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John Coates

David Scharfstein

Essay

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John Coates†
David Scharfstein††

Efforts to recapitalize banks in the current crisis have been, to date, focused on government assistance under the Troubled Asset Relief Program (TARP), rather than private investment, and on bank holding companies, rather than banks. We describe three alternative or complementary approaches designed to lower the cost of bank recapitalizations by drawing in funds from the private sector and focusing on banks: rights offerings, debt restructurings, and FDIC-assisted bridge banks. Each approach was used in dealing with problem banks in the 1990s; each can be pursued without additional legislation; and each is worth considering now. We also propose two legal changes that would assist bank recapitalization: (1) the Federal Reserve should further modestly relax its rules under the Bank Holding Company Act to eliminate the presumption of "control" by investors at the current threshold of five percent, which would permit more capital to be invested in banks by private equity and other institutional investors; and (2) Congress should consider a new statute to streamline the recapitalization of bank holding companies by moving them outside current bankruptcy laws into a new resolution regime similar to the FDIC regime currently used for banks.

Introduction

One of the keys to improving the health of the financial sector is recapitalizing banks. Recapitalization can be achieved by a new, massive infusion of equity from the government, but this approach suffers from at least two basic problems. First, if a bank is insolvent or at risk of being insolvent, the equity infusion helps creditors before it adds to the equity capital of the bank. This transfer will add significantly to the cost of such a program. Second, the government would have to buy so much equity that it would effectively nationalize the banks, which is undesirable on both economic and political grounds.

An alternative or complementary approach would be to facilitate bank recapitalizations funded largely by the private sector. There are three basic

† John F. Cogan, Jr., Professor of Law and Economics, Harvard Law School.
†† Edmund Cogswell Converse Professor of Finance and Banking, Harvard Business School.

approaches. First, the government could pressure banks into raising large amounts of equity from private investors. Second, the government could seek a more comprehensive recapitalization through a restructuring of bank holding company debt with some debt forgiveness and conversion of debt into equity. This kind of debt restructuring is occurring now in the nonfinancial sector, and occurred in the savings and loan (S&L) crisis of the early 1990s. Because the restructuring would occur at the bank holding company level, it might be accomplished without interfering with day-to-day banking operations of the holding company's banking and nonbanking subsidiaries. Third, if equity issues prove insufficient or if it proves impossible to restructure bank holding company debt, the FDIC could intervene to take control of an insolvent bank, transferring the assets to a "bridge bank." In the process, the FDIC would provide enough capital to make bank creditors whole, but free the bank of its debt obligations to its parent bank holding company. The bank could then be sold and recapitalized. All of these approaches were used in dealing with problem banks in the 1990s, and they are all worth considering now.[1]

Even if private bank recapitalizations are insufficient, on their own, to restore the financial sector to health, facilitating private investment in banks now, as part of a second round of bailouts, will speed the eventual return of banks to the private sector. In the last part of this Essay we propose two additional legal changes that would assist bank recapitalization efforts as well as private capital raising, both now and after the financial sector returns to health. First, the Fed should relax its rules under the Bank Holding Company Act to eliminate the presumption of "control" by investors at the current threshold of five percent,[2] which would permit more capital to be invested in banks by private equity and other institutional investors. Second, more ambitiously, Congress should consider adopting a new statute to streamline the recapitalization of bank holding companies by moving them outside current federal bankruptcy laws into a new resolution regime similar to the FDIC resolution process currently used for banks.

I. Bank Holding Companies

At the largest U.S. financial institutions, all major banking activities are conducted through bank holding companies (BHCs). These entities, which are publicly listed companies, own bank and nonbank subsidiaries. For example, Citigroup owns the FDIC-insured bank Citibank, as well as numerous other subsidiaries that engage in financial activity (such as brokerage and insurance).[3]

1 *See* Edward D. Herlihy et al., Financial Institutions M&A 2009: Convergence, Consolidation, Consternation and Complexity in an Industry in Transition 127 (Jan. 2009) (unpublished manuscript, on file with the *Yale Journal on Regulation*).

2 *See* 12 U.S.C. § 1841(a) (2006).

3 *See* Citigroup, 2007 Annual Report (Form 10-K) (Feb. 22, 2008), *available at* http://idea.sec.gov/Archives/edgar/data/831001/000119312508036445/d10k.htm.

Bank subsidiaries are typically the largest subsidiaries and the most directly involved in corporate and consumer lending. The banks owned by the three largest BHCs originate or participate in over seventy percent of corporate lending to large U.S. borrowers.[4] They raise most of their funds directly (that is, not through their parent holding companies) in the form of deposits, short-term debt (commercial paper and repos), and long-term senior and subordinated debt.[5] However, a bank subsidiary also receives some financing from its parent BHC through equity capital contributions and loans. In the fourth quarter of 2008, for example, Citigroup made a six billion dollar capital contribution to its main bank subsidiary.[6]

The BHCs finance themselves with public equity, short-term debt, and long-term bonds. The assets of a BHC are mainly equity in its subsidiaries and loans to its subsidiaries. For concreteness, Table 1 shows the unconsolidated balance sheet of Citigroup (a BHC) as of September 30, 2008. Appendix Table 1 provides more balance sheet details for Citigroup and the three other large BHCs (JPMorgan Chase, Bank of America, and Wells Fargo).

