Razor Alert

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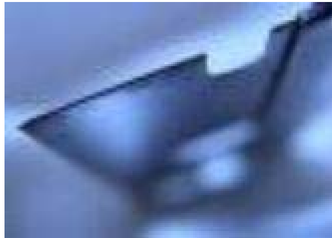

FED and FDIC Guidelines for Private Equity Investments in Banks

The Fed has issued and the FDIC has proposed guidelines for investments in banking organizations which will affect all investors with a special impact on private equity funds.

FDIC Proposals to Guidelines for Investments in Failed Banks and the Role of Private Equity

The FDIC has issued for comment a Proposed Policy Statement for standards for bidder eligibility in connection with the resolution of failed insured depository institutions, which provide for:

- capital support of the acquired depository institution;
- agreement to a cross guarantee over substantially commonly owned depository institutions;
- limits on transactions with affiliates;
- maintenance of continuity of ownership;
- clear limits on secrecy law jurisdiction vehicles as the channel for investments;
- limitations on whether existing investors in an institution could bid on it if it failed; and
- disclosure commitments.

Capital Commitment: Investors would be expected to agree to cause the depository institution acquiring deposit liabilities, or both liabilities and assets, from a failed depository

institution in receivership to be initially capitalized at a minimum --15 percent Tier 1 leverage ratio for a period of 3 years or longer and at least at a "well capitalized" level during the remaining period of their ownership. Failure to keep an institution at this level would mean the institution is treated as undercapitalized and the regulators would take prompt corrective action.

Source of Strength: Investors organizational structures would be expected to agree to serve as a source of strength for their subsidiary depository institutions. Source of strength commitments under this paragraph are to be supported by the agreement of the depository institution holding company in which the Investors have invested that holds the stock of such depository institutions to sell equity or engage in capital qualifying borrowing.

Cross Guarantees: Investors whose investments, individually or collectively, constitute a majority of the direct or indirect investments in more than one insured 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 assistance provided to, any other such institution.

Transactions with Affiliates: All extensions of credit to Investors, their investment funds if any, any affiliates of either, and any portfolio companies (i.e., companies in which the Investors or affiliates invest) by an insured depository institution acquired or controlled by such Investors under this policy statement would be prohibited.

Secrecy Law Jurisdictions: Investors employing ownership structures utilizing entities that are domiciled in bank secrecy jurisdictions would not be eligible to own a direct or indirect interest in an insured depository institution unless the Investors are subsidiaries of companies that are subject to comprehensive consolidated supervision ("CCS") as recognized by the Federal Reserve Board, and they execute agreements on the provision of information to the primary federal regulator about the non-domestic Investors' operations and activities; maintain its business books and records (or a duplicate) in the U.S.; consent to the disclosure of information that might be covered by confidentiality or privacy laws and to cooperate with the FDIC, if necessary, in obtaining information maintained by foreign government entities; consent to jurisdiction and designation of an agent for service of process; and consent to be bound by the statutes and regulations administered by the appropriate U.S. federal banking agencies.

Continuity of Ownership: Investors subject to this policy statement would be prohibited from selling or otherwise transferring securities of the Investors' holding company or depository institution for a 3 year period of time following the acquisition absent the FDIC's prior approval. This time period is consistent with the current de novo business plan change approval and other requirements in FDIC Deposit Insurance Orders. The FDIC does not expect to approve any sale to a private capital investor during such 3 year period unless the buyer agrees to be subject to the same conditions that are applicable under this policy statement to the selling Investor.

Special Owner Bid Limitation: Investors that directly or indirectly hold 10 percent or more of the equity of a bank or thrift in receivership would not be considered eligible to be a bidder to become an investor in the deposit liabilities, or both such liabilities and assets, of that failed depository institution.

