

# **Insolvency and Restructuring 2009: Where's the Turn-Around?**

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# The Continuing Fallout from the Credit Crisis, a Lender's Perspective

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# U.S. Bancorp Businesses

## 3Q09 Dimensions

• Asset Size	\$265 billion
• Deposits	\$170 billion
• Loans	\$183 billion
• Customers	15.8 million
• NYSE Traded	USB
• Market Capitalization*	\$48 billion
• Founded	1863
• Bank Branches	2,851
• ATMs	5,175

\* Market Value as of October 22, 2009



# Total Assets and Market Value

## Assets

U.S. Rank	Company	\$Billions
1	Bank of America	\$2,251
2	J.P. Morgan	2,041
3	Citigroup	1,889
4	Wells Fargo	1,229
5	PNC	271
<b>6</b>	<b>U.S. Bancorp</b>	<b>265</b>
7	SunTrust	173
8	BB&T	165
9	Regions	140
10	Fifth Third	111

## Market Value

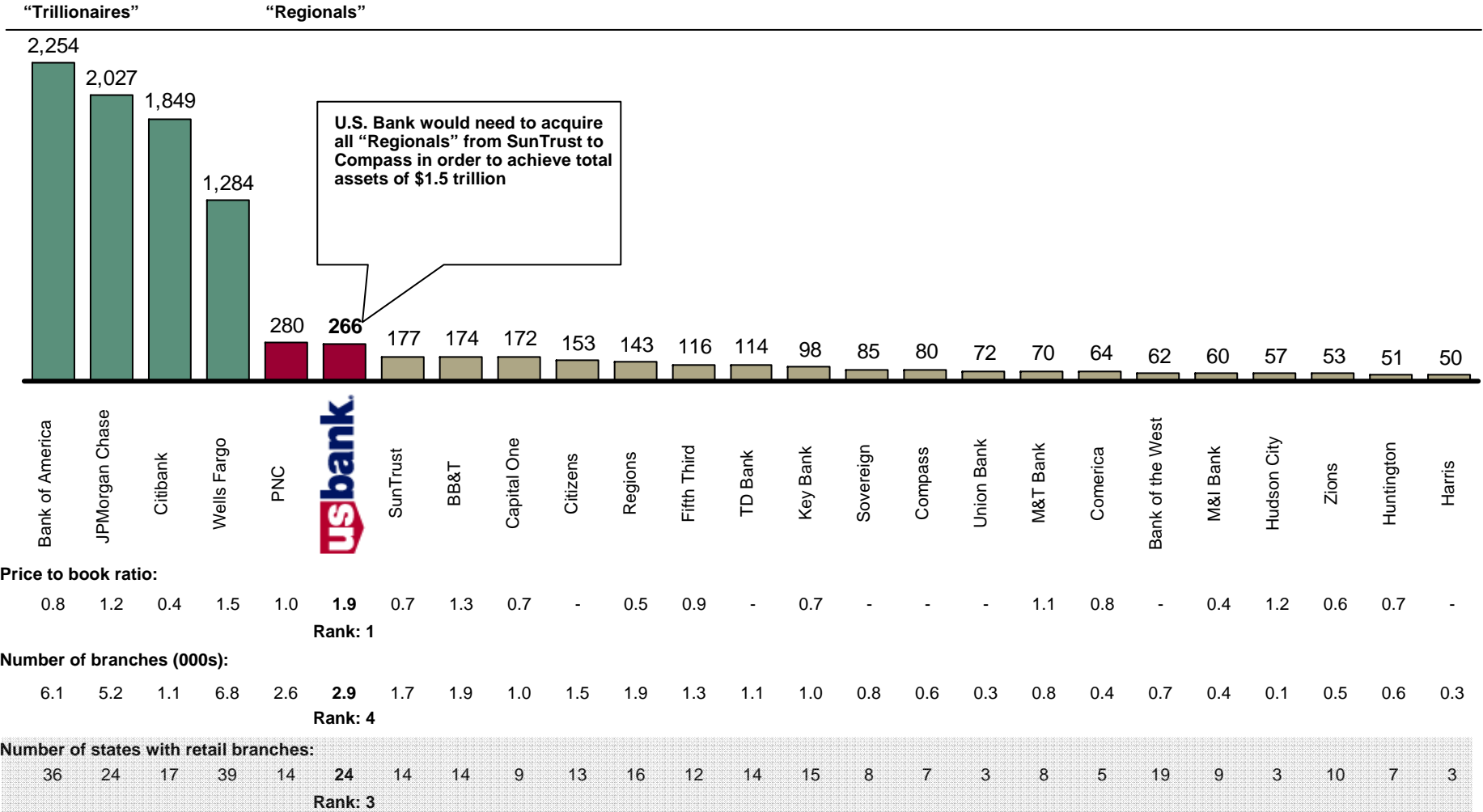
U.S. Rank	Company	\$Billions
1	J.P. Morgan	\$180
2	Bank of America	143
3	Wells Fargo	141
4	Citigroup	102
<b>5</b>	<b>U.S. Bancorp</b>	<b>48</b>
6	PNC	23
7	BB&T	18
8	SunTrust	11
9	Fifth Third	9
10	M&T	8

Source: company reports & FactSet  
 Assets as of September 30, 2009  
 Market Value as of October 22, 2009



# The U.S. banking landscape today includes “Trillionaires”, “Regionals”, and all others

**Top U.S. banks by assets (>\$50B)**  
 \$ Billions; Q2 2009 including announced acquisitions



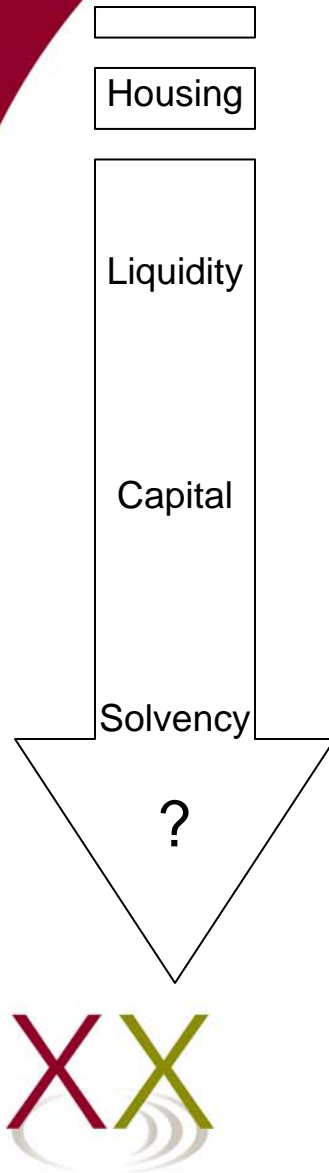
SOURCE: SNL Financial, Q2 2009, Yahoo Finance

