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Private Equity Investment in Failed Banks: Appropriate Investors Welcome

I. INTRODUCTION

One hundred sixty-nine insured depository institutions have failed since Lehman Brothers filed for bankruptcy on September 15, 2008. One hundred forty failed in 2009, the greatest number of failures since 1992. More bank failures are expected. The Federal Deposit Insurance Corporation’s (FDIC) list of problem banks includes an additional 552 banks, up from 416 during the second quarter of 2009. Some insiders predict as many as 3,000 banks will fail over the next two years. Bank


3. See id.


failures have cost the FDIC billions of dollars and have depleted the FDIC's Deposit Insurance Fund (DIF).  

Troubled banks have attracted the attention of some private equity investors. These investors believe the combination of discounted asset prices and government guarantees against potential losses will allow failed banks to yield the return on investment that they demand.

However, federal regulations significantly restrict private equity investors' ability to invest in failed banks. Private equity investors eager to invest in failed banks hope federal bank regulators will lower the regulatory barriers to private equity investment in failed insured depository institutions. Thus far, however, private equity investors have received a mixed reception from bank regulators, who are concerned that private equity investors may cause more damage to an already battered industry. Nevertheless, the need for capital is too great to dismiss private equity completely, and bank regulators have taken a


10. See infra Part III, pp. 411-16; Jacobius, supra note 7.


12. See infra Part 2.A.


series of small steps towards allowing private equity investment in failed banks.\textsuperscript{17}

Beginning in the fall of 2008, a series of actions by the Federal Reserve Board (Board),\textsuperscript{18} the Office of the Comptroller of the Currency (OCC), and the FDIC lowered barriers for private equity investment in failed insured depository institutions.\textsuperscript{19} In the wake of these changes the FDIC, in its role as receiver of failed banks,\textsuperscript{20} received bids from private equity firms to acquire the assets and liabilities of failed banks.\textsuperscript{21} In two instances, the resolutions of IndyMac Bank F.S.B. (IndyMac) and BankUnited F.S.B. (BankUnited), the FDIC determined that a group of private equity investors were "appropriate" investors and allowed them to purchase a failed insured depository institution.\textsuperscript{22} In the press release announcing the resolution of BankUnited, the FDIC announced that it would issue guidelines to clarify its policy regarding private equity investment in failed banks.\textsuperscript{23}

In crafting its policy on the qualification for failed bank acquisitions, the FDIC attempted to balance the need for investment in the banking sector and its duty to minimize losses to the DIF.\textsuperscript{24} On July 2, 2009, the FDIC issued a Proposed Statement of Policy on Qualifications for Failed Bank Acquisitions (Proposed Policy Statement) for comment.\textsuperscript{25} After receiving sixty-one individual comment letters and 3,190 form letter comments, the FDIC issued a Final Statement of Policy (Final Policy

\textsuperscript{17} See Cadwalader, Private Equity, \textit{supra} note 14, at 1 (explaining bank regulators' responses to increased private equity interest in acquiring insured depository institutions).

\textsuperscript{18} Policy Statement on Equity Investments in Banks and Bank Holding Companies, 12 C.F.R. § 225.144 (2008).

\textsuperscript{19} See \textit{infra} Part II.B.


\textsuperscript{21} See Final Policy Statement, \textit{supra} note 16.

\textsuperscript{22} See Jacobius, \textit{supra} note 7.


Statement) effective August 26, 2009. Whereas the preceding actions by the Board, the OCC, and the FDIC easing restrictions on private equity investment in failed banks represented steps to facilitate private equity investment in failed banks, the Final Policy Statement adds new regulations on top of existing bank and thrift regulatory requirements. The Final Policy Statement allows private equity investment, but it also creates “significant restrictions” for such investment. The question remains, will the restrictions keep private equity investors from investing in failed insured depository institutions?

Part II of this Note discusses the regulatory barriers to private equity investment in failed banks and the recent actions by bank regulators prior to the promulgation of the Final Policy Statement that slightly eased them. Next, Part III explores the FDIC's motivations for encouraging increased private equity investments in failed banks and the two instances where the FDIC accepted bids from private equity investors before issuing the Final Policy Statement. The provisions of the Final Policy Statement, their differences from the Proposed Policy Statement, and the FDIC's response to comments to the Proposed Policy Statement are examined in Part IV. Then, Part V analyzes the trends in bank resolution since the promulgation of the Final Policy Statement, including acquisitions by groups of private equity investors.

28. See ARNOLD & PORTER LLP, ADVISORY: FDIC FINAL STATEMENT OF POLICY ON QUALIFICATIONS FOR FAILED BANK ACQUISITIONS 3 (Sept. 2009) [hereinafter Arnold & Porter].
29. See Cadwalader, Private Equity, supra note 14; Foley & Lardner, supra note 15; Demetriou et al., supra note 27.
31. See infra Part III, pp. 411-16.
II. THE LIMITS TO PRIVATE EQUITY INVESTMENT IN FAILED BANKS

A. Regulatory Restrictions

Two federal statutes regulate private equity investment in failed banks: the Bank Holding Company Act (BHCA)\(^\text{34}\) and the Change in Bank Control Act (CIBCA).\(^\text{35}\) Under both acts, an entity with control over a bank must register with the appropriate regulatory agency and be subject to the provisions of the corresponding act.\(^\text{36}\) The acts have different definitions of control\(^\text{37}\) and under each a control determination carries different consequences.\(^\text{38}\)

1. Control and its Implications under the BHCA

Any company with “control” over a bank is automatically a bank holding company and subject to the provisions of the BHCA.\(^\text{39}\) A “company” includes “any corporation, partnership, business trust, association, or similar organization.”\(^\text{40}\) There are three ways a company can have control over a bank.\(^\text{41}\) First, a company has control over a bank if it, “directly or indirectly . . . controls, or has power to vote [twenty-five] per centum or more of any class of voting securities of the bank.”\(^\text{42}\) Likewise, a company that “in any manner” controls the elections of the majority of directors or trustees of a bank exerts control over the bank.\(^\text{43}\) Finally, after due process proceedings, the Board may determine that a company exercises control over a bank.\(^\text{44}\)

