August 10, 2009

BY ELECTRONIC MAIL

Mr. Robert E. Feldman
Executive Secretary
Attention: Comments
Federal Deposit Insurance Corporation
550 17th Street, NW
Washington, DC 20429

Re: ***Proposed Statement of Policy on Qualifications for Failed Bank Acquisitions***

Dear Mr. Feldman:

On behalf of CapGen Financial Group, Belvedere Capital, and Castle Creek Capital, we are pleased to submit this letter in response to the Federal Deposit Insurance Corporation's ("FDIC") request for comments on the Proposed Statement of Policy on Qualifications for Failed Bank Acquisitions (hereinafter "Policy Statement").[1] We appreciate the opportunity to express our firms' views on the FDIC's Policy Statement and to provide suggestions for its improvement.

In summary, our view is that a number of aspects of the Policy Statement require substantial revision before the statement may be implemented to the benefit of the U.S. banking system and the Deposit Insurance Fund ("DIF"). As proposed, the Policy Statement −

- Assumes incorrectly that private equity investors pose greater risks to the investee banks or to the DIF than other types of investors.
- Will effectively deny much needed new capital and other resources to the ailing U.S. banking system.
- Will very likely increase the FDIC's resolution costs.

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

- Does not clearly exempt private equity investments made through registered bank holding companies, as CapGen, Belvedere Capital, and Castle Creek Capital do.
- Contains no limitation on retroactive application of the Statement to existing organizations and investment arrangements.

In addition to providing our detailed comments on the Policy Statement below, we are enclosing a revised version of the Statement that reflects our comments. We believe that our proposed revisions would significantly advance the Policy Statement's objectives of enhancing the safety and soundness of insured depository institutions while mitigating risks to the DIF.

I. Overview of Our Firms

CapGen Financial Group ("CapGen"), Belvedere Capital ("Belvedere"), and Castle Creek Capital ("Castle Creek") are private equity firms that invest in financial services businesses with a focus on small- to medium-sized community banks. Each firm has an experienced team of banking professionals that are highly regarded for their integrity, operating expertise, investment performance, regulatory knowledge, and relationships with federal and state bank regulators. CapGen, Belvedere, and Castle Creek are among the few private equity firms that focus exclusively on the financial services sector. Neither they nor their affiliates are engaged in commercial activities.

Unlike traditional private equity funds, all of CapGen's, Belvedere's, and Castle Creek's funds invest in banks through registered bank holding companies. Thus, the Federal Reserve approves and supervises their investments in banks, with full scope bank holding company supervision and regulation, including mandatory reporting requirements, periodic examinations, and restrictions on non-banking activities. Indeed, CapGen, Belvedere, and Castle Creek generally seek a controlling interest in their investments because such a position allows these firms to provide important value – through board oversight – due to their decades of comprehensive banking experience. The firms' principals serve on the company's boards of directors and regularly advise senior management on strategic and operational issues. As control investors with decades of banking experience, CapGen, Belvedere, and Castle Creek are deeply committed to the safety and soundness of the banks in which they invest. Each firm stresses strong capital, strong core deposits, strong liquidity, high asset quality, hard-working quality management teams, and community service. When weaknesses are identified, these firms have a history of working cooperatively with bank management and regulators to resolve deficiencies. Our firms typically hold investments for considerable periods of time, recognizing that the value of a banking franchise is nurtured over time by adherence to banking fundamentals, not by short-term trading strategies.

II. Private Capital and the Banking Industry

The Policy Statement would establish stricter criteria for acquisitions – direct or indirect – of assets from the FDIC by private equity investors than for acquisitions by other bank investors, such as existing bank holding companies and banks, presumably on the assumption that private equity investors present heightened risk to the acquired banks or to the DIF. This premise is not supported by a review of the private equity investments in banks that have occurred over the past 20 years.

Guhan Subramanian, a professor at Harvard Law School and Harvard Business School and the author of numerous publications relating to private equity funds, conducted an independent study for CapGen, Belvedere and Castle Creek of private equity transactions in banks since enactment of the Financial Institutions Regulatory Reform and Enforcement Act in 1989.[2] The study analyzed investments in banks from that period, including investments involving minority versus controlling interests and investments made by a solo investor versus a consortium of investors. The results illustrate that private equity fund investors present no greater supervisory or regulatory risks than other types of investors. Indeed, Mr. Subramanian's study, a copy of which is attached, shows no harm to investee banks or to the DIF from private equity investments.

Moreover, the study confirms an even more important point with respect to CapGen, Belvedere, and Castle Creek Capital. Our firms have an established history of investing in and adding value to regional and community banks. As discussed, the principals of these firms are seasoned banking professionals with decades of experience managing banks. The study shows that banks entering into transactions with our firms generally have strong capital ratios, safety and soundness and compliance records.

Thus, far from being a danger to banking or the DIF, investment by firms such as ours is a boon to the banks in which they invest, to community banking generally and to the DIF. Unfortunately, the FDIC's Policy Statement, if implemented in its present form, would make it so unrewarding for our firms to invest in community banks and/or buy assets from the FDIC that they might not be able to operate going forward, and they certainly would not be able to raise funds for new investments.

III. The Policy Statement's Effect on the Banking System

The detrimental impact that the Policy Statement would have on the banking system and the FDIC itself cannot be understated. The Policy Statement would reduce the

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[2] *See* Pub. L. No. 101-73, 103 Stat. 183 (1989) (codified as amended in 12 U.S.C. § 3331 *et seq.*)

amount of private capital available for banks, close off valuable sources of managerial expertise, and ultimately increase the FDIC's resolution costs.

A. Private Capital

The Supervisory Capital Assessment Program ("SCAP"), commonly referred to as the stress tests conducted by the Federal banking agencies in May 2009, revealed that ten of the largest banks had a combined capital shortfall of at least $75 billion.[3] Numerous "unofficial" tests of small- and medium-sized banks conducted around the same time as the agencies' SCAP found that small- and medium-sized banks in the United States would need between $24 billion and $86 billion in additional capital.[4] And legacy assets continue to take a toll on banks' capital buffers so that barring an immediate and unexpected improvement to the U.S. economy, banks will need capital to absorb further losses anticipated in the remainder of 2009 and in 2010.[5]

The availability of adequate capital is of course essential to a healthy banking community in the United States. A July 20, 2009, report by the Financial Stability Oversight Board emphasized the importance of bank capital availability not just to day-to-day banking but in systemic terms:

> Capital plays a critical role in supporting confidence in the health of the banking system. While the vast majority of U.S. banking organizations have capital in excess of the amounts required to be considered well-capitalized, the uncertain economic environment has eroded confidence in the amount and quality of capital held by some organizations. In turn, market participants' concerns over the capital positions of some institutions is impairing the ability of the system overall to perform its critical role of credit origination and intermediation.[6]

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3 *See* Press Release, Federal Reserve, OCC, and FDIC release results of the Supervisory Capital Assessment Program (May 8, 2009).

4 *See* Saskia Scholles, Julia MacIntosh & Francisco Guerrera, *Smaller US banks need additional $24 bn*, Fin. Times (May 17, 2009); Pallavi Gogoi, *Stress tests find small banks need to raise capital, too*, USA Today (May 13, 2009).

5 *See* SCAP Results (May 8, 2009) (providing information on expected losses in 2009 and 2010 for the 19 largest U.S. banks).

6 Financial Stability Oversight Board Quarterly Report to Congress for the quarter ending June 30, 2009 (released on July 20, 2009).

Particularly in an environment of the sort we are now weathering − although even in quieter times − it is essential that the FDIC, and other policymakers, should lean against, not for, proposals that have the effect of decreasing the amount of capital available to our banks.

Yet, the Policy Statement, if implemented in its current form, is likely to have just such an effect. The onerous new requirements set forth in the Policy Statement are likely to discourage private equity investors from providing capital to banks.[7] In the days following the FDIC's announcement of the Policy Statement, multiple private equity funds involved in recent FDIC-administered auctions for failed banks have expressed their strong concerns with the Policy Statement, and even doubt as to whether their firms would have participated had the Policy Statement been applicable at the time of their transactions.[8]

Furthermore, the Policy Statement will likely reduce investments in all banks, not just in failed banks expressly covered by the Statement's requirements. Even though the Policy Statement, as proposed, appears to be fundamentally intended to apply to investments in failed banks, one consequence − albeit unintended − will be to deter investments in healthy banks, which are themselves seeking to acquire failed banks. Most healthy banks today are looking to acquire some assets of failed banks or entire failed banks themselves, and the FDIC presumably wants to foster such interest. But what healthy bank is going to want a private equity investor, if as a result of such investment, the bank may incur more restrictions, direct or indirect, including increased capital requirements, when it subsequently seeks to undertake a failed bank transaction? Yet, private equity capital should be and can be an important source of uncommitted capital for healthy banks, giving them an additional layer of protection as well as additional resources to acquire failed bank assets or failed banks in their entirety. In the end, the Policy Statement is likely to have a much broader effect on private equity investments in banks than just on FDIC failed bank transactions alone.

If the Policy Statement were to go forward as proposed, we would expect most private equity firms simply to invest in industries other than banking. For most firms, their ability to raise capital from investors will not be significantly affected because they will still be able to evaluate and identify investment opportunities in other industries that meet their investors' return expectations. This clearly would be a bad result for the banking industry and

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[7] Moreover, aside from the immediate disincentives created by the Policy Statement, investors in private equity firms and the private equity firms themselves may well read into the Policy Statement a general aversion on the federal regulators' part to private equity funds' investments in banking, which would markedly chill capital availability for banks.

[8] *See* Emily Flitter, *FDIC Failed-Bank Bid Plan Blasted by OCC, Investors*, Am. Banker (July 2, 2009); Reuters, *OneWest says proposed FDIC rules to inhibit capital* (July 23, 2009).

the FDIC, but it would very likely be, at most, only a small negative for most private equity firms.

For private equity firms like our own that focus on investing in banks, however, the consequences would be much more severe if the Policy Statement goes forward as proposed. The Statement would most likely make it uneconomic for firms such as ours to continue to invest in banks. At a minimum, we anticipate that going forward it would be virtually impossible for our firms to attract capital for additional bank investment programs. Investors in our funds are among the most respected firms and individuals in the United States, including major retirement funds, endowments, and state pension funds. Our investors have many options, and they would have to ask themselves why invest in bank funds like ours for little or no return when they can invest in non-bank funds for superior returns?[9]

B. Managerial and Related Resources

It is well-documented that private equity firms add value to the companies in which they invest by providing management advice and support on operational and strategic issues.[10] If the Policy Statement should deter private equity firms from investing in depository institutions, those institutions will be deprived of a valuable source of managerial expertise and support.

This potential effect is particularly acute in the case of firms like CapGen, Belvedere, and Castle Creek, which focus exclusively on investments in the financial services industry and therefore have the capability to provide a special level of bank-specific expertise. The Policy Statement, as discussed, would effectively reduce the amount that investors are willing to invest in such firms' funds, and thus their ability to provide managerial expertise and assistance.

In this connection, it also is worth noting that private equity investment in a company brings with it special expertise and industry contacts for additional capital investments

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[9] It also bears noting that only funds like CapGen, Belvedere, and Castle Creek are typically positioned to invest in smaller community banks. Most large private equity funds have minimum investment amounts of at least $100 million. An investment of that size would likely trigger the "control" definition in the Bank Holding Company Act for most community banks. *See* 12 U.S.C. § 1841(a)(2). Therefore, for the most part, only funds that invest as bank holding companies can invest in community banks. The Policy Statement, however, would make less money available for such funds, thereby reducing the amount of private capital that is available for community banking organizations throughout the country.

[10] *See* Erin White & Gregory Zuckerman, *The Private-Equity CEO*, Wall St. J., Nov. 6, 2006 at C1

if needed subsequently. When a private equity firm makes an equity investment in a bank or other financial firm, it puts itself on the line. Any kind of loss or failure impacts the private equity fund's, and its investors', own equity, the reputation of the firm, and its prospects for the future. Hence, private equity firms have a strong incentive to support companies in which they invest. And they have the contacts and expertise to effect additional investments when necessary to do so.

In many ways, this capability makes private equity firms a superior source of bank capital to a "strategic" investor, that is, another bank investor. When a bank invests in another bank, there is no net increase in the capital within the banking system. By contrast, a new private equity investment in a bank yields a net pick up of capital to the industry – capital that effectively supports the DIF as well.[11]

C. The FDIC's Resolution Costs

The FDIC is generally required to use a "least-cost resolution" method in exercising its resolution authority over specific institutions.[12] Although this requirement is focused on the methods by which the FDIC resolves individual insured institutions, the spirit of this requirement appropriately influences the FDIC's policies and procedures more broadly insofar as the Agency seeks to protect the DIF. Notwithstanding this fact, the Policy Statement as proposed would potentially *increase* the FDIC's resolution costs in at least two significant respects.

First, the Policy Statement will discourage private equity investors from bidding on failing institutions, which will reduce the number of bids the FDIC receives and likely reduce the value of winning bids in FDIC auctions. In fact, in the two largest bank failures in the past year – involving IndyMac Bank FSB and BankUnited FSB – both winning bids were submitted by private equity firms. Four of the total five bids submitted for BankUnited FSB's assets and liabilities were by private equity firms.[13] The only bid for BankUnited FSB that would not have been affected by the Policy Statement was submitted by TD Bank; and TD Bank's bid was nearly $1 billion less than the winning bid placed by an investor consortium composed of private

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[11] Further, for example, if Bank A invests in Bank B and Bank B subsequently encounters financial difficulties, Bank A is weakened as well, and the potential problems for the industry and the FDIC can be compounded. The same is not the case, however, with a private equity investment in a bank.

[12] *See* 12 U.S.C. § 1823(c)(3).

[13] See Bids received by the FDIC for BankUnited FSB, *available at* http://www.fdic.gov/about/freedom/biddocs.html

equity firms.[14] In short, the FDIC's resolution costs for BankUnited FSB could well have been substantially greater if private equity investors had not participated in the auction − a result neither in the interest of the banking system nor in the interest of the FDIC. Yet, this is the likely effect of the Policy Statement as currently proposed.

Second, the general mistrust generated by the Policy Statement, as well as the Statement's impact on investments in healthy banks,[15] will deter private equity firms from making investments in depository institutions, as we have noted. But capital injections in the form of minority investments or complete acquisitions by private equity investors serve to bolster institutions' capital positions and to lessen the need for draws on the DIF due to a subsequent failure. Even in the case of those institutions that do later require FDIC assistance, the amount of such assistance is at least partially reduced by the amount of any private equity injection.[16]

Although the effect that the Policy Statement would have on the DIF cannot be calculated with precision, we can be certain as to its general effect of discouraging private equity firms from participating in FDIC auctions and from providing capital injections to banks. In such circumstances, the ultimately result will be more failures and more costly failures. In our view, sound policy requires that the Statement should be revised to avoid such results.

IV. Proposed Revisions to the Policy Statement

We well understand and appreciate the FDIC's need to promote the safe and sound operation of insured depository institutions and to protect the DIF. We support these goals and believe that both of them can be promoted by a Policy Statement that appropriately takes into account the available information on the risk presented by private equity investments in banks, particularly the type of private equity investments our firms provide.

At the same time, however, certain requirements in the Policy Statement, in its present form, appear to be based essentially on the assumption that private equity investments

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14 This is an estimate since the exact value of the two bids is impacted by individually negotiated loss-sharing agreements with the FDIC.

15 *See supra* p. 5.

16 In the worst-case scenario where an institution does fail or is about to fail despite a recent capital injection from a private equity investor, the capital injection may still play a valuable role in mitigating the effect on the DIF. For example, in 2008, the Corsair Capital-led investor consortium's investment in National City most likely played a role in the sale of National City to PNC Financial, thereby averting the need for a draw on the DIF.

present heightened risk to investee institutions and to the DIF.[17] But, as discussed, private equity investors do not in fact present increased risk to investee institutions or to the DIF, and the requirements that are based on such assumption – particularly the capital commitment, source of strength, and cross guarantees – should therefore be adjusted or eliminated so that private equity investors remain on an equal footing with other bank investors, as follows:

Capital Commitment. A minimum 15 percent Tier 1 leverage ratio for three years greatly exceeds the leverage ratio required for well-capitalized institutions.[18] We of course want robust capital for the banks in which we invest. But setting heightened capital requirements for private equity investments will make it impossible for firms like ours to compete with a strategic investor. Why would an investor put funds in a private equity firm rather than a strategic investor, if the private equity firm is subject to more onerous terms and a lower return than the strategic investor can provide? Having a special capital requirement for transactions involving firms like our own will effectively put our firms on the sidelines for purposes of FDIC transactions.

Source of Strength. Requiring private equity investors' organizational structures to serve as a source of strength is a redundant requirement for CapGen, Belvedere, and Castle Creek since our funds are bank holding companies and therefore are already subject to the Federal Reserve's source of strength doctrine.[19] As sources of strength, we provide oversight as well as capital, an ability to commit available additional holding company funds if needed, and the ability to help the bank raise further funds from third parties given our expertise and contacts. These sources of strength are as good as those offered by a strategic investor, if not better. Indeed, a strategic investor often does not have the same investor resources upon which potentially to draw as do private equity investor-funded bank holding companies like our own, very likely has less expertise at raising additional funds, and may not have additional managerial resources to devote to an institution.[20] There simply is no good justification for establishing an additional source of strength obligation for funds like our own that are bank holding companies and are already subject to the Federal Reserve's source of strength doctrine.

