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FDIC Releases Policy Statement Restricting Private Equity Investments in Failed Banks
Posted by Edward D. Herlihy, Wachtell, Lipton, Rosen & Katz, on Friday August 28, 2009 at 9:56 am

(Editor's Note: This post is based on a Wachtell, Lipton, Rosen & Katz client memorandum prepared by Edward D. Herlihy, Richard K. Kim, Lawrence S. Makow, Nicholas G. Demmo and Matthew M. Guest.)

The FDIC issued yesterday its final policy statement on private equity investments in failed banks. In early July, the FDIC issued a proposed policy statement containing stringent restrictions on these types of transactions. While the final policy statement relaxes some of these limitations, it continues to impose significantly higher requirements for private equity investors seeking to acquire failed banks than for strategic acquirors.

• **Scope**. Although the FDIC's policy is generally viewed as focused on private equity investments, the policy is worded more broadly and applies to "private investors" – a term which is not defined in the policy. The earlier proposal applied to "private capital investors" and contained language, which has since been omitted, that made it clearer that the focus was private equity investors. In contrast, the policy statement does not apply to, and in fact encourages investment structures where private equity investors acquire a failed bank in conjunction with a bank or thrift holding company with a successful track record where the bank/thrift holding company has a strong majority interest in the resulting bank or thrift.

• **Capital Support**. Investors will be required to commit that an acquired depository institution be capitalized at a minimum 10% Tier 1 common equity ratio for at least three years following acquisition. The FDIC had previously proposed a minimum 15% Tier 1 leverage ratio – a higher number but a different measurement. The Tier 1 common equity ratio was a key measurement for the recent stress tests conducted by the Federal Reserve on the largest U.S. banks, but before then was not typically used as an explicit measure of regulatory capital. (In order to pass the stress test, banks were required to have sufficient common equity to achieve a Tier 1 common equity ratio of at least 4% at year-end 2010 under a hypothetical economic scenario.) Under the FDIC's final rules, failure to meet the 10% Tier 1 common equity ratio would result in the institution being treated as "undercapitalized" for purposes of Prompt Corrective Action. This designation triggers strong 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**. Previously, the FDIC had proposed that 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. The final policy does not contain this requirement.

• **Cross Support of Affiliated Institutions**. Investors and investor groups whose investments constitute 80% or more of the investments in more than one depository institution must 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.

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

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

• **Bank Secrecy Law Jurisdictions**. Investment structures involving entities domiciled in bank secrecy jurisdictions would not generally be eligible to own an interest in a depository institution acquired from receivership, unless they are subsidiaries of companies located in countries that exercise comprehensive consolidated supervision as recognized by the Federal Reserve and commit to provide extensive information to the FDIC.

• **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.

Private equity investors already face significant regulatory obstacles in bidding on failed banks. Since becoming a bank or thrift holding company and submitting to consolidated regulatory supervision is not practical for most private equity investors, investors need to satisfy the Federal Reserve (in the case of bank acquisitions) and the Office of Thrift Supervision (in the case of thrift acquisitions) that they will restrict themselves to largely passive roles. At the same time, they strive to ensure the placement and maintenance of competent management with the wherewithal to engineer a turnaround. There remain powerful arguments for the banking system to tap the investment resources available to private equity. Whether the FDIC's final policy has changed enough to permit private equity to participate in acquiring failed banks remains to be seen.