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Controlling a bank requires registration as a bank holding company, and therefore being subject to the limitations of the BHCA and the accompanying Board regulations.45 The most significant limitation is that bank holding companies may only engage in activities closely related to banking.46 Thus, registering as a bank holding company would significantly limit a private equity firm’s ability to function by prohibiting it from investing in businesses not closely related to banking.47 Bank holding companies must also act as a “source of strength” for their subsidiary banks, which may require the bank holding company to make capital interventions or repay the FDIC for any losses the FDIC incurs as a result of troubled banks within the holding company.48 This provision means that private equity investors could be liable to the FDIC for losses from unrelated funds within a private equity firm.49

2. Control under CIBC

The CIBCA has wider applicability than the BHCA because its definition of “person” includes entities that do not qualify as a “company” or “bank” under the BHCA.50 A person has “control” of an insured depository institution if it has the “power . . . to direct management or policies of an insured depository institution” or the ability to vote twenty-five percent or more of any class of an insured depository institution’s voting securities.51 The consequence of control under CIBCA is that

46. 12 C.F.R. § 225.21(a).
47. See id.
49. See Private Equity Commenters, supra note 13, at 6 (arguing against the “source of strength” requirement).
notice must be given to the appropriate regulatory agency and that agency has sixty days to disapprove of any acquisition. Private equity firms seeking to acquire failed banks are both persons subject to the CIBCA and companies subject to the BHCA. An individual private equity investor, however, may qualify as a person under CIBCA, but not as a company under the BHCA.

B. Regulatory Actions Facilitating Private Equity Investments in Failed banks

A series of recent regulatory decisions has lowered the barriers to private equity investment in failed banks. First, in September 2008, the Board increased the percentage of equity that private investors may own without exerting “control” over the bank. Then, in November 2008, the OCC provided private equity investors a formal vehicle by which to bid for failed banks. Subsequently, the FDIC deepened the pool of potential investors who may bid on failed banks to include groups with a “shelf charter.”

The Board Policy Statement (Board Statement) regarding equity investment in banks and bank holding companies allows private equity investors to make larger investments and exert more influence in the governance and day-to-day policies and operations without exercising control over the bank. The Board Statement increases the amount that equity investors may own from twenty-

52. 12 U.S.C. § 1817(j)(7); 12 C.F.R. § 225.43.
56. 12 C.F.R. § 225.144.
57. Id.; Desai, supra note 50, at Part 2D (discussing the Board’s policy statement on equity investment in banks and bank holding companies).
five percent to thirty-three percent provided the investor does not own more than fifteen percent of any class of voting securities. The Board Statement permits, for the first time, private equity investors to hold as many as two seats on the board of directors without exerting a controlling influence. Finally, in a reversal of previous policy, the Board Statement allows minority investors to sit on committees and consult with management over the policies and operations of the bank.

Shortly thereafter, on November 21, 2008, the OCC implemented procedural changes facilitating non-bank bidding for failed bank assets when it granted the first “shelf charter” to Ford Group Bank. A “shelf charter” is a temporary, conditional bank charter, which remains inactive until an investor group is in a position to acquire a failed bank or its assets. It makes private equity bids more competitive because the preapproval allows non-bank investors to immediately acquire the deposits and assets of failed banks. Before the shelf charter, a non-bank investor would have to go through the charter approval process at the time of bidding. The lengthy charter approval process kept private equity firms from being able to immediately acquire deposits from the FDIC placing private equity firms at a disadvantage. In conjunction with the OCC’s use of shelf charters, the FDIC issued a “modified bidder qualification process,” on

58. 12 C.F.R. § 225.144.
59. Id.; Desai, supra note 50, at 396.
60. 12 C.F.R. § 225.144; Desai, supra note 50, at 396.
61. See Orrick, supra note 54, at 1; see also Press Release, OCC Approves Shelf Charter, supra note 54 (announcing the OCC’s first grant of a shelf charter); Cadwalader, Private Equity, supra note 14, at 1, 4-5, (describing the shelf charter process).
65. See id.; Subramanian, supra note 63, at 14.
November 26, 2008, expanding the pool of qualified bidders for failed, insured depository institutions.\textsuperscript{66} In the modified process, the FDIC will grant preliminary approval for deposit insurance based on abbreviated "information submissions and applications."\textsuperscript{67} The modifications allow entities without a bank charter, including those with shelf charters, to bid on assets and liabilities of failed banks.\textsuperscript{68}

By permitting increased private equity ownership in banks without triggering bank holding company status, and with the OCC and FDIC's expansion of the universe of bidders for failed banks, private equity investors are now more easily able to purchase and assume the assets and liabilities of failed banks.

III. MOTIVATIONS FOR INCREASED PRIVATE EQUITY INVESTMENT

A. \textit{The FDIC's Attraction to Private Equity}

One hundred sixty-nine banks have failed since the collapse of Lehman Brothers in September 2008,\textsuperscript{69} and analysts predict hundreds if not thousands of banks will fail in the next two years.\textsuperscript{70} Recent bank failures have steadily eroded DIF reserves,\textsuperscript{71} leaving the FDIC with a "significant need for capital."\textsuperscript{72}