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[17] *See* Policy Statement, 74 Fed. Reg. 32931, 32932 (July 9, 2009).

[18] *See, e.g.*, 12 C.F.R. § 6.4(b)(1)(iii) (establishing a leverage ratio of 5.0 percent or greater for well-capitalized institutions).

[19] *See* 12 C.F.R. § 225.4(a)(1).

[20] Furthermore, if a bank or bank holding company raises money in the public markets, there certainly is no assurance of those markets serving as a "source of strength" if later needed. For public markets can shut down at any time for a particular institution or even more broadly, and once they do, there is no prospect of further public-market funding for the institution.

Cross-guarantee Liability. This requirement could greatly reduce the ability of firms like ours to invest in depository institutions. To the extent that our investments are aggregated with other private equity investors' and the collective group represents a majority of the direct or indirect investments in an institution, other depository institutions will be reluctant, at best, to consider an investment from one of our firms, since our investment may be pledged to pay for any losses to the DIF caused by the other institution. Moreover, this requirement could be read to aggregate all of our individual funds' investments, which would further expand the requirement's detrimental impact. In the end, the Policy Statement's new cross-guarantee liability requirement, if retained, will deter investment in FDIC transactions and thereby weaken the banking system, not strengthen it.

Applicability to Bank Holding Companies. The FDIC should clarify that the Policy Statement is not applicable to those private capital investors that are themselves registered bank holding companies. Such investors have accepted their "responsibilities under existing law to serve as responsible custodians of the public interest that is inherent in insured depository institutions"[21] through regulation and supervision by the Federal Reserve as bank holding companies. Adding an overlay of FDIC regulation to the existing, comprehensive structure of Federal Reserve bank holding regulation not only is unjustified but would introduce substantial confusion into the federal bank regulatory structure. The FDIC should, in all events, revise the Policy Statement to make clear that it is not intended to, and does not, do so.

V. Retroactive Effect of Policy Statement

As proposed, the Policy Statement would apparently be given retroactive effect to certain existing organizations and investment arrangements. Specifically, the Policy Statement indicates that it would be applicable to private equity investors in a bank or thrift holding company that has "come into existence or been acquired" less than three years prior to the date of the Statement.[22] Whatever form the Agency's final Policy Statement takes, the Statement should not be applied retroactively to existing organizations and investment arrangements. Such an approach would be contrary to both sound policy and established law.

As a matter of policy, it is essential that investors understand and be able to rely on the terms on which they enter into transactions. To apply the Policy Statement retroactively would not only upset established investor expectations but also undermine investor confidence in their ability to deal reliably with the FDIC in the future. Such a result is not in the interest of investors or of the FDIC.

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[21] *See* 74 Fed. Reg. 32931, 32932 (July 9, 2009).

[22] *See id*. at 32933.

Furthermore, it is well established that a federal agency may not engage in retroactive rulemaking unless Congress has clearly delegated to the agency authority to promulgate a retroactive rule.[23] In its Federal Register notice regarding the proposed Policy Statement, the FDIC has cited no authority indicating that Congress has authorized it to change retroactively by rule – or otherwise – the terms of existing investment transactions. Nor are we aware of any such authority.[24]

Accordingly, the FDIC should clarify that the Policy Statement is to apply only prospectively to transactions and investment arrangements into which private investors enter after the date of the Policy Statement.

VI. Conclusion

We urge the FDIC to evaluate carefully the impact that the Policy Statement would have on the U.S. banking system and the DIF. In imposing additional requirements on private equity investors, we firmly believe the proposed Policy Statement would, as a general matter, reduce the amount of capital, managerial and other resources available to U.S. banks and would potentially increase the FDIC's resolution costs.

For those private equity firms like CapGen, Belvedere, and Castle Creek that focus exclusively on investments in financial services companies, the Policy Statement's impact would be far more severe and extensive. As applied to firms such as ours, the Policy Statement would directly reduce the amount of capital and other resources that our firms could otherwise provide to the banking system and thereby disadvantage particularly the small- to medium-sized community banks on which our firms' investment activities are focused. As we have discussed above, the Policy Statement should be revised to avoid such counterproductive results. Furthermore, insofar as firms like ours invest through funds that are registered bank holding companies, such funds should not be subject to the Policy Statement at all; they should continue to operate solely under the well-developed prudential framework administrated by the Federal Reserve under the Bank Holding Company Act. And, for both good policy and legal reasons, the

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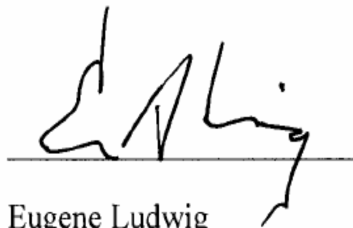
[23] *See Bower v. Georgetown University Hospital*, 488 U.S. 204, 208-09 (1988).

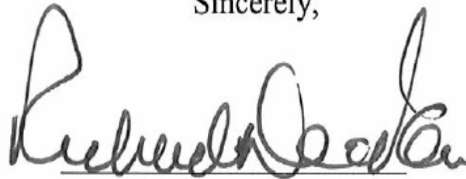
[24] To be sure, the Policy Statement has not been proposed as a formal agency rule. But if the Policy Statement is to be applied with the same effect as an agency rule, then it would have to conform to the same standards that apply to agency rules. *Compare Farrell v. Dep't of Interior*, 314 F.3d 584, 590 (Fed. Cir. 2002) (stating that a policy statement having the effect of a regulation must comply with the administrative requirements applicable to regulations); *Cmty. Nutrition Inst. v. Young*, 818 F.2d 943, 946 (D.C. Cir. 1987) (providing that an agency's characterization of its own guidance is afforded some, but not overwhelming, deference by courts in determining whether the guidance is subject to notice-and-comment procedures).

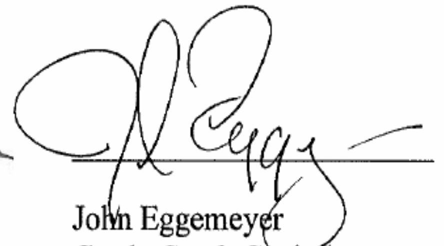
Policy Statement should be revised to make clear that it is not applicable to transactions and investment arrangements into which private parties entered prior to the date of the Statement.

We would be pleased to discuss our comments and proposed revisions and also to respond to any questions you may have. Again, we appreciate the opportunity to comment on the Policy Statement.

Sincerely,







Eugene Ludwig
CapGen Financial

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Enclosures

III. TEXT OF PROPOSED POLICY STATEMENT

Proposed Statement of Policy on Qualifications for Failed Bank Acquisitions Introduction

Capital investments by individuals and limited liability companies acting through holding companies operating within a well developed prudential framework has long been the dominant form of ownership of insured depository institutions. From the perspective of the FDIC's interest as insurer and supervisor of insured depository institutions, this framework has included, in particular, measures aimed at maintaining well capitalized bank and thrift institutions, support for these banks when they face difficulties, and protections against insider transactions. The ability of the owners to provide financial support to depository institutions with adequate capital and management expertise are essential safeguards. These safeguards are particularly appropriate for owners of insured depository institutions given the important benefits conferred on depository institutions by deposit insurance.

Recently, private capital investors have indicated an interest in participating in acquiring the deposit liabilities, or both such liabilities and assets, of failed insured banks and thrifts in receivership in the current circumstances in which substantial additional capital is needed in the U.S. banking system. The FDIC is keenly aware of this need, particularly as it arises in the context of its function as the receiver of failed insured depository institutions charged with protecting insured deposits based on a congressionally mandated least cost to the insurance fund solutions for these institutions. The FDIC is also aware that new banks, regardless of their investor composition, pose an elevated risk to the deposit insurance fund since they generally lack a core base of business, a proven track record in the banking industry, and are vulnerable to significant losses in the early years of incorporation.

The FDIC is of the view that private capital participation in the acquisition of the deposit liabilities, or both such liabilities and assets, from a failed depository institution in receivership should be consistent with the foregoing basic elements of insured depository institution ownership. The FDIC has reviewed various elements of private capital investment structures for consistency with these principles. Some acquisition arrangements, such as those involving complex and functionally opaque ownership structures, typified by 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, would be so substantially inconsistent with these principles as not to be considered as appropriate for approval for ownership of insured depository institutions. While these structuring issues are generally attributed to private equity ownership investments, the FDIC will apply the same standard of review to any prospective proposed acquisition of a failed bank or thrift to ensure parity and to avoid the creation of loopholes or regulatory arbitrage.

In order to address the concerns raised mainly by ownership structures involving more than *de minimis* investments that typically involve a shell holding company owned by another entity or other entities that avoid certain of the responsibilities of bank and thrift ownership, the FDIC is establishing standards for bidder eligibility that would be

applicable to (a) private capital investors in a company (other than a bank or thrift holding company that has come into existence or has been acquired by an Investor at least 3 years prior to the date of this policy statement), that is proposing to directly or indirectly assume deposit liabilities, or such liabilities and assets, from a failed insured depository institution in receivership, and to (b) applicants for insurance in the case of de novo charters issued in connection with the resolution of failed insured depository institutions (hereinafter "Investors"). These standards would not apply to private capital investors that are investment funds registered as bank holding companies.

The standards provide for:

(a) limits on transactions with affiliates;
(b) maintenance of continuity of ownership as specified below; and
(c) avoidance of secrecy law jurisdiction vehicles as the channel for their investments unless the parent company is subject to consolidated home country supervision.

It is the intention of the FDIC to apply these requirements as set out below.

Transactions with Affiliates: All extensions of credit to Investors, their investment funds if any, any affiliates of either, and any portfolio companies (i.e., companies in which the Investors or affiliates invest) by an insured depository institution acquired or controlled by such Investors under this policy statement would be prohibited. For purposes of this policy statement the term "extension of credit" is defined in 12 C.F.R. § 223.3(o) including any subsequent amendments, and the term "affiliate" is any company in which an investor owns 10 percent or more of the equity of that company.

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

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

of process; and consent to be bound by the statutes and regulations administered by the appropriate U.S. federal banking agencies.

A White Paper on the Federal Deposit Insurance Corporation's

Proposed Statement of Policy on Qualifications for Failed Bank Acquisitions

Guhan Subramanian

August 10, 2009

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I. Introduction

A. Statement of the Assignment

I have been retained by CapGen Financial Group, LLC to write a White Paper on the Federal Deposit Insurance Corporation's Proposed Statement of Policy on Qualifications for Failed Bank Acquisitions (the "FDIC Proposal"), dated July 2, 2009.[1] Specifically, I have been asked to summarize the relevant academic literature, examine private equity investments in bank deals historically, and apply this evidence to assess the FDIC Proposal.

Employees of Covington and Burling, LLP, a business and corporate law firm, and Analysis Group, Inc., an economics research and consulting firm, working under my direction and supervision, have assisted me in this assignment. I have been paid by CapGen Financial Group, LLC for my time on this matter. In addition, I receive compensation based on the billings of Analysis Group. My compensation is not affected by the opinions that I express or by the outcome of the FDIC Proposal.

B. Summary of Conclusions

Based upon my own knowledge and experience, the materials I have reviewed, and the analyses I have conducted, I have reached the following conclusions:

- Private equity funds create significant societal wealth through improved managerial incentives, greater leverage, and better governance for the companies that they invest in.
- There is a "natural marriage" that exists today between the large pools of committed but uninvested private equity capital and the capital needs of the troubled financial institutions, yet regulatory barriers have inhibited this natural marriage from being fully consummated.
- There is virtually no evidence of regulatory abuse, excessive risk-taking, or increased costs for the FDIC due to private equity control of financial institutions

[1] FR Doc. E9-16077 (filed July 8, 2009).

over the past twenty years; to the contrary, private equity investments in banks have been generally beneficial to the financial institutions industry.

- In view of these findings, the overall policy approach should be a level playing field between private equity firms and bank holding companies in acquiring failed bank assets – one that neither advantages nor deters private equity investments in failed banks. Recent moves such as the September 2008 Federal Reserve Board policy statement and the November 2008 Shelf Charter Process move toward this goal, while the current FDIC Proposal moves away from it. Three specific aspects of the FDIC Proposal – the 15% Tier One leverage ratio, the source of strength commitment for non-controlling shareholders, and the cross-guarantee provision – are particularly problematic and should be abandoned.

II. Private Equity and Value Creation

A. What is Private Equity?

Private equity funds play an important role in global capital markets, with approximately $1 trillion of funds under management in 2009.[2] The two primary forms of private equity are leveraged buy-out funds, which typically acquire majority control of a company using relatively large amounts of debt and smaller amounts of equity, and venture capital funds, which invest in young or emerging companies. Leveraged buy-out funds account for about two-thirds of total private equity funds under management and are the focus of this study. I therefore use the term private equity to refer to buy-out funds.

The types of transactions and industries in which private equity funds invest are diverse in nature and have changed considerably over time.[3] These include "public-to-private" transactions in which a public company is acquired and taken private, "private-to-private" transactions involving acquisition of a private company, "divisional" transactions in which a private equity fund purchases a division or segment of a larger public or private company, and

[2] Andrew Metrick and Ayako Yasuda, "The Economics of Private Equity Funds," Forthcoming in the *Review of Financial Studies*, June 9, 2009, p. 2.

[3] Steven N. Kaplan and Per Strömberg, "Leveraged Buyouts and Private Equity," *Journal of Economic Perspectives*, Volume 23, Number 1, Winter 2009, pp. 126-128 for a more extensive discussion of the evolution of private equity investments over time.

"secondary" buy-outs in which a portfolio company is sold by one private equity firm to another. While private equity investment is often associated with the manufacturing and retail sectors, buy-out activity in recent years has also targeted firms in financial services, health care, technology, and other industries.[4] The geographic scope of private equity investment has also expanded dramatically, with the share of transactions accounted for by North American target companies declining from 87 percent in the late 1980s to less than half since 1999.[5]

One important feature of private equity funds is that they typically have a lifetime of 10 years, at which time the fund must return capital to investors. As a result, the ability to exit an investment is a crucial consideration for private equity funds. Exit can take a variety of forms: an initial public offering (IPO), sale of the portfolio company to a strategic buyer (e.g., a company operating in the same industry), and sale to another private equity investor. The median holding period for private equity funds' investment in portfolio companies is approximately six years, with 12 percent of investments held for less than two years.[6]

Some private equity investments do end in bankruptcy, which is not surprising given the relatively high levels of leverage that are typically employed. Kaplan and Strömberg estimate an annual default rate on buy-out transactions of 1.2 percent per year, which is lower than the average default rate on U.S. corporate bonds over the 1980 to 2002 period.[7]

B. How Does Private Equity Create Value?

Top private equity firms have earned persistent returns that are significantly higher than the S&P 500.[8] Economists have identified three main ways by which private equity firms generate returns for investors: increasing managerial incentives, increasing leverage, and improving governance.

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[4] Kaplan and Strömberg, p. 128.

[5] Kaplan and Strömberg, p. 127.

[6] Kaplan and Strömberg, p. 130.

[7] Kaplan and Strömberg, p. 129. The authors note that this may underestimate the frequency of bankruptcy given the proportion of buyouts for which the type of exit transaction is unknown.

[8] Robert C. Pozen, "If Private Equity Sized Up Your Business," *Harvard Business Review*, November 2007, p. 2; Felix Barber & Michael Goold, "The Strategic Secret of Private Equity," *Harvard Business Review*, September 2007, p. 53.

First, managerial incentives are a key way in which private equity firms address "agency problems," which are conflicts of interest that can arise between a firm's owners and managers due to their differing incentives. As an example, company managers may pursue their own interests via "empire building" rather than focusing on enhancing firm value on behalf of shareholders. Private equity firms reduce agency problems and align the interests of the investors and management by increasing management ownership stakes in the portfolio companies and directly tying executive compensation to shareholder value. Studies have shown that equity interests of CEOs increased by approximately four times when a company was acquired by a private equity firm.[9] These equity interests are typically illiquid, so gains can only be realized in the event of a positive exit transaction. As a result, management has a strong incentive to focus on long-term gains in firm value rather than short-term earnings performance.

Second, private equity removes excess cash and uses leverage to encourage efficiency and to address agency problems. Too much cash on the balance sheet can create agency problems by tempting management to use surplus cash for value-destroying projects. Private equity companies streamline businesses by keeping idle cash to a minimum. In fact, many private equity funds require daily cash level reports from their portfolio companies.[10] Private equity funds also use leverage to prevent management from keeping surplus cash. Leverage forces management to make regular interest and principal payments to avoid default. In the United States and in most other countries, leverage also reduces the cost of capital and increases firm value through the tax deductibility of interest. However, if leverage is too high, the inflexibility of debt payments increases the chance of costly financial distress.[11]

Finally, private equity firms generate value by closely monitoring their portfolio companies and providing operational expertise. While boards of most public companies typically meet only 6-8 times a year, private equity directors are more actively involved in governance and spend three to five days per month monitoring portfolio companies. Private equity portfolio company boards are smaller and more efficient than comparable public company

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[9] Pozen, p. 7. *See also* Emily Thornton, "Going Private," *BusinessWeek*, Feb. 27, 2006, at 53, 54 ("The attractions [for top managers] are two-fold: money and freedom.").

