August 6, 2009

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

Re: RIN 3064-AD47
Proposed Statement of Policy on Qualifications for Failed Bank Acquisitions, 74 Fed. Reg. 32931 (July 9, 2009)

Dear Mr. Feldman:

Thank you for the opportunity to submit these comments with respect to the FDIC's Proposed Statement of Policy ("Proposed Policy Statement") concerning investments by private equity firms and similar investors ("PE investors") in failed banks. These comments express our personal views and do not represent the views of the University of Connecticut, the George Washington University or any other organization.

We applaud the FDIC for giving careful consideration to the issue of whether investments by groups of PE investors in failed banks can be structured and supervised in a manner that (i) is consistent with established banking laws and policies and (ii) serves the interests of our financial system, the broader economy, and our citizens. In this regard, we believe that acquisitions of failed banks by groups of PE investors raise the following general policy concerns:

1. PE investors are expected to structure any acquisitions of failed banks with the explicit goal of avoiding the limitations on "control" of banks by "companies" under the Bank Holding Company Act, 12 U.S.C. 1841 *et seq.* ("BHC Act"). As a result, important protections provided by the BHC Act – including the source of strength doctrine adopted by the Federal Reserve Board ("FRB") and consolidated holding company oversight by the FRB – would not apply to such acquisitions. That would be so even though PE investors would thereby gain access to a substantial federal subsidy in the form of deposit insurance, access to the FRB's discount window, and possible tax advantages. The Policy Statement should therefore establish alternative prudential requirements that provide reasonable protection to both the Deposit Insurance Fund ("DIF") and taxpayers from risks associated with such acquisitions.

2. PE investors typically own controlling interests in industrial and commercial enterprises. Therefore, acquisitions of failed banks by PE investors could create a significant potential conflict with our long-

> established policy of separating banking and commerce. The Policy Statement should impose restrictions to ensure that such acquisitions are not used to undermine legal barriers separating banking and commerce.

The FRB highlighted these two policy concerns on September 22, 2008, when it issued its "Policy statement on equity investments in banks and bank holding companies," 12 C.F.R. § 225.144 ("FRB Equity Investment Statement"). The FRB Equity Investment Statement provides guidance to PE firms and other investors that seek to make substantial minority investments in banks. Such investments raise significant questions about whether the investors are able to exercise a "controlling influence" over banks. As explained in the FRB Equity Investment Statement, the FRB seeks to implement "two key purposes of the BHC Act" when it determines "whether an investor has the ability to exercise a controlling influence over a banking organization." First, the BHC Act

> . . . is premised on the principle that a company that controls a banking organization may reap the benefits of its successful management of the banking organization but must also be prepared to provide additional financial and managerial resources to the banking organization to support the company's exercise of control. [12 C.F.R. § 225.144(a).]

The FRB's source of strength doctrine and other requirements of the BHC Act are designed to link "control and responsibility" and ensure that "companies have positive incentives to run a successful banking organization but also bear the costs of their significant involvement in the banking organization's decisionmaking process, thus protecting taxpayers from imprudent risk-taking by companies that control banking organizations." *Id.*

Second, the BHC Act

> . . . was intended to limit the mixing of banking and commerce. In particular, the [BHC] Act effectively prevents commercial firms and companies with commercial interests from also exercising a controlling influence over a banking organization. Many minority investors in banking organizations own commercial investments that conflict with this limitation. [*Id.*]

The Treasury Department's recent report on financial regulatory reform demonstrates that both of the foregoing principles are deeply rooted in our nation's bank regulatory policy. The report declared:

> All companies that control an insured depository institution . . . should be subject to robust consolidated supervision and regulation at the federal level by the [FRB] and should be subject to the nonbanking activity

> restrictions of the BHC Act. The policy of separating banking and commerce should be re-affirmed and strengthened.[1]

Thus, the FRB Equity Investment Statement and the Treasury Department's report on financial regulatory reform confirm the need to address public policy concerns about whether investments by PE investors in failed banks will (1) weaken the effectiveness of the source of strength doctrine and consolidated supervision or (2) undermine the separation of banking and commerce. Our comments will first discuss these general policy concerns and will then address the specific issues identified in the FDIC's Policy Statement.

I. General Policy Concerns

A. Weakening Consolidated Supervision and the Source of Strength Doctrine

We understand that PE investors will structure their acquisitions of failed banks or thrifts to avoid consolidated holding company supervision by the FRB under the BHC Act. Consolidated supervision by the FRB would subject the holding company to capital adequacy requirements, mandatory reporting, regular safety and soundness examinations, and stringent restrictions on interaffiliate transactions.[2] Furthermore, pursuant to the BHC Act, the holding company would be subject to the source of strength doctrine. Under that doctrine, the FRB requires that "[a] bank holding company shall serve as a source of financial and managerial strength to its subsidiary banks and shall not conduct its operations in an unsafe or unsound manner." 12 C.F.R. § 225.4(a). The source of strength doctrine requires a parent holding company to stand ready to inject capital into its bank or thrift subsidiary if the subsidiary encounters financial stress. The doctrine is based on the FRB's longstanding policy that "holding companies should be a source of strength to subsidiary financial institutions," a requirement that the Supreme Court found to be "consistent with the language, purpose, and legislative history of the [BHC] Act." *Board of Governors v. First Lincolnwood Corp.*, 439 U.S. 234, 251-53 (1978).

