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FDIC Adopts Modified Guidelines for PE Investments In Failed Institutions: The Debate Continues

If private equity investors ("PE Investors") feel like they have whiplash from the recent actions of the FDIC, there are good reasons for it. In less than two months—unprecedented speed for a banking regulatory agency—the FDIC has proposed and adopted a policy statement that first seemed to suggest that PE Investors were disinvited from the failed bank bidding process and then offered a compromise that suggests they may participate if they are willing to bid more than other bidders or, even more to the FDIC's liking, join forces with an established banking organization, which itself may need additional capital.

The FDIC's position on PE Investors' access to the bidding process is a critical issue, as it impacts the ability of the banking industry to attract capital and avoid taxpayer bailouts. The final Statement of Policy on Qualifications for Failed Bank Acquisitions ("Statement") continues to single out PE Investors as posing peculiar risks to insured depository institutions and the Deposit Insurance Fund ("DIF") and to impose upon them enhanced regulatory requirements. *See* *FDIC Proposes Guidelines for PE Investments in Failed Institutions: The Debate Begins*, 21st Century Money, Banking & Commerce Alert® (July 6, 2009). However, after receiving numerous comments suggesting moderation of its initial approach, the FDIC may have sufficiently modified its requirements to enable PE Investors to consider making investments in the banking industry based on the investments' financial merits.

What the Statement Means

There are some obvious and not-so-obvious practical implications of the Statement:

1. **Second-Class Status.** PE Investors that bid for failed banks or thrifts must understand that they are second-class bidders and that any depository institution in which they acquire more than a *de minimis* investment in the process will have to be capitalized at approximately double the ratio of any strategic bidder.

2. **More Confusion.** In reality, the bidding and acquisition process for failed banks and thrifts may be less transparent as a result of the adoption of the Statement. The absence from the Statement of clear definitions of parties and structures, and the broad discretion that the FDIC has granted itself to vary the terms and applicability of the Statement, make it difficult to articulate clear rules for PE Investors' participation.

3. **Arranged Marriages.** The FDIC is affirmatively encouraging PE Investors to enter into partnership and joint venture arrangements, as we have previewed in our Alerts and articles from as much as a

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year ago. *See, e.g.,* *Crisis Revamps Patterns of Bank and S&L Holding Company Approvals*, *92* Banking Report (BNA) 17 (April 28, 2009); *Private Equity Investments in Financial Services Raising & Solving New Issues*, 21st Century Money, Banking & Commerce Alert® (Feb. 2, 2009); *Update the Rules for Private Equity Stakes,* American Banker (Aug. 29, 2008). When the FDIC is unable to arrange a whole bank transaction for a failed bank or thrift, it appears to have focused on encouraging transactions that (i) dispose of deposits and branches to a strategic buyer and loans and real estate to private investors through structured investment vehicles established by the FDIC or (ii) call upon PE Investors to partner with established depository organizations as a way of recapitalizing bank acquirers and dampening the discomfort the FDIC seems to experience in transferring deposit liabilities to unseasoned investors.

4. **Less Offshore Access.** The Statement makes it difficult for offshore funds and investors to determine, except in the clearest cases, whether a country or territory in which they are domiciled is a "secrecy law jurisdiction," which would bar such funds or investors from investing in a failed bank or thrift.

5. **Incentive to Invent.** If the Statement does not extinguish PE Investors' interest in failed banks, it will no doubt encourage the development of new acquisition structures and bidding models that can accommodate both the concerns articulated by the FDIC and the financial goals of private investors. The Statement creates interesting incentives for PE Investors and banks and thrifts to figure out how they best can use each other's skills and resources.

What the Statement Says

The Statement can be summarized as follows:

- **Applicability** – The Statement applies to "private investors" in a company that is acquired to facilitate bidding on a failed bank or thrift and that would thereby acquire control of FDIC-insured deposits, and to applicants for deposit insurance for a *de novo* institution organized to participate in the resolution of a failed bank or thrift. "Private investors" is not further defined. In discussing this subject in its background statement, the FDIC refers to multiple investors that each hold less than 24.9% of a bank or thrift as a new phenomenon and states that it would be "exceedingly difficult" to adequately define such arrangements. This lack of clarity is tempered somewhat by the FDIC's decision not to apply the Statement to PE Investors that acquire less than 5% of the total voting power of a depository organization and are deemed not to be acting in concert with other investors and by the agency's undertaking to review the Statement's operation and impact within six months. In addition, the Statement is effective only prospectively, and the FDIC will consider a PE Investor's application to terminate its application after seven years if the bank or thrift in which it is invested has continuously received one of the top two composite ratings for safety and soundness during that period. As noted above, the Statement does not apply to, and it "strongly encourage[s]," partnerships or other types of joint ventures between PE Investors and established bank or thrift holding companies in which the holding company has a "strong majority interest" in the resulting bank or thrift.