[10] Pozen, p. 3.

[11] Kaplan and Strömberg, p. 131.

boards.[12] Private equity firms also bring operational expertise into portfolio companies, either through the direct infusion of new management talent or by bringing in board members with extensive operating and industry backgrounds.[13]

In summary, private equity firms use improved incentive structures, leverage, and their industry and operating expertise to identify attractive investments and to implement value enhancing strategies for portfolio companies. In prior work I have described the "growing consensus among academics and practitioners that P/E firms, unlike hedge funds, create significant value, on average, for the companies in which they invest by attracting superior managers with high-powered incentives and then monitoring these managers with experienced, repeat-play directors drawn from P/E firms that have significant 'skin in the game.'"[14] Twenty years ago, Professor Michael Jensen famously predicted that private equity would "eclipse" the public corporation as a method of business organization.[15] Jensen's prediction has been at least directionally correct.

C. How Does Private Equity Differ from Hedge Funds and Banks?

Private equity firms and hedge funds are often lumped together in the popular press. While both are forms of private capital, there are certain key differences between these two classes of investors. These differences arise primarily from different time horizons and different investment strategies. Private equity funds are longer-term investors in portfolio companies, typically investing for five to eight years.[16] Private equity funds have a fixed life of usually ten years, and are structured as closed-end funds, which do not allow investors to withdraw their

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[12] Kaplan and Strömberg, pp. 130-132, and Pozen, pp. 8-9.

[13] For a striking (and perhaps jarring) example of the contrast between public-company and private equity boards, see, for example, Erin White & Gregory Zuckerman, "The Private-Equity CEO," *Wall Street Journal*, November 6, 2006 at C1 ("At Mr. Conde's first meeting with his new bosses [at SunGard Data Systems], SunGard director David Roux, co-founder of one of the firms that bought the company, offered advice on how to train new clients. In three years running SunGard as a publicly traded company, Mr. Conde says he rarely heard such specific suggestions from directors.").

[14] Guhan Subramanian, "Go-Shops vs. No-Shops in Private Equity Deals: Evidence and Implications," *Business Lawyer*, Vol. 63, 729, 732-33 (2008).

[15] Michael Jensen, "The Eclipse of the Public Corporation," *Harvard Business Review*, September-October 1989, p. 7

[16] Kaplan and Strömberg, p. 123.

capital during the life of the fund.[17] The longer investment horizon lets private equity funds invest in companies for several years, which allows them to play an active role in monitoring and managing the portfolio companies to make operational changes and enhance value.

While hedge funds pursue a wide range of investment strategies, they typically have a more short-term orientation and do not have lock-up periods on investor capital longer than two years.[18] As a result, hedge funds generally do not acquire a controlling stake in a business that requires operational improvements over several years. Even when they have a stake large enough to exert influence on a company, hedge funds often focus on pressuring a company's board to take specific actions that they believe will result in near-term share price appreciation.[19] Recent empirical evidence suggests that these specific actions do not, in fact, yield share price improvements on average, unless they lead to a sale of the company.[20]

Private equity firms also serve a different purpose than banks. Private equity firms can add value by intensively scrutinizing firms before providing capital and then monitoring and managing their operations afterward.[21] While banks also monitor the companies they lend money to, these efforts are more narrowly focused on ensuring that loans can be repaid, rather than on increasing the overall value of the borrower. Several factors constrain the ability of banks to provide the governance and managerial expertise that private equity provides to portfolio companies. First, due to regulatory restrictions, banks cannot take significant equity

[17] Kaplan and Strömberg, p. 123.

[18] Vikas Agarwal, Naveen Daniel, and Narayan Naik, "Role of Managerial Incentives and Discretion in Hedge Fund Performance," Forthcoming in *the Journal of Finance*, October 11, 2008, p. 15. The authors note that for the hedge funds in their study, the mean (median) lockup period was 0.8 (1.0) years and the mean (median) restriction period was 0.3 (0.2) years.

[19] William Bratton, "Hedge Funds and Governance Issues," *European Governance Institute Law Working Papers*, February 2007, pp. 5-6. The author states, "[Hedge fund activist shareholders] survey a target with a bias toward near-term gain, regardless of its future, the interests of its long term investors, and the productivity of the wider economy. Hedge fund pressure on present and potential targets is thought negatively to constrain investment policy, skewing managers away from promising but difficult to value projects …"

[20] Robin Greenwood and Michael Schor, "Hedge Fund Activism and Takeovers" (Harvard Business School, Working Paper No. 08-004, July 2007) (reporting abnormal returns not different from zero for hedge fund targets that remain independent a year after the activist investment).

[21] Josh Lerner, Felda Hardymon, and Ann Leamon, *Venture Capital & Private Equity: A Casebook*, 3rd Edition (John Wiley & Sons, Inc., 2005), p. 5.

positions and thus cannot share the upside potential in the same way as private equity investors.[22] Second, banks may not have the industry and operating expertise to evaluate start-ups or businesses undergoing restructuring.[23] Third, banks are unable to finance high-risk projects because they cannot charge borrowers interest rates that are commensurate with the level of risk.[24] Last, and perhaps related to these other factors, banks typically do not offer the same level of compensation and incentives as private equity firms do, and are thus at a disadvantage in attracting the best talent.[25]

D. The Academic Evidence on Private Equity and Value Creation

As part of my assignment I have surveyed the academic literature to compile a list of empirical studies on the impact of private equity on operational performance.[26] Table 1 describes the methodologies and results of studies written during the last decade that analyze the operational effects of private equity investments in U.S. firms. The evidence from these studies is generally consistent with the idea that private equity ownership yields operational benefits to firms that undergo leveraged buyouts.[27]

Several studies examine the effects of private equity on the operating performance of the acquired firms by analyzing accounting ratios. Guo, Hotchkiss, and Song (2009) compare the changes in accounting ratios of buyouts and industry peers from the time of the buyout to the time a firm exits a private equity fund.[28] The authors show median gains in net cash flow/sales

[22] Jonathan Macey and Geoffrey Miller, "Corporate Governance and Commercial Banking: A Comparison of Germany, Japan, and the United States," *Stanford Law Review*, Vol. 48, No. 1, November 1995, p. 82. Under the U.S. Bank Holding Company Act (12 U.S.C. § 1843(c)(6) (1994)), bank holding companies, but not banks, can directly or indirectly own up to 5 percent of shares in a non-bank, provided the investment is passive.

[23] Lerner, Hardymon, and Leamon, p. 5.

[24] 12 U.S.C. 85 (limiting national banks' maximum interest rates).

[25] Lerner, Hardymon, and Leamon, p. 5.

[26] While not the focus of this White Paper, a number of studies also analyze the returns to investors in private equity funds. See Kaplan and Strömberg for a broader survey of the literature on private equity.

[27] Although not reported in Table 1, post-2000 studies from the U.K. also find operational improvements from private equity buyouts (*See, e.g.,* Viral Acharya and Conor Kehoe, "Corporate Governance and Value Creation Evidence from Private Equity," working paper, January 2009). Operational performance results from other non-U.S. studies appear to be more mixed (*See, e.g.,* Philippe Desbrieres and Alain Schatt, "The Impacts of LBOs on the Performance of Acquired Firms: the French Case," *Journal of Business Finance and Accounting*, Volume 29, pp. 695-729).

[28] Shourun Guo, Edith S. Hotchkiss, and Weihong Song, "Do Buyouts (Still) Create Value?," working paper, January 2009.

and EBITDA/total assets of 14 percent and 11 percent, respectively, for leveraged buyouts relative to other firms in the same industry.[29] Cao and Lerner (2009) similarly find that median operating income/sales is higher for leveraged buyout firms undergoing a subsequent public offering (a "reverse leveraged buyout" (RLBO)) than for other IPOs and mature firms.[30]

Leslie and Oyer (2009) analyze accounting ratios and managerial incentives for reverse leverage buyout firms and find little evidence of operational improvements at these firms.[31] While they find significant differences in managerial incentives between the RLBO firms and other firms in their sample, Leslie and Oyer find a statistically significant improvement in operating performance for only one of the four metrics they examined (sales per employee). The authors note however that "[v]alue creation could be taking place through other channels such as more efficient use of leverage or the tax advantages of debt … though it is unclear why these forms of value creation would require such strong managerial incentives."[32]

Other studies have focused directly on the effects of private equity on productivity and employment. Davis et al. use plant-level data to examine the impact of private equity investment on labor productivity and employment.[33] These papers find a substantial positive impact on aggregate productivity, a decline in total employment, and an increase in "greenfield" employment (jobs at newly established facilities) at private equity plants compared to other plants in the same industry. They conclude "that target firms of private equity transactions experience an intensification of job creation and destruction activity, establishment entry and exit, and establishment acquisition and divestiture. ... [T]his intensification of reallocation yields

[29] Guo, Hotchkiss, and Weihong note, however, that their results are significantly lower than the operational improvements documented by studies from the 1980s (*see, e.g.,* Steven Kaplan, 'The Effects of Management Buyouts on Operating Performance and Value," *Journal of Financial Economics*, Volume 24, 1989, pp. 217-254). This finding might be explained by a commonly accepted view that "managerial slack" was generally higher in the 1980s than in the 1990s and today. Cotter & Peck (2001) further distinguish between "buyout specialists" and other private equity buyers to find that buyout specialists achiever higher accounting profits (measured by EBITDA/Total Assets) than private equity buyouts by non-specialists.

[30] Jerry Cao and Josh Lerner, "The Performance of Reverse Leveraged Buyouts," *Journal of Financial Economics*, Volume 91, Issue 2, 2009, pp. 139-57.

[31] Phillip Leslie and Paul Oyer, "Managerial Incentives and Value Creation: Evidence from Private Equity," working paper, January 2009.

[32] Leslie and Oyer, p. 3.

[33] Steven J. Davis, John Haltiwanger, Ron Jarmin, Josh Lerner, and Javier Miranda, "Private Equity, Jobs and Productivity," working paper, December 2008 and Steven J. Davis, John Haltiwanger, Ron Jarmin, Josh Lerner, and Javier Miranda, "Private Equity and Employment," working paper, March 2008.

a substantial productivity growth differential (about 2 percent) within two years after the transaction."[34]

In response to the assertion that private equity firms focus only on short-term performance, Lerner, Sorensen, and Strömberg (2008) study the effects of private equity ownership on innovation by looking at the patenting activity of leveraged buyouts.[35] The authors find no evidence of a decrease in patenting activity and demonstrate that leveraged buyout firms produce patents that are more economically important, as measured by the number of citations, relative to firms not backed by private equity.

Taken as a whole, these studies generally support the view that private equity investment creates value through tangible improvements in operating performance.

III. Private Equity Investment in Financial Institutions

A. Why is Private Equity Capital Needed?

The financial crisis that started in August 2007 and intensified last fall has placed intense pressure on the banking system and the Deposit Insurance Fund (DIF) as bank balance sheets and liquidity deteriorate. During the first quarter of 2009, 21 FDIC-insured institutions failed, which was the largest number of failed banks in a single quarter since the fourth quarter of 1992.[36] Another 24 FDIC-insured institutions failed in the second quarter, with 19 more institutions failing in just the first 24 days of July.[37] The FDIC classified a total of 305 institutions as "problem institutions" at the end of the first quarter, compared to only 90 at the end of the first quarter of 2008.[38]

While many larger banks have scrambled to raise capital in recent months to repay government equity injections under the Troubled Asset Relief Program (TARP), the banking

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[34] Davis et al., December 2008, p. 35.

[35] Josh Lerner, Morten Sorensen, and Per Strömberg, "Private Equity and Long Run Investment: The Case of Innovation," working paper, December 2008.

[36] FDIC Press Release, "FDIC-Insured Institutions Earned $7.6 Billion in the First Quarter of 2009," May 27, 2009.

[37] FDIC, "Failed Bank List", accessed on July 26, 2009 at http://www.fdic.gov/bank/individual/failed/banklist.html.

[38] FDIC, *Quarterly Banking Profile*, March 31, 2009.

system appears to still need capital to fund lending and future loan write-offs. In this context, private equity firms appear to be an important potential source of capital to invest in distressed banks. As of May 2009, the *Wall Street Journal* estimated that there was more than $400 billion in committed but uninvested private equity capital.[39] A number of private equity firms, both large and small, have raised capital in preparation for investing in banks. For example, as of June 15, 2009, Carlyle Group reportedly had more than $30 billion ready to be invested and had assembled a team of former bank executives to search for bank deals.[40] In December 2008, the Blue Pine Financial Opportunities Fund LP was raising $100 million to invest in banks.[41]

These examples of new funds focused on bank deals highlight a more general point. From an industry perspective, private equity capital invested in banks represents a net addition of capital to the banking system. In contrast, a strategic (intra-industry) acquisition typically re-allocates capital within the system rather than adding new capital to it. In addition, a strategic acquirer is likely to be weakened if its acquired bank fails. In contrast, if a bank owned by private equity fails, it does not hurt another bank unless there are cross-guarantees within the private equity firm's portfolio. Both of these points suggest that, all else equal, private equity investments in failed banks should be encouraged, not discouraged, relative to strategic investments in failed banks.

B. Obstacles to Private Equity Investment in Financial Institutions

Despite the large pools of private equity capital and the policy reasons to encourage private equity investments in failed banks, there are important regulatory and other obstacles that make it difficult to put this capital to work to support the U.S. financial system. This Part discusses some of the more important barriers.

[39] Joe Bruno, "A Private Equity Bid is Key for Bank Deals --- Ross-Led Group Seeks BankUnited; Others May Follow," *The Wall Street Journal*, May 18, 2009.

[40] Thomas Heath, "Carlyle Sets Its Sights on Battered Banks; Private-Equity Firms Seek New Source Of Returns Amid Slow Buyout Market," *The Washington Post*, June 15, 2009.

[41] Emily Flitter and Marissa Fajt, "Why TARP May Be Alienating Private Equity Firm," *American Banker*, December 15, 2008.

1. Restrictions on control

The issue of control lies at the heart of regulatory obstacles to private equity investment, as the Bank Holding Company Act (BHCA) requires that any entity that controls a bank or bank holding company be regulated as a bank holding company.[42] The BHCA defines control over a bank as occurring if:

> (A) the company directly or indirectly or acting through one or more other persons owns, controls, or has power to vote 25 per centum or more of any class of voting securities of the bank or company;
>
> (B) the company controls in any manner the election of a majority of the directors or trustees of the bank or company; or
>
> (C) the Board determines, after notice and opportunity for hearing, that the company directly or indirectly exercises a controlling influence over the management or policies of the bank or company.[43]

According to the Federal Reserve, these provisions have two purposes: first, by tying the potential benefits of control to the responsibility for providing the bank with necessary financial and managerial support, the BHCA attempts to ensure that banks are run in a safe and sound manner; and second, the BHCA limits the mixing of banking and commerce by restricting the ability of non-banks to exercise control over a bank.[44]

Once an entity is deemed to control a bank, the BHCA imposes restrictions on the nature of its investments. Because these restrictions are generally anathema to the private equity model, private equity firms frequently use "club" (or consortium) structures, in which each investor holds a small stake, in order to avoid gaining control of a bank.

What constitutes "control" of a bank is a complex question, with considerable grey area.[45] The Federal Reserve considers "all the facts and circumstances surrounding the

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[42] The Office of Thrift Supervision (OTS) is responsible for regulating thrifts and thrift holding companies, including approval of any applications for acquisitions of a thrift holding company or thrift or for engaging in non-bank activities.

[43] Bank Holding Company Act, Section 2. (a) 2.

[44] Press Release, Federal Reserve Board, "§ 225.144 Policy statement on equity investments in banks and bank holding companies," September 22, 2008 ("FRB September 2008 Policy Statement"), pp. 2-3.

[45] *See, e.g.*, A. Patrick Doyle et. al, Arnold & Porter, "Private Equity Investment: Navigating the Mine Field," October 21, 2008 ("What constitutes 'control' over a bank or bank holding company . . . is one of the more complicated areas in financial services law.").

investor's investment in, and relationship with, the banking organization" to determine whether an entity has a controlling influence over a bank.[46] Regulatory authorities have historically deemed non-bank investors to have a controlling stake in a bank or bank holding company if they hold more than 9.9 percent of an institution's outstanding shares. As a result, non-bank investors have generally limited their investments to less than 10 percent of shares or utilized passivity agreements with the Federal Reserve or OTS to ensure that they would not be considered to have a controlling stake in an institution.[47] In cases where a private equity fund has taken a controlling stake in a bank and agreed to be regulated as a bank holding company, the fund has typically used a "silo" structure that attempts to isolate banking investments from any sister funds that would otherwise also be treated as bank holding companies.