Because PE acquisitions will be structured to avoid triggering BHC Act coverage, the FDIC needs to impose alternative conditions on PE transactions to substitute for the source of strength doctrine and the absence of consolidated supervision by the FRB. Indeed, not do so would be anomalous, because the rest of the financial system is moving toward consolidated supervision in order to prevent another financial crisis from ever materializing.

Consolidated supervision by the FRB and the source of strength doctrine apply to any "company" that has "control" over a "bank," as those terms are defined in the BHC Act, 12 U.S.C. § 1841(a)-(c). In the context of an acquisition of a failed bank by a group of PE investors, a key issue would be whether the group of investors constitutes a

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[1] U.S. Treasury Dept., *Financial Regulatory Reform: A New Foundation: Rebuilding Financial Supervision and Regulation* (June 2009) [hereinafter *Treasury Financial Regulatory Reform Report*], at 34 (heading 3).

[2] See generally PATRICIA A. MCCOY, BANKING LAW MANUAL: FEDERAL REGULATION OF FINANCIAL HOLDING COMPANIES, BANKS AND THRIFTS ch. 4 (Lexis 2d ed. 2000 & annual supps.).

"company" that has "control" over the bank. The FRB Equity Investment Statement indicates that a single PE investor would not have "control" over a bank or its holding company if the PE firm's investment is limited to less than 15% of any class of voting shares and less than one-third of the total equity of the organization. 12 C.F.R. § 225.144(c)(2). In contrast, a PE investor would be deemed to have "control" if (i) it held 25% or more of any class of voting securities, (ii) it controlled in any manner the election of a majority of directors, or (iii) it otherwise exercised a "controlling influence" over the organization. 12 U.S.C. § 1841(a)(2).

The FRB Equity Investment Statement addresses the issue of "control" only with respect to a minority investment made by a **single** investor. The Statement expressly refrains from expressing any opinion about whether a **group** of PE investors that make "[c]ontemporaneous minority investments in the same banking organization" could be viewed as either "a group acting in concert for purposes of the Change in Bank Control Act or . . . a single association for purposes of the BHC Act." 12 C.F.R. § 225.144(a) n.2. Under the FRB's regulations, a group of investors is deemed to be "[a]cting in concert" for purposes of the Change in Bank Control Act ("CBC Act") if members of the group knowingly participate in "a joint activity or parallel action towards a common goal of acquiring control of a [banking organization], whether or not pursuant to an express agreement." *Id.* § 225.41(b)(2). The FDIC has adopted a similar definition of "[a]cting in concert" for purposes of the CBC Act. *Id.* § 303.81(b).

The term "company" for purposes of the BHC Act includes an "association." 12 U.S.C. § 1841(b); 12 C.F.R. § 225.2(d)(1). "Association" is a broad term that, on its face, appears to include any group of investors that acts in concert to exercise a controlling influence over a banking organization. In 1977, the FRB determined that a proposal by a group of bank holding companies to make minority investments in an insurance company would create a joint venture that was prohibited under Section 4 of the BHC Act, 12 U.S.C. § 1843. The FRB ruled that Section 4 did **not** allow the bank holding companies to acquire minority interests (each representing 5% or less of the insurance company's equity stock), because Section 4

> . . . was not intended to allow a group of holding companies, through concerted action, to engage in an activity as entrepreneurs. . . . Such a construction would allow a group of 20 bank holding companies – or even a single bank holding company and one or more nonbanking companies – to engage in entrepreneurial joint ventures in businesses prohibited to bank holding companies, a result the [FRB] believes to be contrary to the intent of Congress. [12 C.F.R. § 225.137(d)(2), (e).]

In view of the reasoning set forth in 12 C.F.R. § 225.137, investments by groups of PE investors in failed banks raise serious questions about whether the investor groups will act in concert and will thereby constitute "entrepreneurial joint ventures" that should be viewed as "associations" and, therefore, as bank holding companies under the BHC Act. If groups of PE investors act in such a manner, they should be required to comply with the requirements of the BHC Act, including consolidated supervision and the FRB's source of strength doctrine.[3]

As previously stated, we understand that PE investors will structure their investments in failed banks in a manner that will avoid regulation under the BHC Act. In that event, such investors will not be subject to the FRB's source of strength doctrine or consolidated supervision. We also understand that PE investors intend to establish "shell" holding companies to manage the acquired banks, and these holding companies (i) will have few assets and (ii) will not be a meaningful source of strength to their subsidiary banks. Thus, investments in failed banks by PE investors will effectively avoid the application of the FRB's source of strength doctrine.

One way that the Proposed Policy Statement attempts to address these concerns is by imposing a parallel requirement that the parent holding company in any PE acquisition serve as a source of strength. We concur with this proposal. This commitment, however, would be weaker than the standard source of strength requirement that the FRB imposes on bank holding companies, because bank holding companies are subject to capital adequacy requirements and thus normally have substantial actual capital on hand to inject into a distressed bank or thrift. In contrast, the shell holding company envisioned by PE investors would not have any substantial capital on hand to inject. Instead, the source of strength commitment proposed by the FDIC would simply require the shell holding company to "sell equity or engage in capital qualifying borrowing." That commitment would be meaningless, however, if poor market conditions precluded the shell holding company from raising capital or if the PE investors in question decided to walk away from their investment in an ailing bank or thrift.