Disclosure: Investors would be expected to submit to the FDIC information about the Investors and all entities in the ownership chain including such information as the size of the capital fund or funds, its diversification, the return profile, the marketing documents, the

management team and the business model. In addition, Investors and all entities in the ownership chain will be required to provide to the FDIC such other information as is determined to be necessary to assure compliance with this policy statement.

Issues Raised:

1. The proposed policy statement would be applied to (a) private capital investors in certain companies, proposing to assume deposit liabilities, or both such liabilities and assets, from a failed insured depository institution in receivership (including all entities in such an ownership chain) and to (b) applicants for insurance in the case of de novo charters issued in connection with the resolution of failed insured depository institutions (hereinafter “Investors”).

2. So-called “silo” structures would not be considered to be eligible bidders for failed bank assets and liabilities since under these structures beneficial ownership cannot be ascertained, the responsible parties for making decisions are not clearly identified, and/or ownership and control are separated.

3. The source of strength commitment requires that the shell holding company and/or the Investors must commit to raise additional equity or engage in capital qualifying borrowing and must pledge other assets held through any holding company.

4. The FDIC is considering whether the Proposed Policy Statement should be enhanced by requiring a direct obligation of the Investors.

5. The Proposed Policy Statement limits the use of entities in an ownership structure that are domiciled in bank secrecy jurisdictions unless the investors are subsidiaries of companies that are subject to comprehensive consolidated supervision as recognized by the Federal Reserve Board.

6. Under the Proposed Policy Statement, Investors would be prohibited from selling or otherwise transferring securities of the Investors’ holding company or depository institution for a 3 year period of time following the acquisition absent the FDIC’s prior approval.

Federal Reserve Policy Statement on Equity Investments in Banks and Bank Holding

On September 22, 2008, the Federal Reserve Board issued guidance regarding equity investments in banks and bank holding companies. The policy statement makes significant changes to the terms on which investors can make investments in bank holding companies.

Without being deemed to have acquired “control” (and thereby becoming bank holding companies themselves), an investor can own up to 24.9% (an increase from 10%) of the outstanding voting shares of a bank holding company and obtain a seat on its board of directors, an investor can own up to 33% of the total equity of a bank holding company (as opposed to the current limit of 24.9%), provided that the investment does not include ownership of 15% or more of any class of voting securities of the target; and an investor will be permitted to actively attempt to influence certain governance matters of the bank holding company.

The “source of strength” doctrine continues to apply so any company that acquires control of a bank holding company needs to be prepared to use its resources to financially support the bank holding company should the need arise. If the source of strength document is interpreted to require a private equity fund to make an open-ended commitment to make additional investments in banks that are held by a portfolio company, this would be a significant impediment to a private equity fund seeking to make an investment in a bank or bank holding company.

The policy statement expressly states that it does not address the circumstances in which multiple investors in a bank holding company or different fund vehicles managed by the same private equity firm will be viewed as “acting in concert” or as constituting a *de facto* company for purposes of the Bank Holding Company Act of 1956.

Consequences of Acquiring Control of a Bank Holding Company

Most private equity firms would seek to avoid being treated as bank holding companies because bank holding companies are restricted from engaging in many activities usually conducted by investment banking firms. Financial holding companies (bank holding companies which are well capitalized and well managed) may conduct a broader range of financial activities some significant particularly in the area of real estate investments. Bank holding companies are subject to consolidated capital regulations, extensive reporting requirements, and examination and supervision by the Federal Reserve Board.

Even a bank holding company (like Morgan-Stanley, Citigroup, Goldman Sachs) that is already subject to the BHC Act may not want to acquire control of another bank holding company through an investment fund it manages/controls because in that case, if a bank or thrift subsidiary of the target bank holding company required assistance from the FDIC, the FDIC could assess the cost of such assistance against any of the bank or thrift subsidiaries of the investing bank holding company.

If a bank or thrift subsidiary of the target bank holding company failed to meet the “well capitalized” or “well managed” criteria, the financial holding company status of the investing bank holding company would be jeopardized.