In September 2008, the Federal Reserve Board released a policy statement that loosened some of the restrictions related to determining whether a minority investor is deemed to have control of a bank. While the legislatively mandated limit of 25 percent or more of a class of voting securities remains in place, the Board now allows investors who control between 10 and 25 percent of voting equity to have a single representative on the bank's board of directors. A non-controlling investor can also own up to one-third of the total voting and non-voting equity of a bank or bank holding company as long as it owns less than 15 percent of any class of voting security. In addition, the policy statement broadened the ability of minority investors to advocate for changes in dividend, financing, and other bank policies without being deemed to have control. Taken collectively, these policy changes were intended to facilitate private equity investment in financial institutions, which one commentator described as "a top priority in Washington."[48]

Certain private equity firms do take control interests in banks, and generally do not use silo structures. Private equity firms that invest exclusively in the financial services sector, such as CapGen Financial Group, Belvedere Capital, and Castle Creek Capital, are typically registered

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[46] FRB September 2008 Policy Statement, p. 4.

[47] For example, the Federal Reserve Board approved the sale of Doral Financial Corporation to a group of investors, none of whom would own more than 10 percent of voting equity. (Federal Reserve Board Letter to B. Robbins Kiessling, July 17, 2008.) "Club" deals of this type appear to be the favored way for private equity funds to participate in acquisitions of failed institutions during the current crisis.

[48] Doyle et. al, Arnold & Porter, "Private Equity Investment: Navigating the Mine Field," (October 21, 2008).

as bank holding companies and therefore subject to supervision from the Federal Reserve.[49] These firms generally seek controlling interests, in order to more effectively manage the bank, instead of club deals with multiple investors.[50] The September 2008 loosening of restrictions on control, therefore, do not generally affect these firms.

2. Bank charter process

Historically, private equity firms have been disadvantaged in bidding for failed banks because of the requirement that bidders be ready to immediately take on the deposits and branches of the failing depository institution. In November 2008, the Office of the Comptroller of the Currency (OCC) and the FDIC instituted procedural changes that expedite the approval process for non-financial institutions that want to bid on failed banks.[51] The OCC has developed a "Shelf Charter" process, which enables non-financial institutions to gain preliminary approval for obtaining a bank charter provided that they possess a strong management team, sufficient capital, and a satisfactory business plan.[52] The FDIC also announced that that it would allow institutions with conditional approval for a charter to participate in the bidding process for failed banks.[53] These changes were intended to attract private equity bidders into the bidding process for failed banks.

3. General advantages for existing banks

Banks may also have a more general advantage over private equity funds when bidding for failed institutions. Existing banks are more likely to reap diversification benefits or economies of scale from combining operations with a failed bank. In addition, bank regulators

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[49] *See, e.g.*, CapGen Capital Group LP, Institutional Profile Page, Federal Reserve National Information Center at http://www.ffiec.gov/nicpubweb/nicweb/InstitutionProfile.aspx?parID_Rssd =3599747&parDT_END=99991231

[50] For example, on February 1, 2008, Belvedere Capital -- by itself and not as part of a consortium -- completed an acquisition of Spectrum Bank. *See* Reuters, Belvedere Capital and Belvedere SoCal Complete Acquisition of Spectrum Bank (Feb. 1, 2008).

[51] The OTS also has a "pre-clearance program" intended "to facilitate the infusion of new equity capital into troubled banks and savings associations by investors who do not currently own one. Under this program, the OTS can grant preliminary approval to bid on troubled insured institutions through a bid process operated by the Federal Deposit Insurance Corporation (FDIC). Preliminary approval also enables the OTS to share the prospective investor's contact information with troubled savings associations." See http://www.ots.treas.gov/?p=PreclearanceProgram.

[52] OCC Press Release, "OCC Conditionally Approves First National Bank "Shelf Charter" to Expand Pool of Qualified Bidders for Troubled Institutions," November 21, 2008.

[53] FDIC Press Release, "FDIC Expands Bidder List for Troubled Institutions," November 26, 2008.

may prefer to sell distressed banks to other banks in view of expressed concerns about potential conflicts of interest or excessive risk-taking by private equity-controlled banks, the complexities inherent in structuring bank private equity deals, and the fact that another bank's management will be more of a known quantity to regulators. "Existing banks have a big cost advantage … [T]he FDIC is more comfortable in selling a distressed bank to another bank because they have a history and a track record of regulating them."[54]

In one recent case (Silverton Bank), the FDIC shut down the bank rather than selling it to private equity investors. Silverton Bank was closed by the OCC on May 1, 2009 and the FDIC was named receiver.[55] A consortium of private equity investors, led by the Carlyle Group, was in discussions with the FDIC to acquire Silverton but, for undisclosed reasons, the FDIC chose instead to create a bridge bank to continue operations through July 29, 2009 and eventually liquidate the bank.[56] The FDIC estimated that this bank failure cost the DIF $1.3 billion.[57]

4. Inability to use further leverage

Another obstacle to private equity investment in financial institutions is the fact that financial institutions, and in particular banks, are already highly leveraged. As a result, private equity firms' traditional investment strategy of adding leverage is unsuitable for targets in the financial sector.[58] The ability of private equity firms investing in financial institutions to increase firm value thus lies in the ability to improve performance through aligned managerial incentives, enhanced governance, and operational improvements. This has not proven to be an insurmountable obstacle to private equity funds, however, as firms have developed the operational and financial expertise to create value in bank investments. Specific examples of these investments will be discussed in Section III.C.

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[54] Joe Bruno, "BankUnited Bid Viewed as Test for Private Equity," *The Wall Street Journal Europe*, May 19, 2009.

[55] FDIC Press Release, "FDIC Creates Bridge Bank to Take Over Operations of Silverton Bank, National Association, Atlanta, Georgia," May 1, 2009.

[56] Thomas Heath, "Carlyle Sets Its Sights on Battered Banks; Private-Equity Firms Seek New Source Of Returns Amid Slow Buyout Market," *The Washington Post*, June 15, 2009.

[57] FDIC Press Release, "FDIC Creates Bridge Bank to Take Over Operations of Silverton Bank, National Association, Atlanta, Georgia," May 1, 2009.

[58] "The Kings of Capitalism Want Their Thrones Bank," *The Economist*, April 10, 2008.

C. Private Equity Investments in the Banking Sector

As part of my assignment, I have conducted a systematic survey of private equity investments in the U.S. banking sector over the past twenty years. I have conducted three separate analyses: (1) an analysis of failed banks that have been sold to private equity firms in 2008-2009; (2) an analysis of private equity investments in banks outside of the FDIC's resolution process since 1989; and (3) an analysis of enforcement actions taken against banks controlled by private equity since 1989. The overall picture that emerges from these analyses is virtually no evidence of regulatory abuse, excessive risk-taking, or increased costs for the FDIC due to private equity control of financial institutions over the past twenty years. To the contrary, private equity investments in financial institutions seem to have been beneficial to the banking industry. The remainder of this Section describes these findings in further detail.

1. Private equity investments in failed banks, 2008-09

According to the FDIC's failed bank list, 90 financial institutions have failed between January 1, 2008 and July 26, 2009.[59] The severity of the financial crisis, and the importance of "getting it right" with regard to the market for failed banks, is highlighted by the fact that only 117 banks have failed since October 1, 2000. Therefore, more than three-quarters of all bank failures over the past nine years have occurred in the past nineteen months; and by most accounts there are many more bank failures still to come.

Of the 90 banks that have failed since January 2008, only two were sold to private equity consortiums as part of the FDIC disposition process: IndyMac, which failed in July 2008, and BankUnited, which failed in May 2009.[60] Private equity investors appear to have been potential investors in several other troubled or failed institutions, although none of these deals were consummated.[61] The overall picture, then, is one of very limited private equity involvement in

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[59] FDIC, "Failed Bank List", accessed on July 26, 2009 at http://www.fdic.gov/bank/individual/failed/banklist.html

[60] Bonnie McGeer, "Has BankUnited Broken PE Logjam?", *IDD Magazine* (May 25, 2009) ("David Barr, an FDIC spokesman, said the agency's only other sale [other than BankUnited] to an entity without an existing bank during this downcycle has been IndyMac.").

[61] In addition to Silverton Bank discussed in Section III, *see also* "Bancroft Capital and Orient Property Group to invest $210 million in Temecula Valley Bancorp," *Datamonitor's Financial Deals Tracker*, June 5, 2009 and "Beverly Hills Bancorp Inc. and Orchard First Source Asset Management, LLC Announce Merger Agreement," *Business Wire*, March 3, 2009.

the disposition of failed banks during the current financial crisis. This limited involvement might be due, at least in part, to the obstacles to private equity investment noted in Section III.B above.

In order to assess the impact of private equity participation in the disposition of failed banks, limited as it were, I investigated the BankUnited and IndyMac deal processes in more detail. In both cases, the FDIC chose to auction off the failed bank rather than run it itself or sell the assets piecemeal. With IndyMac, the FDIC contacted 87 parties to participate in the auction, 79 signed confidentiality agreements, 52 became "actively engaged," and 23 indicated serious interest via indicative bids.[62] This market canvass created significantly more competition than what private equity firms typically encounter in buyouts.[63] One person familiar with the deal described the process as "very, very competitive."[64]

In the end, IndyMac was sold to a consortium among investment groups headed by J. C. Flowers, George Soros, Michael Dell, and other prominent individuals. The group paid $13.9 billion for IndyMac's deposits and assets, and reached a loss-sharing agreement with the FDIC in which the investor group agreed to absorb the first 20% of IndyMac's losses. The FDIC would bear any further downside, and would also participate in gain-sharing. An FDIC spokesperson said that the overall sharing of gain and loss was "fairly standard," set by the FDIC, and "not negotiable."[65] Some commentators nevertheless criticized the IndyMac deal as overly generous to the winning consortium.[66]

In the aftermath of the transaction an FDIC spokesperson stated that "[i]t's irrefutable that after an extensive and competitive marketing effort, the [winning consortium] bid resulted in

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[62] "Indymac Federal Bank FSB," Presentation by John F. Bovenzi, Chief Operating Officer of the Federal Deposit Insurance Corporation at the 2009 Credit Markets Symposium (Apr. 2, 2009), available at http://www.richmondfed.org/conferences_and_events/banking/2009/pdf/cms_2009_bovenzi.pdf.

[63] Guhan Subramanian, "Go-Shops vs. No-Shops in Private Equity Deals: Evidence & Implications," *Business Lawyer*, at Table 2 (reporting 22.4 potential buyers contacted, 11.7 signing confidentiality agreements, and 3.1 making bids, on average, in traditional sale process).

[64] Quoted in Lauren Tara LaCapra, "IndyMac's Failure: A Year Later," *TheStreet.com*, July 10, 2009.

[65] Quoted in LaCapra.

[66] This perception might have been fueled by comments by one of the members of the winning consortium that "the government has all the downside and we have all the upside." "Flowers's Power?" *The New York Times*, May 6, 2009.

the lowest cost to the deposit insurance fund."[67] It follows, then, that the absence of private equity involvement in the IndyMac auction would have imposed greater costs on the DIF.

With BankUnited, the FDIC reports that there were three bidders for the bank's assets and liabilities: a winning consortium among Carlyle Investment Management, Blackstone Capital Partners, and Centerbridge Capital Partners, among other investors; private equity investor J.C. Flowers & Co.; and TD Bank NA. If regulatory obstacles had deterred private equity firms from bidding for BankUnited, the FDIC would have had only one bidder for BankUnited.[68] TD Bank's bid was an estimated $1 billion less than the winning bid even in the face of competition.[69] Presumably, in the absence of competition, TD Bank would have been able to bid even more aggressively (lower) for BankUnited, and would have been even more aggressive in negotiating its loss-sharing agreement with the FDIC.

Although IndyMac and BankUnited are just two out of the 90 failed banks since January 2008, they are the two largest failed bank dispositions during this period. If private equity had been deterred from participating in either of these deals, it is almost certainly the case that the ultimate cost to the DIF would have been greater. I conclude from these case studies that presence of private equity in the IndyMac and BankUnited auctions helped the FDIC fulfill its least-cost-resolution mandate and reduced the draw on the DIF.

2. Private equity investments in solvent banks, 1989-2009

Looking beyond failed bank deals from the current financial crisis, I also examined private equity investments in solvent banks over the past twenty years. I used the ThomsonOne Banker M&A database to identify all private equity investments in financial institutions after August 9th, 1989, the date that the Financial Institutions Reform Recovery and Enforcement Act (FIRREA) went into effect and created the regulatory structure for financial institutions that we have today. The sample period ends on July 17th, 2009. I supplemented the ThomsonOne Banker search with on-line searches for relevant transactions, because my experience indicates

[67] Quoted in LaCapra.

[68] This prediction assumes that other banks would not have entered the bidding for BankUnited due to the fact that private equity was shut out.

[69] This figure is an estimate because the two offers had differing loss-sharing agreements that likely affected the overall value of each bid. *See* FDIC Freedom of Information Act Center: Failed Financial Institution Bid Documents, accessed on July 26, 2009 at http://www.fdic.gov/about/freedom/biddocs.html.

that ThomsonOne misses some transactions, particularly in the earlier part of the time period under analysis.

The resulting database contains 32 transactions in which a solo private equity investor or consortium of private equity investors invested in a bank or thrift.[70] Table 2 lists the transactions in this sample, along with the name of the private equity investor, a brief description of the transaction, and the closing date.[71] Table 2 also flags the 19 transactions (59% of the sample) in which the private equity investor took a control position in the bank.[72] These transactions might be of particular concern because private equity has clear influence over the bank's operations.

I looked for evidence of regulatory abuse, excessive risk-taking, or increased costs for the FDIC in three different ways. First, and most directly, I examined whether any of banks in the Table 2 sample required a draw on the Deposit Insurance Fund (DIF) subsequent to the private equity investment. I found no such instances in my sample. This finding runs contrary to the common perception that PE-controlled banks impose above-average costs on the DIF. For example, some commentators point to Texas Pacific Group's April 2008 investment in Washington Mutual as an illustration for why private equity needs to be regulated more closely, and why the FDIC Proposal is a good idea.[73] However, it is widely acknowledged that WaMu's problems pre-dated TPG's investment. Perhaps more importantly, when WaMu failed in September 2008 and was quickly bought by JPMorgan Chase, TPG lost its entire $1.35 billion investment but the DIF did not suffer any loss.[74]

As a second analysis, for each bank in the Table 2 sample I obtained three capital ratios that are commonly used as indicators of a bank's health: total capital to risk-weighted assets, Tier 1 capital to risk-weighted assets, and a "leverage ratio" of Tier 1 capital to total assets. I

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[70] The search identified four additional transactions in which hedge funds acquired significant stakes in a financial institution (E-Trade Financial, Doral Financial Corporation, PanAmerican Bancorp, and Lomas Bankers Corporation). Given my focus on private equity investment, I have not included these transactions in my sample.

[71] Capital ratios were obtained from a combination of the FDIC's website and from the individual institutions' call reports, which are available on the Federal Financial Institutions Examination Council's (FFIEC) website. In cases where a bank holding company has multiple bank subsidiaries, I have focused on the largest bank subsidiary.

[72] I define control using the BHCA threshold of 25%.

[73] *See, e.g.*, Andy Stern, "Private Equity Investment and the Banks," *Wall Street Journal*, August 4, 2009, at A13.

[74] FDIC Press Release, "JPMorgan Chase Acquires Banking Operations of Washington Mutual," September 25, 2008.

compiled these metrics from three years prior to (where available) three years after the investment.[75] Chart 1 provides the median capital ratios for the financial institutions in the Table 2 sample during this time period.

Chart 1: Capital Ratios Pre and Post-Private Equity Investment

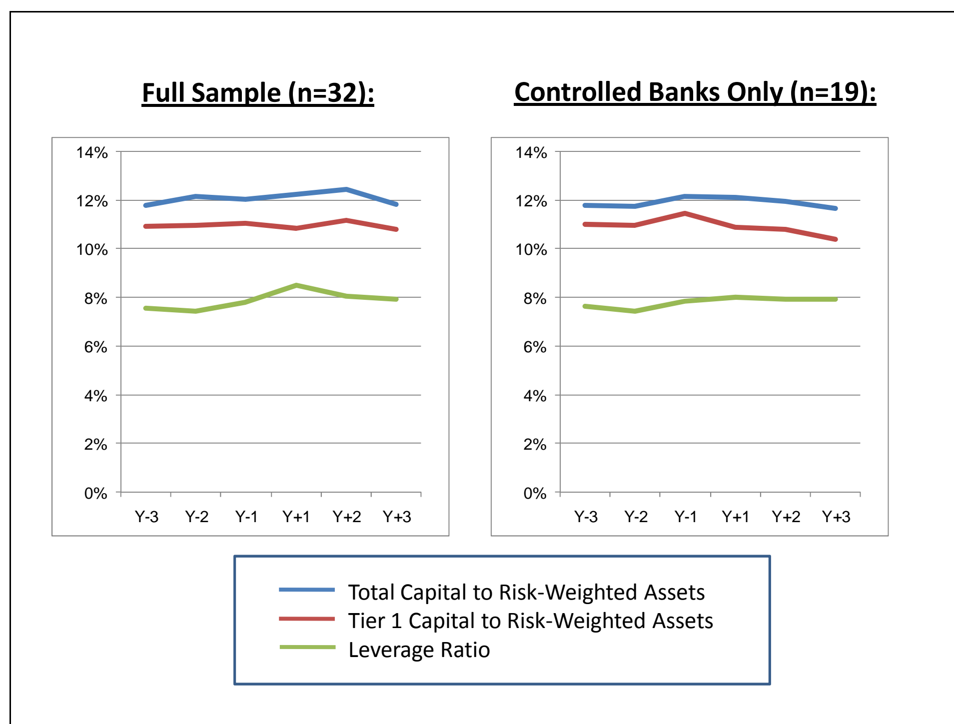

Chart 1 shows that banks have generally maintained their capital ratios, on average, after the private equity investment. This finding continues to hold true for the sub-sample of banks controlled by private equity firms. Of course, these metrics are only three of the many ways in which the health of a financial institution might be assessed. Nevertheless, the evidence on these measures reveals no apparent move toward excessive risk-taking after private equity investment, either overall or in the sub-sample of controlled banks.

