August 6, 2009

Via E-mail

Mr. Robert E. Feldman
Executive Secretary
Federal Deposit Insurance Corporation
550 17th Street, N.W.
Washington, DC 20429

Attention: Comments

Re: Proposed Policy Statement on Qualifications for Failed Bank Acquisitions

Dear Mr. Feldman:

The Private Equity Council ("PEC"), an association of leading private equity firms, appreciates the opportunity to comment on the Federal Deposit Insurance Corporation ("FDIC") Proposed Statement of Policy on Qualifications for Failed Bank Acquisitions (the "Proposed Statement").[1]

We are pleased that the FDIC is making an effort to establish clear guidance governing private capital investment in failing depository institutions. The Proposed Statement raises important and legitimate public policy issues. The sharp increase in the number of recent and expected future bank and thrift failures, and the FDIC's anticipated loss on failures, make it imperative to encourage the broadest possible range of eligible investors to bid for failed banks. We recognize that the FDIC has an important mission to ensure the "experience [and] competence" of owners of depository institutions and their "willingness to run the bank in a prudent manner".[2] However, the specific proposals in the Proposed Statement would have the effect of removing a very large and available pool of private capital from the bidding process for failed banks and thrifts. This would deprive the FDIC and the U.S. banking system of access to a major source of capital at a time when, as the FDIC correctly recognizes, "substantial

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1 74 *Fed. Reg.* 32931 (Jul. 9, 2009).

2 Id. at 32931.

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additional capital is needed in the U.S. banking system."[3] In so doing, it increases the likelihood that the FDIC's resolution costs will be higher, and that U.S. taxpayers will eventually have to foot part of the bill for future bank failures. Private equity firms have an estimated $470 billion in capital to invest, according to market research firm Preqin. Preqin further reports that private equity firms have raised, or are in the processing of raising, over $34 billion for funds dedicated to investments in banks and other financial services firms. At a time of scarcity of investment capital, private equity clearly can provide an important source of equity for failed banks.

Prior to addressing the Proposed Statement in detail, we want to describe briefly the private equity investment model to clear up possible misunderstandings about how private equity ("PE") works and how PE affects companies in which it invests.

A PE firm creates funds in which it invests its own capital, along with larger amounts of capital raised from third-party investors. In these funds, generally structured as limited partnerships, the private equity firm acts as the general partner ("GP") and the third-party investors are the limited partners ("LPs"). The PE firm (or GP) uses the partnership's capital to buy or invest in companies that it believes could be significantly more successful with the right infusion of capital, talent and strategy. Highly sophisticated investors such as large public and private pension funds, endowments and foundations account for 70 percent of the funds invested with the top 100 PE firms since 2005. For example, the 20 largest public pension funds for which data is available (including the California Public Employees Retirement System, the California State Teachers Retirement System, the New York State Common Retirement Fund, and the Florida State Board of Administration) have invested nearly $140 billion in private equity funds.

A key to the success of PE investments is the requirement that both the PE firm (the owners/shareholders) and the senior managers of the acquired company invest their own money into the sponsored business. Because each, therefore, has its own equity at risk, all parties strive to make decisions that will grow the value of the business. Failure to do so means that the PE firm and the company's managers will lose their money. In short, the PE investment model ensures that the interests of PE fund shareholders and the interests of portfolio company management are fully aligned. As a result, they make management decisions focused entirely on what is required to improve long-term performance and value.

PE firms invest in firms in a wide range of industries.[4] But regardless of the type of firm acquired, the objective is the same: increase the value of the business during the time that it is owned by the PE fund by applying prudent, long term-growth strategies executed by best in

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[3] Id. at 32933.