Table 1. Unconsolidated Balance Sheet of Citigroup, Sept. 30, 2008, in Billions of Dollars.[7]

Assets		Liabilities	
Cash and Securities	29.6	Short-Term Debt	17.5
Equity in Subsidiaries	155.1	Long-Term Debt	146.1
Loans to Subsidiaries	136.7	Other Liabilities	6.0
Other Assets	9.4	Loans from Subsidiaries	35.3
		Equity	126.0
Total Assets	330.9	Total Liabilities and Equity	330.9

Importantly, the debt at the BHC level is "structurally subordinated" to the debt at the subsidiary level.[8] In a liquidation of a subsidiary bank, the bank's

4 Private communication from Harvard Business School Assistant Professor Victoria Ivashina to author, based on data from Loan Pricing Corporation calculated by Ivashina (Feb. 1, 2009) (on file with author).

5 Compare the BHC liabilities of Citigroup Inc., reflected in Table 1 (totaling $203 billion) with the liabilities of Citibank, N.A., reflected in Citibank, N.A., Federal Financial Institutions Examination Council Consolidated Reports, Schedule RC, line 21 (Dec. 31, 2008) (totaling $1.14 trillion), *available at* https://cdr.ffiec.gov/public/ [hereinafter Citibank Call Reports].

6 Citibank Call Report, *supra* note 5, Schedule RI-E, line 5.

7 Citigroup Inc., Third Quarter 2008 Quarterly Report (Form 10-Q) (Oct. 31, 2008), *available at* idea.sec.gov/Archives/edgar/data/831001/000104746908011506/a2188770z10-q.htm.

8 F. John Stark, III, J. Andrew Rahl, Jr. & Lori C. Seegers, *"Marriott Risk": A New Model Covenant To Restrict Transfers of Wealth from Bondholders to Stockholders*, 1994 COLUM. BUS. L. REV. 503, 517 n.52; *see generally* Henry Hansmann & Reinier Kraakman, *The Essential Role of*

debt is paid before the BHC receives anything on its capital investment in the bank, and thus before the BHC creditors receive anything from the BHC. In addition, a default of the BHC does not necessarily trigger a default by the bank subsidiary.[9] A BHC recapitalization need not trigger a run on the bank subsidiary if bank depositors and creditors could credibly be assured about these facts, nor would it trigger a default on standard bank swap contracts.[10]

II. Recapitalization Options

There are three basic approaches to recapitalizing the banks: (1) equity issues; (2) debt restructuring by the BHC; and (3) FDIC intervention followed by a sale of the bank.

A. *Equity Issue by a BHC*

In this approach, BHCs would issue equity to private investors. The combined stock market capitalization of the four largest BHCs was $238 billion as of January 30, 2009 (see Appendix Table 1).[11] While a large issue of equity might only be bought at low prices, it would still be possible for better banks to raise significant amounts of capital through equity issues, whether as public offerings or private placements. Alternatively, an equity issue could be structured as a rights issue in which existing shareholders are given the right to purchase equity at a set price. Since this right is given to all shareholders, the price can be at a discount to market or fair value, encouraging new investment, and if existing shareholders do not want to purchase equity, they can sell their subscription right to other investors who do. This form of equity issue is commonly used by European firms, which in 2008 alone raised over $100 billion in equity through rights offerings, including offerings by the Royal Bank of Scotland to raise $24 billion and UBS to raise $16 billion.[12] In the United States, rights offers were used in the restructurings of Glendale Federal Savings in 1994 (as well as a number of other troubled U.S. banks in the early 1990s) and by KKR Financial Holdings in 2007.[13]

Organizational Law, 110 YALE L.J. 387, 393 (2000) (discussing significance of "asset partitioning," which can be accomplished through a holding company structure).

9 Some contracts of the bank may specify that a default of the BHC will count as a default of the bank under the contracts, but this is not generally the case.

10 *See* INT'L SWAPS & DERIVATIVES ASS'N, INC., 2003 ISDA CREDIT DERIVATIVES DEFINITIONS (on file with the *Yale Journal on Regulation*) (defining "Credit Event" as not including the bankruptcy of the holding company of the reference entity or the issuer of the derivative).

11 *See* App. A.