# Economic Overview

November 5, 2009

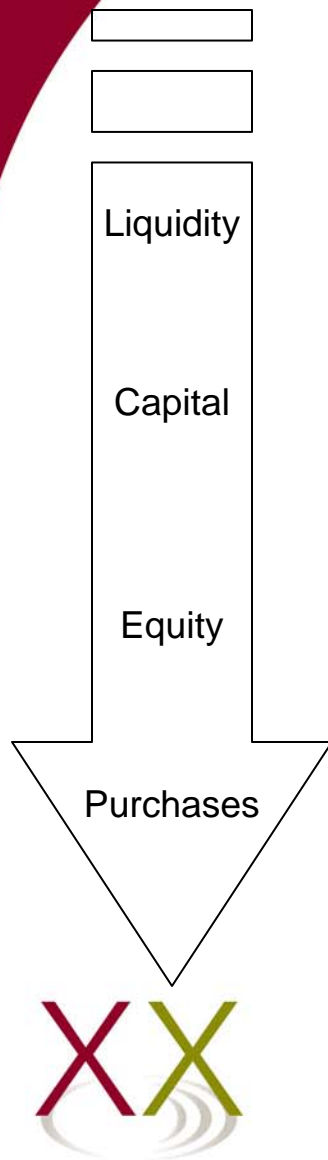


# Market Disruption Background



- Current market disruptions caused by over dependence on mortgage credit, home price appreciation and leverage, particularly in the subprime and structured credit (Summer and Fall 2006)
- Mortgage concerns become evident with subprime losses and deterioration of subordinated subprime mortgage backed securities market (Winter 2007)
- Beginnings of disruption was liquidity based when counter-parties refused to “roll” commercial paper due to mortgage holding and counterparty concerns (Summer 2007)
- Deterioration of monoline insurers puts pressure on municipal issuers; currently 42 states have financial deficits (Fall 2007)
- Wall Street dealers come under significant pressure as liquidity crisis evolves into capital / solvency crisis (March to September 2008)
- Agency mortgage market comes under government control as Fannie Mae and Freddie Mac are seized by U.S. government (September 2007)
- U.S. Government responds with unprecedented levels of market support (Late 2008 into 2009)

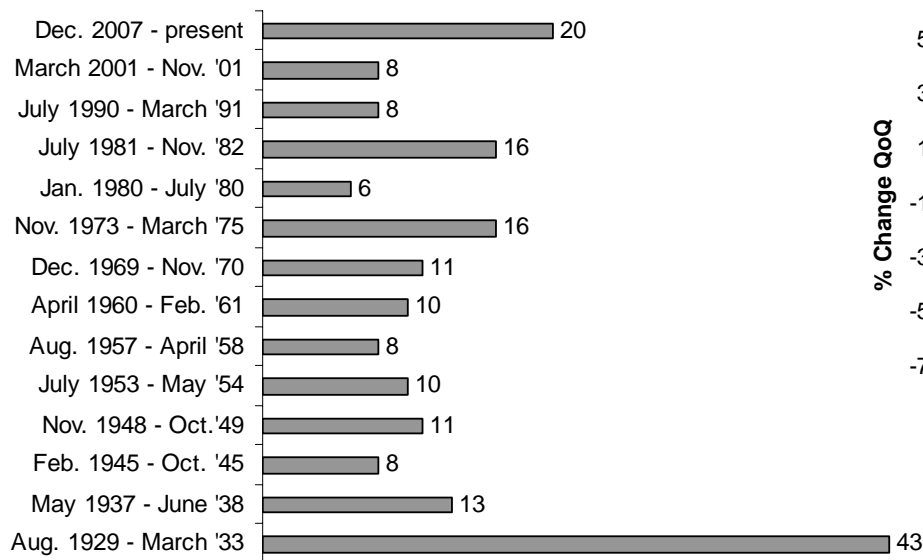
# Unprecedented U.S. Government Intervention



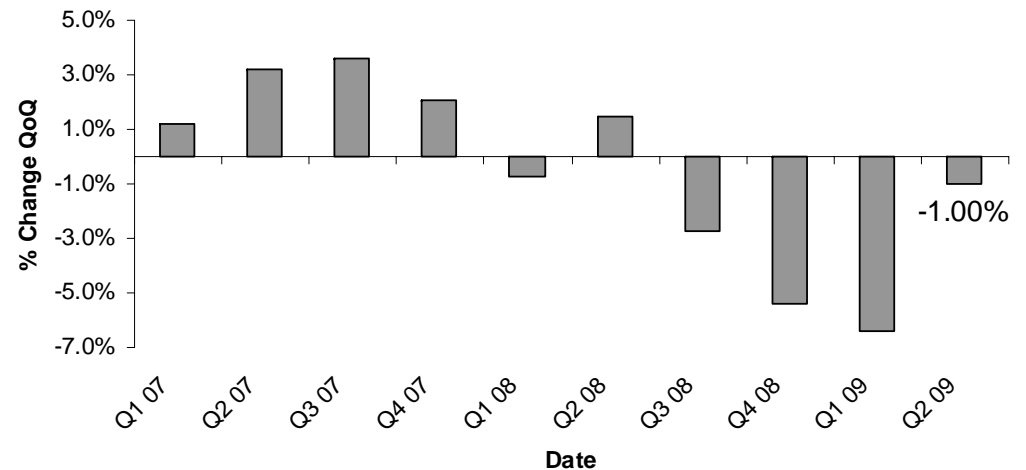
- Borrower refinancing programs – Secure, Hope for Homeowners, Hope Now
- Market liquidity support – TAF, MMIF, CPFF, PDCF
- Government control / nationalization – AIG, Fannie Mae, Freddie Mac
- Preferred capital investments – Treasury Capital Purchase Program
- Insuring bank deposits – FDIC: Transaction Account Guarantee Program
- Insuring bank wholesale debt – FDIC: Temporary Liquidity Guarantee Program
- Purchases of mortgage and government securities – GSE and Treasury purchase programs
- Financing purchases of asset backed securities – TALF facility

# Historical Recessions and Gross Domestic Product

- The current recession is the second worst since the Great Recession
  - Longest was October 1873 to March 1879 or 65 months
  - Recessions are distinguished between business cycle and credit cycle
- Real Gross domestic product forecast for 2009 is -2.5%
  - 2008 1.10%
  - 2007 2.00%
  - 2006 2.80%