Accordingly, the FDIC's Proposed Policy Statement must include provisions to ensure that PE investors provide adequate support to banks they acquire through alternative means. In this regard, as discussed below in Parts II.B. and II.C., we believe that the Proposed Policy Statement's provisions requiring a high level of initial capitalization and a cross-guarantee are essential in order to provide alternative forms of protection for the DIF and taxpayers. In addition to providing a meaningful capital buffer, these safeguards are necessary to ensure that PE investors have sufficient "skin in the game" to avoid high-risk activities or other unsafe practices that could endanger the acquired bank or thrift.

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[3] We acknowledge that the determination of BHC Act coverage falls within the jurisdiction of the FRB and not the FDIC. If the FRB were to rule that groups of investors who act in concert would not trigger coverage of the BHC Act, such a ruling would make the FDIC's proposed safeguards even more imperative.

B. Undermining the Separation of Banking and Commerce[4]

A policy of separating banking and commerce arose early in our nation's history. For example, the first state bank charter – granted by Pennsylvania to the Bank of North America in 1787 – as well as the first federal bank charters – granted by Congress to the First and Second Banks of the United States in 1791 and 1816 – prohibited each bank from engaging in commercial enterprises. During the mid-19th century, state legislatures adopted "free banking" statutes that barred banks from engaging in commercial activities, and Congress followed the same approach in the National Bank Act of 1864. These statutory constraints of the mid-19th century reflected a strong legislative response to a devastating economic crisis that swept through the United States in the late 1830s and early 1840s. Legislators concluded that the crisis had been precipitated by (i) the collapse of the Bank of the United States of Philadelphia and the Morris Canal and Banking Company, which made aggressive and speculative forays into commercial activities, and (ii) the failures of a large number of state-sponsored banks, which were heavily involved in real estate development, public works projects (including roads and canals), and other commercial ventures.[5]

Similarly, the failures of several large financial-commercial conglomerates contributed to the severity of the Great Depression of the early 1930s. In response to those failures, Congress adopted the Banking Act of 1933. The 1933 Act imposed significant restrictions on the activities and affiliations of banks. Sections 5(c) and 16 of the 1933 Act generally prohibited national banks and state banks that were members of the Federal Reserve System ("FRS") from making equity investments in nonbanking corporations (except for authorized subsidiaries).[6] Additionally, the 1933 Act added a new Section 23A to the Federal Reserve Act, which imposed strict limits on financial transactions between FRS member banks and their affiliates.[7] Section 23A was later extended to state nonmember banks, and Congress added further restrictions on affiliate transactions when it enacted Section 23B in 1987.[8]

In response to the thrift debacle of the 1980s – including the failures of Lincoln Savings and Loan and other large thrift institutions that were heavily involved in real estate development and other commercial enterprises – Congress passed the Financial Institutions Reform, Recovery, and Enforcement Act of 1989 ("FIRREA"). Among other things, FIRREA (i) required thrifts to comply with the restrictions on affiliate transactions contained in Section 23A and Section 23B of the Federal Reserve Act, (ii)

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[4] The discussion in this section is adapted from Arthur E. Wilmarth, Jr., "Subprime Crisis Confirms Wisdom of Separating Banking and Commerce," 27 *Banking & Financial Services Policy Report* No. 5, at 1-18 (May 2008), available at http://ssrn.com/abstract=1263453; *see also* Arthur E. Wilmarth, Jr., "Wal-Mart and the Separation of Banking and Commerce," 39 *Connecticut Law Review* 1539-1622 (2007), available at http://ssrn.com/abstract=984103.

[5] Wilmarth, "Subprime Crisis, *supra* note 4, at 3.

[6] *Id.*; *see also* 12 U.S.C. §§ 24 (Seventh), 335.

[7] Section 23A imposes quantitative limits, collateral requirements and other restrictions on extensions of credit, purchases of assets, and other "covered transactions" between a bank and its affiliates. 12 U.S.C. § 371c.

[8] Section 23B requires affiliate transactions to be conducted on arm's length terms and to meet other requirements. 12 U.S.C. § 371c-1.

prohibited thrifts from investing in junk bonds, and (iii) barred thrifts from extending credit to affiliates engaged in activities that are not permissible for bank holding companies. In addition, FIRREA prohibited state-chartered thrifts from making equity investments or engaging as principal in activities that are not permissible for federal savings associations.[9] After a wave of bank failures occurred in the late 1980s, Congress enacted a 1991 law that imposed similar investment and activity restrictions on state-chartered banks.[10]

On four occasions since 1950, Congress enacted anti-affiliation laws when it realized that commercial firms were making widespread acquisitions of banks or other FDIC-insured depository institutions. When Transamerica and other commercial firms purchased numerous banks during the 1950s, Congress responded in 1956 by adopting the BHC Act, which prohibited multibank holding companies from engaging in activities that were not "closely related to banking."[11] When commercial conglomerates established a large number of one-bank holding companies in the late 1960s, Congress responded in 1970 by extending the BHC Act to reach those holding companies. After commercial firms purchased dozens of FDIC-insured "nonbank banks" during the 1980s, Congress stopped the nonbank bank movement by adopting the Competitive Equality Banking Act of 1987 ("CEBA"). CEBA closed the "nonbank bank loophole" by redefining the term "bank" under the BHC Act to include all FDIC-insured banks (with certain limited exceptions). CEBA thereby imposed a general prohibition on ownership of FDIC-insured banks by commercial firms.[12] Similarly, after commercial firms acquired a substantial number of FDIC-insured thrift institutions in the 1990s, Congress barred further commercial acquisitions of thrifts by enacting the Gramm-Leach-Bliley Act of 1999.[13] All four statutes were motivated by Congress' strong desire to maintain a separation between banking and commerce.[14]

Thus, the policy of separating banking and commerce has gained strength over time and has operated with particular force since 1950. The one significant exception to that policy is the provision of CEBA that allows commercial firms to acquire FDIC-insured industrial loan companies (ILCs).[15] When CEBA was passed in 1987, ILCs were small state-chartered institutions that had limited powers and engaged primarily in making consumer loans. It was only in the 1990s that Utah and other states expanded the powers of ILCs to make them comparable to banks. Thus, in 1987 Congress did not appreciate the potential threat that the ILC exemption would ultimately pose to the policy of separating banking and commerce.[16] Congress' lack of awareness of that threat becomes clear in view of CEBA's provision that closed the "nonbank bank loophole."