12 Elena Logutenkova & Elisa Martinuzzi, *Bank Rights Offerings Reveal Need To Throw Good Money After Bad*, BLOOMBERG.COM, June 29, 2008, http://www.bloomberg.com/apps/news?pid=20601109&refer=home&sid=aUMvLmZ8gzzc; Stephen Taub, *UBS Aims for $15.5B in Rights Offering*, CFO.COM, May 22, 2008, http://www.cfo.com/article.cfm/11434978/c_11413464?f=TodayInFinance_Inside; Herlihy et al., *supra* note 1.

13 Herlihy et al., *supra* note 1, at 127.

If equity is raised, each BHC should be encouraged or required to downstream the proceeds of the equity issue to its bank subsidiaries since the goal of the equity issue is to promote bank lending. All of the U.S. Treasury's Capital Purchase Program (CPP) investments—known generally as the Troubled Asset Relief Program (TARP)—were made directly in BHCs, not banks, and there appears to have been no downstreaming requirement in TARP investments.[14] Our analysis of call reports of the lead banks of the four largest BHCs to receive the first $90 billion of TARP investments shows that as of the end of 2008, less than $15 billion had been downstreamed to the banks as equity capital.[15] By contrast, when a bank holding company, Continental Illinois, received a $1 billion preferred-stock investment from the government as part of its 1984 recapitalization, it was required to downstream the funds to its bank subsidiary.[16]

BHCs in the United States have not issued substantial amounts of new equity since the beginning of the financial crisis. We believe they have been reluctant to issue equity because of its dilutive effect on current shareholders—a general problem known as "debt overhang."[17] The primary immediate beneficiaries of an equity issue are the existing creditors of the issuing BHC, because the creditors have a prior claim on assets of the BHC, including new equity capital. For new equity offerings to be attractive to new investors, the equity would have to be priced low enough to compensate for the fact that investors lose their capital if the bank turns out to be insolvent. Thus, the price at which a BHC would have to issue equity may be too low for it to be in the narrow interest of existing shareholders. Uncertainty about the value of bank assets adds difficulty, because new investors cannot be certain that the issuer will be solvent even after the equity issues and because equity issues send a

14 *See* CONGRESSIONAL OVERSIGHT PANEL, FEBRUARY OVERSIGHT REPORT: VALUING TREASURY'S ACQUISITION app. IV (2009), http://cop.senate.gov/documents/cop-020609-report.pdf (describing legal provisions in TARP investments). In fact, TARP application guidelines appear to prohibit a BHC from applying for TARP investments in a bank subsidiary. *See* U.S. Dep't of Treasury, Application Guidelines for TARP Capital Purchase Program, at 2, http://www.treasury.gov/press/releases/reports/applicationguidelines.pdf (last visited Mar. 9, 2009) ("All capital purchases will occur at the highest-tier holding company in cases in which the banking organization has a bank holding company . . . .").

15 To review bank call reports, see Federal Financial Institutions Examination Council, Public Data Distribution, https://cdr.ffiec.gov/public/ (last visited Mar. 18, 2009) (see Schedules RI-A and RI-E).

16 The bank subsidiaries could also issue preferred and/or common equity directly to investors (as in the Glendale restructuring), but if a significant amount of equity was raised in this way the issues might require waivers from creditors to the BHC since equity in the subsidiary constitutes a primary asset of the BHC. Such waivers could potentially be obtained via attractively priced equity-for-debt exchange offers, as discussed below.

17 *See generally* Stewart C. Myers, *Determinants of Corporate Borrowing*, 5 J. FIN. ECON. 147 (1977) (describing debt overhang problem generally); Linus Wilson, Debt Overhang and Bank Bailouts (Feb. 1, 2009) (unpublished manuscript), *available at* http://papers.ssrn.com/sol3/papers.cfm?abstract_id=1336288 (describing debt overhang problem with respect to banks).

negative signal about the bank's value, further depressing the price and reducing the incentive of banks to issue equity.

While an equity issue may not be in the interest of a bank's shareholders, it is clearly in the interest of the bank as whole, that is, it is in the collective interest of all investors because it leads to a better capitalized bank that is better able to function in capital markets. These investors include bondholders, depositors, the FDIC through its insurance exposure, and Treasury through its recent purchase of preferred stock. The reluctance to issue equity is exacerbated by government rescue efforts; as long as there is a prospect of government bailout, banks will avoid private recapitalizations. This moral hazard is more immediate than the moral hazards that are typically envisioned as resulting from bank bailouts. Though less visible, this moral hazard is similar to—but economically more significant than—the decision of banks to continue paying dividends and large bonuses, all decisions that benefit shareholders and management at the expense of others. Banks will likely oppose recapitalization, as they did in prior bank crises, and will need to be encouraged or required to recapitalize through a variety of means.

