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"Private Equity" Are Still Scary Words at the FDIC

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The FDIC and the other federal banking regulators consistently express serious concerns about private equity investments in banks and bank holding companies, often because of perceived "opaqueness" in the organization and governance of private equity investment structures. With the adoption on August 26, 2009, of the FDIC Statement of Policy (SOP) on private capital investments in failed banks, the FDIC itself has ventured into its own "opaque" territory, marked by a lack of clarity and uncertainty for private equity investors.

As a consequence, private equity investors will have to weigh carefully the inherent risks associated with a lack of clarity as they consider the possibility of a private equity investment in a failed bank or thrift. Prior to adoption of the SOP, these kinds of investments have been best exemplified by the *BankUnited* and *IndyMac* (now OneWest Bank) deals of earlier this year.

The SOP finalizes a set of proposals presented for comment by the FDIC in July. The FDIC received over 60 comment letters in response, many from private equity investors or their professional advisors seeking more equitable treatment than the proposals presented. In response, the FDIC Board believes that it has made a significant gesture to the private equity community in issuing the SOP.

Applicability and Exemptions

The SOP applies prospectively to proposals to acquire assets and assume deposit liabilities as part of the resolution process for a failed bank or thrift, whether through an existing entity or a *de novo* chartered institution. However, a proposed investment of 5% or less of the total voting power of the failed institution is exempt as long as there is no evidence of concerted

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action among more than one of such under-5% investors, in which case the exemption would not apply.

Most significantly from the FDIC's perspective, the SOP exempts investments made in a joint venture with an existing bank or thrift holding company where the holding company has a "strong majority interest" in the resulting bank and the holding company has an established record for successful operations of a bank or thrift. The FDIC chose not to define the term "strong majority interest," apparently so as to give it maximum flexibility to determine the appropriateness of any such proposal based on the particular circumstances then obtaining. It reflects the FDIC's overarching belief that private equity has to be constrained in its investments and this is the best way to accomplish that and meet the objectives of minimizing the risk to the deposit insurance fund. It also shows the serious concern that the FDIC has about the importance of proper and experienced management of the resulting bank and the application of prudential standards, since FDIC experience shows that the greatest risk is from institutions chartered for less than seven years.

If private equity does not find such a joint venture with a bank or thrift holding company to be an attractive proposition, it can proceed on its own, but the following specific requirements are imposed by the terms of the SOP. These can be varied by the FDIC if it would be in the best interests of the deposit insurance fund. The limitations of the SOP also will expire at such time as the institution in question has maintained an overall CAMEL rating of 1 or 2 continuously for 7 years.

Capital

While the FDIC retreated from its original proposal that a failed institution acquired by private equity maintain a Tier 1 capital leverage ratio of 15% for 3 years and be deemed to be well capitalized thereafter, the SOP adopts a different requirement. The recapitalized bank or thrift has to maintain a ratio of Tier 1 common equity to total assets of at least 10% for a 3-year period. The FDIC recognizes that this requirement may result in less than optimum pricing for the failed institution; however, it reflects the FDIC's choice to force private equity to manage the institution for long-term prudential growth, not short-term profitability. Thereafter, the institution would have to maintain a "well-capitalized" status. It is important to note that this revised ratio is the minimum and could well be higher under selected circumstances, at the FDIC's discretion. A failure to maintain the required level of capital at the outset, or well-capitalized status after 3 years, would trigger an "undercapitalized" designation, thereby implicating the restrictions on operations contained in the Federal Deposit Insurance Act.

Cross Support

The original FDIC proposal included requirements about cross support among commonly held companies, which caused a great deal of negative comment. The FDIC has scaled that back. Under the SOP, a cross-support obligation would only be required if the same investors own 80% or more of two or more depository institutions. The SOP contemplates that the stock of these commonly-held institutions would be pledged to the FDIC, to be exercised to recoup any losses incurred by the deposit insurance fund in the event of the failure of the bank or thrift.

Continuity of Ownership

The FDIC kept the 3-year ownership requirement of the original proposal but added that if only a transfer to an affiliate was involved, it would not unreasonably withhold approval.

"Silo" Structures

Complex structures in which the actual beneficial ownership and decision-making authority is difficult to determine and actual ownership and control is separated will not be approved to acquire a failed institution under the SOP.

In addition, the SOP contains limitations on transactions with affiliates, the application of foreign secrecy laws and the disclosure of confidential information contained in any application.

FDIC Board Action

The SOP was adopted by a 4-1 vote, with the only negative vote coming from Director Bowman of the OTS. He spoke against the SOP because he believes that far more flexibility on the part of the FDIC is required since, generally speaking, the banking industry needs substantial capital and private equity can be an important source of that capital. Bowman suggested that all potential bidders should be treated equally, even though private equity presents a different risk profile than other potential acquirers. He expressed concerns that the SOP would be applied in a highly subjective and uneven manner.

At the instance of Director Dugan of the OCC, the SOP contains a requirement that it be reviewed by the Board within six months to judge its effectiveness and impact.

The day after the release of the SOP the FDIC announced that its list of very troubled banks had increased to 416. At the same time, the CEO of BankUnited stated that over the next two years some 1000 banks will be lost. Notwithstanding these very troubling numbers, the Chair of the FDIC stated that the Board majority felt that the SOP truly extends a significant and realistic invitation to private equity to participate in the necessary recapitalization of the banking industry in the United States. The private equity community will have to decide if this invitation comes with too many strings attached.

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