As a third analysis, I examined enforcement actions against the banks in the Table 2 sample before and after the private equity investment. I searched the federal banking agencies'

[75] In unreported analyses I find that the conclusions remain the same if I exclude banks that do not have data for the full six-year window.

enforcement action databases, located on the agencies' websites,[76] for actions in the five years prior to the private equity investment and for all years in which private equity investment has been or was in place. Twenty out of the 32 banks in the sample (63%) had no enforcement actions in either time period. Table 3 provides a list of the enforcement actions against the twelve banks that did have enforcement actions against them pre-investment and/or post-investment. Chart 2 summarizes the number of enforcement actions against these twelve banks.

Chart 2: Number of Enforcement Actions Pre- and Post- Private Equity Investment

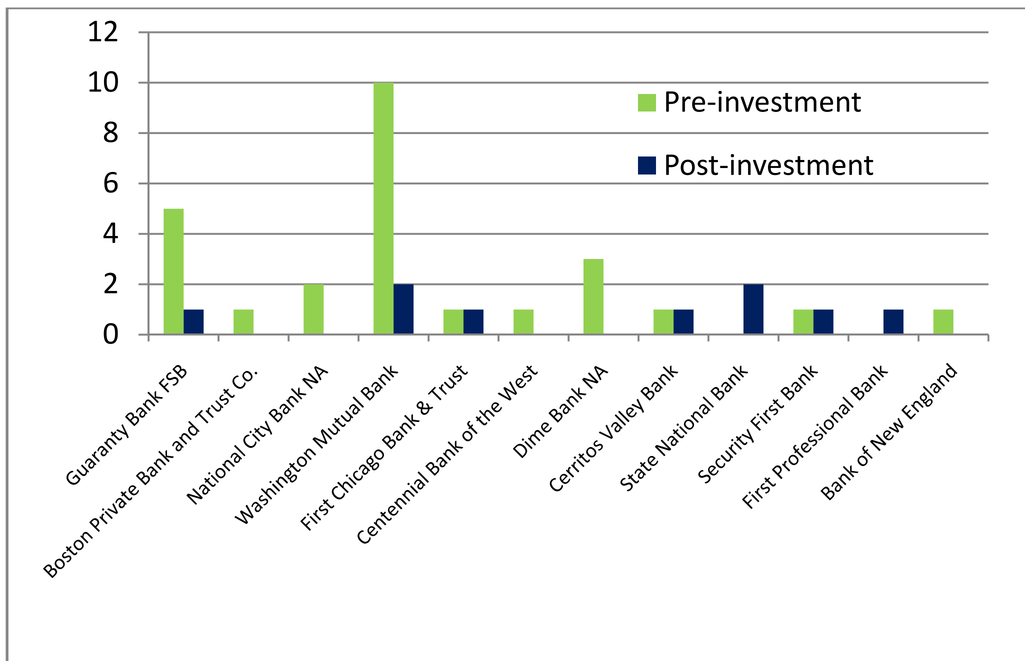

Chart 2 shows no discernible trend from pre- to post-investment. In fact, putting aside Washington Mutual (which is an outlier pre-investment and only had a short life post-investment), the average number of enforcement actions went down after the private equity investment, from 1.45 per bank to 0.64 per bank across the twelve banks in Chart 2. This decline is statistically significant at 90% confidence.

Table 3 shows that the enforcement actions involved a range of banking issues, including the need for competent management, violation of the Home Mortgage Disclosure Act and, in one

[76] http://www.fdic.gov/bank/individual/enforcement/index.html (FDIC Enforcement Decisions and Orders); http://www.occ.treas.gov/EnforcementActions/ (Office of the Comptroller of the Currency Enforcement Actions); http://www.ots.treas.gov/?p=EnforcementSearch (Office of Thrift Supervision Enforcement Actions); http://www.federalreserve.gov/boarddocs/enforcement/search.cfm (Federal Reserve Board Enforcement Actions).

enforcement order, inadequate capital. The OTS imposed an enforcement order against Guaranty Bank FSB in April 2009 because the thrift's capital reserves were depleted by poor earnings and high levels of classified assets.[77] It is noteworthy that none of the enforcement actions appear to relate to improper related party transactions or conflicts of interest with a private equity investor, as that is a concern that is often expressed by critics of potential private equity investment.[78]

IV. Synthesis and Policy Implications

A. Some First Principles in the Market for Failed Banks

There is widespread consensus among academics that, in general, overall social welfare is maximized when assets go to their highest and best use, known as "allocational efficiency" in the marketplace. Parties signal their value for an asset with the price that they are willing to pay, and best price wins. An allocational efficiency objective is consistent with the FDIC's least-cost-resolution mandate, and with the FDIC's public statements regarding the application of least-cost-resolution to private equity.[79]

There is also widespread consensus among academics that, absent distortions, allocational efficiency is best achieved through a level playing field among buyers. In the context of the failed banks, the level playing field principle means that buy-side investment decisions should be driven by economic fundamentals rather than the organizational form of the buyer. A level playing field allows the marketplace to effectively determine the answer to the question: who is best able to manage the assets going forward?

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[77] As was the case with the failure of Washington Mutual, the issues leading up to Guaranty Bank's enforcement action and potential failure appear to be related to the severity of the subprime mortgage crisis and pre-date the involvement of private equity investors. As of March 2008, more than twenty percent of Guaranty Bank's assets were in non-agency mortgage-backed securities (MBS) which had already declined in value by more than 30 percent. Guaranty Financial Group Inc., Form S-1/A, p. 12, filed on June 18, 2008. Guaranty wrote down these securities by $1.4 billion as of March 31, 2009, with the result that its core capital ratio was -5.78 percent as of that date. Guaranty Financial Group, Form 8-K, filed on July 23, 2009.

[78] Peter Latman and Damian Paletta, "Funds Get Freer Hand in Buying Bank Stakes", *The Wall Street Journal,* September 23, 2008.

[79] Bonnie McGeer, "Has BankUnited Broken PE Logjam?" *American Banker*, May 25, 2009 (reporting that FDIC spokesperson David Barr acknowledged "no bias" against the private equity firms, and noting the FDIC is required "to take the least-cost bid.").

Of course, the level playing field concept can go awry if there are distortions in incentives on either the buy-side or the sell-side. To take a simple example, if Buyer A has a capped downside while Buyer B does not, Buyer A can artificially bid more than Buyer B, and then will likely take more risk in running the assets than is socially optimal. Price signals are distorted, and allocational efficiency can be reduced.

In order to test the extent to which distortions in incentives can explain private equity investments in banks, this White Paper examined relevant private equity transactions over the past twenty years. The analysis reveals none of the distortions that might work to reduce social welfare. Specifically, I find virtually no evidence of regulatory abuse, excessive risk-taking, or increased costs to the FDIC due to private equity control of banks. Instead, the evidence suggests that private equity investments in banks have been generally beneficial to the banking industry.

While private equity is unlikely to singlehandedly solve the problems that the banking sector currently faces, my analysis reveals no evidence that it has caused these problems. For example, with the exception of Washington Mutual, which is discussed in Section III.C.2 above, none of the banks in the Table 2 sample appear on the FDIC's failed bank list. That is, out of the 90 banks that have failed between January 1, 2008 and July 26, 2009, none other than WaMu seem to have had a private equity investor at the time of the failure.

B. Some General Concerns with the FDIC Proposal

In the current environment, there is a natural marriage between the capital-rich private equity firms and the capital-starved troubled banks. As discussed in Section III, private equity firms have more than $400 billion in committed but uninvested capital, while *The Wall Street Journal* reports that the FDIC cannot find enough bidders for the banks currently in receivership.[80] One recent commentary on the FDIC Proposal puts it colorfully: "[T]o lock out the $400B of PE cash available to banks – the lifeline to small businesses across the country –

[80] "A Private Equity Bid is Key for Bank Deals --- Ross-Led Group Seeks BankUnited; Others May Follow," *The Wall Street Journal*, May 18, 2009.

seems to ignore the historic role of private capital formation. . . . One market observer suggested it was like a drowning man demanding to see his rescuer's lifesaving certificate."[81]

In late 2008, the Federal Reserve, the OCC, and the FDIC acknowledged the natural marriage by reducing some of the impediments to private equity investments in banks. These refinements moved in the direction of a level playing field. In contrast, the current FDIC Proposal goes in the opposite direction. I agree with the many commentators who predict that the main effect of the FDIC Proposal will not be to improve the safety and soundness of private equity-owned failed banks, but rather will be to deter private equity buyers from buying failed banks at all.[82]

The simple fact is that private equity firms have options. The FDIC Proposal would make many failed bank investments difficult to justify in view of private equity hurdle rates. And the evidence documented in this White Paper suggests that if private equity "left the field," the banking industry would suffer significantly.

To the extent that private equity capital stayed within the banking industry under the FDIC Proposal, it would likely flow to other places. For example, private equity firms could invest in solvent banks without being subject to the FDIC Proposal. And so a non-level playing field in the marketplace for failed banks would re-direct private equity capital that stayed in the industry to solvent banks. Presumably, solvent banks need capital less than failed banks.

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[81] Churchill Financial, "Capital Markets Week in Review: The Nation's Capital," *On the Left,* July 21, 2009.

[82] *See, e.g.*, Clifford Chance Client Briefing, "Harsh Restrictions to be Imposed on Private Equity Investments in Failed Banks Under Proposed FDIC Policy," July 2009, at 2 ("The FDIC's Proposed Policy accomplishes only one thing beyond the things that the BCHA is already designed to do: it will ensure that private equity firms deploy their funds elsewhere."); Edward D. Herlihy, Craig M. Wasserman, Richard K. Kim and Lawrence S. Makow, "FDIC Proposal May Inhibit Private Equity Investments in Failed Banks," *The Harvard Law School Forum on Corporate Governance and Financial Regulation*, July 12, 2009 ("In its present form, the proposed new restrictions, when combined with the existing regulatory restrictions applicable to private equity investments in banks, may effectively dampen private equity interest in acquiring failed banks."); "FDIC Proposed Guidance On Private Equity Investments," Arnold & Porter memorandum to clients, July 2009 ("[T]he Proposed Policy Statement, if finalized as issued, imposes very harsh requirements on private equity investors, and, thus, is not likely to facilitate many future transactions."). *See also* "Release of FDIC Policy Statement on Qualifications for Failed Bank Acquisitions by Private Capital Investors," Gibson, Dunn & Crutcher Memorandum to Clients, July 7, 2009 ("The private equity sector was not alone in these criticisms. Senior federal financial regulatory officials were quick to complain that the proposal would go too far and would have the effect of cutting off access to private capital."); Bill McConnell, "The Ties That Bind," *The Deal*, July 20, 2009, p. 28 (quoting John Dugan, comptroller of the currency, on the FDIC Proposal: "It's great to have safeguards but not if they completely deter people from investing.")

It might be argued that the inability to buy failed banks would promote private equity investment in failing banks, which might in fact be socially desirable. This argument only works if private equity investors currently perceive that they can wait for bank failure and then get a better deal. For reasons discussed in conjunction with my analysis of the IndyMac and BankUnited transactions, this assumption would seem to be unwarranted.

In addition to diverting their capital to solvent banks, private equity firms might also buy assets rather than whole banks in order to avoid the FDIC Proposal. This effect would work against the FDIC's stated interest in "whole bank" deals.[83] As illustrated by our experience with the Resolution Trust Corporation in the early 1990s,[84] allowing investors to buy specific assets would cause private equity firms to "pick over" failed banks, leaving the unwanted residual assets to be managed by the FDIC. In short, the FDIC Proposal would cause private equity capital to either leave the banking industry completely, or flow to places where private equity has a more level playing field but which are less socially valuable than failed bank investments.

Another general problem with the FDIC Proposal is that it does not differentiate between private equity firms that invest exclusively in the banking sector and private equity firms that invest more broadly, even though there are important differences between these two kinds of firms. Several of the concerns that motivate the FDIC's Policy Proposal do not apply to private equity firms that invest exclusively in the financial services industry. As discussed in Section III.B above, these firms are generally registered as bank holding companies, and they generally seek controlling interests instead of using consortium structures. In addition, many of the principals of these firms are seasoned banking professionals with considerable experience in the industry.[85] To the extent that lack of direct supervision from the Federal Reserve, governing structures with diffuse accountability, and/or lack of banking expertise are motivating the FDIC Proposal, these concerns generally do not apply to private equity firms that invest exclusively in

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[83] FDIC, "Evolution of the FDIC's Resolution Practices," *Managing the Crisis: The FDIC and RTC Experience*, Chapter 3, August 1998, p. 89.

[84] Timothy Curry and Lynn Shibut, "The Cost of the Savings and Loan Crisis: Truth and Consequences," *FDIC Banking Review*, Vol. 13, No. 2, December 2000, p. 1.

[85] For example, the managing principal of Castle Creek Capital is John Eggemeyer. Mr. Eggemeyer has nearly 20 years of experience as a senior executive with some of the largest banking organizations in the United States, including First National Bank of Chicago, Norwest Bancorporation, Chemical Bank, and First Trust Company.

the banking sector. The FDIC Proposal is therefore overbroad by not differentiating between these firms and private equity firms more generally.

C. Some Concerns with Specific Elements of the FDIC Proposal

Although I have not conducted a comprehensive review of all aspects of the FDIC Proposal, two aspects that I have reviewed would seem to be directionally consistent with best practices in corporate governance – restrictions on transactions with affiliates, and the improved disclosure requirements. In addition, these two features of the proposal are relatively mild, and could likely be implemented without significantly deterring private equity capital.[86] In contrast, three features of the FDIC Proposal – the 15% Tier One leverage ratio, the source of strength commitment for non-controlling shareholders, and the cross-guarantee provision – are particularly onerous and very likely to deter private equity investors. In addition, certain aspects of these three elements are inconsistent with fundamental principles of business organization. In my opinion, these three elements are unwise, and should be abandoned. I explain these points in more detail below.

1. 15% Tier One leverage ratio

The FDIC Proposal requires that private equity investors in failed banks maintain a 15% Tier 1 leverage ratio for three years, three times what is required at the most highly capitalized banks.[87] After three years, private equity investors must ensure that the bank is "well capitalized" rather than the "adequately capitalized" baseline that is otherwise applicable.[88] These higher capitalization requirements will reduce the returns to private equity investors.

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[86] Following the approach taken in corporate law, "self-dealing" transactions such as transactions with affiliates might be subject to enhanced scrutiny rather than categorically prohibited, because in some instances the optimal counter-party is in fact an affiliated party. This is why, for example, management buy-outs are not categorically prohibited but, instead, subject to stringent procedural hurdles and disclosure requirements. But this alternative approach to transactions with affiliates is a relatively minor quibble with the FDIC Proposal.

[87] The minimum Tier 1 leverage ratio requirement for a "well capitalized" bank is 5% (FDIC, "DSC Risk Management Manual of Examination Policies," Part II – CAMELS, p. 2.1-7). To highlight the severity of a 15% Tier 1 leverage ratio, it is interesting to note that even *de novo* banks are only subject to an 8% leverage ratio. *See* FDIC, "DSC Risk Management Manual of Examination Policies," Part V – Examination Reports, p. 18.1-5).

[88] The FDIC Proposal states that failure to remain "well capitalized" will result in a private-equity-owned bank being classified as "undercapitalized" for the purposes of Prompt Corrective Action (PCA). According to the Federal Deposit Insurance Act, a bank that fails to maintain the relevant capital measures required to be "adequately capitalized" is defined as "undercapitalized." All undercapitalized banks are required to submit a plan outlining the steps they will take to reach adequate capitalization (Federal Deposit Insurance Act, Section 38 (b) 1 and (e)).

Several commentators have pointed to this requirement as the most onerous in the FDIC Proposal. Rather than making private equity-owned banks better-capitalized, it will simply deter private equity firms from investing in failed banks.

FDIC Chairman Sheila Bair has stated that the FDIC is "opening high" with the 15% proposal.[89] This comment would seem to invite a negotiation toward a final leverage ratio of, say, 10%. In my opinion, any leverage ratio that is higher than what is otherwise generally required is misguided. In keeping with the principle of a level playing field, the riskiness of the bank, rather than the source of the capital, should determine the appropriate leverage ratio. In Section D below I propose an approach that would achieve this goal.