[9] Wilmarth, "Subprime Crisis," *supra* note 4, at 3; *see also* 12 U.S.C. § 1468(a), 1831e.
[10] Wilmarth, "Subprime Crisis," *supra* note 4, at 3-4; *see also* 12 U.S.C. § 1831a.
[11] *See* 12 U.S.C..§ 1843.
[12] *See id.* § 1841(c)(1). CEBA excluded limited-purpose trust companies and credit card banks from the definition of "bank" under the BHC Act, but it imposed stringent limitations that prevented such institutions from engaging in a retail banking business or making commercial loans. *Id* § 1841(c)(2)(D), (F).
[13] *See id.* § 1467a(c)(9).
[14] Wilmarth, "Subprime Crisis," *supra* note 4, at 4.
[15] *See* 12 U.S.C. § 1841(c)(2)(H).
[16] Wilmarth, "Subprime Crisis," *supra* note 4, at 4.

As noted above, CEBA was expressly designed to prevent commercial firms from continuing to acquire FDIC-insured "nonbank banks." The Senate committee report on CEBA declared that "[n]onbank banks undermine the principle of separating banking and commerce, a policy that has long been the keystone of our banking system."[17]

In its recent comprehensive report on financial regulatory reform, the Treasury Department recommended that all FDIC-insured depository institutions (including thrifts, ILCs, credit card banks, and limited-purpose trust companies) should be treated as "banks" for purposes of the BHC Act. The purpose of this recommendation is to ensure that companies controlling all types of FDIC-insured depository institutions will comply with the BHC Act's requirements and protections. As the Treasury report explained, this recommendation is designed to reaffirm and strengthen the separation of banking and commerce:

> By escaping the BHC Act, [firms controlling thrifts, ILCs, credit card banks and trust companies] generally were able to evade effective, consolidated supervision and the long-standing federal policy of separating banking and commerce. Federal law has long prevented commercial banks from affiliating with commercial companies because of the conflicts of interest, biases in credit allocation, risks to the safety net, concentrations of economic power, and regulatory and supervisory difficulties generated by such affiliations. This policy has served our country well, and the wall between banking and commerce should be retained and strengthened.[18]

The Treasury report correctly points out that ownership of banks by commercial firms poses serious risks to our financial system and creates significant conflicts of interest and competitive distortions in our broader economy. Ownership of banks by commercial firms spreads the federal safety net – including "too big to fail" (TBTF) subsidies – from the financial sector to the commercial sector of our economy. The magnitude of the safety net for financial institutions is shown by an April 2009 report issued by the International Monetary Fund. According to that report, the United States, the United Kingdom and European countries have already provided nearly $9 trillion of support to financial institutions during the current financial crisis, including $2 trillion of emergency central bank liquidity assistance, $2.5 trillion of government asset purchase commitments, and almost $4.5 trillion of financial guarantees.[19] These massive support measures are consistent with the widely-shared expectation that governments will provide "catastrophe insurance" to important financial institutions during systemic financial crises. The long history of governmental support to financial institutions during financial crises demonstrates that "[i]n times of crisis, everybody wants a government guarantee and those who have one have a fundamental advantage."[20]

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[17] S. Rep. No. 100-19, at 8, as reprinted in 1987 U.S.C.C.A.N. at 498.

[18] *Treasury Financial Regulatory Reform Report*, *supra* note 1, at 34.

[19] Int'l Monetary Fund, *Global Financial Stability Report: Responding to the Financial Crisis and Measuring Systemic Risk* (April 2009), at 38, 39 tbl. 1.7..

[20] Wilmarth, "Subprime Crisis," *supra* note 4, at 5 (quoting Alex J. Pollock, "To the Editor: Government Guarantee the Critical Factor," *American Banker*, Feb. 8, 2008, at 10).

It is already clear that commercial firms will receive TBTF subsidies if they have large, far-flung operations and own FDIC-insured depository institutions. For example, GMAC Financial Services owns Ally Bank, a Utah-chartered ILC. Cerberus (a major PE firm) and General Motors ("GM") currently own substantial stakes in GMAC, and they were formerly the controlling owners of GMAC. GMAC has already received extraordinary assistance from the federal government in the form of (i) $12.5 billion of capital infusions, and (ii) the right to issue up to $7.4 billion of low-interest, FDIC-guaranteed debt under the FDIC's Term Liquidity Guarantee Program ("TGLP"). GMAC was one of the 19 bank holding companies that underwent the recent "stress test." In fact, GMAC was found to have "the biggest capital hole to fill of any of the 19 stress-tested banks, relative to the size of its equity."[21] Nevertheless, federal regulators announced that the federal government would provide any needed capital that GMAC and the other 18 companies were unable to raise on their own. As a result, GMAC is now presumptively viewed as a TBTF company.[22]

