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FDIC Proposal May Inhibit Private Equity Investments in Failed Banks

Posted by Edward D. Herlihy, Wachtell, Lipton, Rosen & Katz, on Sunday July 12, 2009 at 2:40 pm

(Editor's Note: This post is by Edward D. Herlihy, Craig M. Wasserman, Richard K. Kim and Lawrence S. Makow of Wachtell, Lipton, Rosen & Katz.)

The FDIC recently issued a proposed policy statement laying down stringent new ground rules for private equity investments in failed banks. Currently, private equity firms face significant regulatory challenges in structuring investments in banks and thrifts. The Federal Reserve (in the case of bank acquisitions) and the OTS (in the case of thrift acquisitions) remain the principal regulators determining capital, governance and control considerations relating to permissible bank/thrift acquisition structures. However, the FDIC's proposed policy statement would impose meaningful additional capital and related qualifying considerations in order for a private equity sponsored vehicle to acquire a failed bank being sold by the FDIC.

The proposed policy statement appears to be primarily focused on structures used to acquire failed banks involving multiple investors – typically private equity funds – where no investor would be deemed to control the bank going forward for regulatory purposes. By doing so, the investors minimize the amount of regulation to which they would be subject. Structures along these lines were used to acquire both Indymac and BankUnited. The proposed policy statement would impose a number of new restrictions on these types of structures and are summarized below:

• **Capital Support**. Investors would be expected to commit that an acquired depository institution be initially capitalized at a minimum 15% Tier 1 leverage ratio for at least three years – nearly four times the minimum ratio to be deemed adequately capitalized. Failure to meet this capital minimum would result in the institution being treated as "undercapitalized" for purposes of Prompt Corrective Action, triggering harsh regulatory measures, such as a requirement that the institution file a capital plan, restrict the payment of dividends and restrict asset growth.

• **Source of Strength**. Investment vehicles would be expected to serve as a source of strength for their subsidiary depository institutions and would be expected to sell equity or engage in capital qualifying borrowings as necessary.

• **Cross Guarantee of Affiliated Institutions**. Investors and investor groups whose investments constitute a majority of the investments in more than one depository institution would be expected to 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 FDIC assistance provided to, the other affiliated institutions.

• **Bar on Affiliate Transactions**. All extensions of credit to investors, their investment funds, their affiliates, and any portfolio companies by a depository institution acquired from receivership would be prohibited.

• **Bank Secrecy Law Jurisdictions**. Investment structures involving entities domiciled in bank secrecy jurisdictions would not generally be eligible to own a direct or indirect interest in a depository institution acquired from receivership, absent extensive commitments, including to provide the information to the FDIC that would otherwise be protected from disclosure.

• **Minimum Holding Period**. Investors would be prohibited from selling or otherwise transferring securities of the investors' holding company or depository institution for a three year period following acquisition, unless the FDIC has approved the sale or transfer.

• **Ability of Existing Investors to Bid on a Failed Depository Institution**. Investors that hold 10% or more of the equity of a depository institution that fails would not be eligible to bid on the institution once it is in receivership.

• **Extensive Disclosure**. Investors would be expected to submit to the FDIC detailed information about themselves, all entities in the proposed ownership chain, the size of the capital fund or funds, their diversification, the return profile, the marketing documents, the management team and the business model.

Given the apparent scarcity of purchasers of failed banks, it is a difficult time to place higher capital and other standards on acquirors of failed banks and the proposed policy statement will generate significant debate. Potential private equity investors will contend that acquisitions of failed banks from the FDIC often present a lower risk profile than acquisitions of open banks (which are not subject to the proposed policy statement) in the current economic environment. This is because the FDIC frequently enters into loss sharing agreements with the acquirer of a failed bank and offers other risk mitigants not available to acquirors of open banks. Of course, the fact that the FDIC offers these mitigants in selling failed banks is part of the reason for the proposed new requirements. In its present form, the proposed new restrictions, when combined with the existing regulatory restrictions applicable to private equity investments in banks, may effectively dampen private equity interest in acquiring failed banks. As a result, both the formation of new private equity structures and roll-up strategies by existing private equityowned banks may be negatively impacted.