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Sullivan & Cromwell LLP Chairman H. Rodgin Cohen

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H. Rodgin Cohen
Chairman, Sullivan & Cromwell LLP

SNL Financial recently spoke with veteran attorney and Sullivan & Cromwell LLP Chairman H. Rodgin Cohen after he delivered a speech at a Rodman & Renshaw Investment Conference.

Cohen has been chairman of Sullivan & Cromwell since July 2000 and has worked on a number of the major bank deals in U.S. history, including Wells Fargo & Co./Wachovia Corp., PNC Financial Services Group Inc./National City Corp., Bank of New York Mellon Corp./Mellon Financial Corp. and Wachovia/Golden West Financial Corp. As the current crisis deepened, Cohen's clients sought his advice regularly. In fact, in last September alone, Cohen advised Fannie Mae, American International Group Inc., Lehman Brothers Holdings Inc. and JPMorgan Chase & Co.

Cohen focused his discussion at the Rodman & Renshaw event on the immediate and longer-term risks facing banks, but also suggested changes to the regulatory system. SNL talked with Cohen about TARP, the new rules regarding private investments in failed banks, and the possibility of new capital requirements, open bank assistance and industry consolidation. What follows is an edited transcript of that conversation.

SNL: Last November at the BancAnalysts Association of Boston conference, you advised banks to participate in TARP, which clearly seemed to make a lot of sense at the time. It was your understanding then that there would not be any extra strings attached to TARP and that the government would move forward with the plans outlined in the documents associated with the program. There certainly has been a lot of noise around TARP. Have you felt the Obama administration has changed TARP beyond the noise you hear in Congress that drew greater attention to TARP recipients?

Cohen: I think this administration has actually been quite constrained in what it did. TARP today has been a money maker for the government. All the opprobrium which some will cast on it, I don't understand. For banks which need capital, it was the right thing to do. You had to make a decision in November not knowing what I call AIG week with all the hysteria in Washington. When I talk to banks, those that needed [capital] are glad they took it and those who didn't need it are glad to be rid of it.

There are some banks like IBERIABANK Corp. that took TARP funds but went out and raised money shortly thereafter because they didn't know what the future would bring and wanted to have an exit strategy from the program.

Also, last year it became a sign of a government stamp of approval.

You also talked last year about the need for the government to put buyers and sellers together. I think you made your stance fairly clear during your speech a few minutes ago, but if the industry needs help bringing together buyers and sellers, what is the thinking behind such stringent rules toward private equity? I know that the new rules target investments in failed institutions, but it seems to send a message to all private equity investments in the banking industry.

It is beyond that. I think there is just a concern in the ability of private equity controlling banks. I can't articulate it. I don't understand it.

Do we have any examples where private equity investments in the banking industry have run afoul and caused problems for regulators? I can't think of any recently, but were there any examples even 20 years ago?

There have been so few of them and the analogue is a family. There have been lots of families that have invested in banks. I think maybe the concern is, with private equity there is an absence of checks and balances, any single owner. If you have management, board and stockholder all being same, you lack checks and balances. Again, I don't know how validated that is.

You spoke briefly about the U.S. Treasury Department's proposal to increase capital requirements. We haven't seen specifics yet, but it seems like you were saying that simply increasing the minimum well-capitalized threshold is not necessarily the answer. Instead, you suggested finding a different method to determine whether or not someone is well-capitalized. Do you think there needs to be some sort of higher capital measurement?

I think two things. One, in my formula, where A (qualifying capital) over B (assets) must not be less than C (the ultimate capital ratio), what I was really saying is that raising C is not necessarily the right way to go. A (qualifying capital) definitely should be looked at because there is a difference between going concern and gone concern capital. There could be more emphasis on going concern capital to keep a bank open as opposed to capital that protects depositors. I could see A changing with more of an emphasis on common equity. Certainly there are risks which the current formula does not encapsulate, which is B (assets). There needs to be changes in A and B rather than C. And I think the examiners should be looking at C and determining what it should be. And they should not be reluctant to say so. Take the Tier 1 common ratio — let's say there is such a thing — [it] is 5%, but regulators say in your particular case it should be 7%. For somebody else it might be 4.5% or 4.75%.

Why put it into a black box when you have a system and an infrastructure to specifically tailor it for each institution? They have examinations for that reason. Switching gears, do you think we could see the FDIC provide open bank assistance?

It's extraordinarily difficult to do for two reasons. Number one, there is a statutory requirement that stockholders cannot get a penny if the FDIC loses a penny. It's very, very difficult to structure OBA [open bank assistance]. The second aspect of OBA is the least cost resolution. The FDIC thinks, and in some cases it might not be right, but in most cases it is, in a receivership you can hive off a bunch of liabilities and potential liabilities, so in theory someone should be willing to pay more. For example, take a bank with assets equal to 100 and 98 in liabilities, so its equity is 2. But, it also has contingent liabilities — things like lawsuits, long leases, etc. — of 10. In an open bank deal, you can't get rid of these 10. In a receivership, you can. If I'm a buyer and I'm willing to buy this for nothing, I would insist upon getting assistance if I had to take these contingent liabilities. There may be a few cases where contingent liabilities are limited and in that case, you may be able to do it.

There are a lot of things to work out and the way government-assisted deals occur anyway, they might not simply have time. You're talking about something that requires quite a bit of complexity and timing. Do you think we could see more structured transactions? Something similar to the First Niagara Financial Group Inc./Harleysville National Corp. deal, which has a walk-away provision tied to the target's credit quality?

There were those in the '80s. You could see a few more of these. The question often is whether or not someone is prepared. In a deal like that, the ultimate value that you pay can't be less than zero in an open bank deal. If you can get comfortable that zero really covers your full risk, there could be more deals. The problem is these are very hard because if a seller is willing to take the possibility of zero that is going to make it very difficult for the buyer not to believe that the downside is significant.

Is that the only kind of creative structure that you think we could see?

The deals in the '80s, there were several that were done. You could split out a bunch of the bad assets and give the stockholders of the acquired institution only an interest in the bad assets. That was done in that small deal in Texas recently. *i*