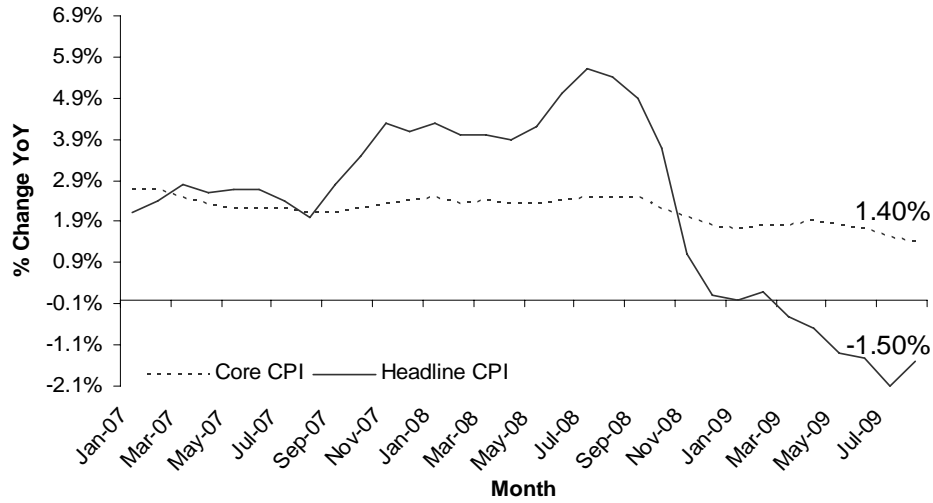
**Gross Domestic Product**



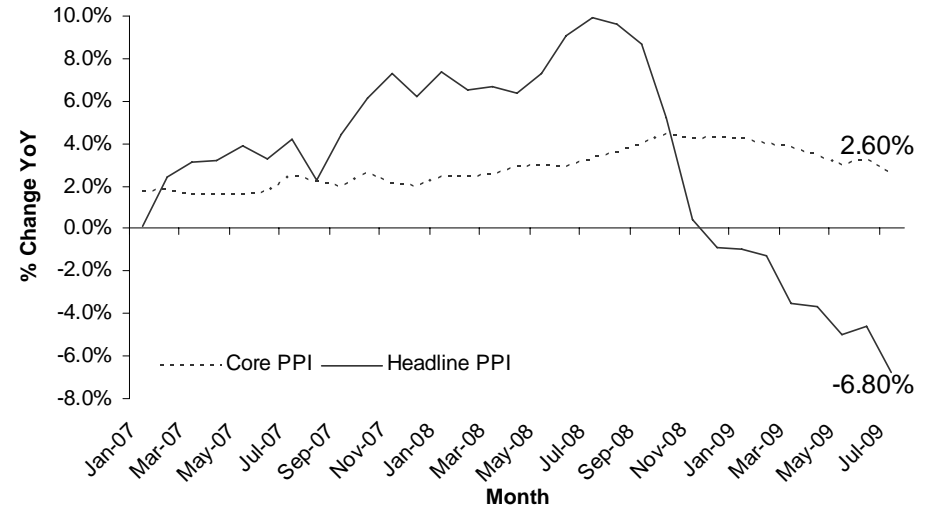
GDP % Change QoQ: Bloomberg, 8/12/09

# Inflation Indicators

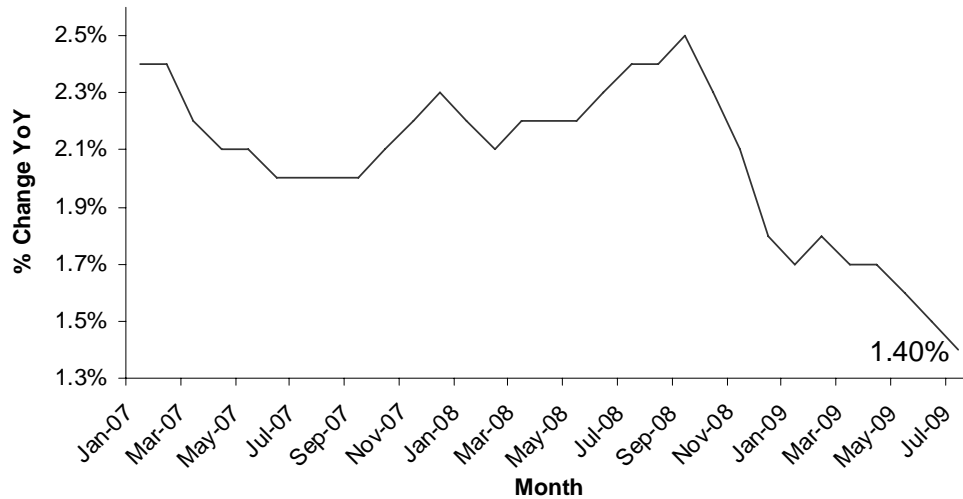
### Consumer Price Index



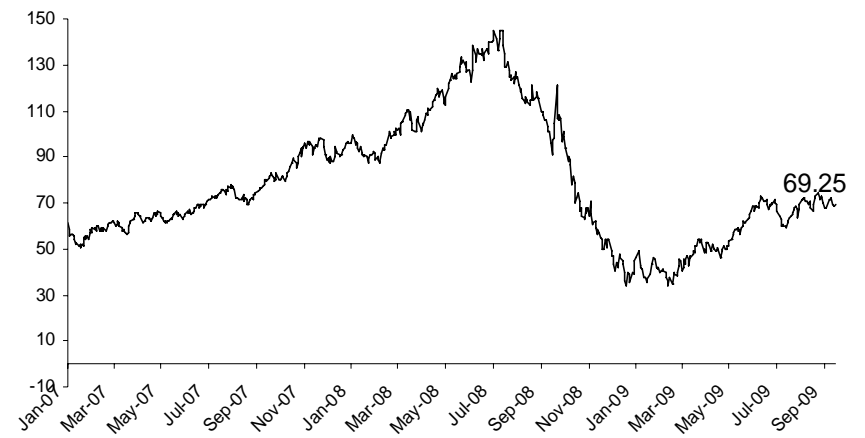
### Producer Price Index



### Personal Consumption Expenditure

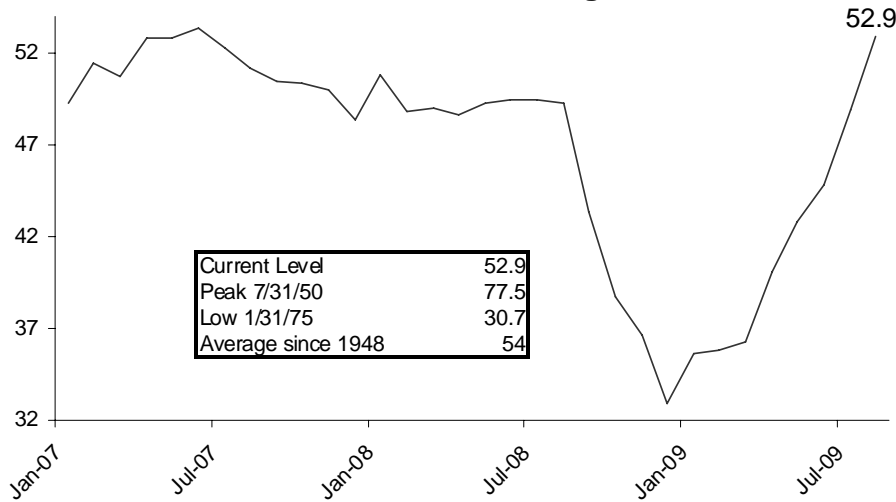