[4] For this reason, as you can appreciate, PE firms are always very careful to structure investments in banks such that they do not control a bank for purposes of the Bank Holding Company Act of 1956, as amended ("BHC Act") (12 U.S.C. § 1841 *et seq.*). Acquiring control, and thereby becoming subject to the restrictions of the BHC Act, would be incompatible with the typical PE firm structure and business model.

sector managers. Independent research fully documents the positive impact of this form of ownership on companies, employees, the economy, and other stakeholders.[5]

The PEC has reviewed the Proposed Statement carefully, and we have significant concerns about four specific areas: capital requirements, source of strength obligations, cross-guarantees, and continuity of ownership. We offer additional comments on other areas of the Proposed Statement to seek clarity and/or technical changes that are not inconsistent with the FDIC's objectives as we understand them.

1. Capital Requirement

Under the Proposed Statement, the FDIC would require private capital investors to "cause the depository institution acquiring deposit liabilities . . . to be initially capitalized at a minimum 15 percent Tier 1 leverage ratio for a period of 3 years", subject to possible extension by the FDIC. After that period, the institution would have to be at least "well capitalized" so long as the initial Investors' "ownership" continues.[6] Failure to meet the well capitalized standard would result in the institution being deemed to be undercapitalized for purposes of the statutory Prompt Corrective Action ("PCA") regime.

The proposal appears to be predicated on the assumption that a private equity acquisition of a failed bank is considerably more risky than a de novo bank.[7] We disagree with that premise. In a de novo bank, there is literally nothing but capital at launch. Failed banks, by contrast, have assets, deposits, systems, employees and other indicia of viable businesses, plus a business plan and new management provided by the purchaser. Viewed in this light, it seems inconsistent to us to subject private investors to far greater capital requirements than those applied to a de novo bank.

We agree that the capital requirement is "[o]ne of the most important elements" in the Proposed Statement.[8] Nonetheless, we submit that the proposed required capital level -- which is *three* times the high end of the range for a well-capitalized depository institution and double that of the industry average -- is onerous.[9] If the guidance imposes capital levels on

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5 This research is available at www.privateequitycouncil.org.

6 For purposes of this letter, "Investors" refers to those persons and entities who would be subject to the restrictions in the Proposed Statement. As we note, however, it is not clear from the Proposed Statement precisely to whom it would apply.

7 We note that section 18.1 of the FDIC's Risk Management Manual of Examination Policies says that de novo institutions generally will be required to have a Tier 1 leverage capital ratio of 8%. ("Normally, initial capital of a proposed institution should be sufficient to provide a Tier 1 capital to assets leverage ratio of at least 8% throughout the first three years of operation.") *See* http://www.fdic.gov/regulations/safety/manual/section18-1.html.

8 74 *Fed. Reg.* 32931 at 32932.

9 As of March 31, 2009, the average leverage ratio for insured depository institutions was 8.04%, and since 2004 the average leverage ratio at FDIC-insured commercial banks has been 7.72%. *See* FDIC

private investors that are significantly in excess of industry standards, it would substantially reduce, and even eliminate, interest by private equity investors in purchasing failed banks or thrifts from the FDIC.

The proposed higher capital levels will adversely influence the bidding process in multiple ways.

To understand why this is, it is important to know first that the cost to a private investor of evaluating and preparing a bid for a failed bank is enormous, and could easily approach $20 million for larger institutions. In light of such significant up-front costs, a decision on whether to bid on a failed bank or thrift is obviously influenced by a bidder's perception of its ability to succeed, as well as the quality of the bank's assets, its franchise value, and the bidder's ability to operate the bank in a safe and sound manner while still achieving returns expected by investors. (Note that PE firms seek risk-adjusted returns for banks that, because of the unique nature of banks and of PE investments, *e.g.*, the need to maintain capital and for individual firms to make only non-controlling investments, are lower than for many other investments.)

Higher capital levels would put private investors at an enormous disadvantage in bidding against strategic acquirers, compelling such bidders to lower their valuation of the failed bank's operations in order to allow them to achieve the risk-adjusted returns expected by their investors. The net effect of the resulting lower bids would be to make private capital investor proposals less competitive with those of other bidders and ultimately, given the aforementioned costs required even to bid, to deter private capital investor participation in FDIC auctions.