The FDIC is attracted by the capital that private equity investors can inject into the banking industry\textsuperscript{73} so long as the investment will reduce the costs of bank failures to the DIF.\textsuperscript{74} The DIF is funded by assessments levied on deposits held by insured

\begin{itemize}
\item \textsuperscript{66} Press Release, FDIC Expands Bidder List, \textit{supra} note 55.
\item \textsuperscript{67} \textit{Id.}
\item \textsuperscript{68} \textit{Id.}; see also Womble Carlyle Sandridge & Rice, LLP, Womble Carlyle Client Alert: FDIC Expands Bidder List for Troubled Institutions (Dec. 04, 2008), \url{http://www.wcsr.com/client-alerts/}.
\item \textsuperscript{69} See Failed Bank List, \textit{supra} note 2.
\item \textsuperscript{70} See Jacobius, \textit{supra} note 7 (estimating 3,000 banks will eventually fail).
\item \textsuperscript{71} Brown, \textit{supra} note 5, at 16.
\item \textsuperscript{74} See 12 U.S.C. § 1823(c)(4) (2006) (requiring the FDIC to find the least cost method of resolution).
\end{itemize}
depository institutions\textsuperscript{75} and because private equity investment decreases costs to the DIF,\textsuperscript{76} private equity investment potentially reduces the assessments banks and thrifts will have to pay to restore it back within its mandated range.\textsuperscript{77} Thus, the FDIC is looking for private equity investors willing to work within "a well developed prudential framework [that] has long been the dominant form of ownership of insured depository institutions."\textsuperscript{78}

B. Private Equity Investment in Failed Banks Before the Proposed Policy Statement

Prior to issuing the Proposed Policy Statement, the FDIC twice awarded winning bids for assets and liabilities of failed depository institutions to private equity investors.\textsuperscript{79} IndyMac and BankUnited were sold to a consortium of private equity investors.\textsuperscript{80} Both consortia included private equity investors with banking experience, who professed the intention to grow extensive banking practices.\textsuperscript{81} Further, both transactions included loss-share agreements and special restrictions including heightened capital requirements.\textsuperscript{82} In its announcement of the BankUnited transaction, the FDIC announced its intention to issue guidelines

\textsuperscript{76} See 12 U.S.C. § 1823(c)(4).
\textsuperscript{77} See 12 U.S.C. § 1817(b).
\textsuperscript{78} Proposed Policy Statement, supra note 25 at 32,931-32. The framework includes measures aimed at maintaining well capitalized bank and thrift institutions, the ability and willingness to support banks facing difficulties, protections against insider transactions, and ensuring that managers have the knowledge and experience necessary to successfully operate a depository institution. Id.
\textsuperscript{80} See, e.g., Associated Press, supra note 79; McGeer, Florida Powerhouse?, supra note 79.
\textsuperscript{81} See, e.g., Associated Press, supra note 79.
for private equity investment in failed banks and thrifts. The resolutions of IndyMac and BankUnited thus provided a partial blueprint for the FDIC’s policy on private equity investment in failed banks.

1. The IndyMac Resolution

The sale of IndyMac to a group of private equity investors was the first sale of a failed bank to a non-banking entity during the current financial crisis. The IndyMac failure in July 2008 was the “second-largest financial institution failure in U.S. history” and led to the most expensive failure of the current financial cycle to date. IndyMac included amongst its $32 billion in assets: $6.5 billion in deposits, a large loan servicing business, and a reverse mortgage business. After the FDIC closed the bank, it was held in receivership and run by the FDIC for six months before being sold by the FDIC to a consortium of private equity investors and rebranded as OneWest Bank F.S.B. (OneWest).

The investment group included experienced investors with experience running banks. J.C. Flowers, through his private equity firm J.C. Flowers & Co., joined lead private equity investor Dune Capital Management, and four other private equity or hedge funds. Flowers is a seasoned private equity investor who has

86. See Bonnie McGeer, Florida Powerhouse?, supra note 79 (reporting Jones Day partner, Ralph MacDonald, estimated that the failure would cost the FDIC $10.7 billion).
87. Associated Press, supra note 79.
89. Press Release, Sale of IndyMac, supra note 82.
90. Associated Press, supra note 79.
been making private equity investments in banks since 2000 and
currently has bank holdings on three continents.  

The sale of IndyMac included a “loss-share” provision. In a “loss-share” provision the FDIC agrees to “absorb a portion of
the loss on a specified pool of assets in order to maximize asset
recoveries and minimize FDIC losses.” Loss-share agreements
are traditionally entered into for commercial real estate and
residential mortgage loans. While the full amount of expected
losses is counted against the DIF reserves, “loss sharing reduces
the immediate cash needs of the FDIC.” Because the FDIC
accounts for the full amount of its expected losses against its
reserves at the time of the agreement, the FDIC benefits if losses
are less than expected because then it will not need all of the
reserves it has set aside to cover the cost of the failure. Under
the terms of the IndyMac transaction, OneWest will assume the
first twenty percent of losses, and the FDIC will assume “eighty
percent of the next ten percent of losses and ninety-five percent of
losses thereafter.”

2. BankUnited

The purchase and assumption agreement entered into
between the FDIC and a consortium of private equity investors in

91. William D. Cohan, Checkmate for a Wall Street Wizard, FORTUNE, Sept. 14,
bank in Missouri, in his individual capacity in order to avoid restrictions the FDIC
might place on private equity firms’ ownership of banks. See Lipton, supra note 24.

92. FDIC, Shared Loss Agreement Between the FDIC as Receiver for IndyMac
Federal Bank, FSB and OneWest Bank, FSB (Mar. 19, 2009), www.fdic.gov/about/
freedom/IndyMacSharedLossAgrmt.pdf [hereinafter IndyMac Shared Loss Agreement].

dividual/failed/lossshare/index.html (last updated Sept. 28, 2009).

94. Id.

95. Id.

96. Id.

97. Id.

98. IndyMac Shared Loss Agreement, supra note 92, at 7; Wukowski & Davies,
supra note 85.

99. Press Release, BankUnited, supra note 23 (listing WL Ross & Co. LLC,
Carlyle Investment Management L.L.C., Blackstone Capital Partners V L.P.,
Centerbridge Capital Partners, L.P., LeFrak Organization, Inc, The Wellcome Trust,
the resolution of BankUnited was the first instance when private equity investors were able to assume the assets of an insured depository institution from the FDIC immediately after its closing.\textsuperscript{100} With $13 billion in assets, BankUnited was the "fourth-largest thrift ever to fail,"\textsuperscript{101} and behind IndyMac, the second most expensive resolution of 2009.\textsuperscript{102} The resolution is estimated to have cost the FDIC $5 billion.\textsuperscript{103} It was a factor in the FDIC's special assessment to help replenish the DIF in May 2009.\textsuperscript{104} Like in the IndyMac resolution, the consortium of investors in the BankUnited deal included investors with experience running banks and a loss-share provision.