### Oil Prices

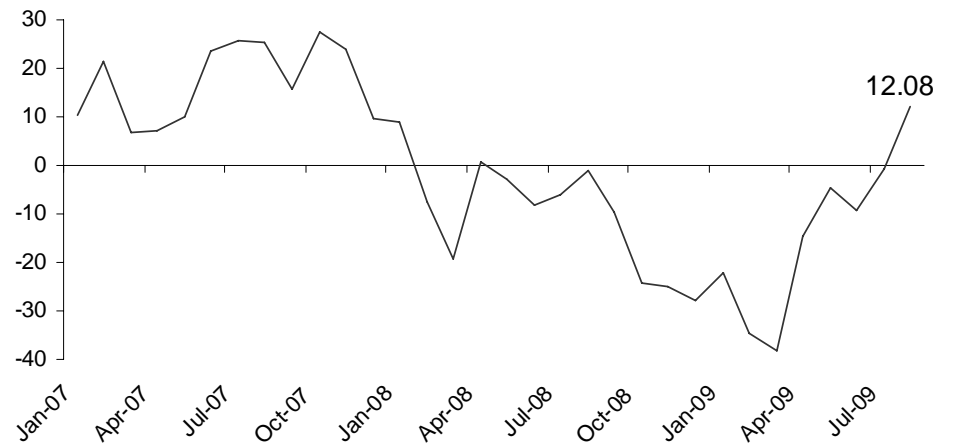


# Manufacturing Economic Indicators

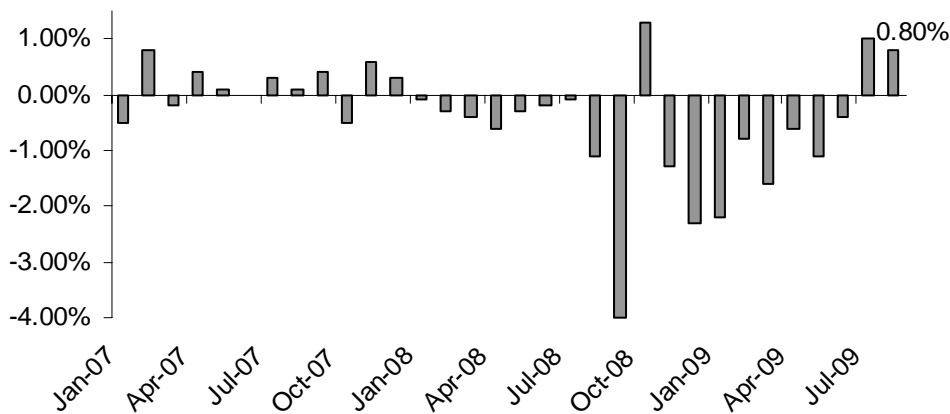
**ISM Manufacturing**



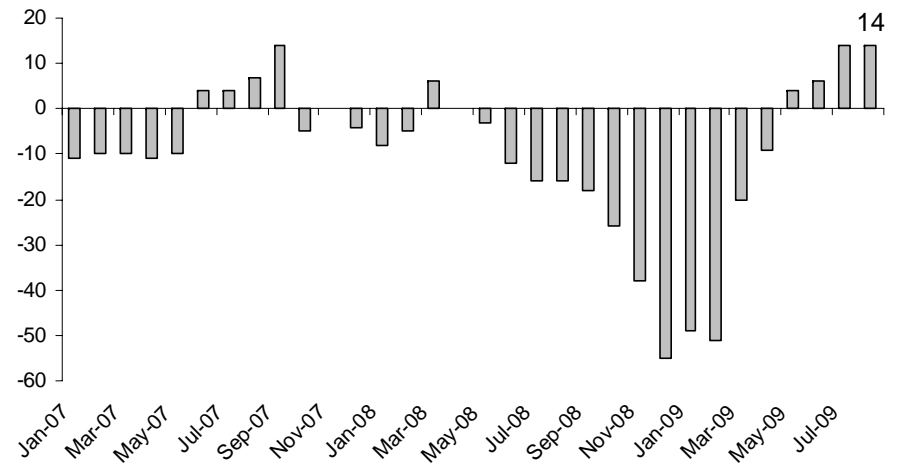
**Empire Manufacturing**



**Industrial Production (MoM)**

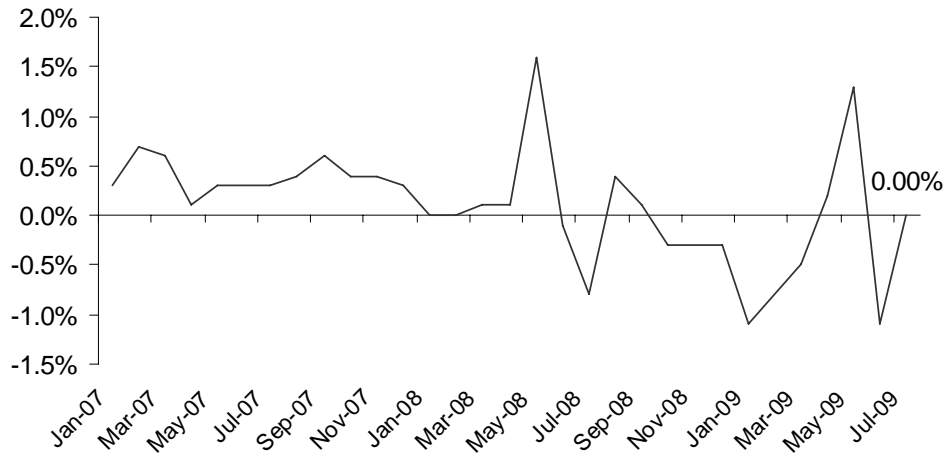


**Richmond Manufacturing Index**

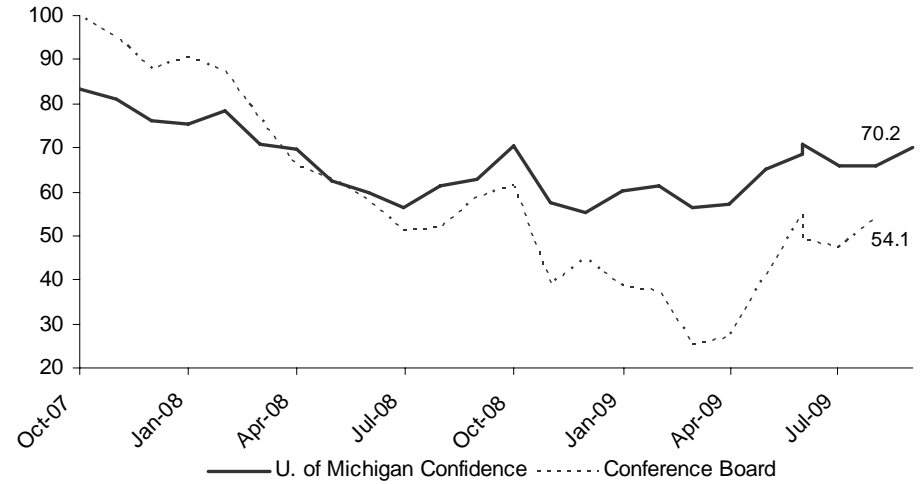


