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PRIVATE EQUITY BANK INVESTMENTS: STRATEGICALLY MANAGING THE REGULATORY PROCESS

CHRISTOPHER J. ZINSKI

In this article, the author identifies the steps a private equity firm should take to strategically manage the regulatory process if it intends to be the lead investor in a distressed bank with a 24.9 percent stake or a larger stake that involves registration as a bank holding company.

Private equity (“PE”) money has invested successfully in distressed-open banks during the current credit cycle downturn, although it has proven to be a difficult process. In reality, the number of PE-sponsored bank recapitalizations has been limited, despite the hundreds of banks pursuing private capital injections to stave off receivership. While PE has broken through on the investment side, whether PE ultimately exits these investments successfully is an open question. Nevertheless, the amount of PE money available to fund open bank recapitalizations continues to grow because of the lack of alternative investment options and the perceived return potential in the banking sector, given the current financial and regulatory climate. With bank valuations at historical lows, institutional investors believe the environment is ripe for once-in-a-lifetime investment opportunities.

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THE CONVERGENCE OF SUPPLY AND DEMAND

Supply and demand have converged. There is an abundant supply of PE capital available to invest in the banking industry, and it has been met with overwhelming demand from hundreds of distressed banks that must complete a recapitalization transaction to avert imminent or eventual failure. PE correctly perceives the strategic roll-up opportunity in the heavily distressed banking sector that will, sooner rather than later, emerge from the current credit cycle.

The typical PE business model involves acquiring a distressed-open bank at a bargain price, completing the bank's recapitalization and returning the institution to a long-term viable state. The recapitalized charter is then used to execute a roll-up strategy that includes acquiring additional distressed banks on an open bank basis or failed banks in FDIC-assisted acquisitions with the benefit of FDIC loss-share protection.

When PE acquires the first bank in a distressed-open-bank acquisition and uses it as a “platform” bank, it overcomes a significant entry barrier to the banking industry and paves the way for PE to make additional bank acquisitions, including perhaps the most valuable option of all — bidding on failed banks in FDIC-assisted acquisitions with loss-share protection. PE cannot bid on failed banks without a banking charter; it needs a platform bank or a shelf charter, which is difficult to obtain and rarely granted to PE. Accordingly, PE firms with an investment interest in banking are likely to continue to pursue distressed-open-bank acquisition opportunities as the most realistic route into the sector. The opportunities to create and grow a banking franchise in the current environment are plentiful, but distressed bank investing is enormously challenging.

SELECTIVITY AND TRIAGE OF THE TARGET BANK

Getting the credit marks right is the threshold issue and clearly the most important focus when PE examines a distressed bank for investment. The credit mark drives the determination as to whether or not the target bank has positive tangible equity on its balance sheet. Positive equity is typically a prerequisite in making an open-bank recapitalization work because investors have

no desire to use their fresh capital to fill a hole in the balance sheet. Besides the credit marks and analysis of pro forma bank equity, other factors influence PE's investment decisions when triaging a particular property for investment.

PE has to conclude that the target bank has franchise value. One factor is whether the bank has adequate pre-provision and pre-tax operating profit; that is, PE evaluates whether the bank makes money despite its credit costs. Franchise value is also assessed based on the quality of the target bank's core deposits, the strength of its net interest margin and the quality of its branch network. The value of the core franchise will determine whether the bank has staying power to survive long enough so that PE can complete its due diligence, negotiate a purchase agreement for the acquisition and get all necessary regulatory approvals to close the acquisition.

To this last point, PE gets nervous about how much runway the distressed bank has before the FDIC seizes it. There has to be an adequate amount of time to assemble a deal before the bank is seized; otherwise, PE will not invest its time, money and resources in pursuing the recapitalization. Assessment of the bank's core franchise affects PE's attitude in other ways as well.

The core franchise value affects PE's evaluation of the potential upside to its investment. Thus, while pre-provision and pre-tax operating profit and net interest margin are important in buying time to complete a transaction and staving off receivership, these metrics are also fundamental to PE's perception of its ability to drive adequate investment returns post-recapitalization. Given the number of distressed banks seeking capital and the multiple factors PE has to evaluate in selecting an ideal investment target, PE has to be very selective in its evaluation of target bank investments.

Quick triage of the target bank's timeline to failure is critically important because PE needs to be selective in the investment opportunities it pursues. It takes several months from beginning to end to complete a bank recapitalization, thus understanding whether the target bank has months left before receivership is the opening question. Basic triage starts with understanding where the target bank stands in relation to regulatory enforcement actions and directives.

