PRIVATE EQUITY INVESTMENT IN FAILED BANKS: CONTROLLING RISKS TO THE FEDERAL SAFETY NET

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I. INTRODUCTION

Two hundred sixty-five insured depository institutions ("banks") have failed since the beginning of 2009 at a cost of tens of billions of dollars to the Federal Deposit Insurance Corporation's ("FDIC") Deposit Insurance Fund ("DIF").[1] These failures have attracted private equity investors interested in purchasing failed banks.[2] The FDIC has been permitting private equity investment in failed banks to mitigate the costs of bank failures even though it is at odds with the longstanding federal regulatory policy of "separating banking and commerce."[3]

Separating banking and commerce advances several important policy objectives, including preventing the "Federal Safety Net" – the set of federal subsidies for banks and other financial institutions – from spreading

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1. *See* FDIC: Failed Bank List, http://www.fdic.gov/bank/individual/failed/banklist.html (last visited Sept. 20, 2010).
2. *See infra* Part II (discussing private equity interest in investing in banks).
3. *See infra* Part III (tracing the legal history of the separation of banking and commerce).

to the commercial sector of the economy at a cost to taxpayers.[4] For this reason, existing federal law generally prohibits commercial firms' ownership of banks. It is possible, however, for private equity and other commercial investors to employ ownership structures that effectively skirt this prohibition. In response, the FDIC promulgated a Statement of Policy on Qualifications for Failed Bank Acquisitions ("FDIC SOP") that imposes special quantitative requirements and other restrictions on private equity ownership of banks.[5] Although the FDIC SOP achieves many worthwhile goals, it ignores a fundamental locus of risk to the Federal Safety Net arising out of private equity bank ownership: the interconnectedness of private equity owners.[6]

Interconnectedness, or financial linkages between firms and across sectors that facilitate the flow of risk, exacerbated the financial crisis of 2008.[7] New sweeping U.S. financial regulatory reform legislation, the Dodd-Frank Wall Street Reform and Consumer Protection Act, recognizes interconnectedness as a major cause of risk within and among firms.[8] The FDIC SOP, however, does not. Rather, the FDIC treats all private equity bank ownership the same, without taking into account the possibility that private equity investors are interconnected in ways that pose an increased risk to the Federal Safety Net. In this article, I argue that the FDIC should amend the FDIC SOP to account for the interconnectedness of private equity investors

This article begins by surveying the current landscape of pervasive bank failures and private equity's interest in investing in failed banks. Next, it establishes that federal banking regulation has historically advanced a policy of separating banking and commerce. Then, it explores a principle purpose for this policy – preventing the Federal Safety Net from spreading to the commercial sector of the economy. Following this, the FDIC SOP and the Board of Governors of the Federal Reserve System's (the "FRB" or the "Board") Statement of Policy on Equity Investment in Banks and Bank Holding Companies ("FRB SOP") are discussed. After discussing the SOPs, I argue that the FDIC SOP is deficient because it does not account for private equity investors' interconnectedness and, as a result, fails to fully consider the risks to the Federal Safety Net that arise from private equity investment in failed banks. Finally, I conclude by outlining recommendations for amending the FDIC SOP to account for interconnectedness.

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4. *See infra* Part IV (explaining the Federal Safety Net).
5. *See infra* Part V (discussing the FDIC SOP).
6. *See infra* Part VI (discussing interconnectedness as a source of financial risk).
7. *See infra* note 124 and accompanying text.
8. *See infra* notes 125 & 126 and accompanying text.

II. THE LANDSCAPE: BANK FAILURES

One hundred forty banks failed in 2009, and 125 more banks failed in the first nine months of 2010.[9] On February 23, 2010, in its report for the fourth quarter of 2009, the FDIC announced that 702 banks with a combined $402 billion in assets were at risk of failure in 2010.[10] As of June 30, 2010, this number increased to 829, the highest number of banks on the FDIC's "Problem Bank List" since 1993.[11] Each time a bank fails, the FDIC's DIF absorbs a loss, which can total hundreds of millions of dollars depending on the size of the bank and whether and when a buyer is located.[12] The surge in failures led the FDIC, in November 2009, to issue a notice of final rulemaking requiring insured banks to prepay their DIF assessments through 2012 because it was unclear that the DIF, funded through normal assessments, would be able to absorb the losses caused by continuing bank failures.[13]

The high rate of bank failures has attracted private equity investors interested in purchasing and operating failed banks.[14] In July 2009, the

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9. *See* FDIC: Failed Bank List, *supra* note 1. In contrast, between October 1, 2000 and December 31, 2007, only twenty-seven banks failed. GUHAN SUBRAMANIAN, A WHITE PAPER ON THE FEDERAL DEPOSIT INSURANCE CORPORATION'S PROPOSED STATEMENT OF POLICY ON QUALIFICATIONS FOR FAILED BANK ACQUISITIONS 16 (2009), *available at* http://www.fdic.gov/regulations/laws/federal/2009/09c37AD47.PDF.

10. Press Release, FDIC, FDIC-Insured Institutions Report Earnings of $914 Million in the Fourth Quarter of 2009 (Feb. 23, 2010), *available at* http://www.fdic.gov/news/news/press/2010/pr10036.html.

11. Hibah Yousuf, *Problem Bank List Climbs to 829* (Aug. 31, 2009), http://money.cnn.com/2010/08/31/news/companies/fdic_problem_bank_list/index.htm.

12. *See, e.g.*, Darrell A. Hughes, *Regulators Seize Four Bank* (Mar. 26, 2010), http://online.wsj.com/article/SB10001424052748703416204575146341839131772.html (stating that on March 26, 2010, Desert Hills Bank of Phoenix failed and was repurchased by New York Community Bank of Westbury, N.Y. at an estimated cost to the DIF of $106.7 million).

13. *See generally*, Prepaid Assessments, 74 Fed. Reg. 59,056 (Nov. 17, 2009) (to be codified at 12 C.F.R. pt. 327). The notice of final rulemaking noted that:

> In June 2008, before the number of bank and thrift failures began to rise significantly… total assets held by the DIF were [worth] approximately $55 billion and consisted almost entirely of cash and marketable securities. … As of September 30, 2009, although total assets had increased to almost $63 billion, cash and marketable securities had fallen to approximately $23 billion.
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> . . . If the FDIC took no action under its existing authority to increase its liquidity, the FDIC's projected liquidity needs would exceed its liquid assets on hand beginning in the first quarter of 2010. Through 2010 and 2011, liquidity needs could significantly exceed liquid assets on hand.

Id. at 59,057.

14. For example, on May 21, 2009, a group of private equity investors including the Blackstone Group, the Carlyle Group, and WL Ross & Co, acquired the banking operations

Private Equity Council, the private equity industry advocacy group, estimated that private equity firms had raised, or were in the process of raising, more than $34 billion to invest in banks and other financial service firms.[15]

The term "private equity investor" has no single, generally accepted meaning.[16] Depending on the circumstances, it may refer to large, established private equity firms with far-flung operations like the Blackstone Group or the Carlyle Group, a high net worth individual who invests in funds managed by one of these firms, a group of loosely affiliated, high net worth investors that invest in a concerted way based on a formal or informal agreement, or any combination of these actors.[17] Traditional private equity firms, like the Carlyle Group, invest their own capital and capital raised from individual investors in under-performing companies across a breadth of industries with the expectation of an above-market return on investment.[18] The firms often install their own staff, which

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of BankUnited, FSB, a Florida thrift with $12.8 billion in assets, through BankUnited, a newly chartered federal savings bank. Press Release, FDIC, BankUnited Acquires the Banking Operations of BankUnited, FSB, Coral Gables, Florida (May 21, 2009), *available at* http://www.fdic.gov/news/news/press/2009/pr09072.html. The Carlyle Group invested in BankUnited through its financial services fund, Carlyle Global Financial Partners, for which the Carlyle Group has raised $1.1 billion. *Carlyle Raises over $1bn for Financial Services Investments* (Apr. 6, 2010), http://www.altassets.com/private-equity-news/article/nz18290.html. The fund has also made substantial investments in Bank of N.T. Butterfield & Son Limited and Boston Private Financial Holdings, Inc. *Id.* IndyMac, which failed in July 2008, was also purchased by a consortium of private equity investors, headed by financiers J.C. Flowers, George Soros, and technology mogul Michael Dell. SUBRAMANIAN, *supra* note 9, at 17. "The group paid $13.9 billion for IndyMac's deposits and assets, and reached a loss-sharing agreement with the FDIC [whereby] the investor[s would] absorb the first 20% of IndyMac's losses," and the FDIC would absorb the rest. *Id.*

15. Email from Douglas Lowenstein, President, Private Equity Council, to Robert E. Feldman, Executive Secretary, FDIC (Aug. 6, 2009) (on file with author), *available at* http://www.fdic.gov/regulations/laws/federal/2009/09c22AD47.PDF. For example, as of June 15, 2009, the Carlyle Group had more than $30 billion ready to invest and had a team of former bank executives assembled to search for bank deals. Thomas Heath, *Carlyle Sets its Sights on Battered Banks*, WASH. POST, June 15, 2009, http://www.washingtonpost.com/wp-dyn/content/article/2009/06/14/AR2009061402268.html. Similarly, in December 2008, the Blue Pine Financial Opportunities Fund LP was raising $100 million to invest in banks. SUBRAMANIAN, *supra* note 9, at 11.

16. Most commonly, however, "private equity" refers to either leveraged buyout funds, which typically acquire majority control of a company using large amounts of debt and smaller amounts of equity, or venture capital funds, which invest in growth stage or emerging companies. SUBRAMANIAN, *supra* note 9, at 3.

17. *See* PRIVATE EQUITY COUNCIL, PUBLIC VALUE: A PRIMER ON PRIVATE EQUITY 6-7, 10 (2007), *available at* http://www.pegcc.org/wordpress/wpcontent/uploads/PEC_Primer_2007.pdf.

18. Lowenstein, *supra* note 15, at 2-3. *See also* SUBRAMANIAN, *supra* note 9, at 4 (noting that "[w]hile 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, heath care, technology, and other industries").

is skilled at turnaround operations, to lead the acquired companies.[19] The approximately 2,000 traditional U.S. private equity firms have an estimated $470 billion at their disposal for such ventures.[20]

Opponents of private equity investment in banks maintain that private equity investment strategies and objectives are anathema to traditional bank ownership.[21] They argue, for example, that private equity investors engage in high-risk strategies and seek quick returns.[22] Indeed, economists have identified maximizing leverage as a principal means by which private equity firms generate profits. This contrasts with the view of banking regulators, who encourage banks to maintain ample capital reserves.[23] Further, opponents argue that because private equity firms typically invest in a variety of commercial enterprises, allowing private equity investment in banks challenges the longstanding federal regulatory policy of separating banking and commerce.[24]

III. THE POLICY OF SEPARATING BANKING & COMMERCE

Legal codification of the policy of "separating banking and commerce" took root early in the United States. For example, the Pennsylvania legislature restored the Bank of North America's charter in 1787 with the express condition that the Bank could not trade in

19. SUBRAMANIAN, *supra* note 9, at 4.

20. Lowenstein, *supra* note 15, at 2.

21. *See, e.g.*, Letter, Tough Regulations, Comment to FDIC's Proposed Statement of Policy on Qualifications for Failed Bank Acquisitions (July 9, 2009) (on file with the author), *available at* http://www.fdic.gov/regulations/laws/federal/2009/09cForm01AD47.PDF) (stating that "[i]f private equity firms get their way, banks could once again be exposed to the same risks that collapsed the economy last year").