The government has the tools to get BHCs to issue equity even though management does not perceive the equity issue to be in the self-interest of the BHC. For example, either the FDIC or the banks' primary federal regulators (either the Office of the Comptroller of the Currency (OCC) or the Fed) could mandate "prompt corrective action" under the FDIC Improvement Act by questioning bank capital adequacy, including whether banks have appropriately marked or reserved against their problem assets.[18] In the Glendale restructuring, the bank operated under a written directive from the Office of Thrift Supervision (OTS) that contained explicit deadlines for raising capital.[19] New private capital could be required as a condition of any additional government assistance. The government could also raise the issue of the fiduciary duty of the board. Courts have held that when a company is insolvent or nearly insolvent (known as the "zone of insolvency"), boards have a fiduciary duty not just to shareholders but also to creditors.[20] As a bank creditor, the government

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18 *See* 12 U.S.C. § 1831o (2006) (prompt corrective action (PCA) statute); 12 C.F.R. pt. 6 (2008) (PCA regulations applicable to national banks); 12 C.F.R. §§ 208.40-.45 (2008) (PCA regulations applicable to state member banks).

19 Glendale Federal Bank, FSB Current Report (Form 8-K) (June 14, 1993).

20 *Compare* North Am. Catholic Educ. Programming Found. Inc. v. Gheewalla, 930 A.2d 92 (Del. 2007) (stating that creditors may not enforce fiduciary duties of directors of Delaware companies operating in the "zone of insolvency," but once a company is insolvent creditors may sue directors derivatively) *with* Credit Lyonnais Bank Nederland, N.V. v. Pathe Commc'ns Corp., 1991 Del. Ch. LEXIS 215, at *108 n.55 (Dec. 30, 1991) (remarking that it may be both efficient and fair for directors of a company in the "vicinity of insolvency" to take actions that "diverge from the choice that stockholders (or the creditors, or . . . any single group interested in the corporation) would make"). For more information, see Henry T.C. Hu & Jay Lawrence Westbrook, *Abolition of the Corporate Duty to Creditors*, 107 COLUM. L. REV. 1321 (2007) (critiquing fiduciary duties of directors to creditors generally) and Jonathan C. Lipson, *Directors' Duties to Creditors: Power Imbalance and the Financially Distressed Corporation*, 50 UCLA L. REV. 1189, 1205–06 (2003) (discussing a New York case noting that directors of an insolvent company may owe duties to creditors).

would have standing to bring such a suit against the board. In addition to using this as a tool to encourage the equity issue, it would also serve as a measure of comfort to directors who might be concerned about the possibility of a shareholder suit. In any case, there is little doubt that if the government wants the bank to issue stock, it can get the banks to do so.

B. *BHC Debt Restructuring*

The second alternative—which would complement and assist the first—is to recapitalize by swapping debt of the BHC for equity. This form of transaction is a common way for financially distressed nonfinancial companies to reduce their debt burdens. Debt-equity swaps are less common for banks, but there are precedents for equity swaps of BHC debt. For example, in 1993, Glendale Federal, then one of the nation's largest thrifts, was required by regulators to issue stock in its subsidiary bank and exchange long-term debt of its holding company for equity in the subsidiary bank.[21] Failure to do so would have resulted in a liquidation of the bank and bankruptcy of the BHC. The equity issue and debt swap were successful, and the bank continued to operate until 1998, when it merged with California Federal, which in turn was acquired by Citibank in 2002.[22] California Federal also successfully restructured with a debt-for-equity swap in 1992.[23]

A similar approach could be taken with current BHCs, though it would be on a much greater scale. Appendix Table 1 shows that the four largest BHCs have total long-term debt of $440 billion. This number does *not* include the debt of their subsidiaries; it is just the long-term debt at the BHC level, which is structurally subordinated to debt of the bank subsidiaries. Debt of the subsidiary bank is much harder to restructure because it is mostly deposits, repos, commercial paper, or other secured debt. Reducing the debt burden of these BHCs by half the outstanding amount would constitute a significant reduction in debt and assist the BHCs in raising additional capital. This capital could come from private investors in the form of new equity, as discussed above, or new debt. Alternatively, the additional capital could come from the government, but it would be investing in a more solvent financial institution. This sort of debt restructuring would be particularly valuable for more troubled BHCs (such as Citigroup) because these BHCs will have a hard time raising significant amounts of new equity without some debt reduction.

To exchange the long-term debt for equity, a BHC would have to initiate a series of exchange offers with long-term debt holders. In an exchange offer, the BHC would offer a current bondholder a package of securities in exchange for his bond. For example, for each $1000 of Citigroup's 5.625% subordinated

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21 Glendale Federal Bank, FSB, Annual Report (Form 10-K) (June 30, 1993), at 2.

22 *See* Golden State Bancorp Inc. & California Federal Bank, www.citigroup.com/citi/corporate/history/gsb.htm (last visited Feb. 14, 2009).

23 California Federal Bank, FSB, Offering Circular (Form OC) (Feb. 14, 1994).

bond maturing in 2012, Citigroup could offer $500 of a new senior subordinated bond plus 150 shares of Citigroup. If enough bondholders agreed to an exchange of this and other bonds, the BHC would have significantly reduced its liabilities.

