FDIC’s New Guidance on Private Equity Investment in Banks May Chill Private Equity Interest in Making Such Investments

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On July 2, 2009, the FDIC released its proposed new guidance on private equity investment in banks in receivership. While intended to provide guidance to private capital investors interested in acquiring or investing in failed insured depository institutions, these proposed new requirements and restrictions may, at best, discourage or complicate additional private equity investment in banks in receivership, or, at worst, make such investments uncompetitive and uneconomic for private equity investors.

Background

Recent months have seen several significant examples of private equity firms investing in troubled financial institutions, both in FDIC-assisted transactions and those without government involvement.

On May 21, 2009, a private equity consortium that included investor John Kanas, WL Ross & Co., Carlyle Investment Management, Blackstone Capital Partners, Centerbridge Capital Partners and others agreed to invest $900 million in Florida's BankUnited Financial, the largest U.S. bank to collapse this year, with the FDIC agreeing to assume the bulk of the future losses on the bank’s $10.7 billion loan portfolio. On May 30, 2009, Lightyear Capital, Fortress Investment Group and Crestview Partners reportedly agreed to invest as much as $450 million to take a non-controlling stake in common and convertible preferred stock of First Southern Bancorp of Boca Raton, Florida. On March 19th of this year, the FDIC completed the sale of the banking operations of IndyMac, the failed mortgage lender, to a consortium of private equity investors led by Dune Capital Management and including buyout firm J.C. Flowers & Co., for $13.9 billion, with the buyers assuming the first $3.2 billion of loan losses, and the FDIC agreeing to reimburse the buyers for 80% of the next $1.6 billion of losses and 95% of all losses thereafter.

Given the challenging economic environment, with bank failures surging to a 15-year high and 305 institutions on the FDIC’s watch list for potential failure, and many banks experiencing a pressing need for
capital, the interest of private equity firms in making investments in such financial institutions, and the opportunities for such investment, will likely continue or increase. Such investments in financial institutions are, however, complicated by regulatory restrictions on bank ownership. The FDIC, in its press release regarding the BankUnited sale, indicated that it had been evaluating the appropriate terms for private equity investments in depository institutions in receivership and that it intended to provide generally applicable policy guidance on eligibility and other terms and conditions for such investments to guide potential investors.\(^5\)

The FDIC’s proposed new guidance on these issues, which was released on July 2, 2009, and is subject to a 30-day comment period (the “FDIC Proposal”), contemplates significant new requirements and restrictions in connection with private equity investment in failed institutions.\(^6\) As discussed in the FDIC Proposal, the FDIC has determined that various elements of private capital investment structures raise potential safety and soundness considerations and risks to the deposit insurance fund as well as important issues with respect to their compliance with the requirements applied by the FDIC in its decision on the granting of deposit insurance. If adopted in their current form, these proposed new requirements and restrictions may discourage or complicate additional private equity investment in banks in receivership or potentially make such investments uncompetitive and uneconomic for private equity investors. The FDIC has, however, indicated that it remains “open-minded on many aspects of this proposal,” and the Comptroller of the Currency John Dugan and Acting Office of Thrift Supervision Director John Bowman, while voting to release the plan for public comment, reportedly have said that they are opposed to the FDIC Proposal in its current form.\(^7\) As a result, the public comment period may yet generate a compromise between the FDIC’s stated concerns and the interests of private equity that will facilitate the flow of additional private capital into the U.S. banking system.\(^8\)