My analysis shows that some of the banks in the Table 2 sample maintained leverage ratios right around 15%, which might be used as evidence to justify a 15% leverage ratio. The problem, of course, is that requiring a 15% leverage ratio is very different from allowing it to happen when it makes business sense. That is, while a 15% leverage ratio may not be a binding constraint in some situations, in many others it will be higher than what the bank would otherwise want. Foreseeing this possibility, private equity firms will be deterred from investing in failed banks.

2. Source of strength commitment for non-controlling shareholders

The FDIC Proposal suggests the imposition of a source-of-strength commitment on private equity investors who hold non-controlling equity interests in the holding company for a failed bank. As with several other features of the FDIC Proposal, this requirement would increase the cost of private equity investment in failed banks, thereby deterring such investments. In addition, the requirement would cut against a basic objective of business organization to co-locate control, ownership, and risk.[90] The FDIC Proposal goes against this goal by imposing potentially unlimited downside risk where there is no control.

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[89] FDIC Press Release, "FDIC Chairman Sheila Bair's Statement on the Proposed Statement of Policy on Qualification for Failed Bank Acquisition," July 2, 2009.

[90] William T. Allen, Reinier Kraakman & Guhan Subramanian, *Commentaries and Cases on the Law of Business Organization* (Aspen Publishers, 3d ed. 2009).

To see why co-location is important, consider the problem of a minority investor in a private equity consortium to buy a failed bank. Under the FDIC Proposal, this minority investor would need to serve as a source of strength to the bank even though the investor does not control the bank. One of the concerns that has arisen in club deals is that the members of the club will disagree as to the operation of the portfolio company. Disagreement without control introduces the possibility of minority investors being "dragged along" in decisions.[91] The FDIC Proposal would then impose potentially unlimited downside liability for the consequences of those decisions. Foreseeing this possibility, private equity firms will be reluctant to take minority positions in failed bank deals.[92]

It might be argued that the source-of-strength proposal will simply push private equity firms to take control positions in banks, which would be a self-help way of co-locating control, ownership, and risk. The problem, of course, is that private equity firms risk subjecting themselves to bank holding company regulation by taking control, which is generally unacceptable for reasons described in Section III.B.1. Certain kinds of "silo" structures that private equity firms have historically used to take control of banks may be unavailable under the FDIC Proposal.[93]

[91] Of course, minority shareholders in corporations can be dragged along too, but the principle of limited liability caps their downside risk, and therefore encourages investment. In addition, in the public-company context minority shareholders can readily exit their investment rather than being dragged along. Exit options in the private equity context are far more limited.

[92] A recent *Wall Street Journal* op-ed reaches a similar conclusion. P. Olivier Sarkozy & Randall Quarles, "Let Private Equity Help the Banks," *The Wall Street Journal*, July 16, 2009 ("[T]he potential for bottomless liability without control would deter nearly all investors.").

[93] FDIC Proposal, p. 32932 ("Some acquisition arrangements, such as those involving complex and functionally opaque ownership structures, typified by 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, would be so substantially inconsistent with these principles as not to be considered as appropriate for approval for ownership of insured depository institutions.") I read this part of the Proposal as a prohibition on "complex and functionally opaque ownership structures" and not a categorical prohibition on all so-called "silo" arrangements. Some silo structures can have significant operational benefits, such as localizing decision-making and facilitating asset partitioning. *See infra* note 95 and accompanying text. For example, there may be good business reasons for a private equity firm to create separate silos for a Florida bank and an Ohio bank even though they are in the same portfolio. Without separate silos, the Florida and Ohio banks would have to cross-monitor each other, which creates inefficiencies. Therefore, a categorical prohibition on what the FDIC is referring to as "silo" structures would unnecessarily prohibit what can be good banking practices. I do not dwell on this concern because I read the FDIC Proposal to prohibit "complex and functionally opaque ownership structures" rather than silo structures in general.

The result is that, rather than pushing private equity firms from minority positions to control positions, the source-of-strength requirements are more likely to push private equity firms away from buying failed banks at all. The irony is that private equity firms, with their deep pools of capital, may be better-positioned than many banks today to serve as a source-of-strength. But it is these same deep pools of capital that make serving as a source-of-strength particularly onerous for private equity firms. As described in Section D below, a better approach is to negotiate source-of-strength sparingly, and on an individualized basis, rather than imposing a one-size-fits-all rule.

3. Cross-guarantee provision

The cross-guarantee provision of the FDIC Proposal states that: "Investors whose investments, individually or collectively, constitute a majority of the direct or indirect investments in more than one insured depository institution would be expected to pledge to the FDIC their proportionate interests in such institution to pay for any losses to the deposit insurance fund resulting from the failure of, or assistance provided to, any other such institution."[94] Although the implementation details and other specifics are somewhat vague, the provision in its most general form raises similar concerns as the source-of-strength proposal: by imposing unprecedented new obligations on minority investors that cut against basic principles of corporate law, it increases the cost of acquiring failed banks, reduces returns, and deters PE investment.

In addition to these concerns, the cross-guarantee provisions would distort investment decisions. Under a regime of cross-guarantees, a private equity firm would hesitate to invest in more than one failed bank, because any subsequent investment would impose potential costs on the other, existing bank investments. The optimal strategy in an environment with cross-guarantees would be to invest in only one failed bank, rather than optimally diversify across banks. Standard portfolio theory tells us that suboptimal diversification will lead to a higher cost of capital for private equity firms. Perhaps more importantly, from a policy perspective, cross-guarantees deter private equity firms that are experienced in the management of failed banks from participating in buying other failed banks. The cross-guarantee proposal works as an

[94] FDIC Proposal, p. 32933.

anti-diversification provision for experienced owners of failed banks, precisely the group of investors that the FDIC should be most interested in attracting.

Finally, at the highest level, expanded source-of-strength rules and cross-guarantees diminish the benefits of "asset partitioning" (or, equivalently, "entity shielding"), which is thought to be one of the most important features of business organization in our modern economy.[95] Asset partitioning allows businesses to specify the pool of assets that are available to contract and tort creditors. Without effective asset partitioning, credit decisions become more complex. Transaction costs and the cost of capital both increase. As with many other second-order effects of the FDIC Proposal, weaker asset partitioning decreases the profitability of private equity investments in failed banks, and will therefore deter such investments.

D. An Alternative Approach

Based on the analysis in this White Paper, it is my opinion that the FDIC Proposal makes two mistakes. First, it regulates according to the buyer, when safety and soundness is best achieved by regulating according to the riskiness of the bank. Second, with respect to the private equity buyers that it would regulate, the proposal takes a ones-size-fits-all approach. Bright-line rules have the benefit of providing clear guidance, but as currently proposed they deter, rather than attract, private equity capital.

The better approach would be to impose requirements on the subsequent buyer of a failed bank according to the specific features of the bank, rather than the features of the eventual buyer. For example, the FDIC might very well require the eventual buyer of a failed bank to maintain a 15% leverage ratio for three years, but this requirement should be based on the FDIC's assessment of the failed bank, not the characteristics of the acquirer, thereby preserving a level playing field among bidders.

In addition, the FDIC should consider further tailoring of deal terms according to individual buyers, based on their reputations, past performance, business plan, banking expertise, and other relevant factors. For example, the FDIC might negotiate with a private equity consortium for source-of-strength guarantees from some of the larger minority investors. In this

[95] Henry Hansmann and Reinier Kraakman, "Organizational Law as Asset Partitioning," *European Economic Review*, Vol. 44, May 2000.

negotiation, the private equity consortium could always say no, and walk away; likewise the FDIC could always veto the deal if the terms weren't good enough, as the Silverton Bank example illustrates.

Tailoring according to individual buyers should be used with caution: on one hand it allows individualized bidder characteristics (both positive and negative) to factor in to the sale process; on the other hand, it introduces the possibility of perceived arbitrary and capricious behavior by the FDIC against certain buyers, or types of buyers. For these reasons the tailoring should be done primarily at the bank level (e.g., required capital maintenance ratios) at the outset, and buyer-specific tailoring should be done only at the margin (e.g., source-of-strength requirements), ideally in ways that improve the deal for both sides.

V. Conclusion

In this White Paper I have reviewed the academic literature and compiled systematic empirical evidence on private equity investments in financial institutions. The weight of this evidence indicates that private equity investments have been beneficial, not harmful, to the banking industry. Moreover, in the current environment, there is a "natural marriage" between the capital-rich private equity firms and the capital-starved troubled banks. These basic facts suggest that the FDIC should reduce the impediments to private equity investments in failed banks. The overall goal should be a level playing field, in which investment decisions are driven by economic fundamentals rather than by the organizational form of the buyer.

The FDIC Proposal goes in the opposite direction by creating significant burdens on private equity investments in failed banks. I agree with the consensus view in the public commentary that these burdens would deter private equity investments in failed banks, which would hurt the banking industry. While certain aspects of the FDIC Proposal are relatively mild and directionally consistent with corporate governance best practices, it is my view that the 15% Tier One leverage ratio, the source-of-strength commitment for non-controlling shareholders, and the cross-guarantee provisions are problematic features. Rather than adopting a one-size-fits-all approach targeted at all private equity firms, the FDIC should adopt a more tailored approach that would create a level playing field for buyers of failed banks. This approach would

improve allocational efficiency in the market for failed banks and more effectively fulfill the FDIC's least cost resolution mandate in dealing with the current crisis in the banking industry.

Appendix: Biographical Information for Guhan Subramanian

Guhan Subramanian is the Joseph Flom Professor of Law and Business at the Harvard Law School and the Douglas Weaver Professor of Business Law at the Harvard Business School. He is the only person in the history of Harvard University to hold tenured appointments at both HLS and HBS. At HLS he teaches courses in negotiations and corporate law. At HBS he teaches in several executive education programs, such as *Strategic Negotiations*, *Changing the Game*, *Managing Negotiators and the Deal Process*, and *Making Corporate Boards More Effective*. He is the faculty chair for the JD/MBA program at Harvard University and the faculty director for the Corporate Dealmaking project at the Harvard Program on Negotiation. Prior to joining the Harvard faculty he spent three years at McKinsey & Company in their New York, Boston, and Washington, D.C. offices.

Professor Subramanian's research explores topics in corporate dealmaking, corporate law, and corporate governance. He has published articles in the *Stanford Law Review*, the *Yale Law Journal*, the *Harvard Law Review*, and the *Journal of Legal Studies*, among other places. His work has been featured in the *Wall Street Journal*'s "Heard on the Street" column, the *New York Times*, the *American Lawyer*, *The Daily Deal*, and *Corporate Control Alert*. Over the past ten years he has published more "top ten" articles in corporate and securities law, as selected by academics in the field, than any other scholar in the country. He is also a co-author on *Commentaries and Cases on the Law of Business Organization*, a leading textbook in the field.

Professor Subramanian has served as an expert witness in major public-company deals such as Oracle's $10.3 billion hostile takeover bid for PeopleSoft, Cox Enterprises' $8.9 billion freeze-out of the minority shareholders in Cox Communications, the $6.6 billion leveraged buyout of Toys "R" Us, and Exelon's $8.0 billion hostile takeover bid for NRG Energy. He also advises individuals, boards of directors, and management teams on issues of dealmaking and corporate governance.

Professor Subramanian holds an A.B. in Economics (*magna cum laude*) from Harvard College, where he was elected to Phi Beta Kappa; an M.B.A. from Harvard Business School; and a J.D. from Harvard Law School (*magna cum laude*), where he was an editor of the *Harvard Law Review* and a winner of the Ames Moot Court Competition. He is formerly a Fellow of the

Harvard Negotiation Research Project and an Olin Fellow for research in law and economics, both at Harvard Law School. He is a member of the New York Bar Association and the American Law & Economics Association.

Table 1: U.S. Empirical Studies on Changes in Operational Performance from Private Equity Buyouts (1999-2009)

Paper	Sample	Methodology	Results	Discussion
Jerry Cao and Josh Lerner, "The Performance of Reverse Leveraged Buyouts," *Journal of Financial Economics*, Volume 91, Issue 2, 2009, pp. 139-57.	526 reverse leveraged buyouts (RLBOs), 1981-2003	The authors estimate the median values of Operating Income/Sales and Return on Assets (ROA) for the RLBOs in their sample set. Using statistical signficance tests, the authors compare the RLBO medians to the median values of non PE-backed initial public offerings (IPOs) and mature firms in the same industry. (Mature firms are at least three years removed from an IPO.)	The Operating Income/Sales ratio for RLBOs is 3 percent higher than the industry-adjusted median of IPOs and 5 percent higher than the industry-adjusted median for mature firms.	Based on their results, the authors conclude that "RLBOs have better financial performance than other IPOs [and] ... their industry peers." The authors note that in their sample, RLBOs are larger in size, have greater leverage, and are backed by more reputable underwriters than other firms. They do not test whether these factors contribute to the better performance of RLBOs.
Phillip Leslie and Paul Oyer, "Managerial Incentives and Value Creation: Evidence from Private Equity," working paper, January 2009.	144 reverse leveraged buyouts (RLBOs), 1996-2006	The authors use regression analyses to measure operational performance. The dependent variables include Return on Assets (ROA), EBITDA/Total Assets, Sales per Employee, and Employees/Total Assets. The key independent variables are two dummies: one measures whether or not a firm was involved in an RLBO, and the other captures firms that are within one year of being purchased by a private equity fund. Other control variables measure cash/assets, assets, sales, and employees.	There are no significant profitability and operational performance improvements caused by PE ownership. Profitability and operational performance are measured by ROA, EBITDA/Total Assets, Sales per Employee, and Employees/Total Assets. The only one of these measures to show a significant (and positive) effect from PE ownership is Sales per Employee. There is also no significant difference between RLBOs and other going-private firms that are not yet owned by private equity.	The authors state that they "have not found any evidence that the increased incentives ... improve bottom-line performance." The authors also argue that "one might suspect that this is because the firms that go into PE ownership are often turnarounds and their PE owners are successful in returning them to financial health, this would imply that firms ... would be underperforming their peers at the time [of measurement]," but they see no evidence of that trend in their data. The authors suggest that the above-normal profits for PE firms stem from sources other than performance gains, such as tax advantages or value capture.

Table 1 (cont): U.S. Empirical Studies on Changes in Operational Performance from Private Equity Buyouts (1999-2009)

Paper	Sample	Methodology	Results	Discussion
Shourun Guo, Edith S. Hotchkiss, and Weihong Song, "Do Buyouts (Still) Create Value?" working paper, January 2009.	94 leveraged buyouts (LBOs), 1990-2006	The authors examine two measures of operational performance: profitability (e.g., Net Cash Flow/Sales) and return on assets (e.g., EBITDA/Total Assets). For each variable, the authors calculate adjusted percentage changes, which compare the performance of LBOs to firms in the same industry with similar performance. The authors also run regressions to analyze the factors that contribute to differences in profitability and return on assets. Key independent variables include a firm's leverage (Total Debt/EBITDA) and a dummy variable that measures whether or not the CEO was replaced in the first year after an LBO.	Net Cash Flow/Sales and EBITDA/Total Assets for LBOs are 14 percent and 11 percent higher than their peers, respectively, by the last year prior to exit.The authors state that these increases in operational performance for LBOs are much smaller than what studies found in the 1980s. For LBOs in their sample, profitability and return on assets are higher for firms with both higher pre- and post-buyout leverage. Profitability and return on assets are also higher for LBOs experiencing a management change in the first year after the buyout.	The authors argue that LBOs in their sample have lower leverage compared to firms in the 1980s, and this may help explain why operational improvement is lower for their dataset.The authors also state that lower operational improvements may be reflective of the fact that "[u]nlike deals of the 1980s, the more recent buyouts are not largely motivated by the ability to produce large gains by targeting significantly underperforming companies."
Josh Lerner, Morten Sorensen, and Per Strömberg, "Private Equity and Long-Run Investment: The Case of Innovation," working paper, December 2008.	495 leveraged buyouts (LBOs), 1986-2005	The authors use regression analyses to analyze one form of long-term activities for LBOs, namely investments in innovation as measured by patenting activity. The authors focus on the quality, size, and structure of the company's patent portfolios, using the number of patent citations as a proxy for patent quality. The key independent variable is a dummy that measures whether or not a firm was involved in an LBO.	The authors find no evidence that LBOs are associated with a decrease in patenting activity. Specifically, the authors find that "patents granted to firms involved in private equity transactions are more cited (a proxy for economic importance), show no significant shifts in the fundamental nature of the research, and are more concentrated in the most important and prominent areas of companies' innovative portfolios."	The authors argue that "breakdowns of the patenting patterns suggest that the areas where the firms concentrate their patenting after the private equity investment, and the historical core strengths of the firm, tend to be the areas where the increase in patent impact is particularly great."