22. *See* Rob Cox & Lauren Silva Laughlin, *Another Advantage for the Biggest Banks*, N.Y. TIMES, March 29, 2010, at B2 (asserting that private equity firms are generally considered to have greater risk appetites than traditional investors). For example, Harra's Entertainment, which is owned and operated by the private equity firms TPG and Apollo, has outperformed its rival MGM Mirage. It, however, is rated riskier by Moody's, and its debt trades at a lower price. *Id.* "This may be a case of private equity's reputation catching up to it. . . . Buyout firms, of course, can inject more equity but also can – and often do – walk away more easily from troubled companies." *Id.* The median holding period for private equity funds' investment is approximately six years, with twelve percent of investments held for less than two years. SUBRAMANIAN, *supra* note 9, at 4 (citing Steven N. Kaplan & Per Strömberg, *Leveraged Buyouts and Private Equity*, 23 J. ECON. PERSP. 1, 130 (2009)).

23. *See* SUBRAMANIAN, *supra* note 9, at 5 ("Private equity companies streamline businesses by keeping idle cash to a minimum.").

24. Letter from Patricia A. McCoy, Director, Insurance Law Center, University of Connecticut School of Law, & Arthur E. Wilmarth, Jr., Professor of Law, George Washington University Law School, to Robert E. Feldman, Executive Secretary, FDIC (Aug. 6, 2009) (on file with author), *available at* http://www.fdic.gov/regulations/laws/ federal/2009/09c21AD47.PDF.

merchandise or hold real estate.[25] Similarly, charters for the First (1791) and Second (1816) Banks of the United States prohibited the Banks from dealing in commodities or merchandise, and state "free banking" laws, like New York's Free Banking Act of 1838, prohibited state-chartered banks from engaging in "mercantile enterprises."[26]

New York's Free Banking Act served as a model for the National Bank Act of 1863, which authorized banks to exercise "all such incidental powers as shall be necessary to carry on the business of banking."[27] In four decisions issued between the enactment of the National Bank Act and 1910, the Supreme Court construed the National Bank Act narrowly, finding that it prohibited national banks from acquiring ownership interests in commercial enterprises, except for the limited purposes of settling creditor claims and obtaining security for debts previously contracted.[28]

Despite these efforts to separate banking and commerce, during the 1920s, large banks increasingly expanded their operations to non-banking

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25. Arthur E. Wilmarth, Jr., *Wal-Mart and the Separation of Banking and Commerce*, 39 CONN. L. REV. 1539, 1554 (2007). In 1782, the Bank of North America was granted the first bank charter in U.S. history. *Id.* In 1785, when power shifted in Pennsylvania's legislature to include more representatives from agrarian districts and fewer from urban Philadelphia, the legislature repealed the bank's charter. *Id.* The restored charter only permitted the bank to hold real estate for use as the bank's business premises and as collateral for its loans. *Id.*

26. *Id.* at 1555. Free banking laws typically authorized state-chartered banks to "carry on the business of banking" by engaging in certain specified functions and, in addition, granted banks certain "incidental powers" necessary to carry on such business. *Id.* Despite the early policy separating banking and commerce, certain banks nonetheless engaged in commercial enterprises. *Id.* For example, the Bank of the United States of Philadelphia's charter required it to underwrite bonds issued by the Pennsylvania state government, and permitted the Bank to purchase government securities and bank stocks. *Id.* at 1556. The Bank engaged heavily in speculative securities, foreign exchange, and commodities, and closed in 1841, unable to survive dislocations in the broader economy. *Id.* at 1557.

27. 12 U.S.C. § 24 (2010) (authorizing national banks, in addition to incidental powers, to engage in: (1) discounting negotiable instruments; (2) receiving deposits; (3) buying and selling exchange, coin, and bullion; (4) loaning money on personal security; and (5) obtaining, issuing, and circulating notes).

28. *See* Merchants Nat'l Bank of Cincinnati v. Wehrmann, 202 U.S. 295 (1906); First Nat'l Bank of Ottawa v. Converse, 200 U.S. 425 (1906); Cal. Bank v. Kennedy, 167 U.S. 362 (1897); First Nat'l Bank of Charlotte v. Nat'l Exch. Bank of Balt., 92 U.S. 122 (1875). The authority of a national bank to hold real estate under these circumstances persists today; pursuant to 12 U.S.C. § 29, a national bank may "purchase, hold, and convey real estate . . . such as shall be conveyed to it in satisfaction of debts previously contracted in the course of its dealings." The Office of the Comptroller of the Currency recognizes the authority to hold property in satisfaction of debts previously contracted, i.e., extensions of credit, as "a necessary corollary to the lending authority of national banks." Letter from Lawrence E. Beard, Deputy Controller, Office of the Comptroller of the Currency, to Daniel W. Morton, Senior Vice President & Senior Counsel, The Huntington Nat'l Bank (Mar. 31, 2009) (on file with the author), *available at* http://www.occ.gov/static/interpretations-and-precedents/apr09/ca895.pdf.

financial activities like securities underwriting and trading, and commercial real estate investment.[29] For example, by 1929, Bank of United States – a New York state-chartered bank and one of the thirty largest banks in the United States – controlled three securities affiliates, an insurance company, and more than twenty real estate affiliates.[30] When real estate values plummeted in 1929, Bank of United States failed, causing depositor runs at three associated banks, which also failed.[31] In response, Congress adopted the Banking Act of 1933 (the "Glass-Steagall Act") to "separate as far as possible national banks and [state] member banks from affiliates of all kinds."[32] To accomplish this objective, Congress: (1) limited the financial transactions between Federal Reserve System member banks and their affiliates;[33] (2) required state member banks and national banks to separate their stock certificates from the stock certificates of their nonbank affiliates;[34] and (3) authorized bank regulators to examine bank affiliates to evaluate their effect on the affairs of their affiliated banks.[35] In addition, sections 20 and 32 of the Glass-Steagall Act imposed restrictions on bank ownership of interests in commercial enterprises and prohibited national banks and state member banks from affiliating with securities underwriters and dealers.[36]

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29. Wilmarth, *supra* note 25, at 1559-62.

30. *Id.* at 1561. Bank of United States established these securities and real estate affiliates "for the specific purpose of evading restrictions imposed by New York's banking laws on securities underwriting and long-term real estate investments." *Id.*

31. *Id.* at 1562.

32. S. REP. NO. 73-77, at 10 (1933). During debate of the Glass-Steagall Act, Congress referred to Bank of United States' failure and the speculative securities and real estate activities that caused it, and criticized the Bank for utilizing affiliates to circumvent restrictions on investment banking activities and real estate investments. *Id.* at 3-10.

33. *See* 12 U.S.C. § 371c. Section 23A of the Federal Reserve Act limits the total amount of "covered transactions" between a bank and any one affiliate to 10% of the bank's capital and surplus. It also limits the total amount of all "covered transactions" between a bank and all of its affiliates to 20% of the bank's capital and surplus. *Id.* Covered transactions include extensions of credit by the bank to its affiliates. *Id.* As enacted by the Glass-Steagall Act, section 23A only applied to Federal Reserve System member banks; however, Congress later extended section 23A to cover state nonmember banks. *See also* 12 U.S.C. § 1828(j).

34. *See* 12 U.S.C. §§ 336, 52.

35. *See* 12 U.S.C. §§ 338, 481.

36. These sections prohibited national banks and state member banks from affiliating with, or having interlocking directors or officers with, any firm that was "engaged principally" in the issuance, underwriting, public sale, or distribution of bank-ineligible securities. Congress repealed sections 20 and 32 in 1999 as part of the Financial Services Modernization Act (popularly known as the "Gramm-Leach-Bliley Act"), Pub. L. No. 106-102 (1999). Section 21 of the Glass-Steagall Act, which remains in effect today, prohibits state member banks from underwriting, selling, or distributing any type of securities (except for bank-eligible securities). 12 U.S.C. § 378(a)(1). In 1991, Congress extended these restrictions to state nonmember banks. *See* 12 U.S.C. § 1831a.

Later, in response to widespread commercial acquisition of FDIC-insured banks, Congress adopted the Bank Holding Company Act of 1956 ("BHC Act") to control the growth of bank holding companies and to force them to divest their nonfinancial activities.[37] As enacted in 1956, the BHC Act prohibited holding companies that owned more than one bank from acquiring nonbanking firms and required these holding companies to divest of all nonbanking subsidiaries.[38] The BHC Act was intended to prevent holding companies from controlling both banks and commercial businesses, thereby reaffirming the policy of separating banking and commerce.[39] However, the BHC Act only applied to multibank holding companies and, consequently, provided a loophole for holding companies that owned only one bank.[40]

Congress closed the "one bank" loophole in 1970 by amending the BHC Act to extend coverage to all bank holding companies, without regard to the number of banks owned.[41] This amendment reflected Congress's view that a strict separation of banking and commerce was necessary, among other reasons, to prevent banks affiliated with commercial firms from engaging in activities that could threaten the financial system.[42] Congress closed another loophole to the BHC Act in the Competitive Equality Banking Act of 1987 ("CEBA") by broadening the definition of "bank" to bring more ownership arrangements within the BHC Act's purview.[43] As a result, more bank owners became bank holding companies

37. *See* S. REP. NO. 84-1095, at 1 (1955) ("[P]ublic welfare requires the enactment of legislation providing Federal regulation of the growth of bank holding companies and the type of assets it is appropriate for such companies to control. . . . [B]ank holding companies ought not to manage or control nonbanking assets having no close relationship to banking.").

38. *See* 12 U.S.C. § 1843(a).

39. *See* 102 CONG. REC. 6755 (1956) (statement of Sen. Robertson) (stating that the BHC Act was intended to ensure that bank holding companies only engage in "banking activities" and "functions closely related to banking which are essential for their efficient operation").

40. Holding companies quickly exploited this loophole, and "[b]y 1970 the six largest banks in the nation had formed one-bank holding companies." Wilmarth, *supra* note 25, at 1568.

41. *See* Bank Holding Company Act, Pub. L. No. 91-607, §§ 101-103 (1970) (codified as amended at 12 U.S.C. §§ 1841-1843). Congress closed the one bank loophole "to continue [its] long-standing policy of separating banking and commerce." S. REP. NO. 91-1084, at 1 (1970), *reprinted in* 1970 U.S.C.C.A.N. 5519, 5522.

42. Bank Holding Company Act, §§ 101-103. Congress contemplated several such activities, including: (1) making unsound loans to support the commercial affiliate; (2) refusing to make loans to competitors of the commercial affiliates; and (3) requiring borrowers to do business with the commercial affiliate as a condition of obtaining loans. *Id.*

43. Competitive Equality Banking Act of 1987, Pub. L. No. 100-86, 100 Stat. 552. Prior to Congress's enactment of CEBA, the BHC Act only extended to owners of banks that both accepted demand deposits and engaged in commercial lending. *See* Bank Holding Company Act Amendments of 1970 § 101(c), 12 U.S.C. § 1841(c). During the 1980s, commercial firms took advantage of this loophole by acquiring FDIC-insured banks and causing those banks to cease engaging in either demand deposits or commercial lending,

subject to the BHC Act's restrictions on commingling banking and commerce.[44]

The Savings and Loan Crisis ("S & L Crisis") of the late 1980s reinvigorated the legislative movement to separate banking and commerce.[45] A 1989 study released by the U.S. Government Accountability Office ("GAO") found that twenty-six of the most costly thrift failures prior to October 1987 involved thrifts that participated in nontraditional banking activities, including investments in equity securities, junk bonds, and service corporations engaged in non-financial activities.[46] Moreover, the study found that a substantial portion of these thrifts failed after entering into illegal or unsound loans or other transactions with affiliates.[47]

In response to the S & L Crisis, the Financial Institutions Reform, Recovery and Enforcement Act of 1989 ("FIRREA") limited thrifts' authority to associate with commercial firms. FIRREA imposed restrictions on transactions between thrifts and their affiliates by requiring all thrifts to comply with sections 23A and 23B of the Federal Reserve Act, which, until then, were only applicable to banks.[48] In addition, FIRREA restricted

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thereby avoiding BHC Act regulation. *See* Wilmarth, *supra* note 25, at 1569 (noting that Sears and J.C. Penny both owned such FDIC-insured "non-bank banks").