# Consumer Economic Indicators

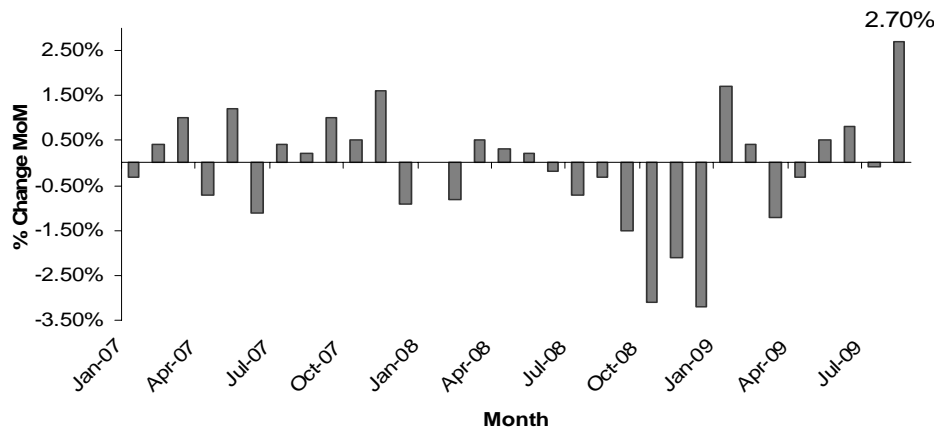
**Personal Income (% Change MoM)**



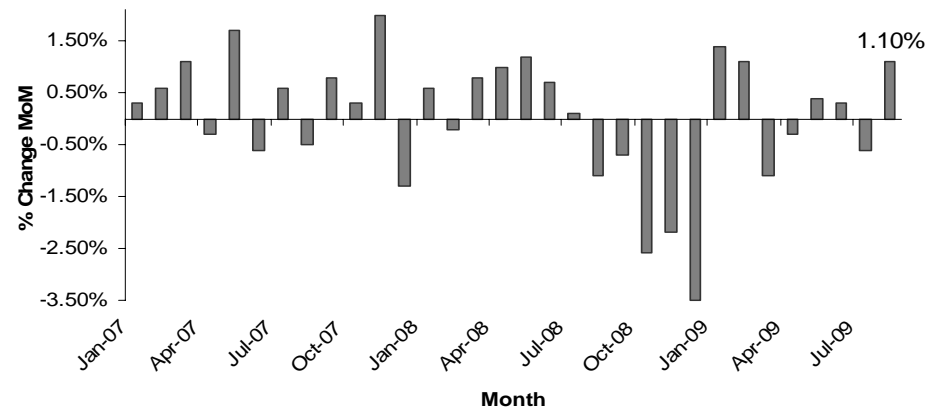
**Confidence**



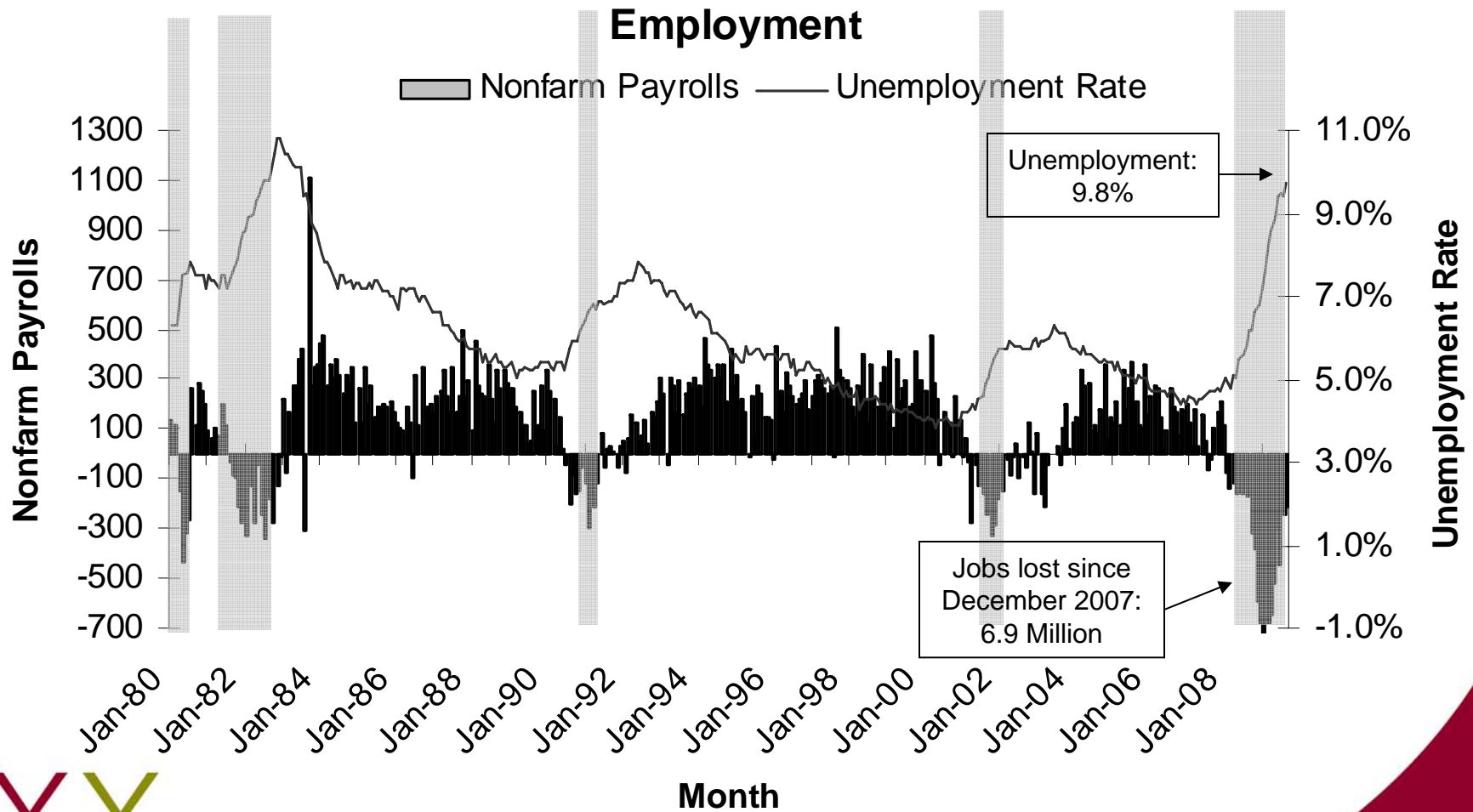
**Retail Sales (incl. Autos)**



**Retail Sales (ex. Autos)**

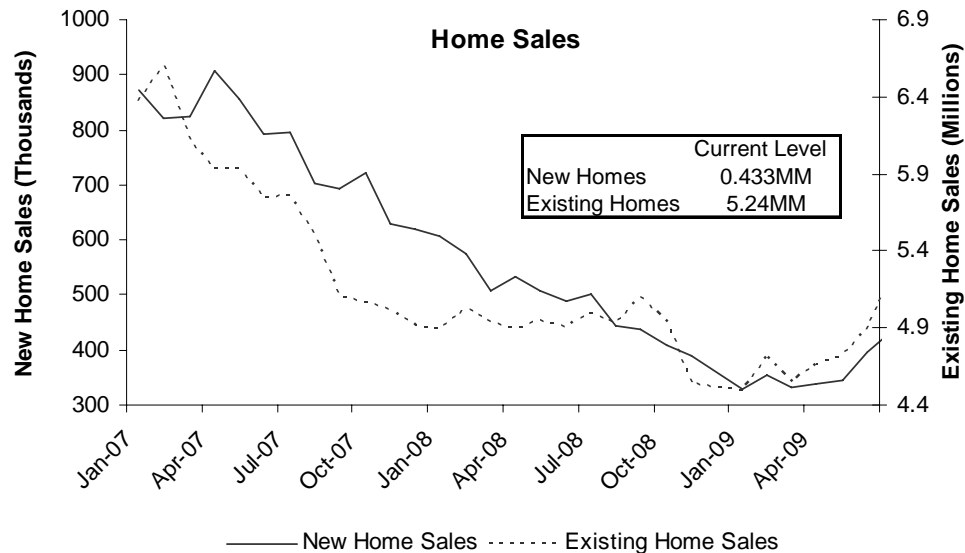
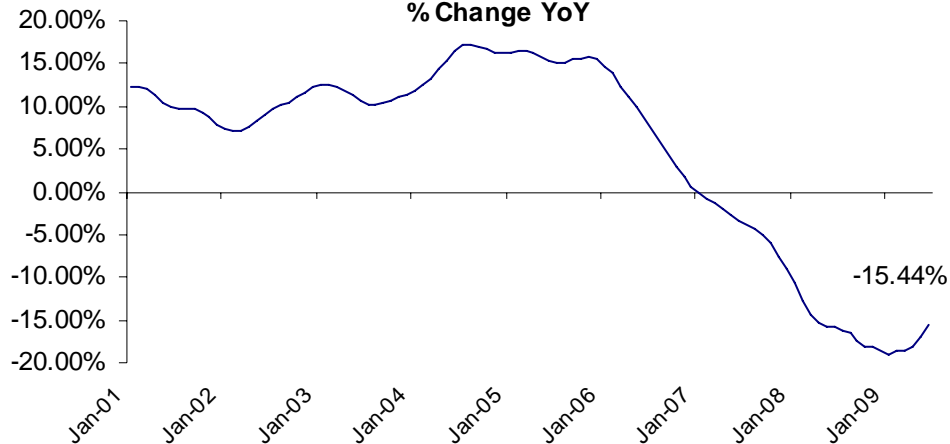


