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A CLIENT ALERT FROM PAUL HASTINGS
July 2008

Lessons Learned from Indymac

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On July 11, 2008, the Office of Thrift Supervision ("OTS") closed the $32 billion Indymac Bank, FSB, and appointed the Federal Deposit Insurance Corporation ("FDIC") as receiver in the third largest bank failure in United States history. Various aspects of the failure of Indymac will be examined closely over the next few months as bank regulators and the banking industry brace for many more banks to fail over the next year. In the near term, the failure of Indymac and continued volatility among other banks provides immediate lessons to participants in the financial services industry.

I. The Traditional Notion that Capital is King has Been De-Throned as the Need for Liquidity Reigns Supreme

- The prompt corrective action ("PCA") provisions of the Federal Deposit Insurance Act are frequently cited as an important tool enabling regulators to prevent a wide-spread repeat of the multiple bank failures in the 1980s and 1990s. Even with OTS's authority to limit a troubled bank's operations under PCA[1], until early July 2008, Indymac was deemed to be well capitalized and not formally subject to the limitations of PCA. Given that a well capitalized bank can be in troubled condition, it likely will be more common to see regulatory actions taken against well capitalized banks, including downgrades in the PCA capital status. Make no mistake about it – bank regulators clearly have the PCA authority to downgrade well capitalized banks for reasons other than current capital levels, and will likely do so in the coming months.
- As Indymac demonstrates, satisfying PCA ratios does not mean a bank has sufficient capital to address customer demands, especially when a bank faces adverse publicity. Until days before its failure, Indymac was well capitalized and not subject to PCA. However Indymac was unable to maintain appropriate liquidity to satisfy continuing customer demands. Given that most banks are well capitalized, in the near term adequate liquidity should be viewed as a strategic asset to ensure ongoing viability.

II. Hot Money Can Burn You

- Indymac and the several other banks that failed this year held significant amounts of brokered deposits. Well capitalized banks are under no restrictions on acceptance, renewal or roll over of brokered deposits. However, as noted above, well capitalized status under the PCA does not mean a bank necessarily has sufficient liquid assets to meet customer demands.
- Banks dependent on brokered deposits should expect to see more vigilant regulatory measures designed to restrict or limit brokered deposits, even when solicited and held by well capitalized

institutions. Congressional hearings on brokered deposits have already been held and regulators have sounded warnings that limits may be forthcoming.

- For banks with high levels of brokered deposits, regulators will use their PCA powers to make downgrades from well capitalized to adequately capitalized based on grounds other than capital. This will permit regulators to gain greater control and limits the ability of liquidity-challenged banks to accept brokered deposits.
- Bankers need to be aware, pursuant to FDIC guidance, brokered deposits include not only funds placed by third parties, but those generated by a bank itself offering interest rates in excess of market conditions, generally greater than 75 basis points.
- While the agencies have the power to grant waivers for adequately capitalized banks, bankers cannot count on receiving a waiver. The FDIC is extremely cautious in granting waivers even in the best of times, and these clearly are not the best of times.
- Where waivers are granted, it is likely that the FDIC will impose limits on both the amount of brokered deposits that may be accepted and the interest rates paid thereon.

III. Uninsured Depositors Face Unprecedented, but Not Unexpected Risks

- Unlike other periods of multiple bank failures when the FDIC arranged for the assumption of virtually all deposit liabilities, recent bank failures have resulted in uninsured depositors receiving a Receivership Certificate entitling depositors to share proportionately in any funds recovered through the assets of the failed bank. In its receivership of Indymac, the FDIC issued Receivership Certificates providing an "advance dividend" of 50% of uninsured deposits, with the other 50% of such deposits remaining at risk. Uninsured depositors may receive a *pro rata* portion of FDIC's resolution of Indymac, however, the amount and timing of such recovery is not certain.
- The failure of the FDIC to honor all uninsured deposits could create some shock waves through the financial services industry and among depositors who maintain uninsured deposits at banks. While the FDIC has typically not protected all uninsured deposits (*e.g.,* NetBank, ANB Financial, etc.), the size of Indymac and the extent of the uninsured deposits will heighten sensitivity to this important issue.
- While to individuals the financial soundness of a bank is irrelevant as long as their deposits are under the applicable insurance limits, commercial flows of funds through insured depositories may begin to flow through banks considered "too big to fail." Competition based on bank asset size may be enhanced, creating a flow of corporate and small business deposits funds out of small and community banks. Accordingly, small and community banks should be wary of their own potential liquidity challenges.
- The threshold for "too big to fail" is pretty large. Indymac, the second largest failure ever, had approximately $32 billion in assets. Continental Illinois, which was previously considered too big to fail, had approximately $40 billion. Based on this record, it is unlikely that banks up to the $40 billion asset range would be considered too big to fail today.

IV. Immediate Information Exacerbates Need for Liquid Assets

- Our modern society, replete with 24/7 communication, fosters new challenges to the financial services industry as news and rumors travel at an unprecedented pace.

Newspaper websites and financial news reports grant bank customers instant access to information about a bank's financial status. Even the FDIC provides access to bank balance sheet and capital information – albeit with a 45-90 day delay.

- Access to immediate information is coupled with technological advances. Sophisticated bank customers can withdraw funds in line at bank branches as well as online from anywhere in the world, creating the opportunity for stealth runs and requiring increased vigilance to bank liquidity.
- Having back-up lines of credit may not be sufficient. Often these lines can be pulled at any time for any reason. In a time of stress, don't count on a friendly bank assuming your liquidity risks.
- A jittery depositor population bombarded with constant stories of financial sector weakness and vulnerability is predictably quick to act upon bad news, especially if it involves their particular institution. Uninformed insured depositors are just as likely to withdraw their deposits in reaction to bad news as are informed uninsured depositors, creating further liquidity challenges.

