Institutional Risk Analytics

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Robert E. Feldman
Executive Secretary
Federal Deposit Insurance Corporation
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Dear Mr. Feldman:

Below please find our comments regarding the proposed request and the specific questions contained in RIN 3064–AD47, "Proposed Statement of Policy on Qualifications for Failed Bank Acquisitions."

The request outlines some significant issues that regrettably neither the FDIC nor the other regulators may be fully equipped to resolve in terms of legal authority. The two key issues seem to be 1) whether or not a private equity ("PE") fund and/or other qualified investor should be considered a control party with respect to the restructured bank that is sold by the FDIC as part of the resolution process, and 2) the amount of initial capital required should the PE and/or qualified investor not be deemed to be a control party of the bank.

Determination of Control

The traditional approach by regulators to require that the control party of banks serve as a source of financial and managerial strength to the depository is both practical in prudential terms and also good public policy. Just as the US banking industry acts collectively to ensure the safety and soundness of banks and the stability of the Deposit Insurance Fund ("DIF"), control parties are the first line of defense for ensuring the soundness of individual depositories. The key problem faced by regulators in cases where the investors, be they a corporation or a group of investors, do not explicitly accept the duties under existing law to serve as responsible custodians of the public interest that is inherent in owning an insured depository institutions is that this leaves a vacuum instead of the advocate for strong performance provided by professional owners such as PE funds and may make it more likely that the institution will fail again.

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This request for comments rightly highlights the fact that neither the FDIC nor the primary regulators, including the OCC and the Fed, have the statutory authority to bless a change in bank control where "nobody" is explicitly responsible for the safety and soundness of the insured depository at the close of the transaction. Such a situation would in effect be as though the FDIC were going to conduct an initial public offering for the failed bank and hope that the institution will be able to function and perform without the management leadership and financial resources of a recognized control party.

But all of that said, necessity seems to be forcing the issue when it comes to traditional approaches to safety and soundness when it comes to restructuring failed banks. In fact, just this sort of "IPO" type approach was illustrated in transaction involving the Georgia banker Joe Evans who reportedly used $300 million raised from 26 institutional investors — none of which were PE funds or qualified investors — to acquire the six subsidiaries of Security Bank Corp. of Macon, Ga., which all failed in late July. "There is no investor in the transaction large enough that would have required any kind of filing on their part," Evans said in an interview. [1]

The extreme situation created by the government's need to sell the assets of failed banks to new investors really begs the question regarding the entire concept of bank "control." While from a regulatory perspective, it may be desirable or even mandatory under current law for a bank to have a single, strong control party to serve as a source of financial and managerial strength to the bank, in practical terms there may not be sufficient numbers of qualified private equity investors with the management personnel to meet the control criteria. Also, there are practical and liability issues that may dissuade PE investors from accepting a determination of control. Many PE firms participate in "club" transactions where only one PE firm is actively involved with the portfolio company, while other participants maintain a passive role.

There are many PE firm active in this area that have spent the time and financial resource to assemble management, capital finance and other factors needed to serve as a source of strength to a commercial bank. But there are many, many more investment firms that have the desire to participate financially in these transactions, but do not have the capacity or the intent to accept the role of control party with respect to a depository and/or bank holding company. More, if you consider that there are no control parties in most larger banks and that the management and directors of these large depositories typically bear the burden of meeting regulatory goals for safety and soundness purposes, without an identified control party being involved, it seems inconsistent for FDIC and other regulators to insist on a control party for smaller failed banks but in essence allow for disaggregated ownership in larger banks where there is no control party. Regulators (and the Treasury and the Congress) cannot have it both ways.

The FDIC should be mindful that in most cases, even large institutional investors in banks, bank holding companies and non-bank entities, who act as investment advisors on behalf of other beneficiaries, explicitly declaim control of securities in all companies in

[1] See Adler, Joe, "FDIC, Buyers Get Creative With Failures," *American Banker*, July 28, 2009

which they invest. This practice may be offensive to those of us who believe that managers have a fiduciary duty to their investors to exercise active oversight of all such investments, but the fact is that today institutional investors frequently assume a passive posture with respect to such investments, including large investments in publicly traded banks that require disclosure to the SEC and might, in some cases, be interpreted as having some indicia of control based percentage ownership.

