COUNSELOR'S CORNER

Private Equity: Pro$ and Con$

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Many community banks and their holding companies rely on loan participations as an important source of liquidity for their lending operations. Traditionally, these programs have allowed lenders to diversify assets, comply with lending limits, and spread credit risk by getting participated assets off their balance sheets.

IN TODAY'S CHALLENGING ECONOMY, the ability for regulated financial institutions to raise additional capital has become increasingly important. Changes to the capital requirements for bank holding companies brought about under the Dodd-Frank Wall Street Reform and Consumer Protection Act (Dodd-Frank Act) also will make raising additional capital more difficult. Under the Collins Amendment to the Dodd-Frank Act, certain bank holding companies will face increased capital requirements and will no longer be permitted to treat trust preferred securities as an element of Tier 1 capital. Without the ability to raise capital through the sale of trust preferred securities, it will become important for bank holding companies to develop alternative methods for raising capital.

With the growth of private-equity firms (PEFs) and their continued search for new acquisition targets, financial institutions should consider the potential for private-equity investments as one alternative. However, PEFs looking to invest in banking organizations face unique considerations as a result of the highly regulated environment in which financial institutions operate. Accordingly, financial institutions as well as PEFs must take special care to assure that private-equity investments in financial institutions are properly structured.

Tier 1 Capital

As a result of the Collins Amendment, trust preferred securities have been eliminated as an element of Tier 1 capital for bank holding companies with assets of $500 million or more. To mitigate the effect, existing trust preferred securities issued before May 19, 2010, are grandfathered in for all bank holding companies with less than $15 billion in total consolidated assets as of Dec. 31, 2009. Bank holding companies with $15 billion or more in total assets have three years to phase out their trust preferred securities, beginning on Jan. 1, 2013. As many bank holding companies of all sizes rely on this type of capital at the holding company level, certain bank holding companies will need to find replacement Tier 1 capital in order to comply with regulatory requirements.

Tier 1 capital typically includes common stock and certain types of preferred stock. Preferred stock meeting the requirements of Tier 1 capital must be non-cumulative, permanent, and be free from significant ongoing rights, such as the right to have the shares redeemed at a fixed time for a fixed price or the right to guaranteed dividends. As most financial institutions would desire for any new investment to constitute Tier 1 capital, investments need to be structured as common stock or limited preferred stock purchases. As a result, the cost of raising Tier 1 capital through private equity can be higher than raising other types of capital.

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In addition, as the PEF would be required to purchase the shares directly from the entity, the investment may have a dilutive effect if the new common stock is priced below book value. Such purchases also would need to be structured in a manner that complies with the requirements of the Securities Exchange Act of 1933 and relevant state securities laws.

Control Requirements

To the extent a PEF acquires a "controlling interest" in a regulated financial institution, the investment will trigger regulatory review, including a safety and soundness assessment, a consideration of the management team of the PEF, and a review of the financial resources of the PEF. In addition, to the extent a PEF obtains a "controlling interest," the PEF may itself become a bank holding company subject to certain significant reporting requirements and activities limitations. As a bank holding company, the PEF also would be required to act as a "source of strength" to its regulated subsidiaries, meaning that it could be required to contribute additional capital in the future. As a result of these regulatory burdens, PEFs will normally require that their investment be structured as a non-controlling investment.

Under existing guidelines issued under the Bank Holding Company Act of 1956 by the Federal Reserve Board, a PEF would be deemed to have made a non-controlling investment if it (a) acquires less than 25 percent of any class of voting securities of a bank holding company or less than 33 percent of the total equity of a bank holding company (so long as it does not hold more than 14.9 percent of the total voting shares of the bank holding company), (b) does not control in any manner the election of a majority of the directors of the bank holding company, and (c) does not directly or indirectly exercise a controlling influence over the management or policies of the bank holding company.

Issues for Banks to Consider

When considering whether an investment from a PEF is right for a particular financial institution, several issues should be addressed. A primary consideration should be whether the investment will qualify as Tier 1 capital. As discussed above, investments in Tier 1 capital can be more costly for the financial institutions than investments in other types of capital. Accordingly, the financial institution must consider the type of capital that is needed and whether the cost of the investment in such capital is acceptable to the institution.

Another primary consideration to be addressed prior to accepting private-equity investments is the type of PEF making the investment. As the PEF will become a significant part of the institution after the investment, the financial institution should have a complete understanding of the PEF involved, the objectives of the PEF, and the role the PEF seeks to play within the organization. PEFs take numerous shapes and sizes, and it is important that the financial institution understand the PEF involved in order to confirm that the goals and objectives of the PEF match those of the financial institution in order to ensure a successful relationship.

What All of This Means

As the need for capital continues to increase and the availability of traditional sources of capital continue to decrease, financial institutions will need to look at alternative funding sources. With the continued expansion of PEFs looking to make investments in financial institutions, banks and bank holding companies should not ignore the potential for this source of capital. If structured appropriately and in accordance with applicable regulatory limitations, private-equity investments in banking organizations might prove to be a workable and beneficial option for all involved.

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