V. Securities Disclosure Rules Require Prompt Disclosure of Material Events

- Banks and their holding companies that are public companies are required to provide public disclosures of material information, contributing to the adverse news frenzy.
- While the rules and regulations of the Securities and Exchange Commission provide certain deadlines for prompt disclosures, stock exchange rules may impose short timeframes for the dissemination of material information via press release.
- Bankers need to carefully balance nonpublic supervisory correspondence/ communications with their obligations to disclosure material information under the federal securities laws.
- Frequently, securities filings – particularly material events filings, such as Form 8-K -- and press releases are the basis of initial press reports and, therefore, bankers should be prepared to tell their story, fully, fairly and accurately.
- Whenever potentially adverse information is released, bankers must be monitoring their deposit outflows and prepare for liquidity challenges. The need for an updated liquidity plan cannot be understated for a bank facing potential adverse business prospects.

VI. The Deposit Insurance System Still Works and Does Protect Individual Depositors

- The failure of Indymac is yet another example of how FDIC deposit insurance works to protect the average depositor's funds. While federal banking regulation depends to a great extent on customer confidence, the failure of Indymac reminds all participants in the financial services industry that FDIC insurance protection is limited and not absolute.
- Bankers should emphasize that deposits at their banks are subject to FDIC deposit insurance and they should work with customers to structure their accounts to maximize FDIC insurance. Branch personnel should be well versed and trained on deposit insurance coverage issues.
- Depositors should review their balances, and make sure they are taking advantage of maximum insurance coverage. Depositors with uninsured deposits should monitor news sources for information about their bank to avoid adverse

consequences if their bank faces a liquidity shortfall.

VII. It is Critical to Identify Problems and Act Early

- Though easy to discern in hindsight, the primary difference between Indymac and Countrywide, which also faced significant liquidity troubles but was recently acquired by Bank of America, is that Countrywide was able to do a transaction early (*i.e.,* before it was too late). The transaction stabilized its deposit base, took the regulatory pressure off (at least to a significant degree), and allowed Countrywide to continue to operate. Indymac, on the other hand, was not able to pen a deal, and as the markets continued to weaken, it was left with a liquidity crisis and unable to obtain new capital.
- Accordingly, potentially troubled banks should hire investment bankers and experienced counsel *now,* and look to recapitalize or merge with a stronger institution.

VIII. What Bankers Must Do Now:

- *Liquidity Planning*. Review liquidity plans and have sufficient liquid assets available during periods of enhanced bank publicity, not just about their bank, but adverse publicity about the industry in general. Where applicable, review lines of credit with Federal Home Loan Banks, correspondent banks, and Fed Funds agreements. Be prepared for the loss of the ability to use brokered deposits. Understand the rules of what is and is not permissible in terms of deposit gathering.
- *Monitor Deposit Activity*. During periods of adverse publicity to the financial services sector, monitor both in line and online traffic to avoid stealth deposit outflows and liquidity challenges. Banks with significant uninsured deposits should also plan to enhance liquidity to address potential outflows during periods of adverse publicity.
- *Develop Contingency Plans for Deposit Outflows***.** Be prepared to do what is necessary to address customers' concerns – if a traditional run occurs, a media circus may follow. Be aware of customer needs and fears and make accommodations where practical or necessary. For example, things as simple as providing refreshments may soothe customers' frazzled nerves while waiting in line in the summer's heat. Keep in close contact with your regulator in the face of potential or actual unusual deposit outflow activity. You need an ally, not a surprised regulator.
- *Plan to Increase Capital Now*. The longer a bank waits, the more difficult and expensive it will be to raise capital. Bankers and boards of directors should be considering contingency plans for equity raises, trust preferred offerings and asset sales.
- *Plan For a Potential PCA Downgrade*. Review covenants in contractual commitments (*e.g.,* loans or lines of credit) that the bank or its holding company may be a party to. Develop contingency plans to address situations that may arise if your bank's capital status drops below well capitalized, such as plans to communication with lender(s) about potential default waivers and strategies to communicate with regulators about the consequences of a potential PCA downgrade.
- *Be Proactive With Your Regulators*. There is no downside to being fully open and candid about your condition and potential weaknesses. If your bank is in trouble, the regulators already know its condition. Give regulators every reason to want to work with your bank proactively to avoid a deteriorating crisis. And if there are things that they can do to help, reach out to

them, do not wait for them to come to you.

- *Deposit Insurance Customer Education*. Develop plans to educate your customer base on the limits of FDIC insurance and work with customers to structure their accounts to maximize FDIC insurance coverage.

IX. What Depositors Should Do Now:

- *Insured Depositors Need Not Worry*. If deposits are insured, there is nothing to do.
- *Uninsured Depositors Need to Stay Vigilant*. If holding uninsured funds, review the financial health of bank(s) you do business with and consider prudent changes to avoid uncertainties if you have doubts of your banks' financial wherewithal. If a depositor at a failed bank has uninsured funds, learn and understand your rights under the FDIC's claim process.
- *Maximize FDIC Deposit Insurance Coverage*. Understand FDIC categories of deposits and use FDIC tools and resources such as its Electronic Deposit Insurance Estimator available at http://www.fdic.gov/edie/.

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If you have any questions regarding these developing issues, please contact any of the following Paul Hastings lawyers:

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[1] For a comprehensive review of actions bank regulators can take when a bank faces challenges, see "Shock and Awe": When Banking Agencies Unleash Their Regulatory Weapons available at http://www.paulhastings.com/publicationDetail.aspx?PublicationId=939.