Typically a distressed bank will be under a consent order, written agreement or another form of formal enforcement action with its regulatory authority mandating that it raise capital within a defined period of time (for instance, 60 to 120 days) and in amounts higher than capital levels required

by regulation. A further step in the regulatory enforcement process involves the imposition of a prompt corrective action (“PCA”) directive on the bank, whereby the regulators order it again to raise capital within a short period of time or risk seizure. These regulatory enforcement actions, the timelines set forth in those actions for compliance and the bank’s standing with the regulators are indicators of the timeline to failure.

Further complicating PE’s analysis of a particular distressed bank investment opportunity is the debt of the target bank’s holding company, which may include trust preferred securities (“TRuPs”), a senior, secured credit facility with another bank, TARP payable to the U.S. Treasury or a combination of some or all of these debt instruments. Whether the consent of some or all of these stakeholders to a recapitalization transaction is required and, if so, whether that consent can be obtained are other early questions for PE to consider and influence how PE plans to structure its capital investment.

THE CASE FOR STRATEGICALLY MANAGING THE REGULATORY PROCESS

Many PE firms have deep experience making bank recapitalization transactions work and others have less experience. The current climate and early success of a few PE firms in realizing quick, large investment returns in buying distressed-open banks or failed banks has provoked the interest of many PE firms toward investing in banks. The opportunities are plentiful but for the PE firms that have had little prior experience in the banking sector, understanding the regulatory environment is a precondition to executing a successful investment strategy.

The bank regulators are the gatekeepers in recapitalization transactions. They control the timing of a bank’s receivership and whether a particular PE firm will be allowed to control a bank. Any PE firm interested in successfully completing a bank recapitalization, therefore, needs to understand the regulatory environment and the regulators’ mindset. Moreover, given the complexity of bank recapitalizations and the regulators’ control over the bank’s runway to failure, engaging the regulators early and effectively is important to navigating the normal regulatory encumbrances to completing a transaction.

For PE firms new to the banking space or firms that have unsuccessfully

pursued bank recapitalizations, this article is intended to identify a short list of steps to take in strategically managing the regulatory process if a firm intends to be the lead investor with a 24.9 percent stake or a larger stake that involves registration as a bank holding company. PE success in managing the regulatory relationship requires understanding how the regulators think and their sensitivities and identifying a credible prospective CEO who will run the recapitalized bank. Success also requires taking tactical steps that acknowledge the tension the regulators feel between allowing time for PE to save a distressed bank from failure and the regulator's statutory duty to put a bank into receivership and control the losses to the insurance fund.

UNDERSTANDING THE REGULATORS' MINDSET

The federal and state banking agencies have their hands full supervising distressed banks, issuing and monitoring enforcement actions and moving banks into and through the receivership process. The FDIC's list of problem banks is close to 1,000 and the number of bank failures in the current cycle has reached 345, with many more to follow in 2011 and 2012.

These are busy people, so respecting their valuable time is a tenet in discourse with them. They also have to cope with political pressure in the current environment and this influences their thinking and conduct. Understanding the regulators' sensitivities is the first step for PE in assembling an effective strategy for approaching and working with them in a distressed bank recapitalization transaction.

The U.S. Congress, the media and main street have the regulators under a microscope, asking probing questions about failures in bank supervision that led to a distressed banking industry and hundreds of bank failures that are costing the FDIC insurance fund billions of dollars. Bank regulators tend to be risk averse by nature and the heightened political scrutiny in the current environment enhances their aversion.

For regulators, much is at stake right now — funding levels, personal careers and even their very existence, which the demise of the Office of Thrift Supervision illustrates. When a PE firm approaches the regulators in a bank recapitalization seeking approval to acquire control of a distressed bank or to petition the regulators to conclude that a particular ownership interest does

not constitute control, understanding the regulators' workload, risk aversion and bias informs the strategic approach.

The regulators are appropriately cautious about PE money flooding into the banking industry, which some have construed as a bias against PE investments. Fundamentally, PE wants to invest in a distressed bank because of the substantial return opportunities over the normal five year investment horizon, and this creates tension because permitting the arbitrage of bank charters is not a part of the mission statement of the agencies. Moreover, there is a perception that Wall Street created the crisis in the banking industry and, consequently, there is a bias against letting Wall Street profit from the disaster.

A PE firm can be quickly and permanently dismissed by the agencies and its investment opportunities derailed based on a few simple mistakes. Avoiding those missteps and designing an effective strategy for engaging the bank regulators will help to ensure that any PE firm has the chance to participate in the once-in-a-lifetime recapitalization and other investment opportunities presented by the wide scale distress in the banking industry.

