corrective Action regulations, and it remains to be seen how the FDIC's approach in this regard will be applied by the other agencies for depository institutions under their supervision.

The Staff Memorandum states that "the FDIC believes that heightened capital levels are necessary in view of the higher risk profile of what are de novo institutions being acquired and for the protection of the [Deposit Insurance Fund] from losses."

Source of Strength

Another area of the Proposal that caused substantial concern for private equity firms was the proposed requirement that "Investors organizational structures subject to the measures provided for in this [Proposal] would be expected to agree to serve as a source of strength for their subsidiary depository institutions." The potential imposition of a source of strength obligation—which is derived from a Federal Reserve Board policy applicable to bank holding companies⁴—to private equity investors with non-controlling stakes in depository institutions would have been a fairly unprecedented expansion of the financial obligations of non-controlling shareholders and would have been difficult or impossible for private equity funds to agree to or satisfy. Recognizing these problems, the Policy Statement eliminates the source of strength provisions.

Cross Guaranty

The Proposal provided that:

- Investors whose investments, individually or collectively, constitute a majority of the direct or indirect investments in more than one insured depository institution would be expected to pledge to the FDIC their proportionate interests in each such institution to pay for any losses to the deposit insurance fund resulting from the failure of, or assistance provided to, any other such institution.

This provision generated substantial negative comment from private equity commenters to the FDIC, many of which noted that there was no statutory basis for applying the cross-guarantee provisions of the Federal Deposit Insurance Act (which apply to commonly-controlled depository institutions) to non-controlling private equity investors.

³ To be "well capitalized" under the federal Prompt Corrective Action regulations, a depository institution must have a ratio of Tier 1 capital to total consolidated risk-weighted assets of at least 6 percent, a ratio of total capital to total consolidated risk-weighted assets of at least 10 percent, and a Tier 1 leverage ratio of at least 5 percent.

⁴ The Federal Reserve Board "source of strength" doctrine requires that a bank holding company serve as "sources of financial and managerial strength" to its subsidiary banks. The Federal Reserve Board expects that a bank holding company, in serving as a source of strength to its subsidiary banks, would stand ready to use available resources to provide adequate capital funds to its subsidiary banks during periods of financial stress or adversity and maintain the financial flexibility and capital-raising capacity to obtain additional resources for assisting its subsidiary banks.

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The Policy Statement does not retreat from the cross-guaranty principle embodied in the Proposal, but does scale back the circumstances under which it would apply by increasing the common ownership threshold required to trigger the cross-guaranty. The Policy Statement, which refers to the requirement now as “cross support,” provides that:

- If one or more Investors own 80 percent or more of two or more banks or thrifts, the stock of the banks or thrifts commonly owned by these Investors shall be pledged to the FDIC, and if any one of those owned depository institutions fails, the FDIC may exercise such pledges to the extent necessary to recoup any losses incurred by the FDIC as a result of the bank or thrift failure.

The Policy Statement further provides that “the FDIC may waive this pledge requirement “where the exercise of the pledge would not result in a decrease in the cost of the bank or thrift failure to the Deposit Insurance Fund.”

Even as scaled back, the cross-support provision is a cause for concern for a private equity investor seeking to become involved in two or more club deals for depository institutions, at least one of which involved an investment in a failed bank or thrift. Although the Policy Statement (like the Proposal) does not contain any details as to how the cross-support provision would be applied by the FDIC in practice, it appears that a private equity investor that acquires more than a five percent voting stake in each of the two depository institutions would become subject to the cross-support requirement if the combined direct or indirect ownership stake in each of the underlying depository institutions of at least some of the common members in the two consortia represented at least 80 percent. This provision could lead private equity investors to avoid entering into more than one depository institution club deal with other private equity firms in which the combined private equity ownership stake is 80 percent or greater, at least in cases where an existing or proposed common depository institution investment involves the acquisition of a failed bank or thrift in the FDIC receivership process. Additionally, a private equity firm considering club deal transactions that might subject it to the cross-support provision would need to evaluate whether the requirement to pledge the depository institutions’ shares to the FDIC would be permissible as a contractual matter. Moreover, the cross-support provision may affect the ability of affected depository institutions or holding companies to raise capital or debt funding.