Furthermore, the risks to private investors apply even in the absence of a strategic acquirer. This is because lower bids resulting from a higher capital requirement could come in below the FDIC's "reserve price," raising the possibility that a private capital investor's bid could "lose" even if there is no competing bid, leaving the failed institution in the FDIC's hands.

The Proposed Statement appears to be premised, in part, on a concern that private investors might be tempted to operate an acquired institution in an unusually risky manner. However, as noted above, inherent in the PE investment model is a very powerful disincentive to achieve returns through excessive risk because PE firms and senior executives at businesses they own each put their own equity at risk. In the context of an FDIC transaction, this means that PE owners have a strong incentive not to take on excess risk to achieve return objectives. In fact, the capital premium proposed by the FDIC may create the very risk it seeks to avoid as a new owner may feel compelled to take on more credit or other risk to increase returns on equity.

To the extent that bids for failed banks are lower, either because private bids are driven down or because they disappear and there is less (or no) competition, the resulting deficiency would be directly funded by the FDIC, representing a real cost to the Deposit Insurance Fund and, potentially requiring the FDIC to draw on its $500 billion line of credit from the Treasury.

Quarterly Banking Profile 2009 (Vol. 3, No. 2) at 3. Available at http://www2.fdic.gov/qbp/2009mar/qbp.pdf; http://www2.fdic.gov/qbp/2009mar/cb1.html.

As a potential solution, the FDIC should consider reformulating the capital requirement to be based on the recently adopted Tier 1 Common test -- the ratio of Tier 1 common equity to risk weighted assets (the "Tier 1 Common ratio"). This ratio was used by the federal banking agencies in their Supervisory Capital Assessment Program ("SCAP") because common equity demonstrates the true capacity of banks to absorb losses. Investors, analysts and the rating agencies also focus on common equity.

In administering the SCAP, the agencies deemed a Tier 1 Common ratio of 4% to be satisfactory.[10] We expect that the FDIC will elect to subject private capital buyers of failed banks to higher than normal initial capital requirements. Accordingly, we recommend that, where appropriate, those buyers be made subject, for the FDIC-required initial holding period, to a Tier 1 Common ratio that is no more than 50% higher than the SCAP test requirement. This would produce a ratio no greater than 6%. The institution would also need, of course, to be well capitalized under the basic regulatory tests. Given the fact that most of the asset side of a recapitalized institution's balance sheet is composed of cash and FDIC receivables, neither of which is an especially risky asset, this proposed capital level should be sufficient. If the FDIC would prefer to modify the Tier 1 Common test to use total assets as the base (rather than risk weighted assets), the required ratio would more appropriately be approximately 5%.[11]

We are also concerned about the proposal to treat any bank controlled by private capital investors as undercapitalized for PCA purposes should it fall below the initial or well capitalized thresholds. The PCA restrictions for "undercapitalized" banks can have severe consequences for the affected bank, its management, depositors and shareholders. We do not think that subjecting private capital-controlled banks to these requirements in circumstances where another bank would be deemed to be adequately capitalized offers significant supervisory benefit. Moreover, it could operate to destabilize a private capital-controlled institution that experiences sudden and unexpected losses that only temporarily cause one of the institution's capital ratios to dip below the well capitalized standard – raising the risk to the Deposit Insurance Fund rather than lowering it. Accordingly, this part of the Proposed Statement could be another major disincentive for PE investors to invest in failed banks. We therefore believe that depository institutions in which private capital investors have invested should be subject to the same PCA standards as other institutions.

2. Source of Strength

As the PEC understands the Proposed Statement's source of strength standard, a holding company owned by private capital investors would agree that, if the FDIC determines that the depository institution requires additional capital, the holding company will sell equity or otherwise sell debt that can support the depository institution. Implicit in this agreement is a

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10 Board of Governors of the Federal Reserve System, *The Supervisory Capital Assessment Program: Overview of Results* 2 (May 7, 2009).

