Private Equity Investments in the Financial Industry – a Regulatory Challenge

To date, acquisitions of banks by private equity sponsors have been rare in Germany. One of the reasons may be that, as a result of the financial crisis, obtaining the required regulatory approval has become more complex and time-consuming and thus a decisive factor in the course of a transaction. The regulatory requirements for the design and implementation of such transactions and the approval practice of the supervisor shall be highlighted and discussed in the following.

Following earlier cases of investments in (partly non-performing) banks (for example the investment by J.C. Flowers in HRE, the acquisition of IKB by Lone Star in 2008 or the purchase of the Düsseldorf mortgage bank DüsselHyp also by Lone Star in 2010) there have been a few examples in 2014, namely RHJ’s acquisition of BHF Bank (meanwhile sold on to Oddo) and the acquisition of the German KBC subsidiary by a consortium of the Teachers Retirement System of Texas, Apollo Global Management, Apollo Commercial Real Estate Finance as well as Grovepoint Capital.

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It is noteworthy here that the supervisory approval processes have over time become increasingly complex and time-consuming.
In case of private equity transactions, the reason for this may be the particularly burdensome transparency requirements, which may extend not only to direct and indirect shareholders and investors, but also to other portfolio companies of the sponsor. Moreover, it may be difficult to align the investment approach typically taken by private equity sponsors with the requirement to commit to a sustainable long-term business and risk plan which meets the expectation of the supervisor, possibly combined with the requirement to show a general willingness to provide additional equity and liquidity in the event of a crisis. Nevertheless, in view of the existing consolidation pressure in the banking sector, it is quite conceivable that private equity sponsors will be more inclined to invest in this sector.

**Regulatory requirements for private equity investors**

The regulatory requirements for bank acquisitions present particular challenges for private equity investors due to their organizational structures and their typical investment approach. The transparency requirements, commitments to binding long-term business plans, as well as equity and liquidity requirements are particularly noteworthy in this regard. These challenges do not only occur as part of the Ownership Control Procedure in a regulatory context, but also arise where
the target bank is a member of the German Depositary Protection Fund and its ongoing membership therefore requires a separate control procedure by the Auditing Association of German Banks (Prüfungsverband deutscher Banken e.V.).

Ownership control procedures
Legal requirements
It is worth highlighting at the outset that the decision-making power regarding ownership control procedures within the Eurozone has been shifted to the ECB, irrespective of whether the target bank qualifies as “significant” or “less significant”. The notification of the intended acquisition must still be filed with the competent national authorities, which, based on their own evaluation, will then prepare a draft decision for the ECB in which they recommend a refusal or approval. However, the final decision will be made by the ECB alone. It remains to be seen to what extent this change in the decision-making process will lead to a change in the supervisory practice.

Whoever intends to acquire a “significant participation” in a bank, whether alone or together with other persons or companies, must notify the German Supervisory Authority (BaFin) and the German Central Bank (Bundesbank). In simple terms, the notification requirement affects everyone who, as a result of the transaction:

- directly holds at least 10 percent of the capital or the voting rights of the bank;
- indirectly holds at least 10 percent of the capital or the voting rights of the bank;
- or
- can exercise a significant influence on the management of the bank.

Therefore, the group of persons who are required to notify comprises not only those who directly acquire a significant participation in the bank, but also indirect buyers, to whom a significant participation in the bank is attributed. This will be determined by means of various rules on attribution which may be applied separately or in combination. As a general rule, one and the same participation can be attributed multiple times so that the participation of a direct participant may also be attributed to several indirect participants. Finally,
it has recently been decided that – in contrast to voting rights which in the case of subsidiaries are attributed in full – indirect capital investments must be calculated pursuant to the multiplication criterion, i.e. the percentages of the holdings must be multiplied across the corporate chain. Hence, in contrast to the previous practice, the attribution of an indirect capital investment no longer requires the involvement of a subsidiary.

