Private Equity Allowed a Bigger Bit of Banks

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Federal regulators continue their search for ways to shore up the banking system even as skepticism grows about a proposed $700 billion rescue now being debated on Capitol Hill.

On Monday, the Federal Reserve relaxed some rules on bank minority ownership by private-equity investors and other investment groups, saying they could own up to 33% of a bank's equity, including 15% of voting shares, without triggering greater scrutiny under decades-old banking regulations. Previously, the ceiling was set at 25%, with voting shares usually triggering concerns closer to a 10% cap. The Fed also loosened restrictions on board memberships and communications with bank boards.

Finding fresh sources of new capital has become a vexing problem for many banks, mostly because previous investments from foreign sovereign wealth funds in major U.S. banks have lost value since the spring, making many players reluctant to sink more money into them. But part of the problem has also been the limitations on the amount of stock U.S. private-equity firms can own in a bank without triggering regulator concerns. The old rules were designed to protect banks from being overly influenced by non-bank companies.

With lowered restrictions, private-equity infusions could bring relief to many U.S. small and regional banks. Many of the biggest private-equity firms have raised billions of dollars in war chests aimed at the ailing financial sector, and are just waiting for the chance to put them to use. In April, National City (nyse) raised $7 billion in a stake sale to Corsair Capital, but since then there has been little private-equity action in the sector.

Instead, banks have had to resort to cutting their dividends or selling shares in the open market. Wachovia (nyse), for example, raised $8 billion in the spring by selling new shares, and it cut its dividend to 5 cents a quarter in July to preserve capital.

As the Fed tries to deal with the credit crisis, many of its old ideas have gone out the window. Using emergency powers that date back to the 1930s, the Fed opened its emergency lending authority to primary dealers in March, trying to alleviate some of the stress on the nation's biggest investment banks, which hadn't fallen under direct Fed control.

On Sunday, the Fed quickly approved applications filed over the weekend by Goldman Sachs (nyse) and Morgan Stanley (nyse) to convert to bank holding companies, ending the modern era of Wall Street banks that operated largely without accountability. Goldman and Morgan Stanley will submit to regulation by the Fed in exchange for permanent access to its emergency lending window, bringing the financial system back to the days before Depression-era laws formally separated commercial and investment banking. (See "Why Goldman, Morgan Raced For The Fed")

On Monday, Morgan Stanley announced it would sell up to 20% of itself for $8.4 billion to Japan's biggest bank, Mitsubishi UFJ Financial (nyse)

Globally, banks have written-down more than $500 billion in the value of bad assets on their books and raised more than $350 billion, but the search for new capital continues.

A slowdown in lending, plus expectations of rising losses from outstanding loans, is forcing banks to find ways to replenish capital reserves. The Treasury Department's plan to buy up to $700 billion worth of bad bank assets could be one way to relieve bank balance sheets. Opening the door to private-equity infusions is another.

Source: Forbes