# Employment Economic Indicators



# Housing Economic Indicators

**S&P/Case-Schiller 20-City Composite Home Price Index**  
% Change YoY



(as of June 2009)

City	Peak	% Change from Peak
TX-Dallas	Jun-07	-5%
CO-Denver	Aug-06	-10%
NC-Charlotte	Aug-07	-11%
OH-Cleveland	Jul-06	-14%
MA-Boston	Sep-05	-16%
OR-Portland	Jul-07	-20%
NY-New York	Jun-06	-21%
GA-Atlanta	Jul-07	-21%
WA-Seattle	Jul-07	-22%
IL-Chicago	Sep-06	-26%
DC-Washington	May-06	-31%
<b>Composite-20</b>	<b>Jul-06</b>	<b>-31%</b>
<b>Composite-10</b>	<b>Jun-06</b>	<b>-32%</b>
MN-Minneapolis	Sep-06	-34%
FL-Tampa	Jul-06	-41%
CA-San Diego	Nov-05	-41%
CA-Los Angeles	Sep-06	-41%
CA-San Francisco	May-06	-43%
MI-Detroit	Dec-05	-45%
FL-Miami	Dec-06	-48%
AZ-Phoenix	Jun-06	-54%
NV-Las Vegas	Aug-06	-54%

Source: S&P / Case Shiller Home Price Indices



# Where we've been

November 5, 2009



## Where we've been

- Overall weakness in the housing market had a profound impact on bank loan portfolios.
- Sectors affected:
  - Homebuilders (National, Regional, Local)
  - Service providers (Mortgage Bankers, Title Companies)
  - Building Materials (Lumber, Drywall, etc.)
  - Land Developers
  - Transportation (Automobile, Trucking, etc.)



# Where we are

November 5, 2009



## Where we are

- Housing markets appear to be stabilizing, but at what level?
- Unemployment rising – what impact to consumer spending?
- Tightening of Credit Standards
- Banks are internally focused on shedding non-performing loans and Other Real Estate Owned
- Significant stress in Commercial Real Estate
  - Tenant downsizing/failures negatively impacting Retail and Office Developments
  - Rising Capitalization Rates decreasing property valuations
  - Value declines stressing owners ability to remargin loans or support project's negative cash flow

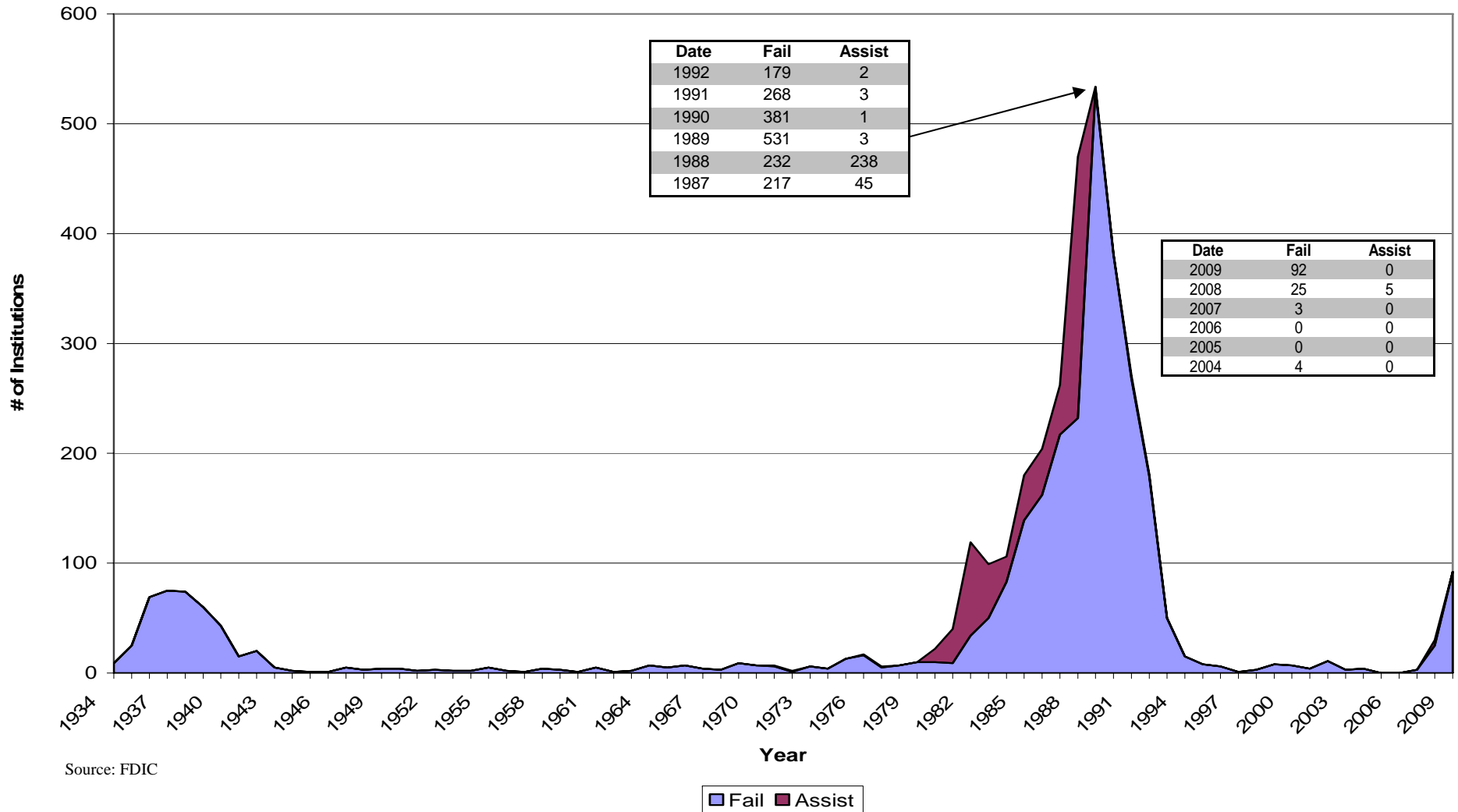


## Where we are (cont'd)

- Regulatory oversight of Financial Institutions increasing
- Growth in problem assets has stressed bank balance sheets – resulting in Capital Raises and a “Flight to Quality”
- Number of failing/stressed Financial Institutions growing