- **Prohibited Structures** – The Statement continues to provide that "functionally opaque ownership structures" will not be approved for ownership of an insured depository institution. In such structures, according to the FDIC, it is difficult to ascertain beneficial ownership, ownership and control are separated and the parties responsible for making decisions are not clearly identified. The Statement no longer characterizes such organizations as "silo" structures, but the FDIC has added a description of such organizations as those involving a single private equity fund with

multiple investment vehicles controlled by the parent fund. Read literally, this description covers many PE Investors, and nearly all larger ones, which typically create and manage multiple investment vehicles in order to serve diverse clients or to pursue varied investment strategies and opportunities. As a practical matter, the FDIC still appears to be concerned with PE Investors that propose to place their investment in an insured depository institution in a single investment vehicle or "silo" and are able to isolate that investment vehicle legally and financially from the rest of the organization, thereby relieving the rest of the organization from responsibility for that investment. The application of this ambiguous prohibition is likely to engender further discussions between the FDIC and prospective PE Investors.

- **Capital Requirement** – A depository institution that is covered by the Statement is required to maintain a minimum ratio of common equity to total assets of 10% for three years, as compared to the requirement in the proposed Statement to maintain a minimum ratio of Tier 1 capital to total assets (the "leverage" ratio) of 15%. The new capital measure excludes perpetual preferred stock and certain other non-common equity elements of Tier 1 capital. As a result of this exclusion and the far higher capital ratio imposed on PE Investors as compared to non-PE Investors, the Statement puts PE Investors at a significant competitive disadvantage. After three years, the capital of the new or acquired institution must be maintained, as provided in the proposed Statement, at no less than the standard to be "well capitalized" under the prompt corrective action ("PCA") provisions of the Federal Deposit Insurance Corporation Improvement Act of 1991. The "well capitalized" standard requires such an institution to maintain a minimum leverage ratio of 5% as compared to 4% (and in certain cases 3%) for a bank or thrift acquired by a non-PE Investor, a minimum ratio of Tier 1 capital to risk-weighted assets of 6% as compared to 4% and a minimum ratio of total capital to risk-weighted assets of 10% as compared to 8%. As long as the Statement remains in effect with regard to its investors, such an institution will be required to take immediate steps to come into compliance if its capital falls below either its initial three-year or subsequent "well capitalized" requirement, and the institution would be subject to PCA as if it were an undercapitalized institution if it fails to do so. The Proposed Statement indicated that PE Investors would be required to agree to cause a covered depository institution to maintain its required capital levels, but all references to obligations of PE Investors have been eliminated from this provision of the final Statement.

- **Source of Strength** – The FDIC has dropped any requirement in the proposed Statement that a non-controlling PE Investor serve as a source of financial strength for an institution in which it invests.

- **Cross Support Liability** – PE Investors that hold 80% or more of two or more banks or thrifts must pledge their stock in each such institution to pay for any losses that the DIF may suffer as a result of the failure of any other such institution. The threshold in the proposed Statement was 50%, and the higher threshold in the final Statement, combined with the exclusion of PE Investors that hold less than a 5% interest, make this much less of a hair-trigger provision. However, the FDIC has not described precisely the types of investment instruments to which the 80% threshold applies.

- **Transactions with Affiliates** – The Statement continues to prohibit extensions of credit by a bank or thrift to any PE Investor in the institution that is covered by the Statement, such PE Investor's investment fund and any company in which such PE Investor or such fund owns, directly or indirectly, 10% or more of the total equity for a minimum period of 30 days. Such PE Investors must provide periodic reports to the bank or thrift identifying all such affiliated companies. Unlike the proposed Statement, the final Statement does not apply the prohibition to all companies in which such PE Investor or such fund invests, which should ease the burden of compliance and should

avoid prohibiting extensions of credit to companies in which PE Investors have insignificant interests. In addition, only extensions of credit that take place after the acquisition of a failed bank or thrift are covered. While this provision has been relaxed, it continues to significantly exceed the conditions and restrictions that apply to extensions of credit by banks and thrifts to affiliates under Sections 23A and 23B of the Federal Reserve Act and Regulation W of the Federal Reserve Board.