44. In enacting CEBA, Congress asserted that "[n]onbank banks undermine the principal of separating banking and commerce, a policy that has long been a keystone of our banking system. . . . The separation of banking from commerce helps ensure that banks allocate credit impartially, and without conflicts of interest." S. REP. NO. 100-19, at 8 (1987), *reprinted in* 1987 U.S.C.C.A.N. 489, 498. Significantly, however, CEBA exempted industrial loan companies ("ILCs") from treatment as banks for BHC Act purposes as long as the ILC is chartered in a qualifying state and either does not accept demand deposits or does not maintain assets in excess of $100 million. CEBA § 101(a)(1); 12 U.S.C. § 1841(c)(2)(H). As a result, holding companies of qualifying ILCs are exempt from the BHC Act's restrictions. Currently, there is a substantial movement to close this exemption. *See, e.g.*, U.S. DEP'T OF TREASURY, FINANCIAL REGULATORY REFORM – A NEW FOUNDATION: REBUILDING FINANCIAL SUPERVISION AND REGULATION, FIN. STABILITY 35 (2009), *available at* http://www.financialstability.gov/docs/regs/FinalReport_web.pdf (recommending closing the loophole in the BHC Act for industrial loan companies).

45. *See generally* H.R. REP. NO. 101-54(I) (1989) (making the case for new legislation in light of the S & L Crisis).

46. U.S. GOV'T. ACCOUNTABILITY OFFICE, THRIFT FAILURES: COSTLY FAILURES RESULTED FROM REGULATORY VIOLATIONS AND UNSAFE PRACTICES 26-30 (1989).

47. *Id.* at 19-20 ("Examiners found that 21 of [the] 26 failed thrifts violated the regulation governing transactions with affiliates . . . ."). For example, American Continental Co., the holding company of Lincoln Savings Bank, engaged in a series of transactions resulting in phony profits for Lincoln based on sham asset sales to straw buyers, and the impermissible transfer of profits from Lincoln to American Continental Co. Wilmarth, *supra* note 25, at 1576.

48. *See* 12 U.S.C. § 1464(c)(2)(B). Section 23A imposes quantitative restrictions on extensions of credit and other "covered transactions" between banks and their affiliates, prevents banks from purchasing low-quality assets from their affiliates, and requires all extensions of credit from banks to their affiliates to be fully collateralized. 12 U.S.C. § 371c (setting forth section 23A's quantitative requirements). Section 23B requires that

federal savings associations' authority to make commercial real estate loans and prohibited all thrifts from making further investments in junk bonds.[49]

IV. SEPARATING BANKING & COMMERCE PREVENTS THE SPREAD OF THE FEDERAL SAFETY NET TO THE COMMERCIAL SECTOR

Separating banking and commerce prevents the Federal Safety Net from spreading to the commercial sector of the U.S. economy. The Federal Safety Net colloquially refers to explicit and implicit federal subsidies provided to banks and other financial institutions.[50] The Federal Safety Net includes: (1) deposit insurance; (2) access to the Board's Discount Window; (3) "Too Big to Fail" ("TBTF") protection; and (4) the Board's guarantee of interbank payments via Fedwire – the Board's credit transfer service.[51] These subsidies, which are funded by taxpayers, support confidence in and ensure the stability of the U.S. financial system. Extending the Federal Safety Net to the commercial sector, however, creates competitive distortions and increases the likelihood of bailouts funded by taxpayers.[52]

The FDIC insures deposits up to $250,000 per depositor held at the 7,793 FDIC-insured banks.[53] When a bank fails, the FDIC covers the costs of the receivership principally through the DIF, which is funded by risk-based assessments on FDIC-insured banks.[54] Unlike deposit insurance,

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transactions between banks and their affiliates be on fair market terms. *See* 12 U.S.C. § 371c(a)(1).

49. *See* 12 U.S.C. § 1831e(d).

50. Wilmarth, *supra* note 25, at 1589.

51. *See* Kenneth Jones & Barry Koltach, *The Federal Safety Net, Banking Subsidies, and Implications for Financial Modernization*, 12 FDIC BANKING REV. 1, 2-3 (1999), *available at* http://www.fdic.gov/bank/analytical/banking/1999may/1_v12n1.pdf.

52. *Cf.* U.S. GOV'T. ACCOUNTABILITY OFFICE, INDUSTRIAL LOAN CORPORATIONS: RECENT ASSET GROWTH AND COMMERCIAL INTEREST HIGHLIGHT DIFFERENCES IN REGULATORY AUTHORITY 15, 71-72 (2005), *available at* http://www.gao.gov/new.items/d05621.pdf (stating that the Federal Safety Net "provides a subsidy to commercial banks and other depository institutions by allowing them to obtain low-cost funds," and by "shift[ing] part of the risk of bank failure from bank owners and their affiliates to the federal bank insurance fund and, if necessary, to taxpayers").

53. As of June 30, 2010, the FDIC insured total deposits of approximately $9,158,301,000,000. *See Institution Directory*, FDIC, http://www2.fdic.gov/idasp/ (last visited Oct. 10, 2010).

54. *See The Deposit Insurance Fund*, FDIC, http://www.fdic.gov/deposit/insurance/index.html (last visited Oct. 27, 2010). If the DIF were inadequate to cover the cost of resolving failed banks, the FDIC could, at a cost to taxpayers, tap its $500 billion line of credit with the U.S. Department of Treasury. *See* Karen Wutkowski, *FDIC to Consider Ways to Replenish Deposit Fund*, REUTERS (Sept. 18, 2009, 11:54 AM), http://www.reuters.com/article/idUSN1825028520090918 (discussing how the FDIC could replenish the DIF). If this $500 billion line of credit were inadequate to cover the cost of resolving failed banks, Congress could establish a larger line of credit. *See* Arthur E. Wilmarth, Jr., *The Transformation of the U.S. Financial Services Industry, 1975-2000: Competition, Consolidation, and Increased Risk*, 2002 U. ILL. L. REV. 215, 448 (2002)

which provides an explicit guarantee, TBTF protection is an implicit federal guarantee of financial institutions, the failure of which would cause unacceptable disruptions in the broader financial system.[55] Accordingly, it is generally understood that the federal government would act to prevent the failure of a TBTF institution.[56]

Other features of the Federal Safety Net include the Board's Discount Window, which is a credit facility providing short term liquidity to solvent but illiquid institutions struggling with internal or external disruptions.[57]

(noting that when the Bank Deposit Fund was depleted to the point of insolvency during the S & L Crisis, Congress expanded the FDIC's line of credit with the Treasury from $5 billion to $30 billion).

55. Jones & Kolatch, *supra* note 51, at n.2; *see also* Wilmarth, *supra* note 25, at 1590 ("The existence of a subsidy for TBTF institutions is further indicated by the fact that no major U.S. bank has ever surrendered its bank charter and chosen to operate as a nonbank.") Since TBTF protection is an implicit guarantee, its scope is unclear. Currently, legislators and regulators are seeking to eradicate the implicit TBTF subsidy. *See, e.g.*, Deborah Levine, *End 'Too Big to Fail': White House's Summers*, MARKET WATCH (Apr. 25, 2010, 11:26 AM), http://www.marketwatch.com/story/white-houses-summers-we-must-end-too-big-to-fail-2010-04-25?reflink=MW_news_stmp (quoting Lawrence Summers, director of the National Economic Council and President Barack Obama's top economic advisor, "we must end too big to fail"); *see also* Dodd-Frank Wall Street Reform and Consumer Protection Act of 2010, Pub. L. No. 111-203, 124 Stat. 1376 (2010) (creating a systemic risk council responsible for preventing financial firms from becoming TBTF).

56. As a result of this implicit guaranty, TBTF institutions enjoy lower costs of funds than non-TBTF institutions. Wilmarth, *supra* note 25, at 1589. For example, TBTF banks, i.e., those with assets over $100 billion must:

> (i) "pay interest rates on deposits that are significantly lower than the rates paid by non-bank companies of comparable size on short-term, uninsured debt, (ii) TBTF banks operate with [substantially more] leverage (i.e., lower capital to asset ratios) than uninsured financial intermediaries . . . and (iii) TBTF banks achieve higher credit ratings and pay lower interest rates on their bonds as they grow in size to reach TBTF status.

Id. at 1589-90; s*ee also* Cox & Laughlin, *supra* note 22 (stating that as a result of the implicit TBTF guaranty, the ten biggest U.S. banks collectively benefit in the amount of $30 billion annually measured by the interest rates these banks pay on deposits). In the fourth quarter of 2009, institutions with more than $100 billion in assets paid an average of .77% annual interest on deposits, whereas institutions with less than $10 billion in assets paid an average of 1.73% annual interest on deposits. *Id.*

57. Section 10(b) of the Federal Reserve Act, 12 U.S.C. § 347b(a), sets forth the Board's primary discount window lending authority, providing that "[a]ny Federal Reserve Bank . . . may make advances to any member bank on its time or demand notes having maturities of not more than four months and which are secured to the satisfaction of such Federal Reserve Bank." Recently, however, the Board has increasingly relied on section 13 of the Federal Reserve Act, 12 U.S.C. § 343, for authority to permit non-banks, such as Morgan Stanley, Goldman Sachs, and American Express, to access the Discount Window. *See* Kristin Jones, *Why is Everyone Becoming a Bank Holding Company*? PRO PUBLICA (Nov. 12, 2008), http://www.propublica.org/article/why-is-everyone-becoming-a-bank-holding-company-1112. Section 13 of the Federal Reserve Act provides, in pertinent part, that:

Finally, since all Fedwire fund transfers are immediate, irrevocable, and guaranteed by the Board, the Board is exposed to credit risk when it processes Fedwire payments.[58] Furthermore, the Board's guarantee of Fedwire transfers permits participants to temporarily overdraw their accounts (a "daylight overdraft"), thereby providing inexpensive liquidity to participants.[59] These Federal Safety Net subsidies are unique benefits available only to banks and certain non-bank financial institutions, such as bank and financial holding companies that have access to the subsidies due to their ownership of banks.[60]

> [i]n unusual and exigent circumstances, the Board of Governors of the Federal Reserve System, by the affirmative vote of no less than five members, may authorize any Federal Reserve bank . . . to discount for any individual, partnership, or corporation, notes, drafts, and bills of exchange when . . . secured to the satisfaction of the Federal Reserve Bank: Provided, that before discounting . . . the Federal Reserve bank shall obtain evidence that such individual, partnership, or corporation is unable to secure adequate credit accommodations from other banking institutions.

A bank seeking to obtain discounted credit from its Federal Reserve Bank would present an asset meeting the type and maturity specifications set forth in the Federal Reserve Act, and the Federal Reserve Bank would then extend credit in an amount that reflected the value of the asset at maturity less a "discount" based on the FRB's discount rate and the time until maturity of the asset." James A. Clouse, *Recent Developments in Discount Window Policy*, FED. RES. BULL. 965 (Nov. 1994), *available at* http://www.federalreserve.gov/monetarypolicy/1194lead.pdf.

58. *See* Official Comment to section 210.31(a) of Board Regulation J, 12 C.F.R. § 210.31(a) (2010) (providing that Fedwire funds transfers are final and irrevocable).

59. *See* Jones & Kolatch, *supra* note 51, at 3.