The consortium of investors led by chairman and CEO of the recapitalized BankUnited, John Kanas, a veteran banker, and senior advisor to investment firm W.L. Ross & Co., agreed to assume $12.7 billion of BankUnited's assets and $8.3 billion in non-brokered deposits.\textsuperscript{105} Kanas is the former chairman and CEO of North Fork Bank, originally a small bank in New York that he grew to $60 billion in assets, before selling it to Capital One Financial Corp. for $13.2 billion in 2006.\textsuperscript{106} His presence in the deal was deemed as "crucial" in making the deal palatable to both regulators and investors because of his experience growing banks and working with bank regulators.\textsuperscript{107}

Under the terms of the deal, the new investors assumed the deposits at a $3 billion discount,\textsuperscript{108} and promised to recapitalize the thrift with $900 million in fresh capital.\textsuperscript{109} The discount reflected the low quality of the assets the investors assumed.\textsuperscript{110} Real-estate loans accounted for $10.1 billion or 98.2% of the thrift's loan

\textsuperscript{100} McGeer, \textit{Logjam}, \textit{supra} note 84.
\textsuperscript{101} Adler, \textit{Fla.'s BankUnited Fails}, \textit{supra} note 88, at 3.
\textsuperscript{102} \textit{Id.}; see McGeer, \textit{Florida Powerhouse?}, \textit{supra} note 79.
\textsuperscript{103} Adler, \textit{Fla.'s BankUnited Fails}, \textit{supra} note 88, at 3.
\textsuperscript{104} \textit{See id.}
\textsuperscript{105} McGeer, \textit{Logjam}, \textit{supra} note 84.
\textsuperscript{106} See McGeer, \textit{Florida Powerhouse?}, \textit{supra} note 79.
\textsuperscript{107} \textit{Id.}
\textsuperscript{108} \textit{Id.}
\textsuperscript{109} \textit{Id.}; Adler, \textit{Fla's BankUnited Fails}, \textit{supra} note 88, at 3.
\textsuperscript{110} McGeer, \textit{Florida Powerhouse?}, \textit{supra} note 79.
portfolio. No investor will own more than a 24.9% stake in the bank, allowing the investors to avoid being designated a bank holding company. The loss-share agreement covered $10.7 billion in assets. The team plans to alter BankUnited’s strategy to become more like a commercial bank. While BankUnited will remain a thrift, it will focus on offering its residential mortgages to a more localized market, growing its commercial business, and looking for opportunities for continued expansion.

Prompted by increased interest of private equity firms in investing in failed insured depository institutions and guided by its experiences from the IndyMac and BankUnited resolutions the FDIC announced its intention to promulgate guidelines for future private equity investment in failed banks.

IV. THE FDIC’S FINAL POLICY STATEMENT ON PRIVATE EQUITY INVESTMENT IN FAILED BANKS

Slightly more than a month later, on July, 9 2009, the FDIC issued a proposed policy statement regarding requirements for failed bank acquisitions. In a press release accompanying the Proposed Policy Statement, FDIC chairwoman Sheila Bair described the statement’s goals as: to maximize the prices the FDIC receives for failed bank assets, to minimize losses to the DIF, and to keep failed institutions from failing again. She also stressed the importance of bank owners having the experience,

111. Id.
112. Id.
113. McGeer, Logjam, supra note 84.
114. Adler, Fla’s BankUnited Fails, supra note 88, at 3; McGeer, Florida Powerhouse?, supra note 79 (stating that the FDIC will pay eighty percent of the first $4 billion in loan-losses and ninety five percent of any additional losses).
116. Id.
117. See Press Release, BankUnited, supra note 23.
118. Proposed Policy Statement, supra note 25, at 32.931 (stating the intention of the policy statement was to provide guidance regarding the terms and conditions for investment and acquisitions).
119. Press Release, Sheila Bair’s Statement, supra note 82.
competence, and willingness to run the bank in a prudent manner while supporting their banks when they face difficulties and protecting the banks from insider transactions. In other words, she expressed that the FDIC welcomed private equity investment within the well-developed framework that has been the dominant form of bank ownership.

The Proposed Policy Statement establishes standards providing for: capital support of the acquired depository institution, cross support for substantially commonly owned deposit institutions, limits on transactions with affiliates, maintaining continuity of ownership, placing clear limits on the use of secrecy law jurisdictions for channels of investment, limitations on whether existing investors in an institution could bid on it if it failed, and disclosure commitments. The FDIC called for public comment on nine specific issues as well as on the Proposed Policy Statement as a whole. Chairman Bair acknowledged the difficulties of striking the correct balance with regard to the FDIC’s goals, but believed it was a “good solid document.”

Not everyone agreed with Chairwoman Bair’s assessment of the proposal. Two of the FDIC’s five-member board of directors, Comptroller of the Currency John Dugan and Acting Director of the Office of Thrift Supervision John Bowman, voted against issuing the Proposed Policy Statement. Dugan thought the Proposed Policy Statement placed too many restrictions on private equity investors. Private equity investors agreed. Wilbur Ross, a billionaire private equity investor who invested in BankUnited, called the restrictions “harsh and discriminatory” and said the provisions “could guarantee that there [would] be no

120. Id.
121. See Proposed Policy Statement, supra note 25, at 32,931-32.
122. Id. at 32,931.
123. Id.
125. Crittenden, supra note 72.
126. Id.
127. See Sarkozy & Quarles, supra note 73; see Private Equity Commenters, supra note 13.
more private equity coming into banks.”

