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Private Equity Can Save the Banks

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In recent months a major U.S. investment bank has failed and the global financial-services industry has announced over $350 billion in losses. In response, banks and other financial-services firms have had to raise close to $330 billion in new capital.

It may be tempting to think the worst is over, but this is only the beginning. The International Monetary Fund recently estimated that the global financial sector can expect to realize nearly another $600 billion in losses, while some economists have projected the figure will be closer to $1 trillion. In any case, it is clear that the financial-services industry will continue to need unprecedented amounts of new capital over the rest of this year.

Over the past 20 years, private equity firms have demonstrated the ability to shoulder risk and to improve the efficiency and profitability of the companies they invest in. They are exactly the kind of investors we should attract to the financial-services industry. Restrictions and disincentives, however, dramatically and unnecessarily reduce the pool of capital available to the industry. In addition to increasing the industry's cost of capital, these limitations increase the risk that taxpayers will ultimately be called on to assume some of these burdens.

Recapitalizing troubled financial institutions in times of stress is particularly difficult due to the lack of transparency available to traditional sources of capital – namely, public markets. The financial disclosure available to public investors, while perfectly adequate in normal times, is insufficient to comfort investors in times of stress and price volatility. Furthermore, the extent to which the industry overleveraged in the years leading to this bubble has made it susceptible to rapid and breathtaking deteriorations in value, as was recently the case with Bear Stearns.

As a result, while public investors acted as the primary providers of capital to the industry's initial recapitalization wave, their appetite for continued investment appears increasingly constrained. According to a recent report by Goldman Sachs, of the 42 equity issuances undertaken since July 2007 by U.S. financial institutions, 39 are trading below their issue price. When taken together, the implied losses to investors from these transactions could exceed $35 billion.

Private sources of capital on the other hand, have the time, resources and capability to evaluate the assets of financial-services firms and make informed investment decisions. For this reason, the industry has increasingly turned to private equity as a capital source, as has been the case in the recent recapitalizations of Washington Mutual and National City Corporation.

With more than $400 billion in available funds, private equity represents a large pool of untapped capital for the financial-services industry. Yet an array of regulations and administrative interpretations limits private equity's ownership and influence in regulated depository institutions. While these measures were largely designed to safeguard the separation of depository institutions from industrial enterprises, the policies underlying these rules have limited applicability to the private equity industry.

The law generally prohibits an entity that controls commercial firms from owning more than 25% of the voting stock of a banking company. In practice, the limit is much lower. If an investor seeks to appoint even one director to the board of a banking company, the investor is limited to a voting equity stake of

less than 10%. Even if the investor is willing for all or a portion of its investment to be completely nonvoting, its total ownership position is usually restricted to 15% or less.

Moreover, current regulatory practice would prohibit most of the common safeguards and governance rights for a private investor making a substantial new capital infusion. But these restrictions can be easily amended to provide the financial-services industry with the necessary access to private sources of capital, while maintaining the requisite structural safeguards.

The law has been interpreted to impose limitations on how much a private equity firm may own of a banking company. But the law also recognizes that private equity firms are not operating companies making strategic investments with unlimited holding periods. They are funds making financial investments for a limited period of time, and as a result the potential for concentration of economic power and conflicts of interest – which drives these control restrictions – is much less.

Still, even if a controlling investment could be structured around these limitations, it would face an even greater barrier in the "source of strength" doctrine, which exposes a controlling entity to potentially unlimited loss. Designed to ensure that the long-term operators of a depository institution stand ready to support it, this doctrine should not be applied to new investors proposing to provide fresh capital to a troubled institution. The unlimited liability entailed in the "source of strength" doctrine serves as a powerful deterrent to potential new capital.

We are not contesting the longstanding policy of drawing a line between banking and commerce. But the limitations on capital investment are far stricter than necessary to maintain these barriers, and can be amended by administrative intervention that is entirely consistent with the existing laws governing the country's depository institutions.

Private equity is ready and willing to step forward in large amounts – restoring lending capacity, encouraging efficiency, and protecting the taxpayer. The Federal Reserve and other banking regulators can help remove obstacles to this important pool of capital.

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