> If the sender's Reserve Bank processes the transfer when the sender did not have sufficient funds in its account to cover the amount of the transfer, the sender incurs a 'daylight overdraft' in its account with the Federal Reserve. The Federal Reserve bears the risk of loss if the sender is unable to cover this overdraft. The failure of an institution to cover daylight overdrafts on Fedwire, therefore, would by itself have no effect on other institutions, including the receiver; all of the loss would be absorbed by the Federal Reserve.

Proposals to Reduce Risk on Large-Dollar Transfer Systems, 49 Fed. Reg. 13,186, 13,187 (proposed Apr. 3, 1984). On December 24, 2008, the Board adopted revisions to part II of its Policy on Payment System Risk, 73 Fed. Reg. 79,109, which, among other things, eliminated the fee imposed by the Board for collateralized daylight overdrafts and increased the fee for uncollateralized daylight overdrafts.

60. The fact that many large non-banking companies have acquired FDIC-insured depository institutions indicates the Federal Safety Net's presence and value. The four largest U.S. securities firms as of May 2007 – Merrill Lynch, Morgan Stanley, Goldman Sachs, and Lehman Brothers – each owned an ILC. *See* Douglas H. Jones, Acting Gen. Counsel, FDIC, Industrial Loan Companies: A Review of Charter, Ownership and Supervision Issues, Address Before the House Committee on Financial Services 2 (July 12, 2006) (on file with the author), *available at* http://www.fdic.gov/news/news/speeches/archives/2006/chairman/spjul1107-.html. Additionally, Charles Schwab and MetLife, a major discount securities broker and life insurer, respectively, are both bank holding companies. Wilmarth, *supra* note

Commercial ownership of banks threatens to extend the Federal Safety Net beyond the banking sector to banks' commercial owners at a potentially significant cost to the federal government and, consequently, to taxpayers. Such a threat could occur under at least five factual scenarios: (1) commercial owners could shift losses and risky assets from their commercial holdings to their banks; (2) commercial owners could cause their banks to make illegal or preferential loans to the commercial owners' affiliates or to the commercial owners themselves; (3) commercial owners could cause their banks to sell the banks' depositors risky assets for the benefit of the commercial owners; (4) commercial owners could cause their banks to pay out inappropriate dividends to the commercial owners; and (5) commercial owners could convert uninsured accounts into insured deposits at their banks.[61]

Commercial owners of banks have extended the Federal Safety Net to the commercial sector under each of these scenarios. In 1976, Hamilton National Bank failed after its holding company violated section 23A of the Federal Reserve Act by forcing Hamilton to purchase large amounts of low-quality mortgages from its commercial affiliate.[62] The United States National Bank of San Diego failed in 1973 after making massive loans to its controlling shareholder and its affiliates in violation of legal lending limits.[63] "[I]n the early 1970s, Beverly Hills Bancorp sold $12.5 million of commercial paper to more than two hundred customers of its subsidy bank, Beverly Hills National Bank,"[64] which the holding company used to make speculative real estate loans. When the real estate developer defaulted, Beverly Hills National Bank defaulted on the commercial paper, prompting litigation and a depositor run that precipitated the Bank's failure.[65] Superior Bank failed in July 2001, in part, because an affiliate of Superior's holding company provided Superior with erroneous asset valuations that caused Superior to overstate its risk-based capital and, in turn, to inappropriately pay dividends.[66] Finally, in 2000, Merrill Lynch introduced a "sweep

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54, at n.1033. Accordingly, Arthur J. Wilmarth, Jr., Professor of Law at George Washington University Law School and banking law expert, posits that "banks and nonbanking companies have indisputably proven the existence of a safety net subsidy – at least for large financial institutions – by voting with their feet." Wilmarth, *supra* note 25, at 1591.

61. *See* Wilmarth, *supra* note 25, at 1594-95.

62. JERRY W. MARKHAM, A FINANCIAL HISTORY OF THE UNITED STATES 75 (2002).

63. *See* First Empire Bank v. FDIC, 572 F.2d 1361, 1364-65 (9th Cir. 1978). "Many interested persons attributed USNB's failure in large part either to the mismanagement by the Designated Group [i.e., UNSB's controlling shareholder and various of his associated entities] or to their misuse of official power for personal gain. . . ." *Id.* at 1365.

64. *See* Wilmarth, *supra* note 25, at 1594.

65. *See generally* In re Beverly Hills Bancorp, 649 F.2d 1329, 1329 (9th Cir. 1981).

66. *See* OFFICE OF INSPECTOR GEN., U.S. DEP'T OF TREASURY, OIG-02-040, MATERIAL LOSS REVIEW OF SUPERIOR BANK 3 (2002), *available at* http://www.ustreas.gov/inspector-general/audit-reports/2002/oig02040.pdf. Superior's overstated risk-based capital may have also allowed it to avert Prompt Corrective Action brokered deposit restrictions

program" to transfer its customers cash balances from uninsured brokerage accounts into FDIC-insured deposits at its subsidiary banks.[67] As a result of the program, the FDIC-insured $80 billion of new deposits at Merrill Lynch's subsidiary banks, which Merrill used to fund $70 billion of commercial and consumer loans.[68]

Sections 23A and 23B of the Federal Reserve Act restrict affiliate transactions; however, these regulatory firewalls have proven insufficient to prevent the spread of the Federal Safety Net to the commercial sector.[69] For example, a study of the S & L Crisis published by the U.S. GAO found that of the one hundred and seventy-five banks that failed between 1990 and 1991, regulators found violations of insider lending rules at eighty-two of the institutions and improper affiliate transactions at forty-nine of the institutions.[70] Intentional managerial evasions of sections 23A and 23B are often subtle and difficult to detect and, as a result, often go unsanctioned.[71] In addition, the Board has repeatedly waived section 23A's restrictions on affiliate transactions to allow banks to support their commercial affiliates during crises or to achieve a particular desired result.[72] In May 2009, for example, the Board exempted GMAC's subsidiary, Ally Bank, from section 23A so that it could extend loans to finance purchases of GM automobiles, and in April 2008, the Board permitted JP Morgan Chase to make loans to Bear Stearns in excess of the Section 23A limits as part of its acquisition of Bear Stearns.[73]

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intended to curb or reverse growth by limiting the institution's funding sources. *Id.* at 16. "The events precipitating Superior's insolvency in July 2001 were essentially a series of accounting adjustments resulting in losses and capital depletion. . . . The accounting adjustments were necessitated after OTS and FDIC examiners determined that Superior needed to write-off a $36.7 million receivable from the holding company, and had overstated the value of residual assets by $150 million." *Id.* at 5-6.

67. *See* Wilmarth, *supra* note 54, at 424-25.

68. Wilmarth, *supra* note 25, at 1591. A 2004 study estimated that such sweep accounts have created $350 billion of FDIC insured deposits that would otherwise be held in uninsured money market mutual funds at brokerage firms. *Id.* Many securities firms with bank affiliates have implemented similar programs because FDIC-insured deposits pay interest rates that are much lower, and earn spreads that are much higher, than the rates and spreads applicable to uninsured money market mutual funds. *Id.*

69. *Id.* at 1596.

70. *Id.*

71. *Id.* at 1597. Pursuant to 12 C.F.R. § 223.16(a), a bank must treat a transaction as an affiliate transaction subject to sections 23A and 23B if the proceeds of the transaction "are used for the benefit of, or transferred to an affiliate." However, as one commentator noted, "it is questionable whether the [Board] would have sufficient resources to monitor bank compliance with [section 223.16] in an environment involving extensive bank/commercial firm affiliations." JONATHAN BROWN, THE SEPARATION OF BANKING AND COMMERCE 25, http://www.public-gis.org/reports/sbc.html.

72. *See* McCoy & Wilmarth, *supra* note 24 (citing instances where federal regulators have waived these regulatory firewalls).

73. JP Morgan Chase's acquisition of Bear Stearns was extraordinary because it was facilitated with a $29 billion loan by the Federal Reserve Bank of New York, which

Commercial ownership or control of banks creates opportunities for transactions that spread the Federal Safety Net to the commercial sector. When such transactions occur, either in violation of the law or with regulators' permission, taxpayers assume risks. In other words, non-bank commercial activities can drain the Federal Safety Net but escape supervision by bank regulators. Private equity investment in failed banks has the potential to create such risk and, consequently, should only be permitted subject to comprehensive regulatory and supervisory controls that prevent the transfer of risk from the investors to the banks.

V. THE FDIC AND FRB SOPS

The Board and the FDIC have recently issued statements of policy ("SOPs") affecting private equity investment in banks.[74] The FRB SOP clarifies its interpretation of the BHC Act vis-à-vis minority investors. The FDIC SOP, recognizing that minority private investors may, based on the FRB SOP, be able to avoid BHC Act regulation, attaches special terms and conditions on private equity investment in failed banks.

The BHC Act generally applies to companies that "control" a banking organization.[75] A company has control over a banking organization for

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orchestrated the deal to avert the systemic crisis that it was believed would ensue if Bear Stearns failed. *See* Barry J. Orticelli, *Crisis Compounded by Restraint*, 42 CONN. L. REV. 647, 661-62 (2009). The Federal Reserve Bank of New York provided the funds through JP Morgan Chase, rather than directly to Bear Stearns, because, as an investment bank, Bear Stearns was not eligible to borrow from the FRB's Discount Window. *Id.* at 660. In order to execute the deal, the FRB exempted JP Morgan Chase's provision of the Board funds to Bear Stearns from Section 23A of the Federal Reserve Act's limitations on extensions of credit. *Id.* at 669. Otherwise, JP Morgan Chase's $29 billion extension of credit to Bear Stearns would have violated Section 23A because it exceeded 10% of the capital stock and surplus of JP Morgan Chase. *See* 12 U.S.C. § 371c(a)(1)A-B. The Board's Regulation W includes similar quantitative restrictions on the aggregate amount of transactions between member banks and their affiliates. *See* 12 C.F.R. §§ 223.11, 12.

74. Statements of Policy, unlike statutes and legislative rules, are not binding on members of the public, the issuing agency, or the courts. *See* RICHARD J. PIERCE, JR., ADMINISTRATIVE LAW TREATISE 419 (5th ed. 2010); *see also* Statement of Policy on Qualifications for Failed Bank Acquisitions, 74 Fed. Reg. 45,440, 45,446 (Sep. 2, 2009) ("The FDIC notes that the policy statement is just that – a policy statement and not a statutory provision imposing civil or criminal penalties and that the requirements that it imposes on investors only apply to investors that agree to its terms."). Therefore, the FDIC could, in its discretion, adjust the FDIC SOP's terms and conditions as to any particular private equity investor.

75. *See* 12 U.S.C. § 1841(a)(1).

> [T]he BHC Act was intended to ensure that companies that acquire control of banking organizations have the financial and managerial strength, integrity, and competence to exercise that control in a safe and sound manner. The BHC Act is premised on the principle that a company that controls a banking organization may reap the benefits of its successful management of the banking organization but also must be prepared to provide additional financial and managerial resources to the

purposes of the BHC Act if: (i) the company directly or indirectly or acting through one or more persons owns, controls, or has the power to vote 25% or more of any class of voting securities of the banking organization; (ii) the company controls in any manner the election of a majority of directors or trustees of the banking organization; or (iii) the Board determines that the company directly or indirectly exercises a controlling influence over the management or policies of the banking organization.[76] An entity that controls a banking organization is not permitted to engage in non-banking activities and must serve as a source of financial and managerial strength for the banking organization.[77] In addition, BHCs are subject to Board examination and supervision and must satisfy minimum capital requirements.[78] To avoid these burdens, minority investors in banking organizations generally endeavor to avoid exercising "control" over banking organizations.[79]

> banking organization to support the company's exercise of control. In this way, the Act ties the potential upside benefits of having a controlling influence over the management and policies of a banking organization to responsibility for the potential downside results of exercising that controlling influence. By tying control and responsibility together, the Act ensures that companies have positive incentives to run a successful banking organization but also bear the costs of their significant involvement in the banking organization's decision making process, thus protecting taxpayers from imprudent risk-taking by companies that control banking organizations. Minority investors in banking organizations typically seek to limit their potential downside financial exposure in the event of the failure of the banking organization. Concomitantly, the BHC Act requires that minority investors seeking this protection limit their influence over the management and policies of the banking organization.

