FDIC Proposed Rules Against Private Equity

This submission is in response to your request for commentary on your proposed Statement of Policy on Qualifications for Failed Bank Acquisitions. My partners and I are delighted that the FDIC approved our participation in the winning bid for BankUnited, and at the time of the investment, we looked forward to investing further in it and in other future resolutions. We found your staff to be highly professional, and we fully understand that any such investment is, and should be, highly regulated. The following comments are intended merely to help you develop a regime that minimizes the cost of resolutions in a manner totally consistent with safety and soundness and with fair treatment to private equity funds. We look forward to a long and mutually beneficial relationship with you.

Several of the proposed rule changes regarding private equity investment in insured depository institutions are appropriate and desirable. These include prohibition of silo structures, requiring fulsome disclosure of ultimate ownership, prohibition of incestuous lending and prohibition against those who are major shareholders of a depository institution pre-failure bidding in the auction of the institution post-failure. My firm endorses all of these provisions and will encourage other private equity firms to do the same.

We are dismayed, however, that the FDIC accepted the bid for BankUnited from our firm and other private equity funds with no indication of pending rule changes and then within a few weeks propose changes that would radically and retroactively diminish the value of the investment we just made. This action would be unfair and unreasonable to impose on us. We therefore request that if any part of the proposed policy statement is adopted, all transactions completed prior to the public announcement proposed rule changes be grandfathered and exempted from them, not just those that closed at the arbitrarily suggested three year cut-off date. Since the FDIC not only was on notice of, but also expressed support for our intention to use BankUnited as a platform to acquire other failed institutions, it would impose on us rules that are effectively retroactive. By instead imposing new rules only on holding companies created subsequently to the proposal of the rules, this patent unfairness would be eliminated. All parties contemplating holding companies then would be on fair advance notice of what they must do.

The substance of the financial proposals is to impose such discriminatory burdens that private capital will no longer bid in the FDIC auctions of failed banks. Since the announcement of the proposed rules, many providers of private capital have spoken out against them. So have a number of major law firms. None has endorsed them. I assure you that my firm will never again bid if the proposed policy statement is adopted in its present form. Since private equity would only win by making a lower cost bid than the strategic bidders, adoption of these rules by definition would cost the FDIC billions of dollars of unnecessary expenditures. In the case of BankUnited alone the added burden on FDIC would have been $200 million or more if FDIC had accepted the lower bid and more onerous contract terms proposed by TD Bank, and in the case of Indy Mac, the FDIC would have had no bid at all. Why would you want to chill the bidding and what is the logic of making it more difficult for the new BankUnited to attract additional capital and execute on its roll-up strategy?

As to specific problems, the proposal that a 15% Tier 1 leverage ratio base be maintained for three years is totally unsupported by any empirical data. The standard for newly chartered start up institutions has been 8%, and five percent is the level at which depositories are deemed to be "well

capitalized". Since the assets of a resolved bank are marked to market and the more risky assets are subject to loss sharing arrangements with the FDIC which minimize the bank's exposure, a resolved bank with a 7.5% Tier 1 leverage ratio would effectively rank after stress testing among the handful of best capitalized banks in the country. No unresolved bank has written down all assets to market and therefore "real" capital is lower than the reported figures. I estimate that if you applied to the new BankUnited the same stress test assumptions that were applied to the 19 major banks, it would pass with around a 6% ratio. How could a cleaned up bank, all of whose capital was in cash paid for common equity, possibly be riskier than an average bank encumbered with debt and preferred stock, or especially a start up bank that inevitably would lose money for several years? There is no bank in the country with a 15% Tier 1 leverage ratio, nor will there ever be one because such an enormous amount of excess capital would assure that no prudent management could achieve a reasonable rate of return. Therefore, no one would invest in it.

The application of the 15% ratio to the new BankUnited also gives no credit to the proven management team that is in place. This is another significant way in which the new BankUnited differs from a start-up. Excess capital should be required of startups, not banks run by management teams with highly successful track records owned by professional investors who, like my firm, have previously demonstrated in other countries an ability to buy failed banks and turn them around.

It also is the case that institutions comparable in size to BankUnited or IndyMac are where ongoing private equity participation will most likely be needed. These banks are also the ones likely to acquire the 500 or more smaller institutions that will fail over the next year or so. At the FDIC roundtable which I attended on July 6, the major banks confirmed that they would not bid on small ones and they added that they would only bid on larger ones if, in addition to providing good economic returns, they were of strategic significance. Once again the history of the IndyMac and BankUnited transactions confirms how limited the interest of major banks is relative to mid-sized institutions. Does FDIC really want to be stuck with hundreds of failed banks?

A 7.5% ratio will provide adequate assurance of safety and soundness without chilling the bidding process.

The second problem is the cross guarantee of investments if a similarly constituted group of funds buys two or more banks in separate entities. WL Ross' partnership documents, as is typical of private equity partnerships, do not authorize cross guarantees and even if they did, we as fiduciaries could never agree to such a compounding of risk without an additional rate of return in the form of a lower bid. Once again, why would the FDIC want to eliminate repeat bidders who already had saved FDIC money in one transaction and were prepared to do so again?

