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# FDIC Proposes Guidelines for PE Investments In Failed Institutions: The Debate Begins

After private equity investors (PE Investors) came to the rescue in two of the larger bank failures of the current crisis – IndyMac and BankUnited – the Federal Deposit Insurance Corporation (FDIC) has shifted course and proposed a new and challenging Statement of Policy (Statement) that would impose substantial new and unprecedented burdens on PE Investors seeking to acquire failed banks.

The FDIC has begun the public discussion by expressing concern about PE Investors as a class (a class that the FDIC fails to define) and differentiating them from other owners of bank and savings and loan holding companies. Notwithstanding the fact that the non-controlling "club" investments used to this point by PE Investors have been in conformity with applicable law regarding control, the FDIC appears to suggest that PE Investors nevertheless may be in a position to exercise control over the banks and thrifts in which they invest. Based on that premise, the FDIC has suggested that PE Investors raise unique concerns and has proposed to impose special measures on them in order to "protect" any bank or thrift in which they may invest.

The Statement will be open for comment for 30 days from the date it appears in the Federal Register. It raises a number of important issues that will begin a critical dialogue about the role that PE Investors should play in rescuing troubled financial institutions.

- **Singling Out PE Investors** – The Statement focuses ***solely*** on PE Investors and the issues that their involvement presumably raises in acquisitions of failed banks. It does not provide any basis for that concern or differentiate between the financial and source of strength issues that may be raised by a group of passive PE Investors and any other passive, non-controlling shareholders of a traditional, publicly held shell holding company. The Statement also applies to any holding company in which PE Investors make more than a *de minimis* investment and that was not organized or "acquired" by a PE Investor at least three years before the date of the Statement. The Statement demonstrates a clear bias against the business intentions of PE Investors and creates a significant challenge for them to confront in the comment period.

- **Silo Structures** – The Statement refers to, but does not define, "silo" arrangements, which can cover a wide range of structures and financial arrangements. The FDIC expressed concern, without explanation, that in these structures "beneficial ownership cannot be ascertained," decision makers "are not clearly identified" and "ownership and control are separated." As a result, the Statement


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proposes to make silo structures ineligible to acquire failed banks, but requests comment on the subject.

- **Capital Support** – For three years, PE Investors are required to ensure that any bank or thrift in which they invest is "very well capitalized" by maintaining a minimum Tier 1 capital to total assets ratio of 15%. After that period, PE Investors are required to maintain the capital of the acquired bank or thrift at no less than the standards to be "well capitalized." According to the Statement, if the bank or thrift falls below the applicable standard, it would be deemed to be "undercapitalized" for purposes of instituting prompt corrective action (PCA) under the Federal Deposit Insurance Corporation Improvement Act of 1991. It is not clear how the FDIC would trigger the initiation of PCA where the acquired bank or thrift is regulated by another federal regulator which has its own PCA regulations that apply to the institution.

- **Source of Strength** – A holding company used by PE Investors is expected to agree to serve as a limited source of strength for its subsidiary banks or thrifts. The holding company is required to agree to raise additional capital by issuing equity or qualifying debt to support this undertaking. A PE Investor, therefore, may stand to lose its investment or be significantly diluted, or may otherwise be required to infuse additional capital under a capital support program.

- **Cross Guarantee Liability** – Whenever one or more PE Investors provides more than 50% of the "investments" in two or more depository institutions, those PE Investors are expected to pledge their "proportionate interests" in each such institution to pay for any losses that the Deposit Insurance Fund may incur as a result of the failure of, or providing assistance to, any other such institution. While this requirement on its face would not subject the "minority" investors in a single depository institution to cross guarantee liability, it could have a chilling effect on the willingness of a PE Investor to invest in more than one failing bank transaction.

- **Transactions with Affiliates** – Sections 23A and 23B of the Federal Reserve Act and Regulation W of the Federal Reserve impose, among other things, certain quantitative and qualitative restrictions on extensions of credit by an insured depository institution to, or for the benefit of, its non-banking, non-subsidiary affiliates. Under the Statement, those restrictions are replaced by a prohibition on covered transactions that applies to all PE Investors, any investments funds they control, any company in which a PE Investor or such a fund owns 10% or more of the total equity and any other "portfolio company." These restrictions significantly exceed those that normally apply by ignoring the definition of "control" in Section 23A and Regulation W, the rules of affiliation found in the statute and the rule, and the rules applicable to transactions with portfolio companies under the merchant banking provisions of the Federal Reserve's Regulation Y.

- **Continuity of Ownership (Anti-Flipping)** – PE Investors may not transfer the securities of a holding company in which they invest for three years without the FDIC's prior approval. It is not clear how, if at all, these restrictions apply to investors in funds organized by PE Investors. In order for the FDIC to agree to such a sale, it is expected that the buyer will be required to agree to be subject to all the terms of the Statement. It also is not clear how these restrictions will be applied to a bank or thrift seeking to acquire an institution held as a club investment.

- **Offshore Secrecy Law Jurisdictions** – PE Investors that utilize ownership structures that are domiciled in a "bank secrecy jurisdiction" are not eligible to acquire a direct or indirect interest in a depository institution unless the PE Investors are directly or indirectly subject to comprehensive

consolidated supervision, as determined by the Federal Reserve, and the PE Investors take certain additional actions to ensure the FDIC's access to information.

- **Disclosure** – The Statement also puts PE Investors on notice, even in non-control positions, that they may be required to make more extensive disclosure of their financials, investors and business plans than is the case for other investors. A PE Investor may be required to submit information to the FDIC regarding itself and all entities in its "ownership chain," including such information as its size, diversification, return profile, marketing documentation, management term, business model and such other information as the FDIC determines to be necessary to assure compliance with the Statement.

The Statement also prohibits a PE Investor that directly or indirectly holds 10% or more of the total equity of a failed bank or thrift from being a "bidder" to invest in the deposit liabilities of the same institution and requires that a PE Investor submit any information requested by the FDIC about the PE Investor and "all entities in the ownership chain."

If these rules are finalized, they could have an adverse impact on the amount of capital available to banks and thrifts, even in passive, non-controlling situations. If adopted, some or all of the parts of this Statement could result in corresponding regulatory changes by the other federal banking agencies, which include two other FDIC board members, the heads of the Office of Thrift Supervision and the Office of the Comptroller of the Currency.

PE Investors are strongly urged to participate in the comment process so as to create a dynamic and meaningful rulemaking process.

For additional information and reference, see our prior publications on this issue:

1. ***"Equity Investments and Controlling Acquisitions Involving US Financial Institutions,"***
2. ***"Fresh Capital is So Close: Another Call to Modify Control Rules***,"
3. ***"Private Equity Investments in Financial Services Raising & Solving New Issues,"***
4. ***"FDIC Announces Sale of IndyMac to Holding Company Comprised of Private Equity Investors,"***
5. ***"Some Models for M&A by Private Equity Firms,"*** *American Banker*, October 3, 2008; and
6. ***"Update the Rules for Private-Equity Stakes,"*** *American Banker*, August 29, 2008.

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