Private equity investors were particularly concerned with the capital requirement, source of strength, cross guarantee, and holding period provisions of the Proposed Policy Statement.

The FDIC received sixty-one individual comment letters and 3,190 form letter comments in response to the Proposed Policy Statement. While comment letters were sent by a variety of stakeholders, the majority of the comments were sent by private capital firms or their representatives. After the comment period, the FDIC issued the Final Policy Statement, effective August 26, 2009.

The Final Policy Statement eliminates the “source of strength” provision from the Proposed Policy Statement and softens the capital requirements and cross support provisions. Additionally, it keeps other provisions meant to encourage sound banking practices the same, but provides further clarification on other provisions.

The Final Policy Statement applies to private investors seeking to invest in the assets or liabilities connected with the resolution of a failed insured depository institution and to applicants for federal deposit insurance for “de novo” charters issued in connection with the failed bank resolutions.

The FDIC “strongly encourages” certain types of non-controlling private equity investment by exempting them from the provisions of the Final Policy Statement. In particular, the Final Policy Statement exempts private equity investors who form partnerships with and

129. Memorandum from Valerie Best, Assistant Executive Secretary, FDIC, Summary of Recommendations Made at the August 5, 2009 Meeting with Private Equities' Representatives to the File (Aug. 24, 2008), www.fdic.gov/regulations/laws/federal/2009/09c63AD47.PDF; see Final Policy Statement, supra note 16, at 45,442; Private Equity Commenters, supra note 13 (commenting on behalf of private equity firms).
131. Id. at 45,441.
132. Id. at 45,446.
133. Id. at 45,447-49.
134. Id. at 45,448.
135. Id. at 45,448.
yield management control to existing reputable bank and thrift holding companies.\textsuperscript{136}

\textbf{A. The Final Policy Statement Eliminates the Source of Strength Requirement}

The Final Policy Statement eliminates the source of strength requirement from the Proposed Policy Statement.\textsuperscript{137} The Proposed Policy Statement would have required “investors[‘] organizational structures” to serve as a source of strength for their subsidiary institutions.\textsuperscript{138} Private equity investors strongly opposed the provision because it would make them potentially liable for amounts exceeding the capital they invested, even though as non-controlling investors they would lack the power to unilaterally take actions to prevent or remedy problems which may give rise to the need for additional capital.\textsuperscript{139}

\textbf{B. The Final Policy Statement Modifies the Most Onerous Provisions of the Proposed Policy Statement}

\textbf{1. Capital Requirements}

The Final Policy Statement requires depository institutions acquired by failed banks to maintain a leverage capital ratio of Tier 1 common equity to total assets of at least ten percent for three years from the time of acquisition.\textsuperscript{140} The increased capital requirements are designed to create a capital cushion with which a bank may absorb losses during its first years of operation, but the ten percent capital ratio minimum is slightly less than double the

\textsuperscript{136} Final Policy Statement, \textit{supra} note 16, at 45,448. The Final Policy Statement also exempts \textit{de minimis} investors—those holding five percent or less of the total voting power and private equity investors making investments in an insured depository institution or its holding company that has maintained a composite CAMELS 1 or 2 rating continuously for seven years. \textit{Id.}

\textsuperscript{137} Final Policy Statement, \textit{supra} note 16, at 45,446.

\textsuperscript{138} Proposed Policy Statement, \textit{supra} note 25, at 32,931.

\textsuperscript{139} See Private Equity Commenters, \textit{supra} note 13.

\textsuperscript{140} Final Policy Statement, \textit{supra} note 16, at 45,448. (defining Tier 1 common equity as “Tier 1 capital minus non-common equity elements”).
Tier 1 ratio to which traditional bankers are subject.\textsuperscript{141} If the Tier 1 ratio drops below ten percent during the first three years, the bank is subject to prompt corrective action.\textsuperscript{142} Though the ten percent ratio was modified from the Proposed Policy Statement, which called for a Tier 1 ratio of fifteen percent, the modifications do not go as far as private equity investors who opposed the heightened capital requirement had advocated.\textsuperscript{143}

Private equity investors expressed concern that heightened capital commitments will place them at a competitive disadvantage in bidding for failed banks compared to existing subsidiaries of banks, thrifts, and holding companies, which must maintain a Tier 1 leverage ratio of only five percent.\textsuperscript{144} They argue this will force them to take increased risks to meet their required rate of return.\textsuperscript{145} The FDIC justified its heightened capital requirements by citing the fact \textit{de novo} institutions, those which were in existence for seven years or less, are overrepresented on the failed bank list for the years 2008 and 2009.\textsuperscript{146}

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\textsuperscript{141} Sarkozy & Quarles, \textit{supra} note 73.
\textsuperscript{142} Final Policy Statement, \textit{supra} note 16, at 45,448.
\textsuperscript{143} See Proposed Policy Statement, \textit{supra} note 25, at 32,933 (proposing a required fifteen percent Tier 1 capital ratio); Best, \textit{supra} note 129 (summarizing private equity investors' suggestions on lowering the heightened capital provisions); Private Equity Commenters, \textit{supra} note 13, at 4 (commenting that heightened provisions will place private equity firms at a competitive disadvantage bidding against existing banks and advocating for a five percent capital ratio).
\textsuperscript{144} Arnold & Porter, \textit{supra} note 28.
\textsuperscript{145} See e.g., Final Policy Statement, \textit{supra} note 16, at 45,440 (Noting that the most common capital ratio recommended by commenters was eight percent, the same ratio \textit{de novo} banks are required to maintain; more hawkish private equity investors suggested a six percent leverage ratio.); Michael R. Crittenden & Peter Latman, \textit{Rules Eased on Bank buyouts --- Hurdles Lowered for Private-Equity Firms in Bid to Drum Up New Rescuers}, WALL ST. J., Aug. 27, 2009 at A1 (discussing private equity firm's lobbying efforts against the Proposed Policy Statements); see Flitter, \textit{supra} note 124, at 1. Wilbur Ross reacted to the proposed capital requirements as follows:
\end{flushright}

We are being asked to take on the risks of a bank that's already failed once, to provide new capital so that it reduces the amount of capital the government has to put in, to introduce new management and possibly enter into loss-sharing, and then as a reward for all that you're condemned to a mediocre rate of return because they've forced you to overcapitalize it.