First, pick the best time to spend time with the regulators. The best time is typically when a particular recapitalization transaction is pending and the PE firm concludes, after due diligence, that it has a strong interest in the particular target. Meeting with the regulators just to introduce the firm without a specific transaction is not as worthwhile as when the PE firm is presenting itself as a legitimate, real time solution to a possible failed bank situation.

Regulators are skeptical whether PE will actually put its money up, a skepticism bred by many unfilled promises in recapitalization proposals. Thus, demonstrating the firm's commitment to a particular deal and available funds to make the investment earns credibility. This is not to say that an introductory call by a legal or other representative of the PE firm to the regulators early on in a proposed transaction is not worthwhile. The purpose of that call would be to give the regulators a heads-up that the firm is interested in the property and background information on the firm. The call, however, needs to be thoughtful and carefully handled.

The introductory call can be an effective way to lay the groundwork for an eventual in-person meeting when the PE firm's investment interest in the target turns from conceptual to tangible. This approach acknowledges the work demands the regulators are under, making judicious use of their time,

and puts the firm in front of the regulators when the regulators have something very specific and positive to react to — an investment proposal to save a particular institution.

Second, PE should talk to the regulators about how its capital contribution can save and recapitalize the bank, the quality and credentials of the post-recap management team, the nature of the prospective business plan and how the firm will ensure the bank operates on a safe and sound basis after the acquisition. These are the basic regulatory “hot buttons” and the discussion with the regulators around these points needs to be carefully scripted in advance of any meeting. The discussion should not emphasize investor returns or time horizons to exit. If the PE firm has identified its CEO candidate, who will run the bank post-recap, that individual will understand these hot buttons and can coach the principals of the PE firm on the language used in meeting with the regulators. Alternatively, the PE firm can retain experienced bank regulatory counsel to prepare for the dialogue with the agencies over the investment opportunity.

Preparing to address the regulatory hot buttons cannot be simple window dressing. The fundamentals of bank regulation require that the PE firm understand and adhere to the basic tenets of sound banking practice and incorporate those themes in all key decision-making from the identification of senior management for the target bank post-recap to the development of the post-recap business plan. These themes need to be echoed not only in direct dialogue with the regulators but in the interaction between the PE firm and the target bank management and its advisors. The regulators will be very sensitive to PE’s approach in a particular transaction and all of the activity they observe needs to support PE’s sensitivity to safety and soundness concerns.

The third guiding principle for getting the relationship with the regulators right in the first instance is that going solo is usually not the preferred approach. Rather, using a seasoned liaison as a point of contact with the regulators is advisable, whether an accountant, lawyer, consultant or investment banker. Find a professional who has a solid, credible relationship with the regulators and use that professional as part of the team that engages the regulators in the particulars of a PE investment. The best liaison, of course, is a former bank CEO who has been selected by the PE firm to become the CEO of the distressed bank post-recapitalization. Such a CEO is a person

the regulators will be comfortable with because of their familiarity with the person and the prior relationship based on trust and confidence.

Finally, be prepared for the meetings and listen to the regulators' concerns. Most of the concerns will be reasonable and easily addressed. Understanding that the regulators hold the keys to the kingdom is a fundamental sensitivity that lays the groundwork for a constructive and successful relationship.

THE PROSPECTIVE CEO MATTERS

Successful recapitalizations need many things but capital and a great CEO are the top two priorities. One without the other makes success impossible. The practical problem is that the CEO of the distressed bank is often the one taking a lead role in the recapitalization with the investment banker for the distressed bank. But the incumbent CEO is also the one who led the bank into its distressed state in the first place. For that reason, it is unlikely the current CEO will be PE's first choice to lead the bank after the recapitalization. As the recapitalization transaction develops, there will be a natural point when CEO succession needs to occur.

Whatever the source, PE needs to start thinking early about the CEO for the recapitalized bank, identifying candidates and nurturing relationships with those candidates. Some PE firms have former bank CEOs in their firm or as advisors or the firm maintains a list of CEO candidates, all good sources for the recruitment purpose. Showing up with the money to recap a distressed bank is important but doing so without the prospective CEO will stall the approval process. The regulators will want to know and vet the CEO candidate thoroughly. A strong candidate can ease the regulatory approval process for the recapitalization.

Not all former bank CEOs are created equal and few candidates meet the definition of "strong." The ideal candidate is one who has served successfully before as CEO of a bank the size of the bank being recapitalized (or larger) and one the regulators know and trust. CEOs that have turned around distressed banks successfully make great candidates for PE, but these CEOs are scarce and in high demand. In some cases the regulators will endorse a former bank CFO or chief operating officer who does not have prior CEO experience so long as the regulators are confident the executive's prior

experience prepared the executive to be a CEO.