- **Continuity of Ownership (Anti-Flipping)** – This restriction has been retained. PE Investors are prohibited from transferring "their securities" for three years without prior FDIC approval. The Statement now provides that such approval will not be unreasonably withheld, provided that the recipient agrees to be bound by the same conditions applicable to its transferee, and open-end mutual funds are not covered. However, the FDIC has not clarified whether this restriction applies to a direct or indirect investment in an investment vehicle, in addition to an investment in a depository organization, and whether the transfer restriction applies to the recipient for the remainder of its transferee's three-year term or for an additional three-year term.

- **Offshore Secrecy Law Jurisdiction** – A PE Investor that utilizes an ownership structure that is domiciled in a "bank secrecy jurisdiction" continues to be ineligible to invest directly or indirectly in a depository organization resulting from a bank or thrift failure, unless the PE Investor is directly or indirectly subject to comprehensive supervision on a consolidated basis ("CCS") as recognized by the Federal Reserve Board and certain measures are taken to ensure that the FDIC will have access to information. Unfortunately, the definition of bank secrecy jurisdictions in the Statement does not provide clear guidance as to which countries or territories would be deemed to be bank secrecy jurisdictions. Furthermore, PE Investors and their investment vehicles typically do not control depository institutions and, therefore, are unlikely to be subject to CCS. Thus, this prohibition is likely to prevent the use by PE Investors of any jurisdiction for organizational purposes that is not viewed in the most favorable terms by the federal banking agencies.

- **Disclosure** – The Statement continues to put PE Investors on notice that they may be expected to make more extensive disclosures than other non-controlling investors make regarding their financial condition, investors and business plans.

- **Bidder Eligibility** – A PE Investor that directly or indirectly holds 10% or more of the total equity of a failed bank or thrift will be ineligible, as provided under the proposed Statement, to participate as an investor in the assumption of any deposit liabilities of that institution. However, the Statement does not appear to prevent such PE Investor from participating in the purchase of any assets of that institution if the transaction does not include the acquisition of any insured deposits.

The Statement is now somewhat less onerous, but it still suffers from the interpretive and conceptual flaws noted by us and many other commenters on the proposed Statement. *See* *Comment Period Closes on FDIC Private Equity Policy Statement*, 21st Century Money, Banking & Commerce Alert® (Aug. 11, 2009). It does not cite to any evidence or explain what makes PE Investors different from other non-controlling investors; why that difference, if any, requires different treatment to protect the DIF or the banking system; and why the existing supervisory structure for bank and thrift holding companies is inadequate to address the issues. Nor does it provide any evidence or analysis regarding the short-term cost or the presumed long-term benefit to the DIF of the restrictions imposed by the Statement. The lack of precision in the Statement also may lead to its uneven application among PE Investors.

Conclusion

The FDIC has decided to deal with PE Investors by holding the door open only part way. Indeed, the FDIC

is signaling that PE Investors will receive a warmer welcome if they approach the FDIC from a different direction altogether, as junior joint venturers with, or investors in, established banking organizations. A variety of investment structures may fit within this mold. Accordingly, we expect the coming months to be as active as the recent past in the development of new public equity investment structures.

Authors and Contributors

For more information regarding this client alert, please contact your usual Fried Frank attorney or any of the attorneys listed below:

Thomas P. Vartanian
+1.202.639.7200

David L. Ansell
+1.202.639.7011

Robert H. Ledig
+1.202.639.7016

Gordon L. Miller
+1.202.639.7173

Fried, Frank, Harris, Shriver & Jacobson LLP

New York
One New York Plaza
New York, NY 10004-1980
Tel: +1.212.859.8000
Fax: +1.212.859.4000

Washington, DC
1001 Pennsylvania Avenue, NW
Washington, DC 20004-2505
Tel: +1.202.639.7000
Fax: +1.202.639.7003

Frankfurt
Taunusanlage 18
60325 Frankfurt am Main
Tel: +49.69.870.030.00
Fax: +49.69.870.030.555

Hong Kong
in association with
Huen Wong & Co.
9th Floor, Gloucester Tower
The Landmark
15 Queen's Road Central
Hong Kong
Tel: +852.3760.3600
Fax: +852.3760.3611

Shanghai
40th Floor, Park Place
1601 Nanjing Road West
Shanghai 200040
Tel: +86.21.6122.5500
Fax: +86.21.6122.5588

Fried, Frank, Harris, Shriver & Jacobson (London) LLP

London
99 City Road
London EC1Y 1AX
Tel: +44.20.7972.9600
Fax: +44.20.7972.9602

Fried, Frank, Harris, Shriver & Jacobson (Europe)

Paris
65-67, avenue des Champs Elysées
75008 Paris
Tel: +33.140.62.22.00
Fax: +33.140.62.22.29

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