\textit{Id.}

\textsuperscript{146} Final Policy Statement, \textit{supra} note 16, at 45,446.
2. Cross Support

The Final Policy Statement scales back from the Proposed Policy Statement instances where cross support is required by investors owning part of two or more insured depository institutions. The cross support provision is meant to ensure a strong parent company. The Proposed Policy Statement called for investors owning a majority of the direct or indirect investments in more than one insured depository institution to pledge to the FDIC their proportionate interest in each institution to cover any losses to the FDIC from the resolution of, or assistance provided to, any other such institution. The Final Policy Statement requires cross support when investors have eighty percent common ownership, not simply a majority, of ownership of two or more banks, and aligns the Final Policy Statement with the common ownership requirement threshold for banks to avoid Regulation W.

The modification occurred in response to strong objections to the terms in the Proposed Policy Statement from private equity investors. Commenters argued that the provision would deter private capital investment and lead to less competitive bids for failed depository institutions because investors would not put their other investments at risk and the provision would hinder private equity managers’ ability to invest in “two different depository institutions through two different funds with two different sets of investors.” The effect would be to make investments by a consortium of investors, known as “club” deals, more difficult because there are a limited number of private equity investors interested in purchasing failed banks leading to a high possibility of a majority overlap in ownership, thereby triggering the

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147. Id. at 45,448-49.
148. Adler, FDIC to take Second Look, supra note 124.
151. See Private Equity Commenters, supra note 13, at 7.
152. See Id. (objecting to the cross support provision); see generally, Proposed Policy Statement, supra note 25, at 32,931 (calling for comments in regards to the cross-guarantee provision).
provision. The FDIC retained the flexibility to waive the cross support provision if enforcing it would not reduce the costs to the bank or DIF.


The FDIC wants private equity investment in failed banks and thrifts, but only to the extent it is consistent with safe and sound banking principles. The Final Policy Statement retained provisions that promote stability and transparency, protect banks from insider transactions, and prohibit investors in a failed depository institution from purchasing assets and liabilities of that failed depository institution.

1. **Continuity of Ownership**

The Final Policy Statement, like the Proposed Policy Statement, encourages stability and long-term investment in banks by prohibiting non-exempt investors from selling or otherwise transferring their shares for three years following their acquisition, absent prior approval from the FDIC. Private equity commenters objected to the required holding period, which was longer than previous private equity deals. For example, the BankUnited sale included an eighteen-month holding period. Private equity investors are concerned that the longer holding period will limit the investment’s return, which is measured as a function of time, and also decrease their “flexibility to raise capital.”

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154. See Private Equity Commenters, *supra* note 13, at 7-9; see also Cadwalader, Private Equity, *supra* note 14 (arguing the Proposed Policy Statement “hesitantly” welcomes “club” deals between private equity firms).
156. *Id.* at 45,440.
157. *See id.* at 45,448-49.
158. *Id.* at 45,449 (describing how mutual funds are exempted from the Final Policy Statement).
159. See Private Equity Commenters, *supra* note 13, at 11.
Private equity investors questioned whether the holding period prohibited them from offering shares at a public offering during the holding period, but the FDIC declined to offer further guidance regarding this issue in the Final Policy Statement. The FDIC did slightly modify the Proposed Policy Statement to state that "its approval will not be unreasonably withheld in the case of transfers to affiliates."

2. Secrecy Law Jurisdictions

In an effort to increase transparency, the Final Policy Statement, like the Proposed Policy Statement, prohibits bidders investing in failed banks from "employing ownership structures utilizing entities domiciled in bank secrecy jurisdictions." The Final Policy Statement defines a secrecy law jurisdiction as any "country that applies a bank secrecy law that limits U.S. bank regulators' ability to determine if the bank is in compliance with applicable laws and regulations." The FDIC exempts investors subjected to the Board's "comprehensive consolidated supervision" from the investment ban. Such an agreement "essentially" requires investors to "forgo the bank secrecy protection afforded by the entity's jurisdiction of domicile." It would also allow the FDIC to sufficiently carry out its supervisory and enforcement duties. Private equity investors argued that a prohibition of the use of secrecy law jurisdictions obstructs private equity investors in their efforts to achieve tax efficiency. From the perspective of the FDIC, its need to carry out its duties trumps private equity investors' desire to maximize profits.
3. Prohibition of “Silo” Structures

The Final Policy Statement clarifies that the FDIC will not approve bids with “silo” ownership structures.172 “Silo” structures are characterized by “[c]omplex and functionally opaque ownership structures” where the benefits of ownership and decision-making powers are not clear.173 These ownership structures “typically involve a private equity firm (or its sponsor) that create multiple investment vehicles funded and apparently controlled by the private equity firm (or its sponsor) to acquire ownership of an insured depository institution.”174 The FDIC is “concerned” that silo structures are used by private equity investors to “artificially separate the non-financial activities of the firm from its banking activities”175 in an effort to “avoid becoming a bank holding company.”176

Many advocates for private equity investment, on the other hand, oppose the “blanket prohibition of ‘silo’ structures as acquisition vehicles.”177 In response to the request for comment on the Proposed Policy Statement, Dory Wiley, President and Chief Executive Officer of Commerce Street Capital, acknowledged some silo structures are created to avoid regulation but proposed that silo structures willing to meet transparency requirements and willing to “submit” to the regulations of the BHCA be allowed to purchase failed banks.178 Other private equity commenters opposing a blanket prohibition of silo structures noted bifurcated ownership and control is characteristic of many categories of institutional investors and argued it should not be “a reason to disqualify potential bidder[s][.]”179 A third group of commenters argued against a strict prohibition because of a lack of an “agreed-
upon definition . . . of what constitutes a ‘silo’ structure." Nevertheless, the FDIC is unwilling to approve such “complex and functionally opaque” ownership structures.

