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FDIC Issues Proposed Guidelines Restricting Private Equity Investments in Failed Banks

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On July 2, the FDIC issued proposed guidelines that would significantly impact private equity investments in failed insured depository institutions. The Proposed Statement of Policy on Qualifications for Failed Bank Acquisitions applies directly only to acquisitions of failed banks, but observers are concerned the FDIC may apply the same or similar guidelines in reviewing applications for approval of investments in operating institutions.

Related Practices:

- Financial Services Law

The Policy Statement reflects a certain unease on the part of banking regulators and Congress with the undeniable appeal of private equity as a deep capital source for the embattled financial services sector. The FDIC has already approved private equity bids to acquire IndyMac and BankUnited. However, some within various bank regulatory agencies and in Congress have expressed wariness. This was reflected in recent correspondence between FDIC Chair Sheila Bair and Senator Jack Reed (D RI), chair of a subcommittee that oversees the securities industry, in which Senator Reed asked Ms. Bair to establish rules regarding private equity investments in banks. The Policy Statement can be seen as a response to that request.

Under the proposed guidelines, the FDIC would evaluate equity investors in institutions seeking to acquire a failed institution, or assume deposits or acquire assets from a failed institution, to determine whether the investor provides sufficient capital and "experience, competence, and willingness to run" the institution "in a prudent manner." The FDIC also proposes to require such investors to "accept the responsibility to support" the banks when they face difficulties and protect them from insider transactions, apparently through additional capital commitments, as discussed below.

The FDIC proposed that so-called "silo" structures not be eligible bidders in failed bank situations, since in those structures beneficial ownership cannot be ascertained and "the responsible parties for making decisions are not clearly identified, and/or ownership and control are separated." "Silo" structures have been proposed by individual founders or sponsors of private equity or hedge funds to invest in the financial services sector without subjecting their private equity or hedge funds to Bank Holding Company Act regulation. They are based on a long-respected doctrine that individuals are not bank holding companies, and thus an individual can control a bank, on the one hand, and a commercial or industrial enterprise, on the other hand. After approving initial applications to acquire financial institutions using such structures, the Federal Reserve, in particular, has raised questions about whether they are appropriate. What the FDIC considers to be a "silo" structure is not apparent, and the reference to them as being ineligible to bid is likely to create much uncertainty about what acquisition structures will pass muster. The proposal invites commenters to discuss reasons that silo funds should be considered eligible bidders.

The proposed Policy Statement is unclear in many other respects, such as how private capital investors will be defined and whether the policy would apply to a fund investor that is neither the largest investor nor a controlling shareholder. The public has 30 days from date of publication in the Federal Register to comment on the proposed Policy Statement. The Policy Statement has already drawn criticism from two regulators on the FDIC Board of Directors and is likely to be subject to criticism for potentially discouraging investment in failed institutions at a time when private capital might lower the cost to taxpayers of resolving failed institutions.

Three Years' "Hold"

The Policy Statement purports to apply to all acquisitions of failed banks, except by those financial institution holding companies or banks that have been in existence for more than three years. In effect, the Policy Statement targets companies or other newly organized capital pools that seek to bid on failed financial institutions. The three-year test leaves open the question of whether existing financial institutions that have been recently acquired by private equity groups would be within the framework proposed by the Policy Statement.

Minimum Capitalization

The proposal provides that any private equity investor that purchases a failed institution will need to invest sufficient capital to cause the institution to maintain a minimum 15% Tier 1 leverage ratio (as contrasted with the leverage ratio of 8% to 10% required for new banks and the current "well capitalized" leverage ratio of 5%). This 15% leverage ratio requirement would apply for three years (or longer if extended by the FDIC in its sole discretion), after which the institution would merely be required to remain "well capitalized." In the event an institution fell below this capital level, the investors would be required to immediately "facilitate" restoring capital to the required level. It is not clear whether this duty to "facilitate" would require the acquiring entity itself to raise new capital or simply to accept dilution to facilitate investment by others. Failure to maintain the required capital level would trigger "Prompt Corrective Action" remedies under the Federal Deposit Insurance Act.