Other Provisions of the Policy Statement Not Materially Changed from the Proposal

The remaining provisions of the Policy Statement are largely or, in some cases, completely unchanged from the Proposal. In most cases, however, these provisions were generally of less concern to private equity firms seeking to acquire failed banks from the FDIC, as reflected in the public comments to the Proposal.

Continuity of Ownership

As in the case of the Proposal, the Policy Statement provides that covered investors are prohibited from selling or otherwise transferring securities of the Investors’ holding company or depository institution for three years after the acquisition of the failed depository institution from the FDIC, unless otherwise approved in advance by the FDIC. The Staff Memorandum states in this regard that:

- The FDIC continues to take the position that it is important to encourage long term investment to promote the stability of a de novo previously failed bank or thrift. In particular, the FDIC has a direct interest in stability of management on which it depends for appropriate management of any agreements it may have with a bank or thrift concerning losses at that bank or thrift.

The Policy Statement does add a statement that in the case of transfers to affiliates FDIC approval shall not be unreasonably withheld, provided the affiliate agrees to be subject to the same requirements that are applicable under the Policy Statement to the transferring investor, and also provides that the continuity of ownership requirement does not apply to investors that are mutual funds. The Policy Statement does not provide any further guidance, however, on how the three-year minimum ownership period would affect the ability of private equity investors to take the depository institution or its holding company public during that time frame.

Investor Disclosure

As in the case of the Proposal, the Policy Statement provides that covered investors:

- would be expected to submit to the FDIC information about the Investors and all entities in the ownership chain including such information as the size of the capital fund or funds, its diversification, the return profile, the marketing documents, the management team and the business model. In addition, Investors and all entities in the ownership chain will be required to provide to the FDIC such other information as is determined to be necessary to assure compliance with this policy statement.

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The Policy Statement adds a statement providing that confidential business information submitted by investors to the FDIC will be treated confidentially and will not be disclosed by the agency except in accordance with law. The Staff Memorandum notes that the FDIC believes that this disclosure requirement could likely be implemented without significantly deterring private capital investments. It remains unclear, however, just how extensive the required disclosure would have to be, and in particular whether a private equity firm would be required to disclose the identities of limited partners in its investment fund, regardless of the sizes of their ownership stakes.

Transactions with Affiliates

Following the approach adopted in the Proposal, the Policy Statement prohibits all extensions of credit to “Investors, their investment funds if any, and any affiliates of either, by an insured depository institution acquired by such Investors” under the Policy Statement. This flat prohibition goes well beyond the quantitative restrictions, collateralization requirements and other prudential requirements applicable to extensions of credit by depository institutions to their affiliates under existing law. The Policy Statement clarifies, however, that extensions of credit existing at the time of the acquisition of the insured depository institution by the covered investors would not be subject to the prohibition. The Policy Statement continues to incorporate the expansive definition of the term “extension of credit” in Federal Reserve Board Regulation W (Transactions Between Member Banks and Their Affiliates) and defines “affiliate” as any company in which a covered investor owns 10 percent or more of the equity, although the Policy Statement now clarifies that this ownership level must have been maintained for at least 30 days in order to trigger the prohibition. The Policy Statement also makes clear that the FDIC will expect that covered investors provide regular reports to the insured depository institution identifying all affiliates.

Use of “Silo” Structures.

The Proposal provided that some private capital investment structures:

- such as those involving complex and functionally opaque ownership structures, typified by so-called “silo” organizational arrangements, in which the beneficial ownership cannot be ascertained, the responsible parties for making decisions are not clearly identified, and/or ownership and control are separated, would be so substantially inconsistent with these principles as not to be considered as appropriate for approval for ownership of insured depository institutions.