4. Insider Transactions

Protecting the banking industry from insider transactions was a primary concern of the FDIC in crafting the Final Policy Statement. Consequently, the Final Policy Statement prohibits insured depository institutions acquired under its provisions from extending “credit to [the] [i]nvestors, their investment funds if any, and any affiliates of either.” An “affiliate” is any company in which the investor or investment fund owns or has held at least ten percent of the equity for at least thirty days. The Final Policy Statement requires investors to make regular reports of their affiliates to the acquired insured depository institution.

Although some commenters proposed easing the ban on transactions to affiliates, many private equity investors were already offering to comply with a ban on transactions with affiliates. The Final Policy Statement indicates the FDIC views its prohibitions against insider transactions and efforts to impede the FDIC from carrying out its supervisory and enforcement duties as non-negotiable.

5. Special Owner Bid Limitations

The Proposed Policy Statement makes investors holding ten percent or more equity in a failed insured depository

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180. Id.
182. See Press Release, Sheila Bair’s Statement, supra note 82.
183. Final Policy Statement, supra note 16, at 45,449 (exempting existing extensions of credit by insured depository institutions acquired by investors from the Final Policy Statement).
184. Id.
185. Id. at 45,449.
186. Id. at 45,444.
188. See Final Policy Statement, supra note 16, at 45,440.
institutions ineligible to bid on the assets or liabilities of that failed institution. One commenter urged the FDIC to be more aggressive towards investors of failed insured depository institutions and recommended a permanent ban on private equity investors who owned ten percent or more of any failed insured depository institution. In contrast, Dory Wiley, President and Chief Executive Officer of Commerce Capital L.L.C., proposed that the eligibility determination should be made on a case-by-case basis by looking at factors such as whether the investor was an active or passive investor in the failed institution. The Final Policy Statement, like the Proposed Policy Statement, adopted a policy whereby under no circumstances may an investor owning ten percent or more equity of a failed depository institution bid on the assets or liabilities of that institution.

6. Disclosure

The Proposed Policy Statement required covered investors to submit to the FDIC information about its entire chain of ownership including the size of the capital fund(s), its diversification, return profile, marketing documents, management team, and business model. Additionally, further disclosures are required for entities in the ownership chain as the FDIC determines is necessary. The Final Policy Statement adopted the disclosure requirement from the Proposed Policy Statement and clarified that the FDIC will treat confidential information submitted in compliance with the policy statement as confidential business knowledge.

191. See Wiley, supra 176.
195. See id. at 45,447-49.
V. PRIVATE EQUITY INVESTMENT AFTER THE FINAL POLICY STATEMENT

Because the Final Policy Statement was issued in August 2009, it is premature to make a dispositive claim as to the effects of the Final Policy Statement. However, seventy-five insured depository institutions have failed in the interim and trends have started to emerge. First, the FDIC continues to sell the majority of its failed banks to existing banks. A second trend is that both the FDIC and private equity investors have looked for innovative ways to meet their needs. Third, investor groups buying one bank are likely to buy another.

The FDIC has entered into purchase and assumption agreements with healthy banks in the majority of resolutions since the Final Policy Statement became effective. When the FDIC is unable to find a buyer for the assets it either forms a Deposit Insurance National Bank to facilitate the winding down of the bank, creates a bridge bank for the continued operation of the bank, or liquidates the bank. No banks were assumed in 2009 after the issuance of the Final Policy Statement by private equity investors, however, more recently there have been signs that the FDIC is serious about

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198. See Failures and Assistance Transactions, supra note 4.
allowing private equity investor groups to purchase failed banks.\textsuperscript{202} In January 2010, Bond Street Bank, a wholly owned subsidiary of Bond Street Holdings LLC, became the first private-equity group to use an OCC shelf charter to assume assets and liabilities of a failed insured depository institution when it bought Premier American Bank in Florida.\textsuperscript{203} After using its shelf charter to purchase Premier American Bank, the investment group purchased a second bank with their charter, Florida Community Bank, which had closed January 29, 2010.\textsuperscript{204} Similar to the IndyMac and BankUnited deals, the investment group included experienced bankers.\textsuperscript{205} The new chairman and Chief Executive Officer, Dan Healy, was the Chief Financial Officer at NorthFork Bank, the same bank where John Kanas of BankUnited was Chairman and CEO.\textsuperscript{206} A second private equity investor group led by Patrick Frawley, a former bank regulator and turnaround specialist, used a Georgia state charter it had gained through Community & Southern Bank, to acquire First National Bank of Georgia.\textsuperscript{207} According to one analyst these deals signal either that private equity bidders are bidding more or there are less bidders at the table overall.\textsuperscript{208} The deals may also be the natural result of a learning period as private equity investors and the FDIC learn to accommodate one another.\textsuperscript{209}

The FDIC has also continued to look for innovative approaches to resolving failed banks at the least possible cost to the DIF. The resolution of Corus Bank (Corus), a Chicagoland
bank that failed in September 2009, provides an example. Believing it would "attract different groups of bidders" and higher prices, the FDIC conducted a split auction for Corus's assets and deposits. First, the FDIC entered into a purchase and assumption agreement with MB Financial in which MB Financial assumed about $7 billion in deposits and $3 billion in other assets from Corus. Second, in a separate auction the FDIC sold the real-estate assets. The assets, a portfolio of mostly performing and non-performing construction loans and real-estate owned assets were bought by a consortium led by commercial real-estate investment developers, Starwood Capital Group. Thus, the resolution of Corus provides not only example of a novel method used by the FDIC, but also shows how private equity firms can invest in real-estate loan portfolios without investing in the chartered institution.