The business plan of the recapitalized bank also matters in the CEO selection. If the plan envisions steady growth through acquisitions, a CEO candidate with merger and acquisition experience would be valuable. Likewise, selecting a CEO candidate who has run a bank the size that the recapitalized bank is projected to be in five years is valuable, too. Selecting the CEO for the new bank early on is critical for another reason — time expended searching for a CEO can take precious time and puts the target bank increasingly in harm's way as the runway to receivership shortens.

While having a first class CEO onboard early can help a PE firm navigate through the regulatory approval process, this is not always possible. A backup plan that can be effective if a CEO has not yet been identified is for the PE firm to volunteer several individuals who will become members of the board once the bank is recapitalized, individuals with prior banking experience. The regulators will give the firm credit for this experience and will be confident in their CEO search criteria. Former bank CEOs, senior bank officers or board members make good candidates for the new board and further substantiate the PE firm's credibility with the regulators. The reputations, trustworthiness and prior business success of those prospective directors may also help the PE firm buy time with the regulators — thus postponing the bank's failure while the firm completes its due diligence, negotiates the purchase agreement and seeks regulatory approval.

THE SHRINKING REGULATORY RUNWAY

A successful PE investment needs to consider the time remaining before the bank fails, and the investment activity needs to be managed in light of this timeline. As mentioned, it takes time to get a recapitalization done, often many months of due diligence, document negotiation and regulatory approvals. Distressed banks have limited time left before they fail and understanding the timeline and buying more time from the regulators if necessary is always a priority.

Building a constructive working relationship with the regulators early may postpone the failure date if the regulators believe the bank can legitimately be saved by PE's investment and the contingencies to close are reason-

able. But PE cannot expect the regulators to postpone the failure indefinitely or make absolute commitments that give PE sufficient time to close a recapitalization transaction. It is important that PE understand the regulators' perspective about the timeline to failure, the length of the runway left and the regulators' view of risk and their statutory duty, all in the interest of managing the investment timeline and PE's time and resource commitments.

If PE is serious about investing in a distressed bank and the regulators give that intent credibility, the PE firm will have the opportunity to request and receive assurance from the regulators that they will give the firm time to get a deal done and not take the bank down in the meantime. Without that kind of assurance, PE will often terminate its discussions. The discussion with the regulators, however, begins with an understanding of the bank's position in relation to a receivership event.

Distressed banks in need of a recapitalization by PE are fighting for their very survival in most cases. Their capital levels have been depleted through large and continuing credit costs and, consequently, the regulators are moving them down the prompt corrective action ladder toward failure. As the bank's capital levels decline from adequate to under, significantly under and critically undercapitalized, the bank will face a prompt corrective action directive that will further erode franchise value and in virtually all cases telegraph its failure. A distressed bank is a disintegrating company, plain and simple. There is a predictable timeline to a bank's failure. PE's capital injection has to be significant enough to create a bank that has long-term viability and extinguishes any failure risk. The regulators will need to give PE assurance that the amount and timing of the capital injection ensures the bank's ultimate survival because PE will not put its capital at risk in an unstable balance sheet or uncertain regulatory outcome.

If a PE firm is not cognizant of the regulators' process for failing a bank and the amount of runway remaining to get a transaction signed up, the firm risks spending enormous amounts of time, money and energy only to find the bank seized while its recapitalization activities are in full swing. Prudent PE firms will pass on a recapitalization transaction or suspend their activities when it is apparent that receivership is highly probable and the reasonable amount of time necessary to complete all the steps necessary for the firm to execute a definitive purchase agreement and collect its money in escrow is in-

sufficient to intercept the seizure. Determining this inflection point is critical to the firm's financial risk management.

Each failed bank costs the FDIC insurance fund millions of dollars. The longer a distressed bank is allowed to remain open when prompt corrective action has been ordered, the more the resolution is likely to cost the insurance fund. Yet, the regulators understand that some banks can be saved through private capital injections, and, accordingly, they want to encourage and support viable investments. Inevitably in distressed bank recapitalizations there is a tension between the time given the bank to find a recapitalization solution and the risk that closure delay will increase the resolution cost to the taxpayer.

This risk equation makes regulators uncomfortable, and they have become increasingly skeptical in bank recapitalization transactions as to whether the PE investor can or will deliver the promised capital. Stated differently, when a bank is sliding toward receivership it is difficult to overcome the regulators' presumption that it is more likely than not that the bank will fail even though recapitalization efforts appear robust and institutional investors seem interested in investing.

