PRIVATE EQUITY INVESTING IN BANKS

by Steve Brown

If you are a bank seeking capital, the FDIC recently opened the door wider to private equity (PE). These buyout firms, that make their money by purchasing companies on the cheap, fixing them up and then selling them, now have much greater access to the banking industry. That is good when you consider some projections of bank failures run as high as 1,000 because PE firms have capital and they are willing to inject it into banks for the right price.

After intense pressure from PE firms and a need by the FDIC to find new pools of fresh capital for failed banks, the original rules were softened. What follows are the major components PE firms will need to consider, when investing in failed banks that the FDIC has taken over and is wishing to sell. The good news - we examined the 39 page statement of policy in detail so you wouldn't have to.

In general, the new rules apply to private investors, including those in a company that has been acquired to facilitate bidding on failed banks. The FDIC is particularly focused on companies that will directly or indirectly assume control over deposits. The rules also apply to de novo charter applications that would be used to purchase a failed bank.

It is interesting to note that the new rules do not apply to investors that are in partnership with a bank where the holding company has a strong majority interest and an established record of successful bank operation. Here, the FDIC went out of their way to say they strongly encourage such partnerships. In addition, investors with less than 5% voting power (a de minimis investor) of the acquired bank would be exempt, provided no evidence of concerted action with other investors exists.

Now that we know who the new rules apply to and who they don't, capital comes into play. The FDIC had originally sought to require PE firms to hold 15% Tier I leverage, but the howls of protest could be heard far and wide. Under the new rules, PE firms would have to maintain a Tier 1 leverage ratio of 10% for 3Ys from the acquisition date, ensure the bank remains "well capitalized" and have to take immediate action to restore capital to the 10% level if needed. It is interesting to note that the rule allows the FDIC to increase capital requirements above 10% "if warranted." Note that even though this level is higher than the 5% requirement for traditional banks, it is not expected to be a deal-breaker to PE firms.

The final rule also eased cross-guarantee requirements slightly. As originally contemplated, if an individual or group of investors had a majority interest in 2 or more banks, they would be required to cover losses to the insurance fund caused by the failure of any one of the banks. In the final rule, that was changed slightly, so that if one or more investors owns 80% or more (of 2 or more banks), then the stock of those commonly-owned banks are automatically pledged to the FDIC. In this way, if any one bank in the group fails, the FDIC could recoup losses incurred by forcing all of the banks in the group to cover losses.

Affiliate transactions are prohibited under the rule, to ensure PE firms aren't tempted to make the new bank they have purchased lend to companies in which they have invested. Under the rule, an affiliate is a company in which the investor owns (directly or indirectly) at least 10% of the equity for at least 30 days.

Finally, the rule clarified that PE firms buying failed banks cannot do so through a complex ownership structure (must be easy for regulators to tell who owns the bank), must provide information about all investors and entities in the ownership structure and cannot invest through an entity domiciled in a bank secrecy jurisdiction (offshore).

Two quick quirks of the new rule - the 3Y holding period does not apply to mutual funds defined as open-ended investment companies and investors that hold 10% or more of the equity of a failed bank are specifically prohibited from bidding.

It will be interesting to see how all of this works and how much capital flows into the banking system. More changes could be coming down the road; however, as the FDIC announced in the ruling that it plans to revisit this in 6 months to be sure all is working as expected and make any tweaks deemed necessary.

BANK NEWS

Fed Beige Book

The economy showed signs of stabilization though consumer spending remained flat.

Fees

According to the ABA, the number of customers charged for overdraft fell by 2% to 17% over the past year. Of those who paid overdraft fees, 36% were hit only once, 10% twice and 15% thrice (that's right, we said thrice).

Branch Sale

In an effort to boost capital, TierOne Bank ($3.2B, NE) will sell 32 branches to Great Western Bank ($5.2B, SD). Under the terms of the agreement, Great Western will assume $1.1B in deposits, $800mm in loans and $20mm in real estate (less a $55.0 million deposit premium paid).

Consumer Stress

Bank of America reports its 2Q credit card default rate reached 13.81%, an all time high. That compares to JP Morgan's at 7.92% and Wells Fargo's at 11.59%.

Housing Stress

Just when you thought it was getting safe to get back into the water, information surfaces that total mortgage delinquencies (where borrowers are late for at least one payment) climbed to an all-time high of 9.24% in 2Q.

Economic Recovery

The IMF said the recession has ended, but recovery will be slow.