11 This reflects the lower risk assets captured in a leverage ratio and is consistent with the existing regulatory capital structure under which the required Tier 1 ratio for well-capitalized status is higher (6%) than the leverage ratio (3%-5%).

commitment that the private capital investors would not seek to abrogate the agreement. If this is an accurate interpretation of the Proposed Statement's intent, we believe it is appropriate and reasonable.

We recommend, however, that the final policy statement explicitly correct an apparent misunderstanding that private capital investors themselves could be obligated to commit additional resources beyond those they choose to invest. It is essential to recognize that any broader obligation would foreclose private capital investment because few, if any, investors are prepared to place at risk more than the amount of their investment. In fact, doing so would be inconsistent with PE funds' fiduciary responsibilities to their pension fund and non-profit investors and would also likely breach their partnership agreements.

3. Cross-Guarantees

We note first that most, if not all, PE firms have existing agreements with their investors that limit the PE firm's ability to make additional financial or other demands on the investors. It therefore may simply not be possible for a PE firm to commit to a cross-guarantee agreement like that contemplated in the Proposed Statement, because the constituent documents of the firm's funds may not allow it. A cross-guarantee commitment would also have the effect of limiting private investors' ability to diversify their portfolios, thus effectively deterring individual private investors from supplying capital to multiple institutions and undermining the objective of the cross-guarantee of reducing the FDIC's loss on a failed institution.

As we read the Proposed Statement, the FDIC is not proposing a cross-guarantee by commonly-owned depository institutions themselves, as currently exists under the Federal Deposit Insurance Act.[12] Rather, private capital investors' interests in commonly-controlled depository institutions would be pledged to the FDIC to support its losses in any one of those institutions. We therefore suggest that it would be helpful to avoid confusion by replacing the nomenclature "cross-guarantee" with "cross-support".

Substantively, the PEC recognizes that there are legitimate supervisory reasons to have cross-guarantees between insured depository institutions that are commonly-controlled by the same company and operated as part of a single enterprise. We submit, however, that these reasons are not persuasive for a cross-guarantee or cross-support arrangement in the case of depository institutions that have a significant, but not total, level of common ownership if those institutions are separately managed and otherwise independent of each other. In such situations, there are substantial legal and practical barriers to actions that would benefit one institution to the detriment of another. These include Sections 23A and 23B of the Federal Reserve Act (if the common ownership level is below 80%) and general fiduciary duties of loyalty. In addition, if multiple private capital investors constitute an "association" under the BHC Act, the existing cross-guarantee obligations would apply to all depository institutions controlled by those investors through the association.

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[12] 12 U.S.C. § 1815(e).

It is also necessary that any new cross-guarantee or cross support rule not affect a wide swath of the banking system. There are a relatively small number of institutional investors that own 25% or more of a large number of U.S. banks.

In order to accommodate these various concerns and objectives, we recommend the following approach. Even if there is not an "association," "Significant Investors" (as defined below) would be subject to a cross-support arrangement if the same two or more Significant Investors collectively own 80% or more of multiple depository institutions and there is common operation and shared infrastructure among the institutions. A clear indicia of joint control and operation has long been a key factor in determining cross-guarantee liability. A Significant Investor would be a 10% or greater shareholder. This 80% test tracks the exception for commonly-controlled affiliates in Sections 23A and 23B.

We also wish to point out that the proposed cross-guarantee provision would likely make it harder for prospective private capital investors to form bidding groups. An investor is much less likely to join a bidding group if cross-guarantee liability exists between the group in formation and an existing group that owns a bank. This is because the investor's interest in the new group would be at risk if the bank controlled by the first group failed, even though the investor has no interest in that first group. This is an especially problematic consequence because the universe of PE firms that are both interested in and capable of making larger investments in banks is rather small (likely fewer than 20 firms in our estimation), so every constraint on group formation would have a significant, negative impact on the number of PE bidding groups in any failed bank transaction.

As indicated above, an attempt to impose any further "direct obligation" by private capital investors in the event of FDIC loss would be counterproductive. Such a requirement would result in no individual private capital investment in multiple institutions because a potential loss of more than the amount invested is not a risk that the investors can take, thereby reducing the amount of private capital available to participate in FDIC resolutions.