Press Release, Bd. of Governors of Fed. Reserve Sys., Policy Statement on Equity Investments in Banks and Bank Holding Companies 2 (Sept. 22, 2008) (to be codified at 12 C.F.R. § 225.144), *available at* http://www.federalreserve.gov/newsevents/press/bcreg/bcreg20080922b1.pdf.

76. 12 U.S.C. § 1841(a)(2).

77. 12 U.S.C. § 1843(a).

78. 12 U.S.C.A. § 1844(c) (2010). FRB Regulation Y, 12 C.F.R. § 225.2(b)(1) defines "bank" as any FDIC insured institution, or any U.S. institution that (a) accepts demand deposits and (b) is "[i]s engaged in the business of making commercial loans." Thus, savings and loan institutions are also "banks" for purposes of the BHC Act, and the companies that control them are subject to its restrictions and limitations.

79. For example:

> [in] the sales of IndyMac Federal Bank, FSB and BankUnited, FSB, the acquiring holding company was a newly formed organization owned almost entirely by a consortium of non-affiliated private equity investors, none of which, alone or in the aggregate, was deemed to control the holding company or the thrift that was organized to acquire the assets and liabilities.

Thomas P. Vartanian & Gordon L. Miller, *2009 Developments in FDIC Failed Bank Resolutions*, A.B.A. BUS. L. NEWSL., Nov. 2009, at 1, 3, *available at* http://www.abanet.org/buslaw/newsletter/0089/materials/pp2b.pdf.

A. The FRB SOP

On September 22, 2008, the Board promulgated the FRB SOP, which clarified the circumstances under which the Board would determine that a minority investment in a bank or bank holding company would cause the investor to become subject to the BHC Act.[80] The FRB SOP acknowledges that private equity investors generally structure bank acquisitions with the explicit goal of avoiding the limitations on "control" of banks by "companies" under the BHC Act and emphasizes the policy concerns created by minority investment schemes that skirt BHC Act regulation.[81] However, the FRB SOP effectively provides a safe harbor whereby a private equity investor can avoid BHC Act regulation. Furthermore, the FRB SOP expressly refrains from commenting on concerted investment by multiple PE investors – an investment strategy that has been employed in some of the largest private equity bank acquisitions.[82]

The FRB SOP clarifies that an investor does not have control over a bank if its investment is limited to less than 15% of any class of the bank's voting shares and less than one third of the total equity of the bank.[83] Conversely, the FRB SOP makes clear that a private equity investor would be deemed to control the bank if it holds at least 25% of any class of the bank's voting shares, it controls in any manner the election of a majority of the bank's directors, or it otherwise exercises a "controlling influence" over the bank.[84] Under this calculus, a private equity investor or group of such investors that owns between 15% and 25% of any class of a bank's voting shares may or may not be deemed to control the bank.[85]

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80. *See* Bd. of Governors of the Fed. Reserve Sys., *supra* note 75.

81. *Id.* Accordingly, the FRB SOP intends to implement two key purposes of the BHC Act. First, the BHC Act is designed to ensure that "companies have positive incentives to run a successful banking organization but also bear the costs of their significant involvement in the banking organization's decision-making process, thus protecting taxpayers from imprudent risk-taking by companies that control banking organizations." *Id.* "Second, the BHC Act was intended to limit the mixing of banking and commerce. In particular, the Act effectively prevents commercial firms and companies with commercial interests from also exercising a controlling influence over a banking organization." *Id.*

82. *Id.* at n.2 ("Contemporaneous minority investments in the same banking organization by multiple different investors also often raise questions about whether the multiple investors . . . are a single association for purposes of the BHC Act. These questions are beyond the scope of this policy statement."); *see also* SUBRAMANIAN, *supra* note 9 (discussing IndyMac deal).

83. 12 C.F.R. § 225.144(c)(2).

84. *Id.*

85. The term "company" for purposes of the BHC Act includes an "association," which, although not defined, appears to include any group of investors that acts in concert to exercise a controlling influence over a banking organization. *See* 12 U.S.C. § 1841(b).

In addition to equity and voting rights, the FRB SOP addresses other indicia of control, including director representation,[86] consultation with management,[87] business relationships,[88] and covenants.[89] The Board notes, however, that "controlling influence determinations depend not just on the contractual rights and obligations of the investor and the banking organization; they also depend on the amount of influence the investor in fact exercises over the banking organization."[90]

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86. The FRB SOP provides that "a minority investor generally should be able to have a single representative on the board of directors of a banking organization without acquiring a controlling influence over its management or policies." 12 C.F.R. § 225.144(c)(1). The Board reasoned that:

> [a]lthough having a representative on the board of the banking organization enhances the influence of a minority investor . . . in the absence of other indicia of control, it would be difficult for a minority investor with a single board seat to have a <u>controlling</u> influence over the management or policies of the . . . organization.

Id. (emphasis in original).

87. Although:

> a non-controlling minority investor, like any other shareholder, generally may communicate with banking organization management about . . . any of the banking organization's policies and operations, . . . [t]o avoid the exercise of a controlling influence, in all cases, the decision whether or not to adopt a particular position or take a particular action must remain with the banking organization's shareholders as a group, its board of directors, or its management, as appropriate.

12 C.F.R. § 225.144(c)(3).

88. The Board acknowledged that it has traditionally prohibited a non-controlling minority investor "from having any material business transactions or relationships with the banking organization[;]" however, it also noted "that not all business relationships,- even when accompanied by a material investment,- provide the investor a controlling influence over the management or policies of the banking organization." 12 C.F.R. § 225.144(c)(4)(i). Consequently, the FRB SOP provides that the Board:

> continues to believe that business relationships should remain limited and will continue to review business relationships on a case-by-case basis within the context of the other elements of the investment structure. In that review, the Board will pay particular attention to the size of the proposed business relationships and to whether the proposed business relationships would be on market terms, non-exclusive, and terminable without penalty by the banking organization.

Id.

89. The FRB SOP provides that: "[b]ecause the BHC Act explicitly defines control (and many of its other thresholds) in terms that include a percentage of voting securities, companies often have structured their investments in banking organizations in the form of nonvoting securities and have attempted to substitute contractual agreements for the rights that normally are obtained through voting securities. The Board has taken and continues to hold the view that covenants that substantially limit the discretion of a banking organization's management over major policies and decisions suggest the exercise of a controlling influence." 12 C.F.R. § 225.144(c)(4)(ii).

90. 12 C.F.R. § 225.144(d). Thus, the Board reminded, "whether a minority investor in a banking organization has a controlling influence over the management or

The FRB SOP relaxes regulation of minority private equity investment in banks. The BHC Act presumes that any company that owns, controls, or has the power to vote less than 5% of voting securities of a banking organization does not control the organization and, therefore, is not subject to the BHC Act.[91] The FRB SOP effectively expands this presumption to investors that own, control, or have the power to vote less than 15% of any class of voting security of the banking organization, assuming that the investor owns less than one-third the total equity of the organization. Thus, based on the FRB SOP, private equity investors can invest in up to 33% of the total equity, including up to 15% of the voting equity, of any banking organization without becoming subject to the BHC Act.

B. The FDIC SOP

On August 26, 2009, the FDIC promulgated its FDIC SOP, which sets forth terms and conditions under which the FDIC will allow a private equity investor to invest in a failed insured depository institution.[92] The FDIC SOP seeks to attract private equity capital to the banking system while imposing safeguards that attempt to harmonize private equity investment with the basic concepts applicable to bank ownership that are contained in the established banking laws and regulations.[93] Specifically, it imposes requirements and restrictions with respect to capitalization, affiliate transactions, and the nature and duration of investments.[94]

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policies of the banking organization depends on all the facts and circumstances surrounding the investor's investment in, and relationship with, the banking organization." *Id.*

91. 12 U.S.C. § 1841(a)(3).

92. Statement of Policy on Qualifications for Failed Bank Acquisitions, 74 Fed. Reg. 45,440 (Sept. 2, 2009) (substantially adopting the Proposed Statement of Policy on Qualifications for Failed Bank Acquisitions, 74 Fed. Reg. 32,931 (July 9, 2009)).

93. Statement of Policy on Qualifications for Failed Bank Acquisitions, 74 Fed. Reg. 45,440 (Sept. 2, 2009).

94. *Id.* at 45,446-47. The proposed FDIC SOP also contained a "source of strength" requirement modeled after that which is required of bank holding companies. Proposed Statement of Policy on Qualifications for Failed Bank Acquisitions, 74 Fed. Reg. at 32,933. That provision read:

> [I]nvestors organizational structures subject to the measures provided for in this policy statement would be expected to agree to serve as a source of strength for their subsidiary depository institutions. Source of strength commitments under this paragraph are to be supported by the agreement of the depository institution holding company in which the investors have invested that holds the stock of such depository institutions to sell equity or engage in capital qualifying borrowing.

Id. at 32,933. This provision would have required investors to inject capital or managerial support into the acquired depository institution. However, numerous commentators on the Proposed FDIC SOP expressed confusion and opposition to the source of strength requirement; the comment submitted by the law firm Simpson, Thatcher & Bartlett, LLP on behalf of a group of major private equity firms, including the Blackstone Group, is illustrative:

In contrast to the FRB SOP, which established measures of "control" to determine whether investors would be subject to the BHC Act, the FDIC SOP focuses on terms and conditions for private equity investment in failed banks. The FDIC SOP recognizes that while a private equity investor may not be subject to the BHC Act according to the FRB SOP, their investment may pose significant risks nonetheless. For example, the FDIC SOP identifies the dilemma that arises when each investor in a consortium owns no more than 24.9% of a bank's voting equity, but the consortium supplies substantially all the capital needed to capitalize the bank.[95] While such investors could avoid BHC Act regulation, the investment would be subject to the FDIC SOP's terms and conditions.[96]

The FDIC SOP applies to:

> The Private Equity Commentators understand [the proposed source of strength requirement] to mean that the top company in an ownership chain which is registered as a bank or thrift holding company, and all of its subsidiary holding companies, must agree to act as a source of strength to the subsidiary depository institutions, but that individual non-controlling investors will not be subject to any financial obligations to provide more capital or funds. If that understanding is correct, the Private Equity Commentators respectfully suggest that the Proposed Policy Statement be revised to state that clearly, given the great importance of this issue to all investors. . . .
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> . . . The Private Equity Commentators strongly believe that imposing financial obligations on non-controlling investors would be unreasonable. Since these non-controlling investors by definition are not able to unilaterally implement measures to prevent or remedy the problems which gave rise to the need for additional capital, they should not be asked to assume unlimited liability for resolving those problems. As a practical reality, the Private Equity Commentators believe that few if any investors of any kind would make a non-controlling investment if they could be exposed to liability in addition to the loss of their investment.

Letter from Simpson, Thatcher & Bartlett, to Robert E. Feldman, Executive Secretary, FDIC 6 (Aug. 7, 2009) (on file with the author), *available at* http://www.fdic.gov/regulations/laws/fede-ral/2009/09c60AD47.pdf.

95. Statement of Policy on Qualifications for Failed Bank Acquisitions, 74 Fed. Reg. at 45,446.

96. The FDIC SOP notes that:

> [c]apital 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. . . . [T]his framework has included . . . measures aimed at maintaining well capitalized bank and thrift institutions, support for these banks when they face difficulties, and protections against insider transactions. . . . 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.