The investors who recently acquired BankUnited commented shortly after the Policy Statement was issued that this level of capital (together with other aspects of the Policy Statement) would have deterred them from bidding on BankUnited.

Source of Strength

The Federal Reserve has for many years required that a bank holding company serve as a source of financial and managerial strength for financial institutions it controls. This "source of strength" doctrine has now made appearance in the FDIC Policy Statement, but it is not clear what specific obligations it would impose on the entities that seek to invest in failed banks. Investors' "organizational structures" in failed institutions would now be "expected to agree" to serve as a "source of strength" for the institutions they acquire. The tenor of the commitment appears to require the acquiring bidding institution to sell equity or engage in capital qualifying borrowing to support the underlying institution that is acquired if, in the future, its capital is lacking. The Policy Statement does not appear to impose a requirement on non-controlling investors to make these commitments, although their investments would be subject to dilution. However, the FDIC's questions published with the proposed Policy Statement request comment on whether broader obligations should be required from the acquiring holding company and the investors.

Cross Guarantees

Under current law, the FDIC may impose "cross-guarantee" liability upon commonly controlled insured depository institutions for deposit insurance losses incurred by the FDIC. This law provides that an insured depository institution is liable for any loss incurred by the FDIC, or any loss that the FDIC reasonably anticipates incurring, in connection with the default of its commonly controlled insured depository institution, or in connection with any assistance provided by the FDIC to a commonly controlled insured depository institution that is in danger of default. Under the Policy Statement, investors whose investments, individually or collectively, constitute a majority of the investments in one or more institutions would be expected to pledge to the FDIC their proportionate interests in each to pay for any losses to the deposit insurance fund resulting from the failure of any commonly controlled depository institution. This would mean that if a group of investors invested in a failed institution, and one or more of those investors also controlled (or later came to control) a majority of another institution, then if one institution failed, the equity of the other institutions held by those investors would be taken by the FDIC to help defray the insurance fund's losses. This extension of the cross-guaranty will clearly be controversial and is sure to draw critical comment.

Affiliate Transactions

Federal banking law already restricts extensions of credit by depository institutions to their affiliates. The Policy Statement purports to extend this law by prohibiting a failed institution acquired by a fund or other investor subject to these new guidelines from extending credit to other funds controlled by that investor, or any portfolio companies in which that fund or investor has an investment of 10% or more. This new restriction would create a category of related party transactions that, rather than being subject to quantitative and qualitative limitations and arms'-length requirements of existing law, would actually be prohibited.

Secrecy Law Jurisdictions

Investors will not be able to invest through entities organized in a jurisdiction that is considered a "secrecy jurisdiction" unless the investors are subsidiaries of companies that are subject to comprehensive consolidated supervision by internationally recognized and respected financial services regulators and certain other reporting, recordkeeping and jurisdictional conditions are met.

Continuity of Ownership

Investors under the guidelines would be prohibited from selling their investment for a minimum of three years except with prior approval from the FDIC. In a recent acquisition involving private equity investment, the FDIC required the investors not to sell control of the investment for 18 months, and it is not clear why the FDIC provided a "hold" period twice as long in the Policy Statement.

Special Owner Bid Limitation

Any current owner of 10% or more of a failed institution would be prohibited from bidding on that failed institution in receivership.

Disclosure

Investors subject to the new guidelines would be expected to make substantial disclosures, including disclosures about all entities in the chain of ownership, such as amount of capital, diversification, business model and management team. Confidential offering memoranda and other solicitation material that were used by the bidding organization to raise capital would need to be disclosed to the FDIC.

If you have any questions pertaining to this alert, please feel free to call Barbara R. Mendelson at (212) 468-8118, Oliver I. Ireland at (202) 778-1614, Henry M. Fields at (213) 892-5275 or Mark T Gillett at (213) 892-5289.