**“Control” and its Implications**

Generally, the acquisition of control of any FDIC-insured financial institution triggers prior approval requirements under the federal Change in Bank Control Act (“CBCA”), Bank Holding Company Act (“BHCA”) and/or Savings and Loan Holding Company Act (“SLHCA”), as well as potentially under state banking laws. Most private equity investors are leery of acquiring a “controlling” investment in a financial institution (or its holding company) and, consequently, being deemed to be a bank (or savings and loan) holding company, in part because of the restrictions imposed on such holding companies that they engage only in financially related activities (with non-qualifying investments required to be divested and the prior approval of the Federal Reserve Board (“FRB”) or Office of Thrift Supervision (“OTS”) required in order to acquire control of a nonbanking entity). Private equity funds that invest in companies other than in the financial sector, such as technology companies or industrial companies, would have difficulty qualifying for approval as bank or thrift holding companies. The FRB also requires that a bank holding company serve as a “source of strength” to a bank that it controls, which requires that the controlling investor agree to refrain from engaging in activities detrimental to its subsidiary bank and provide capital to a faltering bank subsidiary even if it has to tap its non-banking operations to do so. Bank holding companies are also subject to examination and supervision by the FRB, and thrift holding companies may be examined by the OTS.

**“Control” Standards Under the BHCA.** For regulatory purposes, a company is deemed to “control” a banking organization if it, directly or indirectly, controls or has power to vote 25% or more of any class of securities of the banking organization; controls in any manner the election of a majority of directors of the banking organization; or the FRB determines, after notice and opportunity for hearing, that the company directly or indirectly exercises a controlling influence over the management or policies of the banking organization.\(^9\) A determination whether an investor in a banking organization has a controlling influence...
over the management or policies of a banking organization requires consideration of all of the facts and circumstances of each case. "Control" of a banking organization is also presumed to exist under the BHCA and the CBCA upon the acquisition of at least 10% of the banking organization’s outstanding voting stock. These control presumptions can be rebutted based on the overall facts and circumstances of the investment. Any company can own up to 5% of the voting shares of any class of securities of a bank without being considered a bank holding company under the BHCA.

**Acquisition of “Control” of Thrifts.** Acquisition of control of thrifts (i.e., savings association, savings bank, or savings and loan association) involves similar considerations to those discussed above in the case of a commercial bank; however, the federal regulator with principal jurisdiction over the target is the OTS. As in the case of acquisitions of control of a bank by an individual, the acquisition of control of a thrift by natural persons is subject to the CBCA. The OTS approves acquisitions of control by thrift holding companies or savings and loan holding companies under the SLHCA. "Control" under the SLHCA is defined similarly to the BHCA as the power, directly or indirectly or acting in concert with others, to vote 25% of voting shares, control the election of a majority of directors, or exercise a controlling influence over management and policies. Acquisition of less than 5% of voting shares does not raise control issues. The standards imposed are generally comparable to those under the BHCA.

**FRB Policy Statements – 1982 and 2008.** In its 1982 policy statement, the FRB identified a number of structural measures that it believed would limit the ability of an investor to exercise a controlling influence over a banking organization. These included restricting the use of covenants that constrain the discretion of banking organization management, limiting the amount of voting and nonvoting shares of the banking organization acquired by the investor, and limiting the investor’s ability to transfer large blocks of voting shares. Passivity commitments have generally involved the avoidance of control-enhancing mechanisms for example, restricting the size of the investor’s voting and total equity investment, avoiding covenants that would enable the investor to restrict the ability of the banking organization’s management to determine major policies and operations, not attempting to influence the banking organization’s decision-making process regarding major policies and operations, limiting director and officer interlocks and limiting business relationships between the investor and the banking organization.

In September 2008, the FRB issued a new policy statement on equity investments in banks and bank holding companies that reflected a significant policy shift regarding these investments by relaxing certain of these restrictions. While the FRB generally has not permitted a company that acquires 10 to 24.9% of the voting stock of a banking organization to have representation on the banking organization’s board of directors, it now believes that (in the absence of other indicia of control) a minority investor should be able to have one representative on the banking organization’s board of directors without acquiring a controlling influence over the management or policies of the banking organization. A minority investor that has up to two representatives on the banking organization’s board of directors is also unlikely to be deemed to exercise a controlling influence over the management or policies of the banking organization when the investor’s aggregate director representation is proportionate to its total interest in the banking organization, but does not exceed 25% of the voting members of the board, and another shareholder of the banking organization is a bank holding company that controls the banking organization under the BHCA.