The supervisory authority reviews the submitted documentation for any material reasons to dismiss the intended acquisition. Such reasons shall be determined according to an exclusive catalogue of arguments for refusal. Accordingly, a refusal may, for example, be based on the following reasons:

- The person responsible for notification is not reliable or, for other reasons, fails to meet the demands required in the interest of sound and prudent bank management;
- the bank is not able to comply or cannot continue to comply with regulatory requirements under European law, or the creation of the significant participation means the bank would become part of a group together with the holder of the significant participation which, due to the participation structure or due to insufficient economic transparency, impairs the effective supervision over the bank or the exchange of information among the competent authorities or impedes the determination of the allocation of responsibilities among the competent authorities;
- the future manager is not reliable or does not have the necessary professional experience;
- there are reasonable grounds to suspect that, in connection with the proposed acquisition, money laundering or terrorism financing is being or has been committed or attempted, or that the proposed acquisition could increase the risk thereof; or
- the financial soundness of the person responsible for notification is inadequate (particularly in relation to regulatory capital and liquidity).

A refusal may also be based on the grounds that the data in the notification or the additionally requested information are incomplete, incorrect or fail to meet the supervisory demands.
Since facts which justify the assumption that there are reasons for a refusal are sufficient to serve as basis for a refusal, the acquisition may also be denied if, on the basis of the submitted documentation, a final decision cannot be made on whether the interested acquirer meets the legal demands regarding reliability and financial soundness. In such cases the supervisory authority may simply take the view that reliability or financial soundness have not been sufficiently proven.

**Particularities for private equity investors**

With respect to private equity investors, the precise determination of all persons responsible for notification is often a complex task. It is therefore recommended to discuss at an early stage with the supervisory authority which indirect members of the investment chain it actually expects to file a notification. This applies, in particular, in the case of intermediate holdings in the acquisition structure and of holding relationships on the upper level of the respective fund structure which may result in the participation in the target bank being attributed to individual investors.

Identifying the persons responsible for notification is of great importance, as each such person must submit comprehensive documents and statements as part of the ownership control procedure, including information regarding its financial circumstances. Depending on the specific holding structure, individual persons may even be required to file a notification and are then obliged to disclose their own financial standing. With respect to private equity funds responsible for notification, the scope of mandatory disclosure may also extend to other portfolio companies which they hold, meaning that financial data and reports of those portfolio companies would have to be disclosed as well. In order to minimize possible notification and disclosure obligations, it is therefore recommended that private equity investors set up the investment chain for the acquisition of a bank outside of its existing fund structure.

Bearing in mind the reasons for refusal mentioned above, the future business model of the bank, as well as the planned investment term and the financing structure of the purchaser should be thoroughly reviewed in private equity transactions. Of particular importance are a transparent, well-thought-out and
credible business plan, the development of a realistic risk profile and the question of whether and to what extent there exists the willingness and ability to make available additional equity and liquidity, whether for the acquisition or a future crisis. The extent to which capitalization and liquidity are required is dependent on the planned business model for the bank and any requirements related to such business model. On the whole, there should be no doubts whatsoever in relation to compliance with the supervisory requirements at the time of the acquisition as well as in the foreseeable future.

Takeover of BHF-Bank

All of the aforementioned aspects became crucial in the protracted ownership control procedure concerning the acquisition of BHF Bank by a group of purchasers related to the Belgian financial investor RHJ International. In addition to RHJI and the British private bank Kleinwort Benson (in which RHJI was said to hold 65%), the group of investors initially also included the US asset management firm Blackrock, the Chinese conglomerate Fosun, RHJI founder Timothy Collins as well as Stefan Quandt via his investment firm Aqton SE. During exclusive negotiations beginning in 2011, the investors assumed that only RHJI and Kleinwort Benson would have to take part in the ownership control procedure. The supervisory authority, however, acted on the assumption that all participants were „acting in concert“ and alternately attributed the various holdings of all the purchasers to each other, with the result that the threshold value for the ownership control procedure was exceeded by each member of the purchaser group. Blackrock was eventually unwilling to meet BaFin’s demands for disclosure of comprehensive information relating to its holdings, individual fund managers and other internal matters and subsequently decided to leave the bidders’consortium. In 2014, the acquisition was completed by the remaining group of investors. In retrospect, the entire process lasted three years. In the process, BaFin also examined and questioned in detail the goals pursued by the individual investors regarding their engagement and whether the acquisition was in fact intended to have a long-term perspective.
The question regarding the acquirer’s willingness to assume further financial obligations in connection with the acquisition or at a later date in case of a crisis, which is particularly problematic for private equity investors, has gained further significance recently, following the Düsseldorf Mortgage Bank (DüsselHyp) case. In 2015 DüsselHyp had to be rescued by the Federal Association of German Banks (Bundesverband deutscher Banken) because its owner at the time, Lone Star, was unwilling to provide support. As a result of these developments, the announced sale of DüsselHyp in 2014 to a group of investors, related to the investment firm of Attestor Capital LLP, did not take place. Apart from the ongoing selling process (which eventually failed), the decision to rescue DüsselHyp may also have been reached with a view to its importance for the German mortgage bond market.