4. Continuity of Ownership

PE firms traditionally invest in companies for the longer term, so as to ensure that the capital and expertise they provide will have a positive effect on their portfolio companies. Short-term "flipping" of investments is not only uncharacteristic of PE, but it is moreover inconsistent with the expectations of investors in PE funds. The goal of a PE acquisition is to realize gains by placing a portfolio company on a significantly stronger financial footing at the time of its sale than it was when acquired. This process typically takes considerable time.

The PEC believes, however, that a three-year holding period for private capital investors is too long, especially if it would act to prevent a private capital investor from conducting a public offering of the stock of a depository institution (or its parent holding company). A prolonged period of forced illiquidity would not be in the best interests of the institution, as it could require a private capital investor to retain its investment in an institution past the time that the institution has achieved the ability to raise capital independently. A shorter period, perhaps 18 months, would be sufficient to deter speculators with only a short-term focus

without unduly restricting the ability of private capital investors eventually to dispose of their interests in depository institutions, through public offerings or otherwise.

It is important to note that PE firms typically exit bank investments either through public offerings by the bank itself, or by sale to a strategic buyer. In the former case, the bank receives new capital, and PE ownership is diluted, and in the latter case the institution is absorbed by another regulated entity. Both outcomes are positive ones, particularly for an institution that has previously been taken into receivership.

Finally, it would be helpful for FDIC to clarify that the proposed holding period requirement would not prevent an institution from selling its own shares (*e.g.*, in a public offering), but rather would only cover sales by private capital investors of shares they control. We understand this to be the FDIC's intent, but believe additional clarity in this regard would be helpful.

5. Covered Investors

As we understand the Proposed Statement, it would apply to private capital investors in both (i) *de novo* charters and (ii) established depository institutions unless the ownership interest had been held for at least three years (perhaps subject to a *de minimis* exception). We believe that applying the Proposed Statement just to private capital investors in these classes of institutions discriminates against PE firms and their investors for reasons that are based on a misapprehension of the role and operations of PE firms and other similar investors.

6. Transactions with Affiliates

The PEC appreciates the need for controls over transactions by insured depository institutions with their nonbank affiliates, as is provided in Sections 23A and 23B of the Federal Reserve Act and the Federal Reserve's Regulations O and W.[13] If the FDIC believes that additional restrictions beyond those provided in sections 23A and 23B and Regulation W are necessary in the case of transactions involving depository institutions and their private capital investors, we recommend several modifications.

First, we note that the Proposed Statement would cover all private capital investors, regardless of the size of their investment in an institution. The FDIC should include a *de minimis* threshold in any final policy statement, both to reduce the complexities of monitoring compliance with the restriction and to avoid restricting transactions that, because of an investor's small stake in a depository institution, are unlikely to have been influenced by the investor. We would suggest an ownership threshold of at least 10% before an investor's affiliates would be covered by these restrictions.

Second, we believe that the Proposed Statement should adopt the definition of "affiliate" utilized in Regulation W, as it has for Regulation W's definition of "extension of credit". The much more expansive definition in the Proposed Statement -- covering ownership

[13] 12 U.S.C. §§ 371c, 371c-1; 12 C.F.R. Parts 215 and 223.

of 10% of a company's equity -- would cover a potentially vast array of relationships that are much more attenuated than those covered by Regulation W. This would impose significant additional compliance costs on affected depository institutions to ascertain and monitor the universe of covered affiliates. In addition, the Proposed Statement gives no guidance on how this new test is to be applied to the lower tier holdings of a 10%-owned portfolio company, or whether or how such holdings would be aggregated with the holdings of other portfolio companies in which the same investor has an interest.

Third, we believe that the stringent restrictions of Sections 23A and 23B are sufficient and that a total ban on extensions of credit is therefore not required. This would enable a depository institution to engage in the isolated transaction that is in its best interests but with substantial protection to assure against abuse.