Id. at 45,440.

> (a) 'private investors' in a company, including any company acquired to facilitate bidding on failed banks or thrifts, that is proposing to, directly or indirectly, (including through a shelf charter) assume deposit liabilities, or such liabilities and assets, from the resolution of a failed insured depository institution; and (b) applicants for [FDIC deposit] insurance in the case of *de novo* charters issued in connection with the resolution of failed insured depository institutions.[97]

The FDIC SOP expressly does not apply to joint ventures involving private equity investors and existing depository institution owners.[98] It also expressly does not apply to investors with 5% or less of the total voting power of the acquired bank or its bank or thrift holding company, provided that there is no evidence of concerted action by such investors with other investors.[99] However, on April 23, 2010, the FDIC published guidance

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97. *Id.* at 45,448.

98. *Id.* at 45,446. The FDIC SOP does:

> not apply to Investors in partnerships or similar ventures with depository institution holding companies (excluding shell holding companies) where the latter have a strong majority interest in the acquired bank or thrift and an established record of successful operation of insured banks or thrifts. Such partnerships are strongly encouraged by the FDIC.

Id. Although there is no requirement that pre-existing investors must have held their ownership interests for a specific amount of time, in evaluating application of the FDIC SOP, "[t]he FDIC will take into consideration whether a significant portion of the total equity shares or voting shares held by Investors in the established bank or thrift holding company pre-dating the proposed failed institution acquisition was recently acquired." *Id.*

99. The FDIC will presume concerted action among investors in ownership structures in which all or substantially all of the investors own less than 5% of the voting stock but where, in the aggregate, the investors hold more than two thirds of the voting power of the institution. *See Statement of Policy on Qualifications for Failed Bank Acquisitions*, FDIC, http://www.fdic.gov/regulations/ laws/faqfbqual.html (last updated Apr. 23, 2010). The investors can rebut this presumption with sufficient evidence that the investors are not engaging in concerted action. *Id.* In evaluating whether the presumption has been rebutted, the FDIC will consider, among other things:

> [1] whether each investor was among many potential investors contacted by [the] bank/thrift or its agent, and each investor reached an independent decision to invest in the bank/thrift; [2] whether an investor is managed or advised by an investment manager or advisor who performs the same services for another investor; [3] whether the investor has engaged, or anticipates engaging, as part of a group consisting of substantially the same entities as are shareholders of the bank/thrift, in substantially the same combination of interests, in any additional banking or non-banking activities in the United States; [4] whether an investor has any significant ownership interest in any other investor in the bank/thrift; [5] whether an investor is entitled to acquire any other investor's shares; [6] whether there are any agreements or understandings between any of the investors for the purpose of controlling [the] bank/thrift; [7] whether the investors . . . will consult with other investors concerning the voting of bank/thrift shares ; and [8] whether the directors representing the investors will represent only the particular investor which nominated him or her, and will not represent any combination of investors.

Id.

making clear that with respect to a consortium of minority investors, at least one-third of the consortium must agree to be bound by the FDIC SOP, including, if necessary, investors owning less than 5% of the bank's total voting shares.[100]

The FDIC SOP requires that the acquired institution be initially capitalized such that its ratio of Tier 1 common equity to total assets is at least 10% for the three years immediately following acquisition.[101] Thereafter, the institution must remain "well capitalized," as that term is defined in section 325.103(b)(1) of the FDIC's Rules and Regulations, for as long as the investors own the institution.[102] If at any time the institution fails to meet these standards, it would be required to take immediate action to restore the 10% Tier 1 common equity ratio or the well capitalized status, as applicable.[103] The FDIC imposed these requirements, which are more onerous than those that apply to ordinary *de novo* institutions,[104] as a risk-based measure to protect the DIF from loss.[105]

The FDIC SOP imposes a "cross support" obligation that applies if two or more depository institutions are owned by a group of investors covered by the FDIC SOP if both institutions are at least 80% owned by common investors.[106] Subject investors would be required to commit their

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100. *Id.*. The FDIC's stated purpose in requiring this "anchor group" of investors is to help accomplish the FDIC SOP's goal of ensuring "that the ownership and management of insured depository institutions remain stable to provide guidance and continuity for safe and sound operation of the bank or thrift." *Id.* Although the one-third ownership test need only be met at the time of the failed bank acquisition, investors subject to it are prohibited from selling or otherwise transferring their ownership for three years following the acquisition absent the FDIC's prior approval. *Id.*

101. Statement of Policy on Qualifications for Failed Bank Acquisitions, 74 Fed. Reg. 45,440, 45,448 (Sept. 2, 2009).

102. *Id.*

103. *Id.* Failure to meet these standards would result in the institution being deemed "undercapitalized" for purposes of Prompt Corrective Action which, among other things, would restrict the payment of dividends and growth of the institution's assets, and would require the institution to provide an adequate capital plan to its federal regulator. *Id.* at 45,446.

104. A *de novo* bank is a state bank that has been in operation for five years or less. *See De Novo Banks*, FED. RESERVE BANK OF CHI., http://www.chicagofed.org/webpages/banking/supervision_and_regulation/de_novo_banks.cfm (last visited Oct. 30, 2010).

105. *See generally* Statement of Policy on Qualifications for Failed Bank Acquisitions, 74 Fed. Reg. 45,440 (Sept. 2, 2009).

106. The cross support obligation reflected in the FDIC SOP is relaxed from the one set forth in the Proposed FDIC SOP. Under the Proposed FDIC SOP:

> [i]nvestors 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 each 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.

bank or thrift investments to support one or more of these institutions if they failed. Additionally, the FDIC SOP prohibits all extensions of credit from an acquired bank to investors, their investment funds if any, or any affiliates of either.[107] The FDIC imposed this restriction despite industry comments arguing that the restrictions under sections 23A and 23B of the Federal Reserve Act and Regulation W are sufficient to prevent inappropriate insider and affiliate transactions.[108] The FDIC reasoned that the additional restrictions were necessary because under some common private equity investment structures, the investors would not meet the standards that trigger the applicability of sections 23A and 23B.[109]

In addition to these ownership requirements and limitations, the FDIC SOP regulates private equity investors' acquisition of failed banks in several ways. First, investors employing ownership structures utilizing entities that are domiciled in Bank Secrecy jurisdictions are not eligible to own a direct or indirect interest in a bank unless the investors are subsidiaries of companies that are subject to comprehensive consolidated supervision and

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Proposed Statement of Policy on Qualifications for Failed Bank Acquisitions, 74 Fed. Reg. 32,931, 32,933 (July 9, 2009). A comment to the Proposed FDIC SOP submitted by the Private Equity Council is representative of the criticisms advanced by many of the private equity commentators of the proposed "cross guaranty obligation":

> [M]ost, if not all, PE firms have existing agreements with their investors that limit the PE firm's ability to make additional financial or other demands of the investors. It therefore may simply not be possible for a PE firm to commit to a cross-guarantee agreement like that contemplated in the Proposed Statement, because the constituent documents of the firm's funds may not allow it. A cross-guarantee commitment would also have the effect of limiting private investors' ability to diversify their portfolios, thus effectively deterring individual private investors from supplying capital to multiple institutions and undermining the objective of the cross-guarantee of reducing the FDIC's loss on a failed institution.

LOWENSTEIN, *supra* note 15, at 6.

107. For purposes of the FDIC Statement of Policy on Qualifications for Failed Bank Acquisitions, "affiliate" is defined as "any company in which the Investor owns, directly or indirectly, at least 10 percent of the equity of such company and has maintained such ownership for at least 30 days." Statement of Policy on Qualifications for Failed Bank Acquisitions, 74 Fed. Reg. at 45,440, 45,449.

108. *See* McCoy & Wilmarth, *supra* note 24 (noting that Regulation W imposes restrictions similar to Sections 23A and 23B).

109. The FDIC stated that it was:

> of the view that a special situation is presented with respect to transactions with affiliates by private capital investors who are not subject to the activities restrictions of the Bank Holding Company Act with a resultant temptation to cause the de novo bank they have purchased to lend to companies in which they have invested. Moreover, the FDIC notes that the prohibitions on insider lending are among the most crucial requirements for maintaining a safe and sound banking system and for protecting the Deposit Insurance Fund.

Statement of Policy on Qualifications for Failed Bank Acquisitions, 74 Fed. Reg. at 45,447.

consent to a variety of disclosure obligations.[110] Second, the FDIC will not approve so-called "silo" acquisition structures that artificially separate the non-financial activities of the private equity investor from its banking activities such that the private equity investor can avoid becoming a bank or thrift holding company.[111] Third, private equity investors are required to disclose information to the FDIC concerning the investors and all entities in the ownership chain.[112] In addition, the FDIC SOP prohibits investors from selling or otherwise transferring their ownership interests for three years following the acquisition without prior FDIC approval.[113]

Despite criticism from the private equity community that the FDIC SOP is unduly burdensome, private equity investors have and continue to bid for failed banks. Since January 2010, the FDIC has sold at least six failed banks to institutions backed by private equity investors. For example, in late January 2010, Bond Street Holdings, a newly formed bank holding company backed by a group of private equity investors, bought Premier American Bank and Florida Community Bank, two Florida banks with combined assets in excess of $1.25 billion.[114] On February 19, 2010, OneWest Bank, formerly Indymac, bought La Jolla Bank, with assets of roughly $3.6 billion, in a deal that cost the DIF an estimated $882 million.[115] OneWest Bank was formed in 2009 when the FDIC sold Indymac to a group of private equity and hedge fund investors, including former

110. *See* Statement of Policy on Qualifications for Failed Bank Acquisitions, 74 Fed. Reg. at 45,449. This requirement reflects the FDIC's belief that "[e]ntities organized in bank secrecy law jurisdictions can make it difficult for the FDIC as a regulator to obtain information about a company's owners and its affiliates." *Id.*

111. The FDIC reasoned that:

> Complex and functionally opaque ownership structures in which the beneficial ownership interest is difficult to ascertain with certainty, the responsible parties for making decisions are not clearly identified, and ownership and control are separated, would be so substantially inconsistent with the principles outlined [in the FDIC SOP] as not to be considered as appropriate for approval for ownership of insured depository institutions. Structures of this type that have been proposed for approval have been typified by organizational arrangements involving a single private equity fund that seeks to acquire ownership of a depository institution through creation of multiple investment vehicles, funded and apparently controlled by the parent fund.

Id.

112. *Id.*

113. *Id.*

114. *See* Megan Davies & Paritosh Bansal, *Update 1-DealTalk-PE Bank Rules Seen Unlikely to Change*, REUTERS, Feb. 24, 2010, http://www.reuters.com/article/idUSN2313022120100224?type=marketsNews. Prior to these acquisitions, Bond Street Holdings had raised $440 million to focus exclusively on purchasing failed banks in Florida. *Id.*

115. Allistair Barr, *OneWest Buys Another Failed Bank Amid Controversy*, MARKETWATCH (Feb. 22, 2010), http://www.marketwatch.com/story/onewest-buys-another-failed-bank-amid-controversy-2010-02-22.