The FRB has traditionally considered the overall size of an equity investment (both voting and nonvoting) as an important indicator of the degree of influence an investor may have. In its 1982 policy statement, the FRB provided that nonvoting equity investments that exceed 25% of the total equity of a banking organization generally raise control issues under the BHCA. While, in most circumstances, the FRB believes that an investor that owns 25% or more of the total equity of a banking organization has a controlling influence over the management or policies of the banking organization, it recognizes that the
ability of an investor to exercise a controlling influence through nonvoting equity instruments depends on the nature and extent of the investor’s overall investment in the banking organization and on the organization’s capital structure. Likely permissible is an investor’s ownership of a combination of voting shares and nonvoting shares that, when aggregated, represent less than one-third of the total equity of the organization (and less than one-third of any class of voting securities, assuming conversion of all convertible nonvoting shares held by the investor), and does not allow the investor to own, hold or vote 15% or more of any class of voting securities of the organization.

A non-controlling minority investor generally may communicate with banking organization management about, and advocate with such management for changes in, the organization’s policies and operations. Discussions, even those advocating for changes in the banking organization’s management, are not the type of controlling influence targeted by the BHCA. The decision whether or not to adopt a position or take an action must remain with the banking organization’s shareholders as a group, its board, and its management, as appropriate. Communications by minority investors should not be accompanied by threats to dispose of shares in the banking organization or sponsor a proxy solicitation as a condition of action or non-action by the banking organization or its management.

The FRB has traditionally permitted business relationships that were quantitatively limited and qualitatively nonmaterial (particularly where the investor’s equity interest in the banking organization was closer to 10% than 25%). Business relationships should continue to remain limited; the FRB will continue to review business relationships on a case-by-case basis (considering size and whether the proposed business relationships are on market terms, non-exclusive and terminable without penalty). Covenants that substantially limit the discretion of a banking organization’s management over major policies and decisions suggest the exercise of a controlling influence (i.e., hiring, firing and compensation; new lines of business; raising additional debt or equity capital; merging or consolidating; acquisitions or dispositions of assets).

Transaction Structures

Private equity firm investments in, or acquisitions of, financial institutions and/or their holding companies have been structured in a number of ways so as to avoid determinations of “control” and holding company status.

Non-Controlling Investment. Under one such structure, a single passive investor makes a non-controlling investment in a banking organization that is limited in its size and governance rights so as not to trigger the regulatory “control” standards. As a consequence, however, the investor has limited ability to elect directors, appoint management and direct the strategy of the banking organization, which may be inconsistent with the investment model of some private equity funds. Examples of this type of investment include Abu Dhabi Investment Authority’s 2007 investment in Citigroup, Berkshire Hathaway’s recent investment in Goldman Sachs, TPG’s ill-fated investment in Washington Mutual, and Corsair Capital’s $7 billion investment in National City Corporation. As discussed above, the FRB’s September 2008 policy statement provides somewhat greater flexibility for this type of investment, allowing a minority investor to acquire up to 33% of total equity albeit with limitations on the proportion of voting equity, and to have up to two representatives on the board of directors, greater consultations with management and greater flexibility to have business relationships with the banking organization without being considered to be in “control” of the institution.
**Side-by-Side Investment.** Another structure, the so-called “side-by-side” or “club” deal, is exemplified by the recently announced BankUnited acquisition. In this case, institution ownership is dispersed among equity holders who invest side-by-side and do not act in concert so their shares are not aggregated, with no single investor acquiring “control” for regulatory purposes. Arrangements among the investors will be closely scrutinized by the FRB to ensure that they are not “acting in concert.” This structure was also used in The Bear Stearns Companies’ investment in Doral Financial Corporation, J.C. Flowers’ investment in HSH Nordbank and the IndyMac acquisition.

**Bank Fund Complex.** Private equity investors have also organized as a fund complex that invests solely in controlling investments in banking organizations and accepts supervision and regulation as a bank holding company. Belvedere Capital and Castle Creek Capital are examples of regulated bank fund complexes.