# FDIC Failure and Assistance Transactions



Source: FDIC

# Where we're going....

November 5, 2009



## Where we're going.....

- More of the same
- Continued weakness in Commercial Real Estate and stressed Financial Institutions
- Successful businesses are those that have nimble cost structures – able to adjust to falling revenue levels



## Where we're going.....

- Lack of liquidity limits Bank's options in exiting problem credits and entrepreneur's ability to raise capital
- Deficit spending likely to place additional strain upon municipal and state government budgets
- Regulatory Oversight will continue to increase for all Financial Institutions



# Regulatory Headwinds

- Financial Regulatory Reform
  - CFPA
  - Preemption
  - Compensation
- Credit Card legislation
  - CARD Act of 2009
  - Threat of interchange legislation
  - Prepaid cards
- Other consumer lending legislation (ODF)
- Capital levels
- Money market mutual funds regulation
- Accounting



# Chapter 11 in 2009 – and Beyond

Annette W. Jarvis

Eric Lopez Schnabel



# Can You DIP?

## Searching for the Elusive DIP

### Defensive DIPs - Pre-Petition Lenders

- Diverse lender syndications including impaired lenders
- Asset valuations
- Secured junior lenders
- Complex relationships
- Large capital needs with uncertain returns
- Regulatory uncertainty
- Timing uncertainty



# Can You DIP?

## Strategic DIPs – Insider Lenders

- Increased leverage for insiders with cash or resources
- Opportunity to reacquire assets with reduced leverage
- Reinvestment decision

## Absent DIPs - Third Party Lenders

- Where are they? DIP Auctions a thing of the past?



## The Perils of (Low) Valuation

**Early Valuation may be risky (or can you have your cake and eat it too?)**

- Relief from stay
- Resisting DIP loans (except your own)
- Credit bidding
- Cram down



## The Perils of (Low) Valuation

### Dealing with fluctuating and difficult valuations (or how much is that dog in the window)?

- Frequent updating of values
- Strategic use
- Partially completed projects
- Cutting your losses now or waiting it out



# 363 Sales – Expeditious Tool or End Run?

## GM and Chrysler – Exceptions or New Trends?

- Do interests of employees dictate the best and highest offer for assets?
- Are there limits to structuring a sale to determine the buyer?
- What exactly are “wasting assets”?
- Are high profile cases exempt from due process?
- Are there limits to the bidders’ right to determine who gets paid as part of sale?



## 363 Sales – Expeditious Tool or End Run?

**Is there anything absolute (in the priority sense) about 363 sales?**

- Does anyone care about plans anymore?
- Does the absolute priority rule even apply to 363 sales?
- Can a successful bidder bid around the absolute priority rule?



# 363 Sales – Expeditious Tool or End Run?

## **Are Pre-packs back?**

- Limited Financing
- Delayed Restructurings
- Less flexibility after BAPCPA

## **Is there a reasonable marketing time in a dead market?**

- Justification for expedited sales?

## **Have we shed Clear Channel?**

- Back to Plans in the Ninth Circuit?



# 363 Auctions – or How to Have Fun On An All-Nighter

## Qualifying a Bid

- Cash v. non-cash
- Financing and due diligence contingencies
- Regulatory approvals

## Highest and Best

- What does “and” mean?
- Credit bidding
- Disgruntled bidders



# Restructuring (or Not) The Financial System

**Thomas Kelly**



# **The Partly Finished Agenda: Bank Failures and Resolutions in 2008-09**



## **2008: 25 Bank Failures.**

\$ 371.9 billion in assets.  
(not including Wachovia)

\$ 234.3 billion in deposits.

## **2009: 106 Bank Failures.**

\$ 107.35 billion in assets.  
(as of October 23, 2009)

\$ 89.6 billion in deposits

FDIC's "Problem List" has increased from 252 to 416  
Banks since December 31, 2008



## Factors Driving Bank Failures

- Noncurrent loans increased \$101 billion over the first two quarters of 2009, resulting in an average rate of noncurrent loans to loans of 4.32%, the highest level in the 26 years the data has been reported.
- Reserves as a percentage of total loans have been at record levels throughout 2009, reaching 2.77% by the second quarter of 2009, compared to the prior record of 2.38% set in the first quarter of 1992.
- A significant number of institutions that are currently well or adequately capitalized hold classified assets and OREO representing more than 50% of their total capital.



## Factors Driving Bank Failures

- Real estate-related loans continue to be the most common cause of failure among banks that have failed this year. The impact of newly classified commercial real estate and real estate development loans has been significant.
- The ongoing decline in real estate values requires further write downs of already classified credits and repossessed real estate held as OREO.
- Write downs of real estate related securities have been a significant contributor to bank losses in 2009, with smaller institutions holding private label securities being hit particularly hard. In some cases it has been losses in the investment portfolio that caused banks to fail.



## Factors Driving Bank Failures

- For smaller institutions that have been heavily impacted by losses on real estate related assets, little or no access to TARP funds, other government programs or private capital sources have left them in a position of having to “wait and see” if further losses will be too great for them to bear.
- For many potential bank acquirers, a private troubled bank acquisition will rarely be a viable alternative to acquiring a failed institution with the FDIC’s assistance.



## Structure of Resolutions

- Most failed institutions are now offered by the FDIC as whole bank transactions with loss sharing.
- Loss sharing is based on a stated threshold amount set by the FDIC as part of the bid process, with 80% of the losses born by the FDIC up to the threshold amount and 95% of the losses born by the FDIC above the threshold amount.
- A bid then has three key components: (1) whether all deposits or only insured deposits will be assumed, (2) a premium on deposits and (3) a premium or discount on the assets (taking into account the impact of loss sharing).



## Structure of Resolutions

- At closing, cash settlement is based on the sum of assets acquired, minus liabilities assumed, plus deposit premium plus or minus the asset premium or discount. If this results in a negative number, the FDIC pays that amount to the acquirer at closing. If the number is positive, the acquirer absorbs that amount of losses before loss sharing applies.
- Through August 2009, the FDIC has entered into 53 loss sharing agreements, with \$80 billion in assets under loss sharing. The estimated savings exceed \$11 billion, compared to an outright cash sale of those assets.



## The Deposit Insurance Fund

- The extraordinary number of bank closures this year has left the deposit insurance fund with a negative balance. Based on current projections, the fund will remain in the red until 2012 and may not recover to its statutorily required minimum until 2018.
- As a consequence, the FDIC announced on September 29 that it would require insured banks to prepay estimated insurance premiums for the next three years by December 30. The FDIC is also raising the assessment rate by 3 basis points, effective January 2011. The prepaid assessment is expected to raise \$45 billion in immediate cash.