The idea of a cross guarantee is especially inappropriate because none of the investors will have control of the institution. In fact there will have been an official finding of non-control. How could it be reasonable to request a cross guarantee from a non-controlling shareholder?

The third problem is the "source of strength" proposal. I have been unable to find any statutory support for the "source of strength" concept articulated in the proposed policy. In fact, savings and loan holding companies are not subject to source of strength at all. Even leaving that aside, where is the evidence that publicly traded holding companies have in fact been a "source of strength"? Wachovia, Washington Mutual, IndyMac and BankUnited all were publicly traded holding companies and that failed to save them.

Look also at the large bank holding companies, many of which also would have failed if they had not been bailed out by TARP. How can they be a source of strength when they themselves need TARP? Very few bank holding companies have meaningful amounts of excess idle cash and if they were to remove cash from one bank to help another it would be like robbing from Peter to pay Paul. The reality is that if a publicly traded holding company gets into big trouble, the principal way it can provide strength is if *investors – and not the holding company* – are willing to put more money into it. They do so not because it is a holding company but only because and if they believe it will be profitable to do so. Private equity is no different. Since there appears to be neither a statutory nor a real world basis for the "source of strength", how can it be appropriate to apply it to private equity?

It seems incongruous that the FDIC would impose a 15% requirement on bids by private equity but no extra requirement on bank holding companies which still have TARP money without which they would not be adequately capitalized. How can they be viewed as a superior source of strength? Indeed, from a systemic risk point of view, why would you want a bank that was already "too big to fail" to make more acquisitions unless they were so well capitalized that they were "too strong to fail"? Banks the size of BankUnited and IndyMac pose no systemic risk.

It also would seem appropriate not just to focus on the quantity of capital but also on the quality. BankUnited was capitalized 100% with common stock equity paid in cash. Very few bank holding companies are capitalized 100% with common equity. Requiring the investment to be all in common stock equity would provide real strength because it would leave available the introduction of hybrid securities if the need should arise. That would give the private equity-backed firm more financial flexibility than most bank holding companies and therefore a higher probability of being able to provide additional strength if needed. Private equity firms, including mine, already have a strong record of supporting portfolio companies if they need another round of financing and will do so with banks if it is at all rational to do so. Between BankUnited and Indymac, some $2 billion of private capital has been invested. Funds do not lightly walk away from such large sums. Therefore they already have substantial motivation to step up.

In addition to requiring the initial 7.5% investment to be in common equity, the FDIC could further incentivize the fund investors by adopting a rule that if a fund has a board member on one that fails, that fund not only cannot bid on resolving that institution, but also would be barred from bidding on another one.

Finally, there is the three year minimum holding period. It is understandable that you do not want the bank flipped quickly, especially at an embarrassingly large premium but in the case of BankUnited, the FDIC Board approved a negotiated 18 month time period. What has changed in the subsequent few weeks that justifies doubling the period? If the FDIC were to apply a three year period to BankUnited, this would be retroactivity with no justification. It is even more difficult to understand why subsequent approval should be needed to raise capital via an initial public offering during the first three years. Surely adding capital promotes safety and soundness. Also, the underlying thesis of your proposals seems to be a preference for broad public ownership so why put any impediments in the way of accomplishing that objective?

If private equity has been able to create substantial value within three years, it is the banks who bid less (or did not bid) who should be embarrassed, not the FDIC. It also is inconsistent to worry that

private equity is not capable of resolving a bank and yet will make a big gain quickly. Damned if you do, damned if you don't.

It might be useful in conclusion to remind FDIC that the ultimate owners of private equity are not fat cats sitting around smoking cigars in some exclusive club. The principal investors are instead the retirement funds of cities and states, corporate and union pension funds, foundations and endowments. All of them have full time professional staffs and Boards who select the managers for their private equity investments, and often they employ specialized outside consultants to provide further assurance that their managers are of the highest integrity and capability. By and large they have succeeded and over the years private equity funds have achieved cumulatively superior rates of return. The industry also has been almost totally free of scandal. The FDIC should take comfort from the fact that the private equity funds most likely to be seeking to help resolve banks are serious, responsible and experienced professionals, who as a class are ideal custodians of FDIC insured institutions. Far fewer failures have occurred among the $1+ billion dollar private equity funds than among banks not owned by private equity funds. There is no empirical evidence to support the thesis that special, punitive rules are needed to solve problems caused by private equity funds. The simple truth is that there have been no such problems. Nonetheless, we do support the several regulatory initiatives described at the beginning of this response and would be happy to have further constructive discussions with FDIC on these and other topics. As mentioned at the beginning, we fully recognize the confidence you displayed by approving us as a large owner of BankUnited and we appreciate the obligations that accompany your insurance of our deposits.

Wilbur L. Ross, Jr., Chairman and CEO, WL Ross & Co. LLC

WILBUR L. ROSS, JR.
Chairman and
Chief Executive Officer

WL Ross & Co. LLC
1166 Avenue of the Americas
New York, New York 10036

Tel: (212) 826-2111
Fax: (212) 317-4891
www.wlross.com
Email: wlross@wlross.com