Table 1 (cont): U.S. Empirical Studies on Changes in Operational Performance from Private Equity Buyouts (1999-2009)

Paper	Sample	Methodology	Results	Discussion
Steven J. Davis, John Haltiwanger, Ron Jarmin, Josh Lerner, and Javier Miranda, "Private Equity, Jobs and Productivity," working paper, December 2008.	~5,000 firms acquired in PE trans-actions and ~250,000 establish-ments operated by these firms, 1980-2005	The authors compute the real value-added per worker and aggregate this to estimate total productivity for each firm. They also calculate earnings per worker for the firms in their dataset. The authors estimate both labor productivity and earnings per worker separately for different types of establishments within a given firm: establishments that are newly-started or shut down under the same target firm, establishments that have continued to exist, and establishments that are acquired from or divested to other companies. The authors use regression analyses to compare labor productivity and earnings per worker between firms that had PE buyouts and control firms. Control firms are selected to mirror the size, age, and industry of buyouts.	Buyout establishments that have continued to exist have higher labor productivity than control establishments, both in the transaction year (4 percent higher) and two years after a transaction (5 percent higher). Newly-started establishments of control firms have significantly lower productivity than currently existing establishments of control firms. In contrast, newly-started establishments of buyouts show no difference in productivity to the existing establishments of control firms (two years after transaction). The trends for earnings per worker between buyout and control establishments broadly mirror the trends for labor productivity. At the aggregate firm level, productivity growth is approximately two percent higher at buyouts than at control firms in the first two years after a transaction.	The authors argue that their findings suggest that buyouts "are more likely than controls to shut down poorly performing establishments as measured by labor productivity." When coupled with their findings from another paper, the authors conclude "that target firms of private equity transactions experience an intensification of job creation and destruction activity, establishment entry and exit, and establishment acquisition and divestiture. ... [T]his intensification of reallocation yields a substantial productivity growth differential (about 2 percent) within two years after the transaction."

Table 1 (cont): U.S. Empirical Studies on Changes in Operational Performance from Private Equity Buyouts (1999-2009)

Paper	Sample	Methodology	Results	Discussion
Steven J. Davis, John Haltiwanger, Ron Jarmin, Josh Lerner, and Javier Miranda, "Private Equity and Employment," working paper, March 2008.	~5,000 firms acquired in PE transactions and ~300,000 establishments operated by these firms, 1980-2005	The authors compare the change in employment for firms that had PE buyouts and control firms. Control firms are selected to mirror the size, age, and industry of buyouts. The authors also analyze changes in the creation of greenfield jobs (i.e., jobs from the creation of new establishments) between buyouts and control firms.	Two-year cumulative employment at buyout establishments is 7 percent lower than employment at control establishments. In the first two years after a buyout, greenfield job creation is 15 percent at buyouts and 9 percent at control firms. The buyout acquisition (divestiture) rates are 7 percent (6 percent), compared to 5 percent (3 percent) for control firms.	The authors argue that their findings "suggest that private equity groups act as catalysts for creative destruction. ... [E]mployment falls more rapidly at targets post transaction, in line with the view that private equity groups shrink inefficient, lower value segments of underperforming target firms. ... At the same time, however, ... private equity targets engage in more greenfield job creation than controls. This result suggests that private equity groups accelerate the expansion of target firm activity in new, higher value directions. ... [P]rivate equity also accelerates the pace of acquisitions and divestitures."

Table 1 (cont): U.S. Empirical Studies on Changes in Operational Performance from Private Equity Buyouts (1999-2009)

Paper	Sample	Methodology	Results	Discussion
James F. Cotter and Sarah Peck, "The structure of debt and active equity investors: The case of the buyout specialist," Journal of Financial Economics, Volume 59, 2001, pp. 101-147.	64 leveraged buyouts (LBOs), 1984-1989	The authors examine the role buyout specialists play in structuring the debt used to finance the LBO and in monitoring management in the post-LBO firm. (Examples of buyout specialists include private equity firms such as Kohlberg, Kravis, and Roberts and Kelso Company.) The authors analyze the mean and median values of several financial ratios, including EBITDA/Total Assets and EBITDA/Total Sales, for the years before and after an LBO. For each financial ratio, the authors use statistical significance tests to compare the performance of buyout specialist-controlled LBOs to both management-controlled LBOs and other investor-controlled LBOs.	Compared to other investor-controlled LBOs, buyout specialist-controlled LBOs, on average, have higher EBITDA/Total Assets in their first year after an LBO year. This better performance is sustained in the second, fourth, and fifth years after an LBO. Compared to management LBOs, buyout specialist LBOs have higher EBITDA/Total Assets in the third and fourth years after an LBO. Buyout specialist LBOs also have a larger percentage increase in EBITDA/Total Sales than management LBOs from the year before to the year after the LBO. For the year before the LBO, the authors find no difference in EBITDA/Total Assets or EBITDA/Total Sales between buyout specialist-controlled LBOs and other LBOs.	Based on their results, the authors conclude that buyout specialist-controlled LBOs perform better than management-controlled LBOs and other investor-controlled LBOs. The authors findings support the general hypothesis that the presence of an active equity investor, such as a buyout specialist, influences long-term firm performance. However, the authors state, "these higher levels of post-LBO operating performance in firms controlled by buyout specialists could be because they pick deals that are better ex ante or they more effectively monitor management in the post-LBO firm. Similarly, buyout specialists may pick deals that have more assets that can be profitably sold off or they may play a more active role instigating the sell-off of assets."

Table 2: Private Equity Investments in Solvent Banks, 1989-2009

Closing Date	Bank (Holding Company)	Investor(s)	Description	Control?
01/30/09	Flagstar Bank FSB (Flagstar Bancorp Inc.)	MatlinPatterson Global Advisers LLC	Flagstar Bancorp received $266.6 million from Treasury's TARP Capital Purchase Program; $250 million from MatlinPatterson; and $5.32 million from management. MatlinPatterson received convertible participating voting preferred stock in exchange for its investment. On June 30, 2009, MatlinPatterson invested an additional $100 million in Flagstar Bancorp in exchange for trust preferred securities.	Yes
01/14/09	Pacific Western Bank (PacWest Bancorp)	CapGen Financial	CapGen Capital Group II LP purchased $100 million in common shares of PacWest Bancorp. CapGen now owns approximately 12% of PacWest common stock on a fully diluted basis.	No
07/22/08	Guaranty Bank FSB (Guaranty Financial Group)	Icahn Partners LP; TRT Financial Holdings LLP	The investors provided approximately $600 million in exchange for convertible preferred shares.	No
07/22/08	Boston Private Bank and Trust Company; Borel Private Bank and Trust Company; Charter Bank; First Private Bank & Trust; Gibraltrar Private Bank and Trust Co. (Boston Private Financial)	Carlyle Group	The Carlyle Group invested $75 million in newly issued equity securities of Boston Private Financial.	No
04/21/08	National City Bank NA (National City Corp.)	Corsair Capital	The investor consortium provided approximately $7 billion in new capital. Corsair received common stock and preferred stock that amounted to an estimated 9.9% stake in the company. National City was acquired by PNC Financial in October 2008.	No
04/08/08	Washington Mutual Bank FSB (Washington Mutual Inc.)	TPG	The investor consortium provided $7 billion in new capital in the form of convertible preferred stock. WaMu was acquired by JPMorgan Chase on September 25, 2008.	No
02/18/08	Spectrum Bank	Belvedere Capital Partners LLC	Belvedere paid $37 million to acquire Spectrum Bank. Spectrum Bank was merged with Professional Business Bank on July 3, 2008.	Yes
12/11/07	PrivateBank NA (PrivateBancorp Inc.)	GTCR Golder Rauner; Mesirow Financial Holdings	GTCR acquired a 9.28% stake in PrivateBancorp for $100 million in cash. Mesirow acquired a 6.26% stake.	No
12/05/07	First Community Bank Central Texas; First Community Bank, the Woodlands (FC Holdings)	JLL Partners	JLL Partners was approved to invest up to $150 million in FC Holdings. JLL initially invested $75 million in exchange for common stock.	Yes

Table 2 (cont): Private Equity Investments in Solvent Banks, 1989-2009

Closing Date	Bank (Holding Company)	Investor(s)	Description	Control?
11/23/07	Professional Business Bank	Belvedere Capital Partners LLC	Belvedere acquired all of the shares of Professional Business Bank for an estimated $42 million.	Yes
04/2007	Bay Financial Savings Bank FSB (changed name to Progress Bank of Florida)	Community Bank Investors of America, LP (CBIA)	CBIA invested $4.2 million in Bay Financial Savings Bank.	No
01/18/07	BankFirst (BankFirst Bancorp)	Castle Creek Capital LLC; Eggemeyer Capital LLC	The investor consortium acquired 100% of the shares of BankFirst Inc. for $81 million.	Yes
04/11/06	First Chicago Bank and Trust (First Chicago Bancorp)	Castle Creek Capital LLC; Ruh Capital; Western States Opportunity LLC	The investor consortium acquired an 89% interest in First Chicago Bancorp.	Yes
04/11/06	Bank of Atlanta FSB (Atlanta Bancorporation)	Castle Creek Capital LLC; Stockwell Capital	The investor consortium acquired a 35% interest in Atlanta Bancorporation.	Yes
04/03/06	GMAC Bank FSB (GMAC LLC)	Cerberus Capital Management; Citigroup; Aozora Bank	The investor consortium acquired a 51% interest in GMAC's equity in exchange for approximately $14 billion in cash to be provided over a three year period.	Yes
07/16/04	Centennial Bank of the West (Centennial Bank Holding Inc.)	Castle Creek Capital LLC	Castle Creek acquired all of the Centennial Bank Holding Inc. stock for $155 million in cash. Centennial Bank was merged with Guaranty Bank and Trust Co. on January 1, 2008.	Yes
07/07/00	Dime Bank NA (Dime Bancorp)	Warburg Pincus	Warburg invested $238 million in Dime Bancorp in exchange for common stock and warrants. In June 2001, Dime Bank was acquired by Washington Mutual.	No
03/03/00	Sacramento Commercial Bank	Belvedere Capital Partners LLC	Belvedere acquired Sacramento Commercial Bank for $41.6 million in cash. Sacramento was merged into Placer Sierra Bank on March 22, 2001. Placer Sierra was acquired by Wells Fargo on September 22, 2007	Yes

Table 2 (cont): Private Equity Investments in Solvent Banks, 1989-2009

Closing Date	Bank (Holding Company)	Investor(s)	Description	Control?
12/31/99	National Business Bank (formed in 1998)	Belvedere Capital Partners LLC	Belvedere acquired National Business Bank in 1999 and merged it into CalWest and then Bank of Orange County, which was acquired by Wells Fargo in 2007.	Yes
09/13/99	Cerritos Valley Bank (Cerritos Valley Bancorp)	Belvedere Capital Partners LLC	Belvedere acquired all of the stock of Cerritos Valley Bancorp. Cerritos Valley Bank was merged into Bank of Orange County on August 16, 2002 and acquired by Wells Fargo in 2007.	Yes
09/1999	Bank of Lodi	Belvedere Capital Partners LLC	Belvedere acquired all of the stock of Bank of Lodi, which was merged with Placer Sierra Bank on December 11, 2004.	Yes
08/12/99	Placer Savings	Belvedere Capital Partners	Belvedere acquired Placer for $80 million in cash. Placer was acquired by Wells Fargo on September 22, 2007	Yes
06/21/99	State National Bank (State National Bancshares Inc.)	Castle Creek Capital LLC	Castle Creek acquired up to 34.21% of State National Bancshares Inc., which was later acquired by Banco Bilbao Vizcaya, SA on August 31, 2006.	Yes
11/1998	Downey National Bank	Castle Creek Capital LLC	Castle Creek acquired all of the stock of Downey National Bank. Downey National Bank was merged into Bank of Orange County on July 14, 2000.	Yes
11/14/97	Security First Bank	Belvedere Capital Partners	CCFI acquired a 52% interest in Security First Bank for $4.5 million.	Yes
08/28/97	Bank West (Bank West Financial Corp.)	LaSalle Financial Partners LP	LaSalle Financial acquired a 6.7% stake in Bank West Financial. Bank West was eventually acquired by Chemical Bank (Michigan) on September 15, 2001.	No
06/10/97	Merchants National Bank of Aurora (Merchants Bancorp)	Banc Funds	Banc Funds acquired common shares on the open market for $2.6 million in cash. Merchants National Bank was acquired by Fifth Third in 2000	No
10/05/95	Tarrytown Bank FSB (Tappan Zee Financial)	Endeavour Capital Partners	Investors acquired a 7.78% stake in Tappan Zee Financial in the open market for $1.4 million. Tarrytown was acquired by Union State Bank on April 30, 1999.	No
04/1995	First Professional Bank NA, now Pacific Western Bank (PacWest Bancorp)	Castle Creek Capital LLC	Castle Creek acquired a majority interest in First Professional Bank NA.	Yes
06/14/91	Palisade Savings FSB	US Thrift Opportunity Partners	US Thrift Opportunity Partners acquired Palisade Savings in a transaction for which the terms were never disclosed. Palisade was renamed Summit Bank and acquired by United Jersey Bank on February 18, 1995 and acquired by Fleet National Bank, which was acquired by Bank of America.	Yes

Table 2 (cont): Private Equity Investments in Solvent Banks, 1989-2009

Closing Date	Bank (Holding Company)	Investor(s)	Description	Control?
04/22/91	Bank of New England	Kohlberg Kravis Robert & Co.; Fleet	KKR and Fleet raised $683 million of new capital; KKR provided an additional $283 million and Fleet provided $67 million of its own money. Bank of New England was acquired by Fleet on July 14, 1991, which was acquired by Bank of America.	No
02/13/90	First Interstate Bank of California (First Interstate Bancorp)	Kohlberg Kravis Robert & Co.	KKR acquired 45% of a First Interstate Bancorp public offering for $111.5 million. KKR's interest was 9.98%. First Interstate was acquired by Wells Fargo on April 1, 1996.	No

Table 3: Summary of Enforcement Actions Against Banks Pre- and Post-Private Equity Investment

Enforcement Actions Before Private Equity Investment

Bank (Holding Company)	**Description of Enforcement Action**	**Description of Violation**
Guaranty Bank FSB (Guaranty Financial Group)	6/20/08 - OTS initiated an administrative prohibition against Hector Perez, a former contract employee of Guaranty Bank.	Perez misappropriated over $80,000 in funds from customer accounts between March 2006 and May 2006.
	8/31/06 - OTS initiated an administrative prohibition against Joseph M. Salmonte, a former banking center manager of Guaranty Bank.	Salmonte misappropriated $108,000 in funds between April 2004 and January 2006.
	9/2/05 - OTS initiated an administrative prohibition against Michael A. Hess, former banking center manager of Guaranty Bank.	"[B]etween August 2004 and May 2005, Hess made unauthorized transfers from client accounts and made unauthorized securities trades from Guaranty depositor accounts and subsequently transferred proceeds from these transfers and securities trades to his own account and accounts under the control of his family and friends. The amount of unauthorized transfers and trades totaled $834,440.00 by the time the transfers were discovered by Guaranty Fraud Loss officials."
	2/16/05 - OTS initiated an administrative prohibition against John Bellofatto, a former loan officer of Guaranty Residential Lending (GRL),	In May 2004, Bellofatto refinanced a real estate loan in the amount of $141,000 for property located in Plymouth, Massachusetts and received $50,626.08 in cash at closing. Bellofatto accomplished this refinancing by forging the name of the actual owner of the property (Theresa Will) on all of the loan documents without the knowledge and consent of the owner.
	12/22/04 - OTS initiated an administrative cease and desist proceeding against Guaranty Bank. The Bank agreed to comply with the terms of the Order upon issuance. OTS ordered Corrective Provisions, including strategic business plan, risk assessment, internal controls, Suspicious Activity Training, Fraud Management Program, Quality Control Plan, Compliance Management, Home Mortgage Disclosure, and board of director governance.	The OTS found that the Bank, directly or through Guaranty Residential Lending, Inc. (GRL), a wholly owned operating subsidiary of the Bank, had engaged in violations of: A. 12 C.F.R. § 203.4 (regarding compilation of loan data); B. 12 C.F.R. § 203.5 (regarding disclosure and reporting pertaining to Home Mortgage Disclosure); C. 12 C.F.R. § 560.1 70 (regarding records for lending transactions); D. 12 C.F.R. §563.170(c) (regarding establishment and maintenance of records); E. 12 C.F.R. § 563.180(d) (regarding Suspicious Activity Reports); F. The guidelines of Section 11.A of the Interagency Guidelines Establishing Standards for Safety and Soundness, Appendix A to 12 C.F.R. Part 570 (regarding internal controls and information systems); and G. 3 1 C.F.R. § 103.1 8 (regarding reports of suspicious transactions).

