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Could PE Investment Help Cure What Ails Wall Street?

by [Russ Banham](#)

After months of speculation, the Federal Reserve eased decades-old bank ownership regulations in late-September, permitting private equity firms to acquire bigger stakes in bank holding companies, in addition to obtaining representation on bank boards. The more liberal stance comes just in time for U.S. banks starved for capital, while assisting U.S. private equity fund desires for solid investment growth prospects domestically.

The rules impeding investments in commercial banks have been in place since the Bank Holding Company Act of 1956, legislation predicated on regulating and controlling financial institutions that had formed bank holding companies to acquire and own banking and non-banking enterprises. The rules, which ironically predate the establishment of private equity funds, served to hamper investments in a bank by limiting the managerial control a private investor could exercise over the institution. The restrictions thus ran counter to customary private equity objectives, such as the financial return of reviving a moribund enterprise. Consequently, fund investments in banks tended toward the lower end, dollar-wise, so as not to trigger the Fed's control definition.

More private equity dollars are expected to go to the banking sector in the wake of the Fed's new guidelines, which allow a private equity investor to acquire one-third of a bank's stock (up from 25 percent), including 15 percent of its voting shares, in addition to board representation. The new rules will assist commercial banks to tap a new source of ready capital as credit continues to be squeezed. "By rolling back some of these dated obstacles to investment, the Fed is allowing private investors to deliver more of what banks need," says Stephen Moseley, president of StepStone Group LLC, a La Jolla, Calif.-based private equity advisory firm. "Although the revised guidance could have gone further, it is a timely step in the direction of privatizing federal aid to the financial sector. Certainly, this is better than the alternatives—slower growth due to scarce credit and higher taxes to fund new federal programs."

For private equity funds, the eased restrictions offer a rare opportunity these days to garner significant returns by investing in a distressed business. "The loosening of these restrictions should make it easier for funds to take larger stakes in banks without running

afoul of the controlling influence problem,” says Mark Thompson, partner and co-head of the private equity practice at King & Spalding LLP, an Atlanta-based international law firm. “Many funds see good potential investments in the banking sector.”

Despite the challenge of attributing market value to complex financial instruments like CDOs (collateralized debt obligations), funds are beginning due diligence on the sector, maintains Tom Bonney, managing director of CMF Associates, a financial due diligence and consulting firm in Philadelphia. “Once these issues are resolved, private equity funds will invest (in banks) because the sector provides opportunities for above-average returns from current levels,” he says. “Furthermore, having commercially savvy business investors on bank boards should help the banks to rebalance and re-price risk based on ‘Main Street’ operating principles.”

John Forry, a principal in the international finance and taxation practice of Eisner LLP, a New York-based accounting and financial advisory firm, agrees, commenting that “with these kinds of prices and the money to invest, there is a very good upside for private equity funds that should be realizable in two to five years.” Forry adds that the financial expertise of private equity fund managers, many of whom cut their teeth in investment banking, will assist bank boards to more deeply appreciate the risk and return of complex financial instruments.

Others believe the Fed didn’t go far enough in drafting the new guidelines. “It’s just an olive branch to tease private equity to invest,” says Dory Wiley, president and CEO of Commerce Street Capital LLC, a Dallas-based merchant banking firm. “The additional control provided is limited; the truth is that no one controls a bank other than regulators.”

But, Moseley counters that even an “evolutionary adjustment is better than no adjustment.”

The big question is whether or not the investment dollars offered by private equity funds will be enough to calm financial waters. Moseley is doubtful. “Private equity capital pools are large, but only a fraction of that capital could or should be deployed to build and support banks,” he explains. “A broader and massive rescue strategy, as the Fed and Treasury Department have proposed, is needed. Let’s just hope that Congress resists the temptation to saddle the banking sector with more regulation in their effort to help. In times of crisis, we tend to see more regulation, not deregulation.”

Nevertheless, the time is ripe for investment now. “After the values re-improve, I would expect private equity to go do other stuff—they’re not going to be satisfied on the returns of a deposit-taking institution,” says Forry. “That’s just not how they make their money.”