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FDIC Requests Comments on Its Proposed Rules on Private Equity Investment in Failed Banks

On July 2, 2009 the Federal Deposit Insurance Corporation (FDIC) published a request for public comments by August 10, 2009 on a Proposed Policy Statement on the Qualifications for Failed Bank Acquisitions (Proposed Policy Statement) to provide private capital investors with guidance on the terms and conditions for acquiring or investing in failed depository institutions. Private capital investors include individuals, partnerships and companies seeking to acquire the banking business of a failed depository institution or seeking FDIC insurance for a *de novo* banking charter to acquire such business. An individual or entity investing in a healthy bank, or in a troubled bank not in FDIC receivership, would not be considered a private capital investor. As detailed below, the draconian restrictions placed on private capital investors by the Proposed Policy Statement may lead private equity to look more favorably upon troubled, but not yet failed targets.

The private equity community's immediate reaction to the FDIC's Proposed Policy Statement was summed up by Wilbur Ross' statement in the July 6 *American Banker* that "It really feels like something simply designed to make it less attractive for private equity to invest." Mr. Ross, who is a lead investor in a private equity group which purchased Florida's failed BankUnited from the FDIC in May, was also reported in that article to have said that if the Proposed Policy Statement is adopted in its present form, it would make private equity investments in failed banks and thrifts unpalatable. "Under these conditions, we would have never invested in BankUnited," he concluded.

The heads of the Office of the Comptroller of the

Currency (OCC) and the Office of Thrift Supervision (OTS) also announced their opposition to the FDIC's Proposed Policy Statement in its current form. While Comptroller of the Currency John C. Dugan and Acting Office of Thrift Supervision Director John Bowman both formally voted to release the Proposed Policy Statement for public comment, each concurrently expressed concerns that, in its present form, the FDIC's Proposed Policy Statement would choke off private equity investment and thereby increase the cost of resolving failed institutions at the expense of the FDIC's Deposit Insurance Fund and possibly the US taxpayer.

This FDIC Proposed Policy Statement follows the OCC's November 17, 2008 Conditional Preliminary Approval Letter on shelf charters, which provided private capital and other investors with a procedure for securing expedited preliminary approval of a new national bank charter for use in bidding on failed or about-to-fail institutions or their deposits and assets out of FDIC receiverships. For more information on the OCC's Conditional Preliminary Approval Letter see our *November 2008 Alert* on how the new national bank "shelf charters" will facilitate private equity investment in both troubled and healthy banks. The FDIC Proposed Policy Statement also follows a Federal Reserve September 2008 policy statement on equity investments in banks and bank holding companies which expanded the size of noncontrolling investments available to private capital and other nonbank holding company investors to 33 percent under certain circumstances, also detailed in a *Squire Sanders Financial Services Alert.* With different content these three policy pronouncements **could** have combined to provide private equity funds, hedge funds and other forms of private capital with a road map through the decades-old minefield created by the Bank Holding Company Act's control rules, the FDIC's deposit insurance criteria and the OCC's lengthy *de novo* chartering process.

Now that the FDIC released its Proposed Policy Statement, the inconvenient truth appears to be that:

- The Federal Reserve's policy statement does not provide a safe harbor through which a private equity fund complex could easily segregate or "silo" a troubled bank fund as a bank holding company without turning its other funds into bank holding companies;

- The OCC's shelf charter process has rarely been used; and

- The FDIC's Proposed Policy Statement appears to make private capital investment in depository institutions more difficult than was the case prior to the onset of the current rash of bank failures resulting from the 2008 and 2009 financial crisis and recession.

The FDIC's Proposed Policy Statement

The Proposed Policy Statement would impose nine restrictions on private capital investors.

1. **"Siloed" Investment Structures –** The Proposed Policy Statement emphasizes that opaque ownership structures in which beneficial ownership and decision-making power are separated are not appropriate for the ownership of rescued or healthy insured depository institutions by any type of investor.

2. **Capital Commitment –** A Tier-1 leverage ratio of not less than 15 percent would have to be maintained for at least three years after the acquisition of a bank or thrift by private capital investors, with a "well capitalized" level being required thereafter. Failure to contribute additional capital to meet either standard would allow federal regulators to use the so-called "prompt corrective action" provisions of Section 38 of the FDI Act to extract additional capital under penalty of closure of the institution. The proposed 15-percent leverage ratio would represent a dramatic increase in the Tier-1 capital required under current regulations.

3. **Source of Strength –** The bank holding company in which private capital invested would be required to enter into an agreement with federal regulators to sell additional equity and/or to borrow in order to secure funds needed for injection as additional capital into the acquired bank or thrift.

4. **Cross Guarantees –** Private capital investors with controlling investments in more than one bank or thrift would be required to pledge all such interests to pay for any FDIC losses arising from the failure or rescue of any controlled bank or thrift.

5. **Affiliate Transactions –** The existing rules limiting and requiring collateralization of "affiliate transactions" in Sections 23A and 23B of the Federal Reserve Act and FRB Regulation W would be tightened as applied to loans and other extensions of credit from a controlled bank or thrift to its private capital investors, those investors' other investment funds and portfolio companies of those funds. A 10-percent ownership interest would generally trigger these tightened affiliate transaction limits.

6. **Offshore and Secrecy Jurisdictions –** Private capital investment structures could not include holding companies organized in offshore or corporate secrecy jurisdictions unless secrecy protections were waived by the execution of an extensive set of agreements with federal banking

regulators.

7. **Continuity of Ownership –** A private capital investor would be prohibited from selling its shares in the acquired bank, thrift or parent holding company for three years without prior FDIC approval. The Proposed Policy Statement goes on to explain that the FDIC does not expect to approve any such sale unless the new buyer agrees to become subject to all of the restrictions of the Proposed Policy Statement as ultimately adopted.

8. **Bids by Existing Shareholders –** Existing 10-percent-or-more direct or indirect shareholders in a bank or thrift in FDIC receivership would not be eligible to bid for any portion of the receivership assets or liabilities.

9. **Application Disclosure to the FDIC –** Prospective investors would be expected to provide detailed information on the investment structure and related investment funds including the size of such funds, their targeted rate of return on investment, management team qualifications and business model, among other information.

If you, your company or your industry association would like to comment on this FDIC Proposed Policy Statement with our assistance, please contact your primary Squire Sanders contact well before August 10, 2009, the close of the public comment period.