**“Silo” Fund.** Under a “silo” approach, the private equity firm forms one or more special purpose vehicles to make a controlling investment in a banking organization, with ownership and management of these entities, and inter-relationships and cross-investments and lending among funds, structured to ensure that only entities within the new structure become subject to regulation as bank holding companies. A “silo” fund was used in JLL Partners’ 2007 investment in FC Holdings. More recently, in January 2009, the OTS approved a silo-structured acquisition by MatlinPatterson of $250 million of newly issued convertible participating voting preferred stock of Flagstar Bancorp, which upon conversion would represent approximately 70% of Flagstar’s outstanding equity.

In the FDIC Proposal, discussed further below, the FDIC has concluded that such “silo” organizational arrangements are not “appropriate for approval for ownership of insured depository institutions” because such entities involve complex and functionally opaque ownership structures in which the beneficial ownership cannot be ascertained, the responsible parties for making decisions are not clearly identified, or ownership and control are separated.

**The FDIC Proposal**

The FDIC Proposal outlines proposed new requirements to be imposed on private equity investors that are interested in acquiring or investing in failed insured depository institutions. The new requirements are not intended to replace or substitute the requirements imposed by an insured depository institution’s primary regulator in determining the adequacy of a proposed acquisition structure, nor does the FDIC Proposal purport to change the requirements for acquisitions of institutions outside of receivership. Rather, if adopted as currently proposed, the FDIC Proposal would impose significant additional requirements, restrictions and limitations on private equity investors with respect to their investments in failed insured depository institutions. Such requirements, if adopted, could cause concerns for potential private equity investors in failed depository institutions.

The FDIC Proposal generally provides for: (a) enhanced capital support of the acquired depository institution; (b) agreement to a cross guarantee over substantially commonly owned depository institutions; (c) prohibitions on transactions with affiliates; (d) maintenance of continuity of ownership for a period of three years; and (e) avoidance of secrecy law jurisdiction vehicles as the channel for investments unless the parent company is subject to consolidated home country supervision. Below is a summary of the specific proposed requirements.
Capital Commitment. Private equity investors will be required to agree to cause the acquiring depository institution to be initially capitalized at a minimum 15% Tier 1 leverage ratio for three years (much higher than the Tier I leverage ratio that most banks need in order to be considered "well-capitalized"), unless extended by the FDIC. Thereafter, the acquiring depository institution will be required to maintain a "well capitalized" capital adequacy level or be treated as "undercapitalized" for purposes of Prompt Corrective Action, triggering all of the remedial measures that would be available to the institution’s regulator in such situation.23

Source of Strength. Private equity investors’ organizational structures subject to these requirements will be required to agree to serve as a “source of strength” for their subsidiary depository institutions, with source of strength commitments to be supported by the agreement of the depository institution holding company in which the investors have invested to sell equity or engage in capital qualifying borrowing. While this proposal does not appear to require contributions of any additional capital from the private equity investors who hold the equity of the depository institution holding company, the FDIC is specifically seeking comment on whether the source of strength commitment should be enhanced to require broader obligations. Commentary from the private equity industry indicates that this requirement essentially creates uncertain “stand-by obligations” for a private equity firm’s funds, and a similar requirement from the Office of the Comptroller of the Currency for Blackstone Group to backstop the credit card unit of Alliance Data Systems Corp. effectively caused Blackstone to walk away from a deal for Alliance.24

Cross Guarantees. While it is not clear how the requirement will be applied, the FDIC Proposal requires that private equity investors whose investments constitute a majority of the investments in more than one insured depository institution 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.

Continuity of Ownership. Without the prior approval of the FDIC, private equity investors will be prohibited from selling or otherwise transferring securities of the insured depository institution for three years following the acquisition. In order to obtain FDIC approval for a transfer during such three-year period, a process for which there is not a defined timeframe, the transferee must agree to be bound by the same conditions as are applicable under the FDIC Proposal to the selling investor. Note that this three-year holding period is much longer than the 18-month holding period required for the investor group that recently bought BankUnited.