Thus it seems that the FDIC and other regulators have a problem, but one that the agencies may not have the statutory authority to resolve. The FDIC and, indirectly, the banking industry and the US Treasury, have a need to access pools of private capital necessary to recapitalize failed banks, thus some variation on the "IPO" approach seems appropriate and inevitable. It is unclear to us why the regulators need to formalize this approach overmuch compared with current practice.

Looking at the Security Bank transaction, the simple fact is that a group of qualified investors are funding the bank purchase and none of these individual investors are required to formally accept a determination of control. This type of "IPO" format for a bank recapitalization has many attractive elements. The question comes, however, as to whether the FDIC and other regulators can credibly ignore the possibility that the individual PE funds and/or qualified investors may, in fact, may be acting in concert with one another, have common interests and objectives, and therefore should be treated as an association for purposes of bank control.

We do not believe that any purpose is served by creating a "special" category for investors who declaim beneficial ownership and/or control of the shares of a failed bank that is sold as part of the resolution process. Current law and regulation as illustrated by the Security Bank transaction seem more than sufficient. While there may be some significant regulatory and historical reasons for concerns about allowing investors to take what are essentially passive equity stakes in restructured banks, <u>placing excessive burdens on PE and/or qualified individual investors will greatly reduce the number of potential investors in banks and will therefore result in a greater proportion of liquidations and asset sales, as opposed to restructuring these institutions as independent depositories</u>.

Needless to say, many institutional investors would prefer the situation where the failed bank is liquidated and the assets sold piecemeal, but we do not believe that this course serves the public interest. Adoption of special restrictions on passive investments in banks may have the effect of increasing the cost of resolutions to the DIF and, more important, add a bias toward liquidation rather than restructuring that could have a significant negative impact on the public good and the US economy. We expect that if the FDIC and other regulators were to put this question directly to the Congress, the answer would be strongly in favor of restructuring the failed bank rather than liquidation.

Minimum Capital Requirements

All that said, the *quid pro quo* for allowing investors to have latitude with respect to their status as control parties, however, must be that they put more capital into the bank at the outset. If the investors are not willing to commit to provide additional funds as and when the restructured bank needs additional capital, then the FDIC should require higher capital levels from these investors at the outset and make clear that should the bank fall below minimum capital levels, that the primary regulator and the FDIC may either force the sale of the bank or preemptively resolve the institution to protect the DIF. While some investors have complained about the proposed 15% T1 RBC levels being too high, given the likely supra-normal loss rates the US banking industry is likely to see in 2H 2009 and beyond, we believe that requiring higher than normal initial capital infusions from investors who declaim control and/or beneficial ownership of banks is reasonable and may be required given the FDIC's statutory duty to protect the DIF.

Like the FDIC with respect to the issue of control, private investors cannot have it both ways. Either they accept the status of a control party and the duties under existing law to serve as responsible custodians of the public interest that comes along with bank ownership, in which case they accept the formal status of a control party; or they must accept that their investment is entirely at risk should the bank need additional funding. In the former case, less capital would be required at the outset, but a commitment to provided additional capital as needed would also be part of the bargain.

That said, we do not believe that an arbitrary 15% capital requirement is necessarily appropriate and that the FDIC should set the level of capital and reserves based on the likely loss experience of the bank. Some banks may indeed need 15% T1 RBC, but others may need far less. We suggest that a case-by-case approach be used and that the FDIC show flexibility in this regard, but with an eye to having enough capital injected into the institution to ensure that no additional infusions of capital are needed for at least three years. In addition, we support a three-year minimum holding period for transactions involving failed banks where the investors have declaimed beneficial ownership and/or control.

We would be please to discuss these comments with the FDIC.

Yours truly,

Christopher Whalen
Managing Director