Similarly, GE Capital (the finance subsidiary of General Electric, the world's largest industrial company) owns an ILC and a thrift headquartered in Utah. According to the *Washington Post*, GE Capital has issued $74 billion of low-interest, FDIC-guaranteed debt through the TGLP, representing nearly a quarter of all outstanding FDIC-guaranteed bank debt. As a result, GE has become "the biggest beneficiary of one of the government's key rescue programs for banks."[23] The *Wall Street Journal* recently estimated that the value of the TGLP subsidy provided to GE Capital could exceed $3 billion.[24]

The extraordinary federal assistance given to GMAC and GE Capital demonstrates that commercial ownership of banks places great pressure on federal regulators to provide financial support whenever large commercially-owned banks or their parent companies are threatened with failure. The pressure for a federal bailout increases exponentially when a mammoth commercial owner faces bankruptcy, as just occurred with GM. The FDIC should therefore be extremely reluctant to approve transactions that have the practical effect of allowing PE investors or other firms with commercial interests to acquire de jure or de facto control over banks. Such acquisitions are very likely to result in an extension of federal safety net subsidies to the commercial sector of our economy.

Because of federal safety net subsidies – which are greatly magnified during financial crises – FDIC-insured depository institutions enjoy a significant funding

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[21] Aparajita Saha-Bubna, "Stress-Test Results: GMAC Gap Looks to be Filled by Big Stakes from Government," *Wall Street Journal*, May 8, 2009, at C2.

[22] *See* Arthur E. Wilmarth, Jr., "The Dark Side of Universal Banking: Financial Conglomerates and the Subprime Financial Crisis," 41 *Connecticut Law Review* 963, 1050 n.449 (2009), available at ssrn.com/abstract=1403973; Dan Strumpf & Marcy Gordon, "GMAC receives $7.5B in new Treasury aid," *Associate Press Financial Wire*, May 22, 2009 (available on Lexis).

[23] Jeff Garth & Brady Dennis, "How a Loophole Benefits GE in Bank Rescue: Industrial Giant Becomes Top Recipient in Debt-Guarantee Program," *Washington Post*, June 29, 2009, at A01.

[24] Mark Gongloff, "Banks Profit from U.S. Guarantee: Lenders' Earnings Reap the Benefit of FDIC Backing on Company Debt," *Wall Street Journal*, July 27, 2009, at C1.

advantage over nonbanking firms. Commercial owners of FDIC-insured institutions have powerful financial incentives to exploit this funding advantage by causing their depository institutions to pay generous dividends and to provide other support to their parent companies and commercial affiliates. Such support can consist of interaffiliate loans, purchases of questionable assets, and upstreamed tax benefits from the bank to the parent.

The desire to exploit banking subsidiaries becomes especially strong whenever parent companies encounter serious financial problems. For example, when American Continental Company (the parent of Lincoln Savings and Loan) lost access to other sources of funding in the late 1980s, American extracted large amounts of funding from its subsidiary thrift. In addition, American used the branches and employees of Lincoln Savings to promote the sale of American's uninsured subordinated notes to more than 20,000 of Lincoln's customers. Those customers suffered severe losses when Lincoln failed and American filed for bankruptcy. Similarly, in the early 1970s, Beverly Hills Bancorp sold $13 million of commercial paper to more than 200 customers of its subsidiary bank, Beverly Hills National Bank. When the parent company defaulted on its commercial paper, the customers sued the bank and forced it into conservatorship and liquidation. [25]

Commercially-owned banks have repeatedly exhibited conflicts of interest by making investments and loans designed to benefit their commercial affiliates. For example, Azora Bank, a Cerberus-controlled Japanese bank, made a large stock investment in GMAC to support Cerberus' interest in GMAC. Azora Bank reportedly lost more than $370 million on its GMAC investment, and Ceberus' obvious conflict of interest in that transaction led to "public criticism from Japan's top financial regulator."[26] Similarly, ILCs owned by commercial firms have regularly extended credit to their parent companies' customers in order to promote the sale of the parents' products. GMAC, Volkswagen Bank and Toyota Financial Savings Bank all make loans to customers (typically at below-market interest rates) to finance their purchases of automobiles produced by affiliated car manufacturers. Similarly, Target Bank issues proprietary credit cards to business firms to facilitate their purchases of goods at Target stores. The operations of commercially-owned ILCs have reflected a consistent strategy by commercial parent companies to advance their interests by using the credit facilities of their captive ILCs.[27]

Advocates for commercial ownership of banks argue that statutory "firewalls" restricting affiliate transactions and insider lending will prevent a commercially-owned banks from making unsound loans or abusive transfers of funds to benefit their affiliates. As noted above, Sections 23A and 23B of the Federal Reserve Act impose quantitative limits, collateral requirements and other restrictions on transactions between FDIC-insured banks and their affiliates. In addition, federal statutes and regulations impose

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[25] Wilmarth, "Subprime Crisis," *supra* note 4, at 6-8.
[26] Ian Rowley, "A U.S. Private Equity Flop in Japan," *Business Week,* June 1, 2009, at 57.
[27] Wilmarth, "Subprime Crisis," *supra* note 4, at 8.

strict conditions on loans made by FDIC-insured banks to their directors, executive officers, principal shareholders and related interests.[28]