The Proposal did not contain a definition of the term “‘silo’ organizational arrangements,” however, and numerous commenters on the Proposal objected to this lack of specificity as well as to what appeared to be a flat prohibition on the “silo structures” utilized in the past by some private equity firms in acquiring depository institutions.⁵ The Policy Statement now adds by way of clarification that the “prohibited structures... have been typified by organizational arrangements involving a single private equity fund that seeks to acquire ownership of a depository institution through creation of multiple investment vehicles, funded and apparently controlled by the parent fund.” The Staff Memorandum notes the FDIC’s concerns in this area are that “the purpose of these structures is to artificially separate the non-financial activities of the firm from its banking activities so that the private equity firm is not required to become a bank or savings and loan holding company,” and that “this type of structure also raises serious concerns about the sufficiency of the financial and managerial support to the acquired institution, even in those instances where the investing fund(s) agrees to be regulated as a bank or savings and loan holding company.”

5 In connection with private equity investments in depository institutions, the term “silo structure” is commonly used to refer to an acquisition structure designed to allow an investing private equity organization to make a controlling investment in the institution without becoming (and without the private equity organization’s other funds and their portfolio investments becoming) subject to the non-banking prohibitions and other regulatory restrictions and requirements applicable to bank or thrift holding companies under federal banking law. A silo structure generally involves the private equity organization creating a mirror fund (to be capitalized by the investors in the organization’s existing fund or funds) with its own new general partner that would acquire up to 100 percent of the voting equity of a depository institution or its holding company. The new general partner is controlled by an individual partner or partners in the private equity organization, and no legal entity controls both the bank fund and any other fund in the organization. Although the new fund and the new general partner become subject to regulation as bank holding companies or thrift holding companies, depending upon the type of depository institution acquired, the rest of the private equity organization avoids regulated status. Certain private equity organizations have also employed multiple silo structures to prevent their various subsidiary banks from becoming subject to the cross-guaranty provisions of the Federal Deposit Insurance Act.

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Secrecy Law Jurisdictions

The Proposal provided that covered investors employing ownership structures utilizing entities domiciled in bank secrecy jurisdictions would not be eligible to own a direct or indirect interest in an insured depository institution unless:

- the investors are subsidiaries of companies that are subject to “comprehensive consolidated supervision” as recognized by the Federal Reserve Board;⁶ and
- the investors (i) execute agreements to provide the depository institution’s primary federal regulator with information regarding the investors’ operations and activities; (ii) maintain business books and records (or copies) in the United States; (iii) consent to the disclosure of information that might be covered by confidentiality or privacy laws in their home country and to cooperate with the FDIC, if necessary, in obtaining information maintained by foreign government entities; (iv) consent to jurisdiction and designation of an agent for service of process and (v) consent to be bound by the statutes and regulations administered by the appropriate US federal banking agencies.

The Policy Statement retains this provision, and adds in response to commenters’ request for clarification a definition of “Secrecy Law Jurisdiction” as a country that applies a bank secrecy law that limits US bank regulators from determining compliance with US laws or prevents them from obtaining information on the competence, experience and financial condition of applicants and related parties, lacks authorization for exchange of information with US regulatory authorities, does not provide for a minimum standard of transparency for financial activities or permits off shore companies to operate shell companies without substantial activities within the host country.

The Policy Statement does not contain any examples of jurisdictions that the FDIC considers to be covered by this definition.

Special Owner Bid Limitation

As in the case of the Proposal, the Policy Statement provides that an investor that directly or indirectly holds 10 percent or more of the equity of a depository institution would not be permitted to bid in the FDIC receivership process on that institution’s deposit liabilities, or deposit liabilities and assets, if the institution were subsequently to fail. This provision is intended to avoid providing an incentive for such an investor to seek to take advantage of any loss sharing arrangements that might be entered into by the FDIC as part of the resolution of the failed institution.

Links

[FDIC Statement of Policy on the Acquisition of Failed Insured Depository Institutions](#)

[FDIC Staff Memorandum on Final Statement of Policy on Qualifications for Failed Bank Acquisitions](#)

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⁶ The requirement that the investors be subsidiaries of companies that are subject to “comprehensive consolidated supervision” limits the universe of permissible investors domiciled in bank secrecy jurisdictions to those that are controlled by bank holding companies or foreign banking organizations based in countries whose bank supervisory systems have been reviewed by the Federal Reserve Board and determined to be consistent with international standards.