Enforcement Actions Before Private Equity Investment (cont)

Bank (Holding Company)	Description of Enforcement Action	Description of Violation
Boston Private Bank (Boston Private Financial)	4/26/04 - The OTS executed a Stipulation and Consent against Davidson Trust (a subsidiary of Boston Private Bank), which consented and agreed to the issuance of this Consent Order to Cease. (Order was terminated on 05/23/2006)	"[P]rior to January 2003, Davidson Trust Company: (a) Allowed a custodial account to engage in 'Late Trading' of mutual fund shares in contravention of the requirements of applicable forward pricing regulations. Such trading ended at the direction of DAVIDSON TRUST in January 2003. (b) Allowed a custodial account to engage in 'Market Timing' activities relating to mutual fund shares traded through DAVIDSON TRUST. (c) Failed to put in place adequate policies and procedures and systems reasonably designed to ensure DAVIDSON TRUST'S compliance with all applicable requirements for securities transactions, including, but not limited to, the Record Keeping and Confirmation Requirements for Security Transactions set forth in Part 551 of the OTS Rules and Regulations, 12 C.F.R. § 551 et seq."
National City Bank NA (National City Corp.)	9/20/05 - OCC sought to prohibit the Respondent, Brian Bonetti, a sales and service representative, from further participation in the affairs of any financial institution based on actions he took while employed at National City Bank.	Respondent "diverted portions of customer loan proceeds on thirteen home equity loans that Respondent made, authorized and/or booked, by issuing checks from the loan proceeds to make payments on his own credit card accounts (or accounts for which he was an authorized user) and payments on a loan in the name of related persons, or by depositing checks into accounts that were owned or controlled by Respondent. The Notice further alleges that Respondent falsified internal loan documents to hide from the Bank the fact that he was charging customers broker fees that exceeded the Bank's broker fee cap and gave customers misleading HUD-1 Settlement Statements that masked the broker fees charged. In addition, the Notice alleged that Respondent's violations caused loss to the Bank in the approximate amount of $84,970.00."
	11/13/03 - OCC initiated a civil money penalty proceeding against National City Bank for activities detailed in Deputy Comptroller for Large Bank Supervision James W. McPherson's letter to the Board of Directors dated September 23, 2003.	Insufficient information on Deputy Comptroller for Large Bank Supervision James W. McPherson's letter to the Board of Directors dated September 23, 2003.
Washington Mutual Bank FSB (Washington Mutual Inc.)	10/17/07 - Cease and Desist Order for Washington Mutual Bank in Henderson, Nevada	Washington Mutual Bank "has failed to comply fully with the requirements of the Currency and Foreign Transactions Reporting Act (the Bank Secrecy Act or BSA), 31 U.S.C. § 5311 et seq.; the related BSA regulations issued by the United States Department of the Treasury, 31 C.F.R. Part 103 and the OTS, 12 C.F.R. § 563.177; and the OTS regulations governing suspicious activity reports (SAR) set forth in 12 C.F.R. § 563.180."

Enforcement Actions Before Private Equity Investment (cont)

Bank (Holding Company)	**Description of Enforcement Action**	**Description of Violation**
Washington Mutual Bank FSB (cont)	10/17/07 - Order of Assessment of a Civil Money Penalty (Stipulation) for Washington Mutual Bank in Henderson, Nevada	"OTS finds that, despite knowing that one hundred and fifty-seven (157) designated loans had no or inadequate flood insurance, the Institution [Washington Mutual Bank] failed to notify the respective borrowers of the need to obtain flood insurance, or, if the borrowers were so notified and did not obtain flood insurance, failed to purchase insurance on the borrowers' behalf as required by 42 U.S.C. § 4012a(e) and 12 C.F.R. § 572.7. The OTS finds that such behavior constituted a pattern or practice of violations under 42 U.S.C. § 4012a(f)(1)."
	3/2/2007 - Order of Prohibition in the matter of JAHNIQUA MILLINGTON and Washington Mutual Bank, FSB, Henderson, Nevada.	"The OTS finds that Millington (a former employee) knowingly facilitated fraudulent withdrawals from customer accounts on numerous occasions. Specifically, Millington knowingly processed forged instruments and facilitated the fraudulent withdrawal of $206,000 from at least three separate accounts of Washington Mutual depositors."
	12/14/05 - Order of Prohibition in the matter of Scott D. Goldstein and Washington Mutual Bank in Henderson, Nevada.	"[B]etween November 27, 2004 and December 31, 2004, Scott Goldstein misapplied approximately $52,000 from accounts of customers of Washington Mutual."
	11/17/05 - "Joan Marie Capo ("Respondent") has been advised of the right to receive a NOTICE OF INTENTION TO PROHIBIT FROM FURTHER PARTICIPATION ("NOTICE") issued by the Federal Deposit Insurance Corporation ("FDIC") detailing the violations, unsafe or unsound banking practices and/or breaches of fiduciary duty for which an ORDER OF PROHIBITION FROM FURTHER PARTICIPATION ("ORDER")"	"The Respondent has engaged or participated in violations, unsafe or unsound banking practices, and/or breaches of fiduciary duty as an institution-affiliated party of Washington Mutual Bank, Seattle, Washington ("Bank")."

Enforcement Actions Before Private Equity Investment (cont)

Bank (Holding Company)	Description of Enforcement Action	Description of Violation
Washington Mutual Bank FSB (cont)	11/4/05 - "Kenneth D. Dawson ("Respondent") has been advised of the right to receive a NOTICE OF INTENTION TO PROHIBIT FROM FURTHER PARTICIPATION ("NOTICE") issued by the Federal Deposit Insurance Corporation ("FDIC") detailing the violations, unsafe or unsound banking practices and/or breaches of fiduciary duty for which an ORDER OF PROHIBITION FROM FURTHER PARTICIPATION ("ORDER") may issue."	"The Respondent has engaged or participated in violations, unsafe or unsound banking practices, and/or breaches of fiduciary duty as an institution-affiliated party of Washington Mutual Bank, Seattle, Washington ("Bank")."
	4/8/2005 - AN ORDER TO CEASE AND DESIST AND AN ORDER OF ASSESSMENT OF CIVIL MONEY PENALTIES in the matter of CRAIG W. EDWARDS and Washington Mutual Bank, FA, Stockton, California.	"The OTS finds that, EDWARDS, while employed as a financial center manager received a portion of a payment made for the sale and release of confidential customer/borrower credit and financial information to third parties, in violation of the privacy provisions of the Gramm-Leach-Bliley Act (GLBA) and the anti-kickback provisions of the Real Estate Settlement Procedures Act (RESPA). In addition, while a financial center manager, EDWARDS was aware of other instances of such improper sale and release of customer confidential information by his subordinate but took no steps to stop it."
	1/6/2005 - Order of Prohibition in the matter of JAVIER E. PIZARRO and Washington Mutual Bank, FA, Stockton, California.	"The OTS finds that while employed as a financial center manager for Washington Mutual, PIZARRO misapplied approximately $68,000 of the funds of Washington Mutual by causing Washington Mutual to honor his personal checks drawn on another bank that were supported by insufficient funds."
	12/29/2004 - ORDER OF PROHIBITION AND ORDER OF ASSESSMENT OF CIVIL MONEY PENALTIES in the matter of WILLIAM C. MASTRE and Washington Mutual Bank, FA, Stockton, California.	"The OTS finds that, on at least five occasions, beginning in May 2001 and continuing through September 2001, MASTRE, while employed as a credit representative by Washington Mutual, released confidential customer/borrower credit and financial information to third parties for payment in violation of the privacy provisions of the Gramm-Leach-Bliley Act (GLBA) and the anti-kickback provisions of the Real Estate Settlement Procedures Act (RESPA)."

Enforcement Actions Before Private Equity Investment (cont)

Bank (Holding Company)	Description of Enforcement Action	Description of Violation
Washington Mutual Bank FSB (cont)	6/9/2004 - ORDER OF PROHIBITION AND ORDER OF ASSESSMENT OF CIVIL MONEY PENALTIES in the matter of VERNON H. ROY and Washington Mutual Bank, FA, Stockton, California.	"The OTS finds that, on at least twelve (12) occasions, beginning in January 2001 and continuing through September 2001, ROY, while employed as a credit representative at the Horizon Marketplace branch of Washington Mutual, sold and released confidential customer/borrower credit and financial information to third parties, in violation of the privacy provisions of the Gramm-Leach-Bliley Act (GLBA) and the anti-kickback provisions of the Real Estate Settlement Procedures Act (RESPA)"
First Chicago Bank and Trust (First Chicago Bancorp)	11/30/05 - initiate a civil money penalty assessment against Harry M. Fishman ("Fishman"), former Institution-Affiliated Party of Labe Bank (renamed First Chicago Bank and Trust on 12/8/06).	"(a) Fishman served as an institution-affiliated party of Labe in connection with Fishman's development of appraisals and preparation of appraisal reports of a mixed-use property located in Stickney, Illinois as of August 21,2003. Fishman utilized incorrect, inappropriate, and insufficient analytical techniques. (b) Because of Fishman's actions and omissions, the appraisal reports were misleading, in violation of professional standards, specifically, Standards Rules 1 and 2 of the Uniform Standards of Professional Appraisal Practices (USPAP), and OTS minimum appraisal standards as set forth at 12 C.F.R. 8 564.4."
Centennial Bank of the West (Centennial Bank Holding Inc.)	1/28/03 -- Guaranty Bank And Trust Company (a subsidiary of Centennial Bank of the West) agreed to pay civil money penalty assessed by the FDIC in the amount of $4,200.	"[Penalty was] assessed under section 102 of the Flood Disaster Protection Act of 1973 ("Flood Act"), as amended, 42 U.S.C. §4012 and Part 339 of the FDIC Rules and Regulations, 12 C.F.R. Part 339"
Dime Bank NA (Dime Bancorp)	7/3/00 - OTS initiated an administrative prohibition against Cherilyn Kendrick, a former employee of the Bank.	"[B]etween May 7 and September 9, 1996 CHERILYN KENDRICK, without authorization, misapplied $15,900 of the funds of the Institution to her own use. "

Enforcement Actions Before Private Equity Investment (cont)

Bank (Holding Company)	Description of Enforcement Action	Description of Violation
	4/18/00 - OTS initiated an administrative prohibition against Anamaria Pedraza, a former employee of the Bank.	"[O]n January 20, 1999 ANAMARIA PEDRAZA, without authorization misapplied $25,000 of the funds of the Institution to her own use This occurred when she prepared a report showing she cashed a $25,000 U. S. Government check and on the same day she disbursed another check for $25,000 made payable to Beth Frisna."
	5/12/97 - OTS initiated an administrative prohibition against Tonianne M. Milne, a former customer service representative of the Bank.	"[B]etween April 29 and September 9, 1995, TONIANNE M. MILNH removed in a series of seven unauthorized withdrawals, $5,000, from a customer's Dime account, while employed as a Customer Service Representative at the Walt Whitman and Huntington Station Branch Offices of Dime. Further, on September 28, 1995 she signed a hand written statement admitting to taking for her personal use $4,500. And, on September 26, 1995 she signed a second hand written statement admitting to taking an additional $500 for her personal use. These statements were given to Dime Security Officer Anthony Santangelo.
Cerritos Valley Bank (Cerritos Valley Bancorp)	9/22/95 - The FDIC ordered the Bank to cease and desist from unsafe and unsound practices. (9/4/96 - The ORDER TO CEASE AND DESIST was terminated.)	"[Violations include] operating with inadequate management; operating with inadequate equity capital and reserves in relation to the volume and quality of assets held by the bank; operating with a large volume of poor quality loans and other assets; operating with an inadequate allowance for loan and lease losses; following inadequate lending and collection practices; operating in such a manner as to produce low earnings; and operating in violation of California law and the FDIC's rules and regulations."
Security First Bank	03/30/06 - Lorie J. Vowers is prohibited from participating in the conduct of affairs of, or exercising voting rights in, any insured institution without the prior written approval of the FDIC.	In 1996, when Vowers became entrusted with being solely responsible for managing the Security First Bank of Sidney Nebraska's credit card program...[i]n order to pay for her own debts she sequentially created credit card accounts in the names of 15 fictitious persons....She created 50 bank loan customers between 2002 and January 2005. Stockmens Financial Corporation and the FBI did independent analyses that each determined $379,823.36 as the missing dollar amount.
Bank of New England	02/26/1990 - One Cease and Desist Order from the Federal Reserve Board (terminated on 01/06/1991)	Insufficient information on violation

Enforcement Actions After Private Equity Investment

Bank (Holding Company)	Description of Enforcement Action	Description of Violation
Guaranty Bank FSB (Guaranty Financial Group)	4/6/09 - OTS initiated Cease and Desist requiring bank to: maintain core capital ratio ≥ 8% and risk-based capital ratio ≥ 11%; submit business plan; restrict asset growth; submit liquidity management plan; submit MBS portfolio reports; submit strategies to mitigate risk; establish reserves for losses; cease affiliate transactions.	The Order states that "unsafe or unsound practices … resulted in the current high level of classified assets, poor earnings, inadequate capital, and the failure to implement policies and strategies to mitigate concentration risks in its loan and non-agency mortgage-backed securities (MBS) portfolios."
Washington Mutual Bank FSB (Washington Mutual Inc.)	2/27/2009 - Order of Prohibition in the matter of Jo Ann Barba and Washington Mutual Bank, Henderson, Nevada.	"OTS finds that BARBA (a Former Personal Financial Representative) embezzled over $700,000 in funds from customer accounts between February 2006 and March 2007."
	5/5/2008 - Order of Prohibition in the matter of Freshta Atta and Washington Mutual Bank, Henderson, Nevada.	"Freshta Atta, a former teller of the bank, was accused of compromising customer profile information in a scheme to defraud the company."
First Chicago Bank and Trust (First Chicago Bancorp)	5/22/06 - "Labe Bank, Chicago, Illinois ("Respondent") [renamed First Chicago Bank and Trust on 12/8/06] , has been advised of the right to review a NOTICE OF ASSESSMENT OF CIVIL MONEY PENALTY, detailing the violations for which a civil money penalty may be assessed against Respondent. Respondent consented and agreed to pay a civil money penalty in the amount of $5,000 related to its inaccurate submission of the application and loan data for calendar year 2004, as required by HMDA."	Violation pursuant to section 8(i)(2) of the Federal Deposit Insurance Act ("Act"), 12 U.S.C. §1818(i)(2), section 305 of the Home Mortgage Disclosure Act ("HMDA"), 12 U.S.C. §2804, and section 203.6 of Regulation C of the Board of Governors of the Federal Reserve System.

Enforcement Actions After Private Equity Investment (cont)

Bank (Holding Company)	Description of Enforcement Action	Description of Violation
Cerritos Valley Bank (Cerritos Valley Bancorp)	10/15/01 - Written Agreement by and among Cerritos Valley Bancorp, Cerritos Valley Bank, and Federal Reserve Bank of San Francisco states that the bank must: comply with regulations with respect to the appointment of new directors or the hiring or promotion of senior executive officers; within 60 days, submit to the Reserve Bank acceptable written asset/liability management policies, risk management plan, revised loan policies and procedures, asset improvement plan, plan to maintain sufficient capital, strategic plan and budget, plan describing specific actions of internal control, and written internal audit program; maintain adequate allowance for loan and lease losses; not pay any dividends or incur any debt without written approval of the Reserve Bank; ensure regulatory reports filed by the bank accurately reflect the bank's condition.	Insufficient information to determine violation
State National Bank (State National Bancshares Inc.)	11/3/05 - Homeowners Loan Corp. ("HLC"), a subsidiary of the Laredo National Bank ("the Bank") [a subsidiary of State National Bank], and the Bank shall operate at all times in compliance with the articles of the Agreement and shall establish a reserve of fourteen million dollars ($14,000,000) as a reserve for the reimbursement required by this Agreement. (modified on 8/16/06 and terminated on 7/19/07)	Misleading or deceptive representation, statement, or omission, expressly or by implication, in the materials used to solicit any borrower or in any other communication, in connection with loans available from HLC, disclosure to borrowers, audit, reimbursement to borrowers.
	4/25/06 (Texas State Bank) - The Federal Reserve Bank of Dallas and the Bank agreed that the Bank would fully addresses all deficiencies in the Bank's AML program, policies and procedures.	Deficiencies "relating to the Bank's compliance with applicable federal anti-money laundering ("AML") laws, rules, and regulations, including the Bank Secrecy Act (the "BSA"), 31 U.S.C. 5311 et seq.; the rules and regulations issued thereunder by the U.S. Department of the Treasury (31 C.F.R. Part 103); and the AML requirements of Regulation H of the Board of Governors of the Federal Reserve System (the "Board of Governors")

Enforcement Actions After Private Equity Investment (cont)

Bank (Holding Company)	Description of Enforcement Action	Description of Violation
Security First Bank	11/29/07 - Due to violations for which a civil money penalty may be assessed against the Federal Deposit Insurance Act, the Home Mortgage Disclosure Act, and Regulation C of the Board of Governors of the Federal Reserve System, Security First Bank agreed to pay a civil money penalty in the amount of $10,000 to the Treasury of the United States.	Violation of the Federal Deposit Insurance Act, 12 U.S.C. § 1818(i)(2), section 305 of the Home Mortgage Disclosure Act, 12 U.S.C. § 2804, and section 203.6 of Regulation C of the Board of Governors of the Federal Reserve System, 12 C.F.R. § 203.6
First Professional Bank NA, now Pacific Western Bank (PacWest Bancorp)	3/22/00 - Agreement by and between First Professional Bank and the Office of the Comptroller of the Currency (OCC) states that the bank must: within 30 days, the Board shall appoint a Compliance Committee; within 90 days, the Board shall appoint capable, full-time and permanent president and senior lending officer, establish a Loan Workout Department, implement overdraft and loan portfolio management policy, adhere to conflict of interest policy and a written strategic plan; within 60 days, the Board shall establish a loan review system and a clear organizational structure, adhere to loan policy and profit plan; the bank should take immediate action to protect criticized assets; the Bank shall achieve by September 30, 2000, and thereafter maintain certain capital levels.	An October 30, 2000 news article states that First Professional Bank had some "problems with bad loans to health-care borrowers."