The Definition of Control

The definition of control for bank and regulatory purposes includes owning or controlling 25% of one or more class of voting securities. The definition of control also covers the treatment of convertible nonvoting securities, controlling influence (day to day or routine management), ownership of 24.9% or more of equity (voting or nonvoting) controlling the election of a majority of board, Fed determinations, restriction on transfer of securities issued by the bank or bank holding company, passive investment requirements, use of common names, strategic control, influence over the bank’s or bank holding company’s dividend policies or practices, the bank’s investment loan, or credit decisions or policies, the bank’s or bank holding company’s pricing of services, personnel decisions, operations activities (including the location of any offices or branches or their hours of operations, etc.) and covenants that restrict the ability of the bank or bank holding company to, without the investor’s consent, enter new lines of business, make acquisitions or divestitures, or hire, fire and compensate executive officers.

Generally, preferred shareholders continue to enjoy protections against the issuance of additional amounts or classes of senior securities.

Board Representation

The policy statement permits all investors to have at least one director on the target's board of directors. This change will enable private equity investors to take up to 24.9% (instead of 9.9%) of their investment in the form of voting securities while obtaining a board seat, which means they will have greater influence over the company than previously. A director that represents a non-controlling investor may not serve as chairman of the board of directors or of a committee of the board.

The policy statement permits an investor to have two directors without being deemed to control the target provided that (i) another company controls (and is therefore a bank holding company with respect to) the target and (ii) the non-controlling investor's representation is not disproportionately larger than its equity investment (and, in any event, does not exceed 25% of the board). Because it is highly unusual for a public bank holding company to have another bank holding company as a controlling shareholder, this provision is likely to be applicable only for investments in a bank or thrift subsidiary of a bank holding company or to private, closely held bank holding companies with multiple large investors. An investor may not have two board seats if the controlling shareholder was an individual or a family.

Total Equity Investment

Another longstanding position of the Federal Reserve Board was that an investor that acquired 25% or more of the equity (defined in several possible ways) of a bank or company was deemed to control the bank or company even if the equity was held in the form of nonvoting shares, voting equity, convertible debt, and subordinated debt (if significant, subordinated debt is treated as "equity").

Unlike the limits on voting shares, the limit on equity investments are not derived directly from the BHC Act, which, in defining control, refers only to voting shares. Fed position has traditionally been that, to avoid control, an investor could not acquire 25% or more of the equity of a bank holding company, without regard to whether the equity carried with it the ability to transfer voting rights. Voting and nonvoting equity were treated as carrying the same degree of influence.

The new policy statement provides that an investor generally will not be viewed as having a controlling influence over a bank or bank holding company where the investor holds up to 33% of the equity of the bank or bank holding company, provided that the investment (i) does not include ownership of 15% or more of any class of voting securities of the target, and (ii) does not represent more than 33% of a class of voting securities of the target, including for the purpose of this second calculation nonvoting equity that is convertible into equity in the hands of a transferee (as converted).

The policy statement provides guidance on the extent of communications between an investor and the management of a bank holding company in which it has made an investment. Thus a non-controlling minority investor, like any other shareholder, generally may communicate with about, and advocate with banking organization management for changes in, any of the banking

organization’s policies and operations including organizations dividend policy; strategies for raising additional debt or equity financing; entrance into a new business line or divesture of a material subsidiary; mergers; and changes in management. Communications by minority investors should not be accompanied by explicit or implicit threats to dispose of shares in the banking organization or to sponsor a proxy solicitation as a condition of action or non-action by the banking organization or its management. This “guidance” allows investors to be more active, both publicly and privately, than had previously been the case, and may thus affect the type of investors that take significant stakes in bank holding companies.

Links

FDIC Proposed Statement of Policy on Qualifications for Failed Bank Acquisitions

FED Policy Statement on Equity Investments in Banks and Bank Holding Companies