Finally, we believe that the final policy statement should specifically exclude or grandfather existing extensions of credit, as such extensions of credit will have been originated at arms length between unaffiliated parties.

7. "Silo" Structures

The Proposed Statement prohibits "so-called 'silo' organizational arrangements, in which the beneficial ownership cannot be ascertained, the responsible parties for making decisions are not clearly identified, and/or ownership and control are separated".[14] Although we understand the FDIC's desire to avoid structures with these three features, we believe that describing arrangements that exhibit them as "silo" structures is unhelpful and confusing, principally because there is no agreed-upon definition in the PE industry or elsewhere on what constitutes a "silo" structure. We believe, for example, that several recent PE -led investments in troubled or failed depository institutions used what could be described as "silos", but that none of these transactions exhibited the sort of opacity or separation of ownership and control that is described in the Proposed Statement.

8. Secrecy Law Jurisdictions

The PEC understands the FDIC's concerns over private capital investor entities that might operate from or be based in bank secrecy jurisdictions. We think, however, that most if not all of the FDIC's concerns in this area can be addressed through the information requests and other aspects of the "Disclosure" provisions of the Proposed Statement, discussed below.

If the FDIC nonetheless wishes to retain separate provisions on secrecy jurisdictions, our principal concern is clarity. At the outset, we believe that it would be helpful for the final policy statement to clarify what is meant by a "bank secrecy jurisdiction", perhaps by cross-reference to an established list. Second, it should be made clear what situations are actually covered. We assume that the prohibition would apply only if the actual private capital investor, or any organization controlling the actual investor, is domiciled in a bank secrecy jurisdiction. In this connection, we note that many U.S. tax-exempt investors commonly invest

[14] 74 Fed. Reg. at 32933.

in PE funds through vehicles domiciled in jurisdictions such as the Cayman Islands for tax structuring reasons. If the FDIC were to prohibit the use of such structures, it would sharply limit the amount of private capital available for investment in failed depository institution transactions.

We also believe that the FDIC may want to retain the flexibility to evaluate proposals on a case-by-case basis rather than implementing a ban as contemplated in the Proposed Statement. This would involve requiring information on the domicile of potential private capital investors and tailoring any commitments or restrictions based on such factors as the jurisdiction in question and size of the investment. Such an approach would protect the FDIC's interest in having access to needed information while preserving private capital investors' ability to organize efficient and functional structures.

9. Special Owner Bid Limitations

The PEC has no strong objection to the proposed special owner bid limitation. We believe, however, that there may be value in providing for eligibility in exceptional circumstances.

10. Disclosure

The Proposed Statement would require private capital investors to share with the FDIC significant information about "the Investors and all entities in the ownership chain", much of which is nonpublic and often highly sensitive, especially in the case of PE firms and their investors. We think it would be helpful for any final policy statement to state clearly that information submitted by private capital investors to the FDIC as part of a bidding process will be kept confidential and considered to be exempt from disclosure under the Freedom of Information Act's exemption for privileged or confidential commercial or financial information and examination material.[15]

11. Duration

The PEC strongly believes that all the limitations in the Proposed Statement should be lifted after an appropriate period of successful operation. We recommend that the period be three years. "Successful operation" could adopt the same criteria as those that are applied to qualification for and maintenance of financial holding company status.[16]

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The PEC is strongly supportive of the FDIC's objective to provide clarity to companies and organizations interested in acquiring failed institutions from the FDIC, and we believe that the banking system will benefit from rules that enable private capital to invest in depository institutions in a safe and sound manner. We urge with particular emphasis that

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[15] *See* 12 U.S.C. § 552(b)(4), (b)(8).

[16] *See* 12 C.F.R § 225.81.

private capital investment not be discouraged by capital requirements that are unduly stringent, requirements that would put an investor at risk for more than the amount of its investment or coverage standards that are unduly broad.

We appreciate the FDIC's attention to this comment letter. If you have any questions about this letter, or if the PEC can be of any further assistance, please do not hesitate to contact me at (202) 465-7700.

Sincerely,

Douglas Lowenstein
President