It is therefore more important than ever to be aware of the necessity of securing sufficient capital and liquidity resources at the time of the acquisition, as well as having a secured refinancing model. On a separate note, there is a growing impression that, in practice, BaFin is imposing less severe requirements if the acquisition is done by a consortium consisting of three or more investors (Club Deal). This pattern can be observed in the recent acquisition of the German KBC subsidiary. However, there is no apparent legal basis for such practice.

**Harmonization efforts in the area of ownership control procedures**

Along with the concentration of responsibility in favor of the ECB, recent developments give rise to the expectation that ownership control procedures will be further harmonized. These harmonization efforts are reflected in the draft “Joint Guidelines for the prudential assessment of acquisitions of qualifying holdings”, in which the three European supervisory authorities across various sectors have agreed on joint guidelines for all ownership control procedures within the European directives. Furthermore, according to the annual report of the ECB on supervisory activity in 2015, the ECB has developed harmonized guidelines for the evaluation of so-called “specific acquirers” (such as hedge funds, private equity funds and sovereign wealth funds). According to the ECB, these guidelines expressly take into account the challenges often faced by these types of acquirers in identifying the ultimate beneficial owners in order to assess their reputation. In addition, these guidelines consider that such
acquirers regularly finance the acquisition through a form of leverage, which
can possibly impact their own financial soundness and stability as well as their
long-term commitment.

In light of the developments outlined above, one may speculate that the coun-
try-specific practices of national supervisory authorities will be of reduced
significance in future evaluations of private equity investors. Even though the
details of the new supervisory practice remain unclear, the ECB’s approach in
developing a harmonized ownership control procedure with a catalogue of re-
quirements more suitable to private equity investors is, in principle, to be wel-
comed in terms of transaction security.

Deposit protection

If the bank to be acquired participates in the Deposit Protection Fund of the Fed-
eral Association of German Banks (Einlagensicherungsfonds des Bundesverbands
deutscher Banken), in addition to the ownership control procedure, the transac-
tion will also have to be reviewed by the Auditing Association of German Banks
(Prüfungsverband deutscher Banken e.V).

In order for a bank to be permitted to participate in the Deposit Protection
Fund, there must be no reason to justify an assumption that the owner of a sig-
nificant participation (or its legal and constitutional representative or person-
ally liable partner) is not reliable or for other reasons fails to meet the demands
required in the interest of the sound and prudent management of the bank.

Banks participating in the Deposit Protection Fund are obliged to immediately
inform the Banking Association (Bankenverband) about the creation, change
and termination of a significant participation and to provide all the informa-
tion to permit an assessment of whether the concerned owners are reliable and
meet the demands required in the interest of guaranteeing the sound and pru-
dent management of the bank. In the event of a change of control, the bank’s
participation in the Deposit Protection Fund automatically ends (i.e. without
any expulsion proceedings) after nine months from the time of the acquisition
of the participation. There is no termination, however, if (i) the Banking Asso-
ciation was given the opportunity beforehand to determine that the owner of a significant participation meets the above mentioned requirements and (ii) within the 9-months period all facts are disclosed which permit the proof that the acquirer is reliable and capable and overcome any doubts in this respect and that thus all required auditing findings have been facilitated.

As a general rule, the audit mirrors the standards of the ownership control procedure. However, since the audit is an independent process under private law, which is meant to protect the interest of the member banks rather than any superior public interest, the requirements may diverge in the individual case.