## The Deposit Insurance Fund

- The FDIC also has the option of borrowing from the Treasury to cover its costs, but FDIC Chairman Sheila Bair has so far been unwilling to use this option.
- The FDIC projects that resolution costs in 2009 and 2010 will be around \$100 billion; some of which will be paid from recoveries from failed institutions.



# The Unfinished Agenda: Recapitalizing the Banking System



## The Big Banks

- When the results of the Stress Tests for the 19 largest banks were announced on May 7, 2009, 10 of those Bank had capital deficits, totaling \$75 billion .
- Eight of the nine Banks found to have sufficient capital were TARP CPP participants. Six of the eight have since repaid their TARP CPP investments.
- Nine of the ten Banks found to have insufficient capital have raised new, private capital to close the gap. GMAC has requested additional capital from the government to close the gap.



## What About the Rest?

- The number of existing banking organizations with the capital and operational resources to acquire and operate failed or failing institutions continues to decline, as institutions are faced with the realization that their own problems deserve a bigger share of these resources or they have exhausted their resources on early acquisitions.
- In August 2009 the FDIC issued a Final Statement of Policy for Failed Bank Acquisitions, primarily addressing the conditions under which private equity investors could participate in failed bank acquisitions.



## What About the Rest?

- Investors acting in partnership with established bank or thrift holding companies with a strong majority interest in the resulting depository institution and an established record of successful operation are exempt from the policy statement. Investors with 5% or less of the voting power of an acquired depository institution or holding company are also exempt, provided the investor is acting in concert with other investors.
- An investor in a depository institution or holding company where the depository institution has maintained composite CAMEL ratings of 1 or 2 for seven years can apply for exemption.



## What About the Rest?

- Investors subject to the policy statement must maintain Tier 1 common equity at the resulting depository institution of at least 10% of total assets for the first 3 years, and then must meet applicable guidelines for well capitalized institutions thereafter (Current requirement: 5% Tier 1 capital).
- A covered investor that owns 80% or more of a depository institution must pledge its shares of that institution to the FDIC for use in covering losses from the failure of any of the commonly controlled institutions.



## What About the Rest?

- Investors must maintain their ownership for a three year period, absent FDIC approval.
- Complex and functionally opaque structures that make it difficult to ascertain beneficial ownership and responsible decision makers and separate ownership and control are not considered appropriate.
- Extensions of credit by the acquired depository institution to the investors, their investment funds or affiliates are prohibited.



## What About the Rest?

- Investors utilizing entities domiciled in bank secrecy jurisdictions that limits access and review by U.S. regulators are not eligible investors, except where the investors are subsidiaries of companies subject to comprehensive consolidated supervision as recognized by the Federal Reserve Board and then only upon compliance with additional restrictions. Investors that directly or indirectly own 10% or more of the equity of an institution in receivership are ineligible.



## What About the Rest?

- The FDIC's policy on private equity investment has also given the September 2008 Federal Reserve Board policy statement on non-controlling equity investments renewed importance. Eligible investors under the FDIC policy must also comply with restrictions on control.
- An investor with less than 25% of a the voting stock of a depository institution or holding company can avoid being found in control, and an investment fund investing at that level can avoid being subject to approval and regulation as a bank holding company, if the investment is properly structured.



## What About the Rest?

- An investor may acquire voting and non-voting equity interests representing less than 1/3 of a bank's or holding company's total (voting and nonvoting) equity, provided the investor does not own 15% or more of any class of voting securities. Shares convertible to voting shares will be treated as voting shares under certain circumstances.



## What About the Rest?

- Business relationships between the investor and the banking organization will be reviewed on a case by case basis. In addition, covenants restricting discretion over operational and management decisions are prohibited, except those that are designed to prevent adverse changes in the terms of the shares held by the investor, the issuance of senior securities or authorization of the liquidation of the company.
- In August 2009, the FDIC announced enhanced supervisory procedures for de novo banks.



## What About the Rest?

- While the chances of receiving approval of a new bank charter or deposit insurance application in the current environment are slim at best, the enhanced procedures also apply to newly insured institutions that have not reached the end of their third year of operation.
- Prior to the end of their third year of operation, new institutions are required to submit updated pro forma financial statements and business and strategic plans for their fourth through seventh years of operation, four years longer than previously required for approval of a deposit insurance application.



## What About the Rest?

- A key element of these updated projections will be the existence of adequate capital resources throughout the seven year period, at levels no less than that historically required during the first three year's of a de novo's life.
- During this extended seven year review period, these institutions will remain subject to a twelve month examination cycle and, in the future, material changes in an institution's business plan will require FDIC approval, rather than just notice.



**The message: yes to new capital, but  
not to new ways of doing business.**



# The Unfinished Agenda: Too Big to Fail



## “Too Big to Fail”

- “Too Big to Fail” is a poorly articulated policy that effectively protects the creditors of Banks that would create “systemic risk” if permitted to go out of business through a normal bankruptcy or receivership process (with creditors bearing losses and waiting for recovery).
- “Systemic Risk” is not well defined, but is generally the risk that the failure of one Bank could start a “domino effect” that would undermine the banking system.
- “Too Big to Fail” was extended to include non-banks (Bear Sterns, AIG, Merrill Lynch) in 2008.



## “Too Big to Fail”

- “Too Big to Fail” arose out of the collapse of Continental Illinois in 1984. The FDIC covered all (not just insured) deposits, and infused \$1.5 billion in the form of a loan, \$1 billion in the form of equity, and \$4.5 billion by means of a purchase of distressed assets.
- Continental’s failure, and the risks the government sought to contain, arose out of traditional banking activities:
  - aggressive commercial lending practices; especially in the energy sector (Penn Square);
  - LDC lending;
  - Small “core” deposit base; and
  - Large network of correspondent banks that would be affected by the failure.



## “Too Big to Fail”

- FDIC Improvements Act (1991) limited the FDIC’s discretion to bail out “Too Big to Fail” Banks, but left a “systemic risk” exception.
- No major banks failed from 1992-2007.
- Discussion continued around “Too Big to Fail” in banking circles, but no reforms were implemented.
- Gary H. Stern and Ron J. Feldman, Too Big to Fail: The Hazards of Bank Bailouts (2004)



# 2008

- Several “Too Big to Fail” firms were rescued
  1. Bear Stearns
  2. AIG
  3. Merrill Lynch
  4. Wachovia
  5. Citi
- “Too Big to Fail” Banks have grown even bigger.



# Reform Paths

## 1. “Just Say No”

- “Too Big to Fail”= too big to exist
- effective resolution process
- identify and address systemic risks as part of the resolution process



# Reform Paths

## 2. Better Supervision

- identify TBTF Banks (“Tier 1 FHC’s”)
- “strong consolidated supervision and regulation”
- “stricter and more conservative prudential standards”
- inclusion of “Macroprudential” methods of oversight
- pre-planned liquidations
- effective resolution process by regulators



## Reform Paths

- The Administration’s proposals essentially follow Path 2.
- Unclear whether Congress will act, but if they do, they are likely follow the Administration’s lead.
- The result will be a partial formalization of “Too Big to Fail,” with some regulatory disincentives for Banks to fall into this category.



**“The regulators will get it right next time.”**



**Questions?**