More recently, the FDIC created a joint venture with Colony Capital Acquisitions LLC (Colony) for $1 billion in troubled real-estate loans. Colony "paid $90.5 billion for a forty percent stake" in the venture.

Another example of an alternative approach taken by the FDIC and an example of investors attempting to work around regulations, occurred while the Final Policy Statement was still being crafted. The FDIC allowed Joe Evans, a Georgia-based banker, to capitalize the $35 million-asset State Bank and Trust Co. with $300 million raised from twenty-six institutional


211. See id.

212. See id.

213. See id.


215. See Jacobius, supra note 7 (discussing real-estate money managers' interest in the real-estate loan portfolios of struggling or failed insured depository institutions).

216. Associated Press, supra note 79.

investors\textsuperscript{218} and to acquire control over eighty-six percent of the failed Security Bank Corp.'s $2.8 billion in assets.\textsuperscript{219} One commentator gave the FDIC credit for being "innovative" in its approach to bank capitalization.\textsuperscript{220} However, critics of the deal note that such "club" deals, are structured so that none of the investors would own more than a 9.9% stake in the bank, allowing them to avoid filing with the appropriate bank regulator.\textsuperscript{221} One reason that the FDIC may have been comfortable approving the State Bank and Trust Co. deal is because, similar to investors in the IndyMac and BankUnited deals, Evans had run banks the size that he purchased and was known by the FDIC.\textsuperscript{222}

A third trend emerging after the issuance of the Final Policy Statement is that banks recapitalized by investors are buying other banks.\textsuperscript{223} Recapitalized OneWest assumed $4.5 billion in deposits from the failed First Federal Bank of California.\textsuperscript{224} Likewise, Joe Evans' State Bank and Trust Company has purchased the assets of two more failed banks since the Security Bank Corp. deal.\textsuperscript{225} Premier American Bank, which was recapitalized by Bond Street Holdings, assumed the deposits of

\textsuperscript{218} Joe Adler, \textit{FDIC, Buyers Get Creative With Failures}, \textit{Am. Banker}, July 28, 2009, at 1, \textit{available at} 2009 WLNR 14429036 (specifying that no private equity investors were included in the investment group).
\textsuperscript{219} Id.
\textsuperscript{220} Id.
\textsuperscript{221} See id.
\textsuperscript{222} Id.
\textsuperscript{224} Press Release One West Bank, \textit{supra} note 223.
Florida Community Bank. In the public sector, MB Financial Bank raised $175 million in a secondary offering to help finance its purchases of assets and liabilities from four failed Illinois banks.

VI. CONCLUSION

The FDIC's Final Policy Statement is one piece of an evolving framework governing private equity investment in failed banks. Whereas the actions by the Board, OCC, and FDIC preceding the issuance of the Proposed and Final Policy Statements eased restrictions on private equity investment in failed insured depository institutions, the Final Policy Statement adds additional regulations on private equity investment. The Final Policy Statement represents an attempt by the FDIC to reconcile the banking sector's need for capital and the FDIC's duty to protect the DIF. The Final Policy Statement aims to encourage "appropriate" private equity investment, meaning investment "consistent with the . . . basic elements of insured depository institution ownership." To that end, the Final Policy Statement encourages private equity funds to invest in failed banks through partnerships with existing bank holding companies, through _de minimis_ investments, or through investment in strong


228. See _supra_ Part II.

229. See generally _Final Policy Statement, supra_ note 16 at 45,440 (issuing guidelines for private equity investment in failed insured depository institutions).

230. See _supra_ Parts III-IV; Crittenden & Lattman, _supra_ note 145.

bank holding companies.\textsuperscript{232} Private equity investors making non-exempt bids for failed banks face significant restrictions on their investment, placing such bids at a competitive disadvantage compared to traditional banks.\textsuperscript{233} In particular non-exempt investors face heightened capital requirements, a possible duty to provide cross support, a mandatory three-year holding period, and other provisions meant to promote the safety and soundness of the banking industry.\textsuperscript{234}

Despite the Final Policy Statement's restrictions, private equity investors have been able to acquire failed insured depository institutions.\textsuperscript{235} The FDIC will have the opportunity to reevaluate the final provisions of the Final Policy Statement, its effect encouraging or discouraging private equity investment in failed banks, and the desirability of private equity investment as a whole.\textsuperscript{236} When it does, it will do so against the backdrop of a banking industry that has continued to deteriorate since the Final Policy Statement was issued. The number of banks on the FDIC's problem bank list has grown, new bank failures continue, and the DIF now has negative reserves.\textsuperscript{237} However, it remains to be seen whether the FDIC will ease restrictions on private equity investment in failed banks.\textsuperscript{238}

The two private equity acquisitions of bank charters in January 2010 may signal a new-found willingness by the FDIC to work with private equity investors.\textsuperscript{239} In reality, however, it is more likely that the acquisitions resulted from private equity investors adjusting to meet the requirements of the FDIC. Based on the incremental changes between the Proposed Policy Statement and the Final Policy Statement, and because the FDIC

\begin{footnotesize}
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\item \textsuperscript{232} Id. at 45,448.
\item \textsuperscript{233} See id. at 45,449.
\item \textsuperscript{234} Id. at 45,448-49.
\item \textsuperscript{235} See Press Release, Premier Am. Bank, supra note 226.
\item \textsuperscript{236} Final Policy Statement, supra note 16, at 45,448.
\item \textsuperscript{237} Brown, supra note 5, at 16.
\item \textsuperscript{238} See Final Policy Statement, supra note 16, at 45,448-49.
\item \textsuperscript{239} See Fajt & Adler, supra note 203; Trubey, supra note 207.
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is most focused on attracting the right types of investment, it is unlikely that FDIC will significantly alter the provisions of the Final Policy Statement in the near future.

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