However, bank insiders have often disregarded these firewalls during times of financial stress when the financial viability of controlling shareholders or affiliates was threatened. A high percentage of thrift failures during the 1980s involved violations of rules governing affiliate transactions and insider lending. Similarly, a 1994 GAO study found that unlawful insider lending and abusive affiliate transactions occurred frequently within a sample group of 175 banks that failed during 1990-91. United States National Bank of San Diego failed in 1973 after making massive loans to its controlling shareholder and his affiliates in violation of legal lending limits. Hamilton National Bank failed in 1976 after its parent holding company violated Section 23A by causing the bank to purchase large amounts of low-quality mortgages from the bank's mortgage banking affiliate. A bank failure in 2007 was similarly caused in part by the bank's unlawful purchase of low-quality subprime loans from a mortgage affiliate. During the 1987 stock market crash, Continental Illinois violated legal lending limits in order to prevent its options trading subsidiary from failing.[29]

Federal regulators have also repeatedly waived regulatory firewalls to enable banks owned by large conglomerates to support troubled affiliates. For example, after the terrorist attacks of September 11, 2001, federal regulators suspended the application of Section 23A and encouraged major banks to transfer funds to their securities affiliates to prevent a liquidity crunch that could have paralyzed U.S. financial markets and threatened the survival of leading securities firms. In August 2007, after the outbreak of the current financial crisis, the FRB granted waivers to the three largest U.S. banks so that they could extend credit beyond the Section 23A limits to support their securities affiliates. In April 2008, the FRB permitted JP Morgan Chase to make loans to Bear Stearns in excess of the Section 23A limits.[30] In September 2008, during the panic surrounding Lehman Brothers' impending bankruptcy and the run on AIG, the FRB suspended Section 23A for several months to allow all insured depository institutions to provide liquidity to their affiliates for assets typically funded in the tri-party repo market.[31] In May 2009, the FRB exempted GMAC's subsidiary, Ally Bank, from Section 23A so that Ally Bank could make loans to consumers and car dealers in order to finance their purchases of GM automobiles.[32] Thus, in times of serious financial stress, federal agencies have repeatedly shown a willingness to grant relief from regulatory firewalls.

In short, acquisitions of banks by commercial firms pose serious risks to the DIF and taxpayers. In addition, federal safety net subsidies give commercial owners of banks an unfair competitive advantage over commercial firms that do not have bank affiliates. Consequently, if PE firms with commercial interests are allowed to acquire control of

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[28] *Id.* (discussing restrictions on affiliate transactions under §§ 23A and 23B, and restrictions on loans to insiders under 12 U.S.C. §§ 375a, 375b, 1468(b) and 1828(j)(2)).
[29] Wilmarth, "Subprime Crisis," *supra* note 4, at 8-9.
[30] *Id.* at 9.
[31] Federal Reserve Board, Press Release (September 14, 2008), available at http://www.federalreserve.gov/newsevents/press/monetary/20080914a.htm.
[32] Letter dated May 21, 2009, from FRB Deputy Secretary Robert deV. Frierson to Richard K. Kim.

failed banks, other commercial entities will necessarily seek to acquire failed banks or ILCs in order to maintain competitive parity with PE firms. Over time, acquisitions of failed banks and ILCs by commercial entities will create significant competitive distortions within our general economy and increase the risks of federally-funded bailouts.

For the foregoing reasons, PE firms should not be allowed to obtain de jure or de facto control over failed banks. In addition, as discussed below in Part II.E., PE firms that invest in failed banks should be barred from engaging in any interaffiliate transactions with those banks without the prior written consent of the FDIC.

II. Specific Issues Raised by the FDIC's Proposed Policy Statement

A. Prohibited Structures for PE Investments

We understand that many PE investors would prefer to structure their acquisitions of a failed bank or thrift in a "silo" format that insulates their other investments from recourse in the event the depository institution fails again. Any use of a silo format would raise serious concerns about the availability of adequate capital support for the bank or thrift. In addition, a silo format would raise significant questions and concerns regarding the identities of the individuals who are actually running the acquired institution. Such concerns are heightened because PE acquisitions would likely be structured so that no one investor would nominally have control of the acquired institution for purposes of the BHC Act. In reality, however, minority PE investors would not invest in failed banks or thrifts unless they were assured of some method of effective input into management. Accordingly, it is essential for the FDIC and the depository institution's primary regulator(s) to be able to ascertain who is influencing or making decisions for the institution.

As the BCCI experience demonstrated, opaque ownership structures – including but not limited to entities organized in secrecy jurisdictions -- make it extremely difficult for regulators to determine and monitor the individuals who are actually in charge. Opaque structures also make it easier for owners to mask unsafe and unsound practices or fraud. Accordingly, we believe that the Proposed Policy Statement's provisions requiring transparent ownership and full disclosure are urgently needed to obviate these problems.

B. Minimum Capitalization Requirement

The Proposed Policy Statement contemplates a substantially higher minimum Tier 1 leverage ratio for the first three years and a well-capitalized level of capital adequacy thereafter. We fully agree that heightened capital is necessary in PE acquisitions for several reasons:

> First, any acquisition of an institution in receivership poses added risk of failure due to the institution's damaged franchise and the uncertain future performance of

the institution's impaired assets. To avoid repeat failure of the institution, an added capital buffer is necessary to absorb future losses.