There are several regulatory markers that PE firms should observe when assessing the length of runway left before receivership and therefore whether to commit resources to assessing or continuing to assess the investment opportunity. If the distressed bank is under a consent order, written agreement or other enforcement action, the PE firm should make an early assessment of the progress the bank is making in complying with the enforcement action and the time the action gives the bank to increase its capital levels to the new, higher thresholds set forth in the order. This assessment will be an indicator of the timing of a PCA Directive.

When a PCA Directive is issued against a bank, the runway to failure has shortened dramatically and PE needs to be extremely cautious about its time and resource investment. The time to raise capital under a PCA Directive can range, typically, between 30 and 90 days. Obviously a 90-day reprieve is better than something shorter and while receivership is not necessarily imminent at the end of the capital-raising deadline, it does mean time is quickly running out for a capital solution. If the bank's leverage ratio has fallen below two percent, the bank is critically undercapitalized and by statute must be put into receivership within 90 days. Thus, it is important for PE to monitor the

bank's capital in relation to the two percent threshold and have a good sense of where the bank's leverage ratio will stand at the next couple of quarter ends.

The stability of the core franchise is another important marker for PE to observe. The liquidity position of the distressed bank needs to be examined and if it is declining or below the 15 percent range, this is a negative sign that may suggest the regulators will be reluctant to give the bank more time to find a capital solution. The regulators fear customers lining up outside branches withdrawing their money, the media attention that would create and the systemic risk to the banking system of that kind of panic. Thus, forestalling a liquidity crisis is important in arguing that a bank should have more time to close on a PE-initiated recapitalization plan. While capital is critically important for a distressed bank, the priority typically becomes liquidity in the final months of the bank's existence, and it needs to be aggressively managed to prolong the bank's life. Too many banks wait too long to put a crisis liquidity plan in place and so when the bank weakens under the stress of regulatory orders and negative media coverage, it does not have the time or the tools available to enhance liquidity at exactly the time more liquidity is needed. The regulators observe these trends and will be reluctant to postpone receivership when liquidity in the final months is weakening and appears to be improperly managed. Such balance sheet mismanagement raises another issue: the regulators' view of management competence and credibility.

The credibility of management is important in understanding how fast the regulators may act in moving a bank toward receivership or how much grace time they may permit if PE has a serious interest in saving the bank. In many cases, management has lost credibility with the regulators and it is also not unusual that the relationship has become hostile or unconstructive. In that case, the regulators are less likely to give the bank additional time to get a deal done and more likely to move on their clear path toward receivership. If PE is paying close attention in its due diligence process, it will receive signals about management's standing with the regulators.

Observing and thoughtfully considering the regulatory markers that influence the time left before receivership is important. Closing a PE-sponsored recapitalization takes time and it always takes more time than anyone expects. Developing an early view of the runway remaining can help PE succeed in persuading the regulators to grant more time for the bank's salvation or give

PE the information it needs to determine that a commitment of money and time to the particular target property is unjustified given the time constraints. In any event, attention to the runway at all times is central to managing a successful outcome.

CONCLUSION

The tension that exists between the public appearance of letting PE money into the banking industry and the need to save taxpayers millions of dollars by promoting a private sector solution to an impending bank failure is not easy for risk-averse regulators to manage. For PE to be successful in investing in distressed banks, it needs to approach the regulators strategically with a thorough understanding of the regulators' mindset and priorities.

The first impression PE makes on the regulatory agencies is often a lasting impression, so setting the relationship in motion correctly from the beginning is important. If the regulators believe that the PE firm understands their sensitivities and is willing to work cooperatively and with a high degree of transparency, PE investors can succeed in winning regulatory support and approval for distressed bank investments. Conversely, the firm that focuses its discussions with the regulators on its projected investment returns, time horizon to exit and bank charter arbitrage is going to be discredited in its regulatory relationship and likely unsuccessful in investing in the banking segment.

Everyone, including the regulators, understands that PE is attracted to distressed bank investments because of the significant returns that can be achieved right now by buying low and selling high. But how that investment return is accomplished, given the regulators' need to enforce safety and soundness principles, is of paramount importance. The successful, experienced PE firms in the banking sector get it. The newcomers (and there are many) are well advised to spend the time necessary understanding the sector and its regulatory dimensions before pursuing their first distressed bank investment. The regulators are the gatekeepers to bank charters and they are looking for private sector solutions to solve the problems of hundreds if not thousands of distressed banks. Like in all relationships, understanding the needs of the counter-party — the regulators in this case — is the first step to a successful PE investment strategy.