Although there are a number of challenges to achieving debt reduction through exchange offers, they are routinely accomplished successfully in nonfinancial firms.

Holdouts. Bondholders have incentives to hold out—that is, retain their senior unimpaired claim while others bondholders exchange their bonds for a lesser claim on the firm.[24] The most effective way to solve the holdout problem is to offer a generous package of securities in exchange for the debt. Normally, exchange offers are initiated by management to try to enhance the value of equity, so there are limits on what management can offer. However, if the goal is to put the BHC on better financial footing rather than to maximize the value of equity, the holdout problem becomes easier to solve. But achieving this goal will require the government to ensure that generous terms are offered. If the BHC (backed by the government) sets a high minimum exchange requirement and makes a credible threat that the firm will fail if the exchange is not completed, the holdout problem is alleviated (particularly if there are investors with significant holdings). In addition, BHCs could offer creditors a more senior bond in the exchange; holdouts with subordinated bonds would end up with riskier, lower-value claims and feel pressure to exchange. Finally, exchanging bondholders can provide "exit consents" stripping all negative covenants from ongoing bondholders' indentures, devaluing the claims and increasing the risk for holdouts.[25]

Large Number of Bond Issues. Another challenge is that the large BHCs have large numbers of bond issues outstanding.[26] Some are issued in foreign countries and are denominated in foreign currency. The exchange offers would have to be undertaken for each of these bonds, although there are cost-minimizing ways to make combined offers to multiple issues.

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24 Victor Brudney, *Corporate Bondholders and Debtor Opportunism: In Bad Times and Good*, 105 HARV. L. REV. 1821, 1822-23 (1992); Robert Gertner & David Scharfstein, *A Theory of Workouts and the Effects of Reorganization Law*, 46 J. FIN. 1189 (1991); Lewis S. Peterson, Note, *Who's Being Greedy? A Theoretical and Empirical Examination of Holdouts and Coercion in Debt Tender and Exchange Offers*, 103 YALE L.J. 505 (1993).

25 Nicholas P. Saggese et al., *A Practitioner's Guide to Exchange Offers and Consent Solicitations*, 24 LOY. L.A. L. REV. 527 (1991). For non-financial firms, another method is to arrange a "pre-packaged" bankruptcy in which a requisite number of the bondholders for the new securities compel holdouts to exchange their bonds, but even the fastest pre-packaged bankruptcies take weeks if not months to complete. *See, e.g.*, James P.S. Leshaw, *Acquisitions of Troubled Businesses: A Comparison of the Bankruptcy and Nonbankruptcy Alternatives*, 69 FLA. BAR J. 75, 78 (1995).

26 *See* Citigroup, Fixed Income Investors: Prospectuses, www.citigroup.com/citi/fixedincome/cds_prosp.htm (Citigroup web page listing fifty-five series of fixed-rate notes and twenty-seven series of floating rate notes outstanding as of Jan. 30, 2009) (last visited Feb. 14, 2009).

FDIC Debt Guarantees. Some recently issued bonds now have FDIC guarantees as part of the program introduced in October 2008.[27] The holders of these bonds would have no incentive to exchange.

Are BHCs Insolvent? As shown in Appendix Table 1, the assets of the four largest BHCs include cash and securities, equity in subsidiaries, and loans to subsidiaries. Some of these subsidiaries may have value even if the banks are insolvent. If the loans to nonbank subsidiaries are fairly senior, then the assets of the BHC may be enough to cover the BHC's debt obligations. In this case, bondholders of the BHC (particularly holders of senior bonds) may have little incentive to exchange unless very attractive terms are offered. Valuing the nonbank subsidiaries of the large BHCs based on information currently publicly available is difficult. Thus, efforts to pursue a debt restructuring at the BHCs will require a better understanding of the characteristics of the loans from the BHCs to their subsidiaries and of the value of the nonbank subsidiaries.

Effect on Subsidiaries. One concern is that a restructuring at the BHC could generate a run on the credit of the subsidiaries, particularly at the bank and at the broker dealer. However, this debt is structurally senior to holding company debt. Furthermore, much of this debt is either insured deposits or secured. At a minimum, the government will need to help the BHC communicate clearly and effectively that the bank's obligations are not being impaired in the BHC restructuring, and it may be useful for additional guarantees to be provided for some subsidiary debt for some limited period. Another potential concern is that default on BHC debt would trigger a default on derivative contracts entered into by the subsidiaries. As noted above, this concern is generally not at an issue as these derivatives are issued only by the bank subsidiary, and not cross-defaulted to the BHC.[28]

C. *FDIC Control and Creation of a Bridge Bank*

A final option is for the FDIC to take control of an insolvent subsidiary bank, transferring the assets to a temporary bridge bank, in advance of the sale of the bank's equity to another banking institution or a group of private investors.[29] The FDIC would own the equity of the bridge bank and—given the size and importance of the large BHCs—it would also assume all of the bank's liabilities *except* the debts owed to the parent BHC. If the bank is still insolvent after these steps, the FDIC would have to add capital in preparation for a sale of the bank. The bank would continue to function in its status as a bridge bank and would be able to meet all of its counterparty obligations, including swap contracts. Upon a sale, the bank would be recapitalized with additional equity.