Second, with heightened capital requirements, PE investors will be less likely to take imprudent risks because they have more to lose if their business decisions turn out badly. This concern takes on special significance in the PE context because PE investors generally have a short investment horizon and target a return on equity ("ROE") of fifteen to twenty percent or more. Such a high ROE target greatly exceeds the average ROE figures for banks during the past two years and tilts the acquired institution toward heightened asset and liability risk.[33]

Third, the standard PE acquisition will not face consolidated oversight under the BHC Act, raising the potential for regulatory gaps and systemic risk.

Finally, unlike normal bank acquisitions, PE acquisitions will generally be made through a shell holding company, which will not hold substantial assets to inject into the acquired bank or thrift if the subsidiary encounters financial difficulties. Therefore, higher capital requirements are needed initially to offset the holding company's inability to serve as a conventional source of strength.

Currently, the minimum initial Tier 1 leverage ratio for unblemished *de novo* depository institutions is eight percent. For PE investor acquisitions of failed banks or thrifts, the Proposed Policy Statement proposes an even higher minimum initial Tier 1 leverage ratio. We wholeheartedly commend that approach in view of the added risk that PE transactions pose, both in view of the higher risk appetite of PE investors and the higher risk profile of the failed institutions they would be buying. Furthermore, it is wise to gauge initial minimum capital based on the Tier 1 leverage ratio, not risk-based capital, given strong concerns about the abysmal performance of risk-based capital measures during the current financial crisis.

The FDIC's proposed minimum Tier 1 leverage ratio of fifteen percent is well-calibrated to offset the additional risks of PE transactions. At the same time, we recognize that the optimal level of initial minimum capital may vary according to the business plan, management experience, ownership structure, investment horizon, and anticipated return on equity of each acquirer. Accordingly, we would also endorse an alternative sliding scale approach that would calibrate the minimum Tier 1 leverage ratio for the first three years (or longer, if extended by the FDIC) based on factors including, but not limited to, the quality and risk profile of the acquirers' business plan, the quality and experience of their proposed management, the transparency and safety of their ownership structure, the capitalization of the parent holding company, their investment horizon, and their projected return on equity. If a sliding scale approach were adopted, the minimum Tier 1 leverage ratio should be set no lower than ten percent to account for the added risk of the institutions being acquired and of PE acquisitions generally. After the initial period expires, we concur that the institution should maintain a well-capitalized

[33] The average ROE for all FDIC-insured institutions was 0.41% in 2008 and 7.76% in 2007. The average ROE for FDIC-insured institutions in the size range of $100 million to $1 billion was 2.53% in 2008 and 9.27% in 2007. Those were the highest ROEs earned in those respective years by any group of banks based on size. *See* "Quarterly Banking Profile: First Quarter 2009," at 9 (tbl. IV-A) (providing full-year ROE figures for 2008), in 3 *FDIC Quarterly* No. 2 (2009); "Quarterly Banking Profile: First Quarter 2008," at 9 (tbl. IV-A) (providing full-year ROE figures for 2007), in 2 *FDIC Quarterly* No. 2 (2008).

level of capital adequacy thereafter. We also agree that failure to observe these capital adequacy requirements should immediately trigger a source of strength obligation on the part of the PE investors and subject the institution to a Prompt Corrective Action order.

C. Cross-Guarantee Requirement

The Proposed Policy Statement would impose a cross-guarantee requirement on investors whose investments, individually or collectively, constituted a majority of the direct or indirect investments in two or more insured banks or thrifts. This requirement is designed to provide an added source of capital support in the event one of the acquired banks or thrifts later experienced financially distress.

A cross-guarantee requirement has long been standard in bank holding companies. We agree that this requirement is an important substitute for the source of strength doctrine in the PE context. That substitute is needed because the shell holding company favored by PE investors would not have substantial assets on hand to inject into its bank or thrift subsidiary. In addition, PE transactions typically use separate partnerships or limited liability entities to wall off their other investments from exposure to claims or availability as a source of strength. Accordingly, absent a cross-guarantee obligation, PE investors would have no extended exposure beyond their initial investment in the failed bank or thrift if the institution later experienced difficulties. Cross-guarantees would provide needed incentives to PE investors to rehabilitate the institutions they acquire, instead of walking away from those institutions during any future distress.

D. Minimum Holding Period for PE Investments

The Proposed Policy Statement would prohibit PE investors from selling or otherwise transferring securities of their holding company or the acquired bank or thrift for three years following the acquisition without the FDIC's prior approval. We applaud this proposal, except to urge the FDIC to make the three-year minimum holding period an absolute requirement.

A three-year minimum holding period is necessary for PE investments because the PE model is premised on short-term investments with high returns. The standard PE acquisition seeks to make a high return on equity of fifteen to twenty percent or more and to recoup that profit in a relatively short time by selling the acquired company, through a public offering or otherwise.

In the banking context, that model can be and often is a formula for trouble. The concern is that the PE investors will attempt to earn a high rate of return through a combination of risky assets, risky liabilities, and rapid growth. To finance that rapid growth, PE investors may encourage heavy reliance on brokered deposits. Brokered deposits, however, are a costly and volatile funding source and figured prominently in many of today's depository institution failures. In addition, to pay the higher rate of return on brokered deposits, PE investors would have to seek out higher-risk loans and other assets with higher expected returns. As today's financial crisis amply demonstrated, that business model may yield handsome short-term profits but poses the risk of inflicting devastating long-term future losses on the FDIC and taxpayers. Indeed, similar high-risk, high-growth strategies led to many costly federal bailouts of thrift institutions during the 1980s and early 1990s.