Goldman Sachs Group, Inc. executive vice president Steven Mnuchin and billionaire financiers George Soros and J. Christopher Flowers.[116] Most recently, on July 16, 2010, North American Financial Holdings, headed by Gene Taylor, the former chief of Bank of America's investment banking unit, purchased Metro Bank and Turnberry Bank, both failed Florida banks, and First National Bank, a failed South Carolina Bank, with total aggregate assets exceeding $1.38 billion.[117]

In addition, the FDIC continues to develop resolution tools that facilitate private equity investment in failed banks. For example, the FDIC, in conjunction with the Office of the Comptroller of the Currency ("OCC"), has approved a limited number of "shelf charters" that pre-approve groups of investors to purchase failed banks.[118] On October 26, 2009, the FDIC pre-approved SJB bank, owned in part by real estate mogul and Miami Dolphins owner Steven Ross, for deposit insurance in conjunction with the OCC's approval of the bank's proposal for a shelf-charter.[119] In February 2010, SJB Bank raised $1 billion in capital through Deutsche Bank but has not yet purchased any failed banks.[120] The FDIC has also demonstrated a willingness to share in the losses of a failed bank to induce private equity investment, though recently the FDIC has appeared less inclined to enter into loss sharing agreements whereby it absorbs substantially all the losses on failed institutions' most toxic assets.[121]

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116. *Id.*

117. *See* Dealbook, *Private Equity Group Buys 3 Failed Banks*, N.Y. TIMES.COM (July 19, 2010), http://dealbook.blogs.nytimes.com/2010/07/19/private-equity-group-buys-3-failed-banks/.

118. A shelf charter involves obtaining preliminary approval from the OCC for a national bank charter and preliminary approval from the FDIC to obtain deposit insurance in advance of identifying the depository institution that the charter and deposit insurance will apply to. *See* Vartanian & Miller, *supra* note 79.

119. *See* Jonathan Keehner, *Related Cos Executives Cleared by FDIC to Buy Banks*, BLOOMBERG, Oct. 29, 2009, http://www.bloomberg.com/apps/news?pid=20601103&-sid=a_PL6jpaR5ok.

120. *See* Martha Brannigan, *A Rush to Buy Failed Florida Banks*, MIAMI HERALD (Apr. 5, 2010), http://www.miamiherald.com/2010/04/05/v-fullstory/1565029/a-rush-to-buy-failed-florida-banks.html.

121. *See* Shared Loss Agreement Between the FDIC as Receiver for IndyMac Federal Bank, FSB, and OneWest Bank, *available at* http://www.fdic.gov/about/freedom/IndyMacSharedLossAgrmt.pdf (providing that, with respect to certain assets, the FDIC would cover up to 95% of any loss); *see also* Matthias Rieker, *FDIC Pares Loss Aid for Bank Buyers*, WALL ST. J., March 27, 2010, http://online.wsj.com/article/SB10001424-052748703416204575146174050587324.html?mod=WSJ_hpp_LEFTWhatsNewsCollection (reporting that the FDIC has announced that it will absorb a smaller portion of bank losses in future deals).

VI. THE FDIC AND FRB SOPS ARE INSUFFICIENT TO PREVENT THE SPREAD OF THE FEDERAL SAFETY NET

The FRB SOP provides a de facto safe harbor for private equity investors to invest in up to 15% of a bank's voting equity without becoming subject to the BHC Act. As a result, investors can skirt BHC Act regulation and still exercise substantial control over the insured depository institution. The FDIC SOP attempts to account for this deficiency by imposing requirements and restrictions on the investment in and operation of acquired insured depository institutions, regardless of the composition of the investors.

Although the FDIC SOP is an improvement on the FRB SOP, it does not adequately protect the Federal Safety Net from the risks posed by private equity investment in failed banks because it does not account for the interconnectedness of private equity investors. Interconnectedness refers to the direct and indirect linkages and degree of interdependence among firms across sectors and geographic boundaries.[122] As a recent International Monetary Fund ("IMF") report stated:

> The larger the number of links (the larger the number of creditors and clients), the higher potential to cause spillovers onto either clients and/or creditors. In addition, the larger the size of the individual exposures (the "thickness" of the links), the greater the potential that these effects will be magnified.[123]

The financial crisis of 2008 demonstrated that financial linkages among firms create systemic risks and that interconnected firms may be especially susceptible to dislocations in markets.[124] Accordingly, regulatory

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122. *See* INT'L MONETARY FUND, BANK FOR INT'L SETTLEMENTS, & FIN. STABILITY BD., REPORT TO G-20 FINANCE MINISTERS AND GOVERNORS - GUIDANCE TO ASSESS THE SYSTEMIC IMPORTANCE OF FINANCIAL INSTITUTIONS, MARKETS AND INSTRUMENTS: INITIAL CONSIDERATIONS 10-11 (2009) [hereinafter, G-20 REPORT], *available at* http://www.bis.org/publ/othp07.pdf.

123. *Id.* at 10.

124. *See, e.g.*, *Regulatory Perspectives on the Obama Administration's Financial Regulatory Reform Proposals, Part II: Hearing Before the H. Comm. on Financial Services*, 111th Cong. 77 (2009) [hereinafter "Bernanke Testimony"] (statement of Ben S. Bernanke, Chairman, Bd. of Governors of Fed. Reserve Sys.) ("The impact of a firm's financial distress depends . . . on the degree to which it is interconnected, either receiving funding from, or providing funding to, other potentially systemically important firms . . . ."); *Strengthening and Streamlining Prudential Bank Supervision: Hearing Before the S. Comm. on Banking, Housing, and Urban Affairs*, 111th Cong. 66 (2009) [hereinafter "Tarullo Testimony"] (statement of Daniel K. Tarullo, Governor, Bd. of Governors of Fed. Reserve Sys.) (noting that the financial crisis "demonstrated that the framework for prudential supervision and regulation had not kept pace with changes in the structure, activities, and growing interrelationships of the financial sector."); INT'L MONETARY FUND, GLOBAL FINANCIAL STABILITY REPORT: RESPONDING TO THE FINANCIAL CRISIS AND MEASURING SYSTEMIC RISK xxii-xxiii (2009) [hereinafter, IMF FINANCIAL STABILITY REPORT] ("Not only does an institution's size matter for its systemic importance – its interconnectedness and the

reform has been principally concerned with mitigating risks created by financial linkages.[125] The Dodd-Frank Wall Street Reform and Consumer Protection Act, for example, creates a Financial Stability Oversight Council charged with identifying, assessing, and managing systemic risk posed by large interconnected financial market participants, i.e., TBTF institutions.[126] Similarly, the IMF recognized the risk posed by interconnectedness in its April 2009 Global Financial Stability Report on Responding to the Financial Crisis and Measuring Systemic Risk:

> The current crisis reminds us that interconnectedness across institutions is present not only within the banking sector, but as importantly, with the nonbank financial sector (such as investment banking, hedge funds, etc.). Specifically, the liquidity

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vulnerability of its business models to excess leverage or risky funding structure matter as well.").

125. For example, following the Financial Crisis, G-20 Finance Ministers and Central Bank Governors solicited the International Monetary Fund, Bank for International Settlements, and Financial Stability Board to develop guidelines on how national authorities can assess the systemic importance of financial institutions, markets, and instruments. *See* G-20 Report, *supra* note 122. Testifying before Congress in January 2010, FDIC Chairman Sheila Blair reflected on the conditions that led up to the financial crisis, noting that:

> Leading into the crisis, most of the largest financial firms were viewed as having sufficient capital and earnings to weather an economic downturn, even if one or more of them failed. There was little recognition of how interconnected and fragile these large firms had become through their origination and purchases of highly leveraged, structured debt (MBSs, CDOs, SIVs) and closely related derivatives. Regulators were wholly unprepared and ill-equipped for a systemic event that initially destroyed liquidity in the shadow banking system and subsequently spread to the largest firms throughout the financial system.

Sheila C. Blair, Chairman, Fed. Deposit Ins. Corp., Statement on the Causes and Current State of the Financial Crisis before the Financial Crisis Inquiry Commission (Jan. 14, 2010) (transcript available at http://www.fdic.gov/news/news/speeches/chairman/spjan1410.html).

126. The Dodd-Frank Act provides that:

> [t]he [Financial Stability Oversight] Council may provide for more stringent regulation of a financial activity by issuing recommendations to the primary financial regulatory agencies to apply new or heightened standards and safeguards . . . for a financial activity or practice conducted by bank holding companies or nonbank financial companies under their respective jurisdictions, if the Council determines that the conduct, scope, nature, size, scale, concentration, or interconnectedness of such activity or practice could create or increase the risk of significant liquidity, credit, or other problems spreading among bank holding companies and nonbank financial companies, financial markets of the United States, or low-income, minority or underserved communities.

Dodd-Frank Wall Street Reform and Consumer Protection Act of 2010, Pub. L. No. 111-203, § 120(a), 124 Stat. 1376, 1408 (2010). Similarly, the Bank Holding Company Modernization Act of 2009, an antecedent to the Dodd-Frank Act proposed to subject "substantially interconnected financial companies and their subsidiaries to comprehensive and robust prudential supervision and regulation." Bank Holding Company Modernization Act of 2009, § 202, *available at* http://www.financialstability.gov/docs/regulatoryreform/07222009/titleII.pdf.

> problems have demonstrated that rollover risk can spill over to the whole financial system, thus requiring a better understanding and monitoring of both direct and indirect linkages.[127]

In contrast to traditional bank holding companies whose exposure to credit stress events is generally limited to the banking industry, firms that are interconnected across sectors, like many private equity investors with commercial, industrial, and financial holdings, are susceptible to credit stress events in many sectors.[128] Private equity investors are therefore exposed to more and potentially thicker risks. This higher level of risk exposure may, during credit or liquidity squeezes, incentivize private equity investors to transfer risk to the banks they own so they can take advantage of the Federal Safety Net.[129]

Federal regulators have, likewise, recognized the need to look beyond the banks themselves when examining banks' exposure to risks from interconnectedness.[130] In August 4, 2009 testimony before the Senate Banking Committee, FRB Governor Daniel K. Tarullo made this precise point:

> The customary focus on protecting the bank within a holding company, while necessary, is clearly not sufficient in an era in which systemic risk can arise wholly outside of insured depository institutions. Similarly, the premise of functional regulation that risks within a diversified organization can be evaluated and

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127. IMF FINANCIAL STABILITY REPORT, *supra* note 124, at 104.

128. *See* Joseph Philip Forte, *Disruption in the Capital Markets: What Happened?* 574 PLI/REAL 231, 238-39 (2010) (discussing interconnectedness risks in the context of collateralized debt obligations) ("Connectivity" is the interconnected web of investors from all asset classes making common investments in . . . global capital markets. The investment risk of the common investor migrates and eventually infiltrates the entire system. As the investments bec[o]me more diverse, so d[oes] the pervasion of any problem into seemingly unrelated or unconnected portfolios. It [is] akin to an uncontrollable (and invisible) "contagion.").

129. Even before promulgating the FDIC SOP, the FDIC seemed to recognize the additional risks posed by private equity investor's bank ownership. In July 2008, for example, the FDIC ordered auto lender GMAC, LLC, which is majority-owned by Cerberus Capital Management, LP, a leading private equity firm, to conform to a number of conditions in exchange for obtaining a ten year waiver from the conditions that the FDIC had originally imposed in granting Cerberus's application to gain control of GMAC, LLC. *See* David Mildenberg, GMAC, *Cerberus Accord with FDIC Provides $3 Billion*, BLOOMBERG, July 24, 2008, http://www.bloomberg.com/apps/news?pid=20601087&sid=aSt_gunhjog-U&refer=home. The FDIC granted the waiver on the conditions that Cerberus provide the FDIC with a comprehensive accounting of its holdings and affiliates, notify the FDIC after incurring any additional debt or transferring any assets, and maintain an 11% leverage ratio over the following three years. *See* FED. DEPOSIT INS. CORP., IN RE: GMAC BANK REQUEST FOR WAIVER OF CERTAIN CONDITIONS (2008), *available at* http://www.fdic.gov/regulations/laws/bank decisions/other/gmac%28cerebus%29.pdf.