27 *See* 12 C.F.R. § 370 (2008) (creating FDIC Temporary Liquidity Guarantee Program, Final Rule, permitting holding companies for insured banks to have debt guaranteed by FDIC).

28 *See supra* note 10.

29 12 U.S.C. § 1821(n) (2006) (creating authority for bridge banks); Herlihy et al., *supra* note 1, at 32-39 (discussing resolution options for failing banks).

The removal of a bank from a BHC could well leave the BHC itself insolvent. The BHC insolvency could trigger a Chapter 11 filing of the BHC or a sale of BHC assets (its nonbank subsidiaries) with partial payment of the long-term debt of the BHC.

The advantage of this approach over new equity infusions into BHCs, as with the initial TARP assistance, is that each dollar of equity that goes into the bank enhances the capital of the bank. Unlike a BHC equity issue, the equity investment does not go to support BHC debt (either the debt owed by the bank to the BHC or debt owed by the BHC). The disadvantage of this approach is that FDIC intervention might be more likely to trigger a run on the bank or nonbank BHC subsidiaries than if further assistance is provided directly to the BHC. To avoid a run on the newly formed bridge bank, it would be important to clearly communicate the government's guarantee of bank-level debts. A run on nonbank BHC subsidiaries could be avoided if it can be made clear that they are solvent financial institutions.

The bridge bank has been used in ten separate instances since 1987, when the FDIC was given the authority to set up bridge banks.[30] One of the more prominent examples of its use was in the case of Bank of New England (BNE).[31] After management failed to get concessions from BHC creditors, the FDIC transferred the assets and liabilities of BNE's three subsidiary banks into three bridge banks. Within three months, the FDIC was able to arrange a sale of the three bridge banks to Fleet. Shareholders and creditors of the BHC were effectively wiped out by the transaction. Rather than trying to preserve the holding company by propping it up with capital infusions, in this instance the government targeted the subsidiary banks for support, which made the resolution less costly than it might have been.

III. Additional Legal Changes To Facilitate Bank Recapitalizations and Private Bank Investments

The foregoing options may be insufficient to successfully recapitalize the U.S. banking system. Particularly for larger BHCs, the complexity of BHC capital structures may make voluntary debt-for-equity exchanges difficult, and without them, investors may not be willing to purchase new BHC equity. The FDIC resolution process that has worked in the past may not be workable if bank counterparties are unwilling to continue doing business with FDIC bridge banks, if the bankruptcy of the BHC and its nonbank subsidiaries would be too disruptive on their own to the financial markets, or if the interrelationships between a BHC's banks and its nonbank subsidiaries are too important for the continued health of the banks to allow the FDIC to leave the nonbank assets

30 *See* FEDERAL DEPOSIT INSURANCE CORPORATION, MANAGING THE CRISIS: THE FDIC AND RTC EXPERIENCE 1980-1994, at 172 tbl.I.6-2 (1998), *available at* www.fdic.gov/bank/historical/managing/contents.pdf.

31 *See id.*

behind. Significant new government bank assistance may thus be necessary, at least in the near term.

But even if that is the case, few will dispute that government ownership or investments in the nation's largest banks is not a good long-term solution, or that eventual resale of those investments to the private sector will be required. To that end, two sets of legal reforms would facilitate those re-privatization efforts.

A. *Relaxation of Fed Control Regulations*

Under the Bank Holding Company Act (BHCA), no company may acquire "control" of a bank without prior regulatory approval and, more importantly, without divesting itself of nonfinancial activities.[32] The Fed is charged with implementing these general requirements with detailed regulations that specify precisely what "control" means. The Fed has long taken the conservative position that it will presume that "control" exists upon the acquisition of five percent of a bank or BHC's voting securities.[33] While the Fed permits prospective acquirers to propose contractual or other arrangements to rebut this presumption in the context of large "stake-outs" by one BHC investing in another, it has also been conservative in what it has approved as non-controlling investments. The Fed's regulations and its interpretations of them have made it difficult for anyone to make large minority investments in BHCs, and even though the Fed issued new guidelines in September 2008 that permit investments of up to fifteen percent of voting shares, acquirers must still negotiate with the Fed over precisely what limits on the control and influence such an investor must agree to in order to eliminate the risk that the Fed will find an investor to be in "control" of a bank.[34] These difficulties have been most acute for troubled or undercapitalized BHCs, when a prospective investor typically will want (for good business reasons) to impose contractual restrictions or acquire limited oversight powers (for example, one or two board seats). While the Fed's recent guidelines relax the ban on board representation for non-controlling investors, they do not significantly relax prior restrictions on negative covenants.[35]

The Fed's control regulations have posed particular difficulties for private equity funds. That is because such funds typically have controlling investments in nonfinancial institutions, and so cannot legally become BHCs. Such funds

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32 12 U.S.C. § 1843(a) (2006). The repeal of the Glass-Steagall Act, which separated investment and commercial banking, left in place the separation of banking and commerce under the BHCA.

