

FS Regulatory Brief

Private Equity Qualifications for Acquisitions of Failed Banks

On August 26th the FDIC issued a final policy statement regarding qualifications for purchases of failed-banks by non-bank entities. The purpose of the policy statement ("Statement") is to provide guidance to private equity ("PE") firms concerning the FDIC's standards for such purchases.

The standards generally establish higher initial capital requirements and more stringent sale restrictions than those faced by existing bank purchasers and layout potential cross-financial support requirements. PE firms can likely avoid the more stringent conditions, however, if they co-invest with bank holding companies (BHC) to recapitalize and operate banks acquired from the FDIC. In this case, the BHC must acquire a majority interest, meaning that the controlling investor will be under BHC regulation.

The Statement describes purchase conditions in the following areas:

- Capital Requirements
- Cross Support
- Transactions with Affiliates
- Identification and Transparency of Ownership
- Duration of Ownership
- Disclosures/Reporting

Background

U.S. banking law collectively prohibits commercial firms from acquiring or operating banks and conversely prohibits banks from engaging in commercial activities that are not closely

related to the business of banking. These restrictions are reflective of traditional wariness in the United States of the potential conflicts that could arise in the mixing of banking and commercial or industrial operations. This is one reason that non-bank entities have hesitated to acquire U.S. banks in the past: very few non-bank entities have been willing to enter a BHC structure that would subject them to consolidated holding company capital requirements and supervision by the Fed, as well as the limitation on the scope of their nonfinancial business activities. BHCs must be able to demonstrate, on a continuous basis, that the bank and any other depository institution it controls, meets regulatory standards for being well-capitalized, well-managed and adequately serving low-to-moderate income communities. In addition, BHCs must continually serve as a source of financial strength to their insured depository institutions. As a result, the regulatory compliance and economic costs for BHCs can be significant.

Traditionally, a stake of 25% or more of a bank's voting stock has been generally viewed as a controlling interest requiring the owners to submit to BHC status and Fed supervision, and PE investors have historically done everything possible to avoid this result. However, in September 2008, the Fed released guidance that relaxed the threshold, allowing minority shareholders to own up to 33 percent of the total equity of a bank, provided that it does not own, control, or have power to vote more than 15 percent of any class of voting securities. This change, among others included in the September 2008 Fed guidance (such as changes in investor board representation and ability to influence bank policy), has contributed to increased interest among PE firms for the acquisition of minority interests in banks.

For PE managers and their investors who pump large capital infusions into failed banks, remaining passive investors would contrast with their typical approach of turning-around failed companies by actively overhauling management, revising business plans and cutting expenses. Thus one tactic has been to create a separate PE fund solely to control a newly

acquired bank. The new fund becomes a BHC subject to regulators' oversight, but other funds and their investment adviser remain shielded. While avoiding BHC oversight for the rest of a PE firm's operations, this structure also has problems. BHC Act leverage ratios restrict how much money a bank owner may borrow. In contrast, the typical PE business model turns on investing as little of the partners' money as possible and borrowing the rest.

Another option has been for PE firms to structure buyouts so as to diversify control among multiple investors so that no single fund or investment adviser triggers BHC thresholds. In this model, it's necessary for the investors, including participating PE firms, to cooperate along side each other without colluding to make decisions jointly or "acting in concert" as a controlling group.

To date, PE firms have participated in several recent bank purchases from FDIC receivership, including Bank United, IndyMac, and National City. However, PE firms have argued that their participation in such deals could increase if some of the onerous ownership and control requirements imposed by the FDIC as a condition to such acquisitions were relaxed. This prompted the FDIC to review the rules and issue the Statement.

Capital Requirements

Initially the FDIC suggested that it would require banks purchased by non-bank entities to maintain a 15% Tier 1 leverage ratio - the ratio of a bank's capital to its assets. This proposal drew the most criticism from PE participants, mainly because it would impose a ratio requirement that is more than three times the normal requirement for well capitalized banks. The FDIC lowered the requirement to a 10% Tier 1 common equity ratio through the first three years after an acquisition. After three years, the depository institution must remain "well capitalized" as defined in FDIC regulations (e.g. 5% Tier 1 leverage requirement). Acquisitions of failed banks or thrifts completed prior to August 26, 2009 (i.e., the FDIC Statement approval date) are not covered by the Statement.

Investors can likely avoid the more stringent capital requirement (and all conditions laid out in the Statement) if they partner with an existing BHC to make the purchases, and

the BHC has a strong majority interest. Such partnerships are strongly encouraged by the FDIC.

Finally, the Statement provides a "de minimis investments" exception, stating it does not apply to investors with 5 percent or less of a bank's voting shares, provided there is no evidence of concerted action by any group of de minimis investors.