A focal point of the audit of private equity transactions is again the financial soundness of the new majority owner which is usually an acquisition vehicle. In this respect, it may be problematic that the acquirer must submit a declaration by which it undertakes to indemnify the Banking Association from losses arising from possible rescue measures in favor of the bank. As the acquisition vehicle is normally endowed only with the means necessary for purchasing the bank, it is recommended to consider at an early stage which entity is able to and should provide the indemnity. From the Banking Association’s perspective, the relevant entity must be sufficiently funded to cover the indemnity. At the same time, it is important to ensure that any other investments of the private equity group, which are economically independent from the investment in the bank, are adequately protected against the liability risk arising from the indemnity.

**Design of the transaction**

** Acquisition structure**

In practice, acquisition vehicles used by private equity investors for the acquisition of banks are usually established outside of the existing fund structures which are subject to the typical requirements for investment cycles, holding periods, profit expectations etc. While such an isolated acquisition structure does not imply a legal obligation not to re-sell the bank within a certain period or to refrain from restructuring measures, it is supposed to show goodwill in view
of the regulatory restructuring. Moreover, this also facilitates the audit of the participation relationships in the above described acquisition control process.

■ Closing conditions of the acquisition

It is obvious that the lengthy and complex approval procedures have greater uncertainty in a transactional context. A purchase agreement must contain appropriate provisions to deal with this issue.

As a starting point, the regulatory clearance of the transaction must be a condition to the closing of the transaction in order to comply with the legal requirements and to avoid a violation of applicable statutory provisions or the transaction closes under violation of current legal provisions or considerable negative effects (e.g. expulsion from the deposit protection fund). In view of the difficulty to anticipate the duration of the review and approval process, a sufficiently long period (drop dead date) should be provided for.

The parties have flexibility in the question of how to allocate the risk that the transaction is not eventually approved within a reasonable time between the seller or the buyer. The seller – of course depending on his negotiation process – will normally require the acquirer to assume the risk, as it is based in his sphere and only he is ultimately able to make a reasonable assessment. In the context of antitrust approval requirements, such an agreed risk allocation is usually achieved by the acquirer committing himself to (entirely or partially) fulfill possible commitments or conditions on the basis of which the antitrust authority is willing to clear the transaction. However, there are additional criteria in the regulatory review process (as well as possibly in connection with a continued participation in the deposit protection fund) which by nature cannot be simply made a subject-matter of the acquirer’s covenant (e.g. the criterion of reliability).

If the fulfillment of such closing conditions cannot be the subject of an enforceable contractual obligation, a break fee can be agreed upon, which the acquirer must pay if the transaction fails due to the refusal of the required regulatory approvals. As a resulting deterrent effect, the acquirer is induced to make an
effort to use his best efforts for the fulfillment of the closing conditions and/or to examine the prospects of success carefully and realistically before the closing of the transaction.

- **Security packages for purchase-price financing**

Private equity acquisitions are typically financed by debt, resulting in the requirement of comprehensive security packages for the lending banks and appropriate structures for securing the debt financing.

Thus, frequently a debt push-down is effected after the closing in which the acquisition vehicle is merged with and into the target company. As a result, the loans and the operating assets of the target company are combined at one level. This allows the collateralization of the loans by the target’s assets as well as the direct use of the liquidity created in the target’s operations to service the loans.

In practice, these post-closing reorganizations can hardly be implemented after the acquisition of a bank by a private equity investor. Even the merger as such with the related combination of balance sheets is usually not possible, given the complex regulatory requirements for the composition of the capital. The same applies for the usual security packages provided to the lending banks.

Compliance with the regulatory requirements may in no way be affected by the financing structure of the buyer and, as a result, for the purpose of servicing their loans, possible providers of financing will only have access to the dividends which are permitted to be distributed to the acquisition vehicle. This, of course, has a significant impact on the financial structuring of such transactions and thus also on their commercial key terms.

**Summary**

In summary, the acquisition of a bank by a private equity investor raises a number of challenges, in particular from a regulatory point of view both in respect
to the many approvals and in the way it can be implemented. However, by care-
ful planning and early coordination with the relevant authorities these chal-
lenges can be handled in a satisfactory way and a reasonable period of time. To
the extent that the further consolidation in the financial sector will generate
interesting investment opportunities for private equity investors, it should be
possible to realize these transactions despite the complex legal framework.

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