33 12 C.F.R. § 225.11(c) (2008).

34 Policy Statement on Equity Investments in Banks and Bank Holding Companies, 12 C.F.R. § 225.144 (Sept. 22, 2008), *available at* www.federalreserve.gov/newsevents/press/bcreg/bcreg20080922b1.pdf; Herlihy et al., *supra* note 1, at 28 (noting, in particular, that the new guidelines "do not address the circumstances under which the Federal Reserve would treat multiple investors in a bank as a single controlling investor").

35 12 C.F.R. § 225.144 (2008).

have grown to a scale in recent years that makes them an important channel for capital investments of the largest size in the United States. In the current economic and financial environment, they have relatively few good target investments because they typically have depended on borrowed funds and the prospect of an "exit" from their investments via public offerings, neither of which are or will be readily available in the near future. Even as the funds are sitting on massive unused capital commitments, which for many funds will begin to expire over the next several years, they are unable to invest in banks because of the Fed's regulations, even though successfully recapitalizing banks and facilitating a revival of bank lending would benefit the private equity funds in all of their future investments. In short, a large source of private capital with heightened interests in rescuing the banks is legally blocked from doing so.

Legal reforms need not be drastic to permit significantly greater private equity investment in BHCs and banks. The Fed could, for example, double the current "control" threshold from five to ten percent. This would be consistent with the approach long taken for thrifts, both currently by the OTS and by its predecessors.[36] Because the OTS has this only slightly more relaxed approach to the definition of "control," the FDIC was able to sell the failed IndyMac to a consortium of private equity investors last year. This transaction worked because IndyMac was legally a thrift, not a bank—a fact likely unknown to many of its depositors. On such technicalities reform of our current financial system hangs. More generally, the Fed should revisit its overall approach to non-controlling investments in the current crisis. It would seem reasonable to permit larger investments (up to ten percent) for up to five or ten years without triggering any need to negotiate with the Fed over control presumptions, and to adopt clear rules about when and how groups of investors will and will not be deemed to be working in concert. It seems odd, moreover, for the Fed to turn to obscure statutory authority not used since World War II to dramatically expand its balance sheet and assist non-banks such as AIG,[37] but not consider relatively modest changes to its own interpretations of its own control regulations.

B. *A New BHC Resolution Procedure*

More ambitiously, it would also make sense for Congress to develop a new method for resolving troubled bank holding companies. Currently, a BHC is treated as if it were any other company under the federal bankruptcy laws.[38] While current FDIC procedures for resolving banks—partly summarized above—have worked reasonably well for banks, BHCs have been left to the normal lengthy court-supervised bankruptcy procedures applicable to garment

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36 12 C.F.R. § 574.4(b), (c) (2008).

37 *See* Press Release, Bd. of Governors of the Fed. Reserve Sys. (Sept. 16, 2008), *available at* www.federalreserve.gov/newsevents/press/other/20080916a.htm (providing new guidelines).

38 *See, e.g.*, Howell E. Jackson, *The Expanding Obligations of Financial Holding Companies*, 107 HARV. L. REV. 509, 529-30 (1994) (describing MCorp bankruptcy after the Fed sought to have the holding company recapitalize its banks).

companies and airlines.[39] Yet BHCs and their capital structures have become much larger and more complex since they were permitted in 1999 to acquire investment banks and insurance companies. Today's BHCs are thus neither fish nor fowl: too fragile to sustain the routine workout process for nonfinancial companies, and too large and complex for the FDIC to ignore if their banks become insolvent or approach insolvency. The design of a new BHC resolution statute will be complex in details, but it should be simple in concept. It should simply replicate for BHCs the existing FDIC procedures for banks—which were designed on the principle that if the government is the ultimate guarantor of the banks' debts, the government should have a method for rapidly closing and reopening banks to minimize the disruption the process imposes on the economy. If, as seems increasingly likely, some BHCs are too big for the government to permit them to fail, then the same principle should justify the same method for resolving BHCs.

Conclusions

Our conclusions are straightforward. Banks need to be recapitalized. Shareholders and management have insufficient incentives to recapitalize. The government should encourage or require recapitalization and has the regulatory and legal means to do so. Some recapitalization can be achieved by issuing additional equity in public capital markets. This will be less effective for more troubled banks.

A more significant recapitalization can be achieved by converting the long-term debt of bank holding companies into equity. There is precedent for this sort of recapitalization in the restructuring of S&Ls in the 1990s, though the size and complexity of today's troubled bank holding companies raises challenges that need to be addressed.