The three-year minimum holding period proposed by the FDIC is needed to counteract a risky, short-term investment mentality. If a sliding scale approach to the minimum Tier 1 leverage ratio is adopted, we also encourage the holding period to be a factor in the sliding scale analysis.

E. Prohibited Transactions with Affiliates

As discussed above in Part I.B., commercial owners of FDIC-insured banks have exhibited a strong tendency to exploit federal safety net subsidies by causing such banks to provide loans, investments and other support to commercial affiliates or their customers or suppliers. The Proposed Policy Statement would prohibit banks covered by the Statement from making any "extension of credit," as defined in 12 C.F.R. § 223.3(o), to any PE investor in that bank, any investment fund managed by such a PE investor, or any affiliate of such an investor or fund. For purposes of this proposed prohibition, the term "affiliate" would be defined to include any company in which a PE investor owns a ten percent or greater equity interest.

We strongly support the proposed prohibition against any extensions of credit by a covered bank to PE investors in the bank, their managed funds, and affiliates of such investors or funds. The proposed prohibition is strongly warranted by the past history of exploitive affiliate transactions involving commercially-owned banks. We also support the ten percent equity threshold for defining the term "affiliate."

However, we believe that the proposed prohibition does not go far enough. As noted in Part I.B., commercially-owned banks have frequently provided other types of financial support to their affiliates, including equity investments, purchases or sales of assets, and purchases or sales of services. A recent example of such a transaction is the large equity investment that Cerberus-controlled Azora Bank made in Cerberus-controlled GMAC. Accordingly, the Proposed Policy Statement should also prohibit a bank covered by the Statement from engaging, without the FDIC's prior written approval, in any "covered transaction" as defined in 12 C.F.R. § 223.3(h)(2)-(5) or any of the additional transactions listed in 12 C.F.R. § 223.52 with any PE investor in that bank, any investment fund managed by a PE investor, or any affiliate of such an investor or fund. We believe that these designated transactions (which do not constitute extensions of credit) should not be subject to an absolute prohibition but should require prior approval by the FDIC.

In addition, we believe that the Proposed Policy Statement should prohibit banks covered by the Statement from engaging, without the FDIC's prior written approval, in any "covered transaction" as defined in 12 C.F.R. § 223.3(o) or any of the additional transactions listed in 12 C.F.R. § 223.52 with (i) any bank covered by the Statement, (ii) any PE investor that owns an equity interest of ten percent or greater in such a bank, (iii) any investment fund managed by such a PE investor, or (iv) any affiliate of such an investor or fund. The purpose of this limitation would be to prevent abusive "daisy chain" transactions involving multiple banks covered by the Statement. For example, it is conceivable that Bank A might provide financial support to Bank B or PE investors (or managed funds or affiliates) associated with Bank B, based on the explicit or implicit understanding that Bank B would provide financial support to Bank A or PE investors (or managed funds or affiliates) associated with Bank A. This type of reciprocal "back-scratching" support can endanger the banking system just as much as the interaffiliate transactions contemplated by the Proposed Policy Statement.

Failing thrifts and their owners frequently engaged in these types of abusive "daisy chain" transactions during the 1980s.[34] Such transactions should not be permitted to occur with banks covered by the Proposed Policy Statement. We believe that the Proposed Policy Statement would provide adequate protection against "daisy chain" abuses if written FDIC approval is required before a bank covered by the Statement engages in a designated transaction with any other covered bank or any PE investor that holds a ten percent or greater equity interest (whether voting or nonvoting) in such a bank or any managed fund or affiliate of that investor.

F. <u>Disqualification for Bidding on Future Acquisitions of Failed Banks</u>

When contemplating PE acquisitions of failed banks and thrifts, it is extremely important to avoid setting those institutions up for repeat failures in the future. For this reason, to avoid rewarding PE investors for irresponsible management of banks or thrifts culminating in failure, the Proposed Policy Statement would disqualify any PE investor that holds a ten percent or greater equity interest in a bank or thrift that later fails from bidding to acquire deposits or both deposits and assets of that institution.

We strongly support the FDIC's proposal, because it would remove any perverse incentives for PE investors to profit from imprudent practices not only once but twice – initially and later upon resale – while inflicting the cost on the FDIC and taxpayers. Furthermore, we urge the FDIC to go farther and permanently bar any PE investor that has held a ten percent or greater equity interest in three or more depository institutions that later fail from ever bidding on deposits or both deposits and liabilities of any failed bank or thrift. This type of permanent bar would prevent any PE investor with a track record of repeatedly running banks into the ground from inflicting losses on the FDIC or taxpayers ever again.

In conclusion, we express strong support for the FDIC's Proposed Policy Statement. Although PE investors will likely object strongly to at least some of the FDIC's proposals, it is critical for the FDIC to avoid any concessions that could (1) compromise the long-term safety and soundness of rehabilitated banks and thrifts or (2)

[34] *See, e.g.,* William K. Black, *The Best Way to Rob a Bank Is to Own One: How Corporate Executives and Politicians Looted the S&L Industry* 53-54 (2005).

threaten the solvency of the DIF and the stability of our financial system. Some PE investors may not be willing to comply with the FDIC's prudential requirements and may decide to spurn direct investments in failed banks and thrifts in favor of making equity investments in conventional bank holding companies that act as strategic buyers of failed institutions. However, we believe that outcome would be preferable for the overall health of the banking system.

Thank you for your kind consideration of these comments.

Very truly yours,

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