130. *See, e.g.*, Dodd-Frank Wall Street Reform and Consumer Protection Act of 2010, Pub. L. No. 111-203, §§ 151-156, 124 Stat. 1376, 1412-20 (2010) (establishing the Office of Financial Research charged with, among other things, monitoring, investigating, and reporting on changes in systemic risk levels and patterns).

> managed properly through supervision focused on individual subsidiaries within the firm has been undermined further; the need for greater attention to the potential for damage to the bank, the organization within which it operates, and, in some cases, the financial system generally, requires a more comprehensive and integrated assessment of activities throughout the holding company.[131]

Governor Tarullo's testimony highlights a principal weakness of the FDIC SOP: although the FDIC SOP applies to holding companies with respect to Bank Secrecy restrictions, continuity of ownership, and disclosure, it fails to account for risks to a bank that arise "wholly outside" of the bank based on the private equity investors' interconnectedness. As Governor Tarullo indicated, such extraneous risks can flow downstream to banks despite legal restrictions on affiliate transactions and may be especially acute with "diversified," i.e. interconnected, private equity investors.[132]

VII. Recommendations to Address Limitations in the FDIC SOP

The FDIC should amend the FDIC SOP to have its capital requirement vary depending on the interconnectedness of the private equity investor. Rather than requiring an initial level of capitalization sufficient to establish a ratio of Tier 1 common equity to total assets of at least 10%, the FDIC SOP should fix a range – for example, a ratio of Tier 1 common equity to total assets of between 8% and 15%, depending on the FDIC's determination of the investor's interconnectedness (a "Capital Range"). By requiring banks owned by more interconnected investors to hold more capital than banks owned by less interconnected investors, the FDIC SOP would more accurately account for the risk that each particular incident of private equity investment in a bank poses to the Federal Safety Net.

The FDIC SOP already recognizes that private equity bank ownership that skirts BHC Act regulation poses a greater threat to the Federal Safety Net than traditional bank ownership; it requires initial capitalization of at least 10% Tier 1 common equity to total assets, whereas ordinary *de novo* institutions are generally required to have an initial Tier 1 leverage capital ratio of 8%.[133] However, it incorrectly assumes that all instances of private

131. Tarullo Testimony, *supra* note 124, at 68.

132. *See also* Incorporating Employee Compensation Criteria into the Risk Assessment System, 75 Fed. Reg. 2,823, 2,824 (proposed Jan. 22, 2010) (to be codified at 12 C.F.R. pt. 327). In some cases, an institution's risk profile can be affected by holding company and affiliate activities. For example, employees of a parent holding company may be responsible for making decisions or taking actions that will have a material effect on the insured depository institution. In this scenario, the control of significant risks affecting the insured depository institution lies outside the institution, but in the event of failure, the costs associated with the risk will be borne by the DIF. *Id.*

133. *See* FDIC, Risk Management Manual of Examination Policies § 18.1: Report of Investigation Instructions (2004), *available at* http://www.fdic.gov/regulations/safety/manual/section18-1.html (last updated Apr. 6, 2005); *see also* FDIC

equity ownership are equally risky. Fixing a Capital Range would provide the FDIC with the flexibility to assign capital requirements commensurate with the applicable ownership risk, which varies for each investment.[134]

Establishing a Capital Range would be consistent with other FDIC risk-based regulation. For example, the DIF is funded by risk-based assessments on insured banks that vary depending on the probability that the DIF will incur a loss from the bank's failure as determined by the bank's risk-based capital ratios.[135] Similarly, the Uniform Financial Institutions Rating System, under which banks are assigned a composite rating based on several components of their financial and managerial strength, guide the FDIC's supervisory and enforcement decisions.[136] Like tools that impose regulatory requirements based on the level of risk that a bank poses to the DIF, a Capital Range would employ a sliding, risk-based scale that would correlate with interconnectedness.

The FDIC could use available quantitative tools to determine a potential private equity investor's interconnectedness. "Network analysis," for example, refers generally to the suite of methods used to determine the degree of interconnectedness within financial systems.[137] Network analysis

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Proposed Statement of Policy on Qualifications for Failed Bank Acquisitions, 74 Fed. Reg. 32,931, 32,932 (July 9, 2009) ("Clearly, a high level [of capital], above normal levels, is necessary to deal with the unusual circumstances facing banking institutions . . . .").

134. Fixing a Capital Range would also make the FDIC SOP a clearer, more certain statement of the FDIC's policy toward private equity investment in failed banks. Although the FDIC SOP expressly reserved the FDIC's right to adjust the capital requirement beyond a 10% Tier 1 common equity ratio, it did not specify when it would exercise this right or what factors the FDIC would consider. *See* Statement of Policy on Qualifications for Failed Bank Acquisitions, 74 Fed. Reg. 45,440, 45,446 (Sept. 2, 2009) ("Some commentators suggested that capital requirements should be adjusted based on the facts of individual cases. The FDIC adopted this suggestion in so far as it provides that capital requirements may be increased above 10 percent Tier 1 common equity to total assets ratio if warranted."). Uncertainty like this can mystify the rules of engagement and deter potential private equity investors. *See* Thomas Vartanian, *Clear Up Capital Regs, Free Up Capital Access*, AM. BANKER, April 20, 2010, http://www.americanbanker.com/issues/175_74/clear-up-capital-regs-1017822-1.html ("Some policies [expressed in the FDIC SOP] have been developed on a transaction-by-transaction basis, leaving uniformity and clarity to suffer.").

135. Section 7 of the Federal Deposit Insurance Act, 12 U.S.C. § 1817, requires the FDIC to establish a risk-based assessment system. The Federal Deposit Insurance Act authorizes the FDIC to consider any factors that it "determines are relevant to assessing such probability." 12 U.S.C. § 1817(a)(10)(b)(1)(C)(i)(III). On January 19, 2010, the FDIC issued for public comment a proposal to capture banks' executive compensation programs in their DIF assessments because the FDIC has found that compensation programs that encourage excessive risk taking can increase losses to the DIF. Incorporating Employee Compensation Criteria into the Risk Assessment System, 75 Fed. Reg. 2,823 (proposed Jan. 19, 2010) (to be codified at 12 C.F.R. pt. 327).

136. *See* Uniform Financial Institutions Rating System, 62 Fed. Reg. 752 (Jan. 6, 1997) (describing and adopting changes to the Uniform Financial Institutions Rating System).

137. *See* G-20 REPORT, *supra* note 122, at 17.

models risk exposures by accounting for the intensity and complexity of exposures between and among firms.[138] Further, network analysis is capable of simulating spillover risks based on hypothetical stress events;[139] therefore, it is capable of determining both the level *and riskiness* of a potential private equity investor's interconnectedness. The IMF, as well as a number of central banks, including the Bank of England, the National Bank of Belgium, Banco de México, Deutsche Bundesbank, and De Nederlandsche Bank, regularly conducts network analyses to identify institutions whose failure could have systemic implications.[140]

However, network analysis, like all other tools that measure interconnectedness, is imprecise, and therefore susceptible to several criticisms. For example, actual risk exposures may change rapidly and quickly outgrow the results of a network analysis.[141] As a result, any network analysis could become quickly outdated and thus be unable to provide an accurate assessment of interconnectedness. Second, network analysis would require complete disclosure of any potential private equity investor's contractual obligations and exposures to accurately determine the investor's interconnectedness, which may not be feasible.[142] It is also not

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> Policymakers and regulators worldwide have become aware of the importance of proactively tracking potential systemic linkages. . . . [N]etwork analysis is a natural candidate to aid with this challenge, as it allows the regulator to see beyond the immediate "point of impact" by tracking several rounds of spillovers likely to arise from direct financial linkages.

IMF FINANCIAL STABILITY REPORT, *supra* note 124, at 76. Other quantitative tools for determining interconnectedness include: co-risk, distress dependence, and default intensity models. *Id.* at 74. In addition, portfolio models of risk based on market data, stress testing, and scenario analysis may each be used to determine systemic risk. *Id.*

138. Tarullo Testimony, *supra* note 124, at 74.

139. *Id.* ("Network analysis, which can track the reverberation of a credit event or liquidity squeeze throughout the system, can provide important measures of financial institutions' resilience to domino effects triggered by financial distress.").

140. *Id.* at 99.

141. As the G-20 Report recognized in citing challenges to determining systemic importance, any assessment of interconnectedness is likely to be "time varying" depending on the economic environment at the time of the assessment. *See* G-20 REPORT, *supra* note 122, at 7. For example, under strong economic conditions, private equity investors may be more interconnected because they will be engaging in more deals.

> The dependence of this assessment on the specific economic and financial environment has implications about the frequency with which such assessments should take place, with the need for more frequent assessments to take account of new information when financial systems are under stress or where material changes in the environment or the business and risk profile of the individual component have taken place.

Id. at 7-8.

142. As the G-20 Report noted, "[i]nformation to assess . . . interconnectedness remains a key challenge as comprehensive information on [an] individual financial

clear that the FDIC has the technical resources to conduct network analysis, which is data intensive. Finally, even though network analysis is a quantitative tool, interpreting the data it produces depends on qualitative analysis.[143] Therefore, any determination of an appropriate capital requirement based on network analysis would be partly subjective, rendering the determination susceptible to criticisms of arbitrariness, inequity, and favoritism.

Despite these imperfections, interconnectedness plays too large a role in the risk that private equity investment in failed banks poses to the Federal Safety Net to be ignored. Even if the FDIC were unable to determine a potential private equity investor's interconnectedness with precision, network analysis and other risk modeling methodologies would at least allow the FDIC to approximate private equity investors along an interconnectedness spectrum and assign a corresponding capital requirement within a Capital Range. Incorporating this tool into the FDIC SOP would allow the FDIC to more accurately account for the risk posed by each incident of private equity investment in a failed bank and would better protect the Federal Safety Net from the risks of mixing banking and commerce.

VIII. CONCLUSION

Given the current environment of pervasive bank failures, the FDIC needs to attract unconventional investors to purchase failed banks. However, private equity investment in failed banks implicates the longstanding policy of separating banking and commerce, which aims to prevent the spread of the Federal Safety Net to the commercial sector of the economy. The Federal Reserve Board's interpretation of the BHC Act in the FRB SOP effectively creates a safe harbor whereby private equity investors can make substantial non-controlling investments in banks without becoming subject to the BHC Act. Recognizing this loophole, the FDIC SOP aims to prevent the spread of the Federal Safety Net to the commercial sector by imposing additional requirements and restrictions on private equity investors. However, the FDIC SOP fails to recognize a major source of risk that private equity investment in banks poses to the Federal Safety Net: the private equity investors' interconnectedness.

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institution's bilateral exposures is limited in many cases." G-20 REPORT, *supra* note 122, at 16. For example, a network analysis may fail to capture a firm's off balance sheet linkages. *See* IMF FINANCIAL STABILITY REPORT, *supra* note 124, at 101 (citing challenges of collecting information on financial intermediaries like investment banks, insurance companies and hedge funds in determining a bank's interconnectedness).

143. *See* G-20 REPORT, *supra* note 122, at 4-5 ("While quantitative approaches can provide useful inputs to assessment, they cannot substitute for qualitative analysis.").

The FDIC should amend the FDIC SOP to account for private equity investors' interconnectedness to more accurately account for the risk that each incident of private equity investment poses to the Federal Safety Net. The FDIC could do this by fixing a Capital Range within which the FDIC would assign a capital requirement depending on the private equity investor's interconnectedness. To determine interconnectedness, the FDIC could use a variety of quantitative tools, like network analysis, already used by central banks to model interconnectedness. While these tools are not perfect, they would at least allow the FDIC to determine a potential private equity investor's interconnectedness in comparison to other potential investors and assign a capital requirement accordingly. This process would be consistent with the longstanding policy of separating banking and commerce, and would better protect the Federal Safety Net from the risks posed by private equity investment in failed banks.