If equity issues are insufficient and BHC debt restructuring proves difficult to execute, the FDIC can take control of a subsidiary bank and create a bridge bank until the subsidiary can be sold. Recapitalization of a bridge bank is more cost-effective because the bank would not assume the liabilities to the BHC and the liabilities of the BHC.

If none of the foregoing options works, significant new government assistance may be needed to recapitalize the banks. Because of that prospect, and for independent reasons, two legal reforms should be considered: further relaxation of Fed rules on noncontrolling investments to permit private equity funds to help with the bank recapitalizations, and a new procedure for rapid resolution of insolvent BHCs.

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39 The bankruptcy of the Bank of New England Corporation, the holding company for the Bank of New England, was still going on in 2007, sixteen years after it began in 1991. *See In re* Bank of New Eng. Corp., 359 B.R. 384, 385 (Bankr. D. Mass. 2007).

Appendix

Table 1: Balance Sheets of Four Large U.S. Bank Holding Companies: J.P Morgan,[40] Citigroup, Inc.,[41] Bank of America,[42] and Wells Fargo[43] (in Billions of Dollars)

	J.P. Morgan	**Citigroup, Inc.**
<u>**Assets**</u>		
Cash and Securities	**44.3**	**29.6**
Equity in Subsidiaries		
in Subsidiary Banks	126	11.3
in Nonbank Subsidiaries	30.3	52.6
in Subsidiary BHCs	22.9	91.2
Total	**179.2**	**155.1**
Loans to Subsidiaries		
to Subsidiary Banks	36.0	4.6
to Nonbank Subsidiaries	116.5	103.9
in Subsidiary BHCs	0.0	28.2
Total	**152.5**	**136.7**
Other Assets	**22.7**	**9.5**
Total Assets:	**398.7**	**330.9**
<u>Note:</u> Consolidated Total Assets	**2,251.0**	**2,050.0**

40 *See* JP Morgan, 2007 Annual Report (Form 10K) (Feb. 29, 2008).
41 *See Citigroup, Quarterly* Report (Form 10-Q) (Oct. 31, 2008).
42 *See* Bank of America, 2007 Annual Report (Form 10K) (Feb. 29, 2008).
43 *See* Wells Fargo, 2007 Annual Report (Form 10K) (Feb. 29, 2008).

<u>Liabilities</u>		
Short Term Debt		
Commercial Paper	54.5	0.0
Other	23.8	17.5
Total	**78.3**	**17.5**
Long Term Debt		
Subordinated	29.7	28.5
Other	103.9	117.5
Total	**133.6**	**146**
Other Liabilities	**8.0**	**6.0**
Loans from Subsidiaries		
from Subsidiary Banks	0.0	2.2
from Nonbank Subsidiaries	33.0	33.1
from Subsidiary BHCs	0	0
Total	**33**	**35.3**
Equity Capital	**145.8**	**126.1**
Total Liabilities and Equity Capital:	**398.7**	**330.9**
<u>Note:</u> Market Cap (09/30/08)	**184.1**	**111.7**
<u>Note:</u> Market Cap (01/30/09)	**94.9**	**21.3**

Assets	**Bank of America** Excluding Merrill	**Wells Fargo** Excluding Wachovia
Cash and Securities	**98.8**	**22.0**
Equity in Subsidiaries		
in Subsidiary Banks	0.0	13.3
in Nonbank Subsidiaries	7.9	2.8
in Subsidiary BHCs	176.0	39.9
Total	**183.9**	**56.0**
Loans to Subsidiaries		
to Subsidiary Banks	0.0	14.1
to Nonbank Subsidiaries	22.6	19.3
in Subsidiary BHCs	27.4	34.1
Total	**50.0**	**67.5**
Other Assets	**14.4**	**7.8**
Total Assets:	**347.1**	**153.3**
Note: **Consolidated Total Assets**	**1836.0**	**760.6**
Liabilities		
Short Term Debt		
Commercial Paper	33.0	11.9
Other	17.6	12.4
Total	**50.6**	**24.3**
Long Term Debt		
Subordinated	28.5	4.7
Other	77.4	50.7
Total	**105.9**	**55.4**

Other Liabilities	**10.4**	**4.3**
Loans from Subsidiaries		
from Subsidiary Banks	0.0	3.1
from Nonbank Subsidiaries	18.4	17.2
from Subsidiary BHCs	0.8	2.0
Total	**19.2**	**22.3**
Equity Capital	**161.0**	**47.0**
Total Liabilities and Equity Capital:	**347.1**	**153.3**
<u>Note:</u> **Market Cap (09/30/08)**	**159.6**	**124.2**
<u>Note:</u> **Market Cap (01/30/09)**	**43.1**	**79.4**

(1) Bank of America includes acquisition of Merrill Lynch (2) Wells Fargo includes acquisition of Wachovia.