Cross Support

The original proposal provided that non-bank investors that owned two or more depository institutions would have an obligation to commit their bank investments to give each other financial support. The final Statement clarified that this guaranty would apply only if two depository institutions are at least 80 percent owned by common investors. It is unclear whether two PE funds with a common investment manager would be considered "common investors" for this purpose, or whether the definition of "common investors" will look through to the underlying limited partners in each PE fund.

Transactions with Affiliates

The FDIC was concerned that some PE structures would avoid application of banking rules on affiliated transactions, thus allowing PE firms to use their acquired banks to lend money to PE fund portfolio companies. The Statement also noted that the prohibitions on insider lending are among the most crucial requirements for maintaining a safe and sound banking system.

The final Statement prohibits extension of credit by any insured depository institution to one of its private investors or to any affiliate of that investor. For this purpose, "Affiliate" is defined as any company in which the investor owns, directly or indirectly, more than 10% of the equity and has maintained such ownership for 30 days. There is an expectation that investors will supply reports to their owned-depository institutions listing all affiliated companies in order to promote compliance with this rule.

Identification and Transparency of Ownership

The Statement notes that complex and functionally opaque ownership structures in which the beneficial ownership is difficult to ascertain and ownership and control are separated, would not be approved for ownership of insured depository institution. Specifically, the FDIC expressed doubts about silo-structures in which a single PE fund creates multiple sub-funds in order to purchase a bank for the purpose of evading ownership limits and the application of the BHA Act.

The Statement also prohibits the involvement of offshore entities in an ownership structure to the extent such entities are located in "a country that applies a bank secrecy law that limits U.S. bank regulators from determining compliance with U.S. laws or prevents them from obtaining information on the competence, experience and financial condition of applicants."

Duration of Ownership

The Statement requires that PE investors maintain their investments in insured depository institutions for at least three years, unless approval is received from the FDIC. The Statement adds that such approval will not be unreasonably withheld for transfers to affiliates if the affiliate to which the interest is sold or transferred agrees to be bound by the conditions of the Statement. It appears from the Statement that the three-year clock would reset with any transfer or sale to a private investor. The FDIC stated that it has an interest in long-term, stable management of these banks, especially where it has entered an agreement to absorb a portion of future losses.

Finally, the Statement clarifies that open-end mutual funds that purchase a private interest in failed banks or thrifts are not bound by the three-year rule. Interestingly, the Statement did not make a similar concession for open-end hedge funds that issue redeemable securities.

Disclosure

The FDIC will require certain specified information from investors and other entities in the ownership chain, including the size of the PE fund or funds, its diversification, the return profile, the marketing documents, the management team and the business model. Such disclosures will be made to the FDIC and will be non-public. While the statement is not

specific, disclosure of the "ownership chain" may require disclosure of individual limited partners in a PE fund.

Conclusion

The FDIC has adopted a somewhat flexible and nuanced approach which it hopes will attract private capital to banks in receivership, while at the same time instituting stricter limits than would be applied to purchases by existing BHCs. The PE industry will have to maintain an open-dialogue with the banking regulators in order to resolve the inevitable interpretive questions that arise. In particular, the question of ownership and control structures and how the definition of "private capital investor" is to be applied at the investment-manager and the limited-partner levels. Specific questions regarding this Statement that PE firms should be asking include:

- What is the cost of initial and ongoing compliance and monitoring of Statement conditions, and has that been factored into our investment decision?
- Do we have the correct resources and control mechanisms in place to ensure compliance with the Statement?
- Have we firmly established all possible instances where Cross Support agreements will be necessary? Is it clear that the 80% common ownership rule applies at the limited partner/investor level, and not at the level of the management company?
- If we enter an investment subject to the conditions of the Statement, will compliance be consistent with the investment guidelines, investment objectives, targeted realization periods, and other commitments made to our PE fund investors in our offering memo, marketing materials and other disclosures?

- If we entered into an investment subject to the Statement as part of a consortium, what are the controls in place to ensure that the individual PE firm members are not acting in concert?
- Are the disclosures made to the FDIC accurate and consistent with disclosures to other agencies and to our investors?
- How can we know that the list of affiliates provided to the bank that we now own is accurate, complete and up to date?
- What are the controls in place at the bank to ensure that the bank does not lend to one our portfolio companies?
- Who is responsible for ensuring that the bank's Tier 1 leverage ratio is maintained at the 10% level? What are the calculations? Are any adjustments to the calculation necessary based on the conditions of the Statement?

Additional Information

The full release is available at

<http://www.fdic.gov/news/board/Aug26no2.pdf>.

If you would like additional information about the topic discussed in this FS Regulatory Brief or advice related to your specific considerations, please contact:

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