Transactions with Affiliates. An insured depository institution acquired or controlled by private equity investors will be prohibited from extending credit to their private equity firms, their investment funds, affiliates of either or portfolio companies. This prohibition goes well beyond the restrictions on transactions with affiliates that would normally apply to a bank under Sections 23A and 23B of the Federal Reserve Act.

Secrecy Law Jurisdictions. Private equity investors employing ownership structures utilizing entities that are domiciled in bank secrecy jurisdictions will not be eligible to own a direct or indirect interest in an insured depository institution unless the private equity investors: (a) are subsidiaries of companies that are subject to comprehensive consolidated supervision as recognized by the FRB and execute agreements on the provision of information to the primary federal regulator about the investor’s non-domestic operations and activities; (b) maintain their business books and records (or a duplicate) in the United States; (c) consent to the disclosure of information that might be covered by confidentiality or privacy laws and to cooperate with the FDIC, if necessary, in obtaining information maintained by foreign government entities; (d) consent to jurisdiction and designation of an agent for service of process; and (e) consent to be bound by the statutes and regulations administered by the appropriate U.S. federal banking agencies.
Special Owner Bid Limitation. Private equity investors that directly or indirectly hold 10% or more of the equity of an institution in receivership will be prohibited from being eligible to bid on the deposit liabilities, or the liabilities and assets, of such failed depository institution.

Disclosure. Finally, private equity investors also will be required 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.

Conclusion

Several aspects of the FDIC Proposal, particularly the 15% Tier I leverage requirement, the source of strength commitments, the cross-guarantee requirements and the three-year continuity of ownership restrictions, represent significant new requirements and restrictions to be imposed on private equity investors in failed institutions. If adopted as proposed, these new requirements and restrictions may discourage or complicate additional private equity investment in banks in receivership or potentially make such investments uncompetitive and uneconomic for private equity investors. It remains to be seen whether the public comment period will generate an approach that addresses the FDIC’s concerns for fully adequate capital and a source of financial and managerial strength for the target depository institution, while encouraging (or at least not discouraging) private equity firms from bidding on failing depository institutions.

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5 Id., supra note 1.

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10 12 C.F.R. §225.143.
12 A representative of the minority investor should not serve as the chairman of the board, or as chairman of a committee of the board, of the banking organization; however, the FRB believes that such representatives may serve as members of committees of the board of the banking organization when they do not occupy more than 25% of the seats on any committee and do not have the authority to make (or block the making of) policy or other decisions binding the board or management. Id.
13 Nonvoting shares that may be converted into voting shares at the election of the holder, or that mandatorily convert, are considered voting shares for purposes of the BHCA. Acceptable are nonvoting shares that may not be converted into voting shares at the election of the investor, and may only be transferred by the investor; (i) to an affiliate of the investor or to the banking organization; (ii) in a widespread public distribution; (iii) in transfers in which no transferee (or group of associated transferees) would receive 2% or more of any class of securities of the banking organization; or (iv) to a transferee that would control more than 50% of the voting securities of the banking organization without any transfer from the investor.
18 Supra, note 11.
23 The undercapitalized institution would be required to submit to its federal banking agency a capital restoration plan that specifies exactly how it intends to satisfy all applicable capital standards without increasing its risk exposure and identifying the types and levels of activities in which it intends to engage. The capital restoration plan must be accepted by the institution’s federal banking regulator. If the undercapitalized institution does not submit a capital restoration plan that is acceptable to the federal banking regulator, the regulator may require the undercapitalized institution to take remedial actions, e.g., restrict transactions with affiliates; restrict the rate of interest paid on deposits; restrict asset growth; remove and replace officers and directors; restrict capital distributions; divest assets or operations; cease any activity the regulator believes poses excessive risk; and take any other action the regulator deems appropriate.
24 Further, until the institution’s capital plan is accepted and implemented, an undercapitalized institution may not, directly or indirectly, unless its appropriate federal banking regulator determines the action will further achievement of the plan: acquire an interest in any other company or insured institution; establish or acquire any new branch office; or engage in any new line of business.