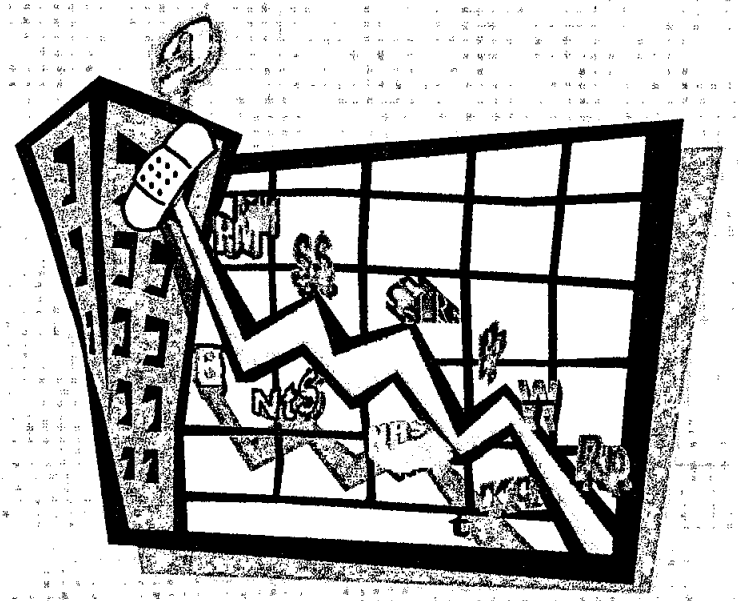
EARLY WARNING INDICATORS, DEPOSIT INSURANCE, AND METHODS FOR RESOLVING FAILED FINANCIAL INSTITUTIONS

Selected Papers of the SEACEN Workshop on
A Regulator's Action Plan on Bank Failures
9-11 March 1998
Kuala Lumpur, Malaysia

Edited by
Delano Villanueva
Deputy Director (Research), The SEACEN Centre



THE SEACEN RESEARCH AND TRAINING CENTRE
KUALA LUMPUR, MALAYSIA

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DELANO VILLANUEVA, EDITOR

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Editor's Note

On 8-10 October 1997, the SEACEN Directors of Supervision held their eleventh meeting in Kuala Lumpur. The theme of that meeting - ***Financial System Soundness and Risk-Based Supervision*** - and the papers presented therein were edited by Dr. Dan Villanueva, Deputy Director (Research), The SEACEN Centre and published by The SEACEN Centre in February 1998. That volume identified many of the preconditions necessary to promote a sound banking and monetary system and highlighted a number of the prudential rules and supervisory practices needed to foster financial stability.

On 9-11 March 1998, a SEACEN Workshop on a Regulator's Action Plan on Bank Failures was held at The SEACEN Centre. It was not a scheduled event for operating year 1997 (ending 31 March 1998), but because of the topic's importance in the light of the financial crisis in the region, Mr. Cheong Kwok Yew, the Centre's Assistant Director of Training, took the initiative and organised the Workshop within a record of only two months. The Workshop was coordinated by Mr. Percy Borras, Training Specialist, Training Division, The SEACEN Centre. It drew 28 participants from 11 central banks and monetary authorities (see back of book). The success of the Workshop was partly attributable to the active interchange among the participants and partly to the highly experienced resource persons as lecturers and discussion leaders. This companion volume, ***Early Warning Indicators, Deposit Insurance, and Methods for Resolving Failed Financial Institutions,*** gathers the lecture and teaching materials for this Workshop. This second SEACEN volume deals with financial crisis management, and as such complements the first SEACEN volume on financial crisis prevention.

The Editor wishes to thank Ms. Rescina Bhagwani and Mr. Guy Saint-Pierre for their contributions to this volume. Special thanks go to Mr. Jesse Snyder for making available for publication selected chapters of the FDIC's Resolutions Handbook: Methods for Resolving Troubled Financial Institutions in the United States, prepared by the Division of Resolutions and Receiverships, FDIC. Finally, many thanks go to Karen How for excellent typing assistance, and to Zamri Abu Bakar for cover design.

Delano Villanueva
Editor and Deputy Director (Research)
The SEACEN Centre

Kuala Lumpur
December 1998

TABLE OF CONTENTS

PART I

EARLY WARNING SIGNALS

1. EARLY WARNING INDICATORS

Guy Saint-Pierre

1.1 Introduction

This paper draws on CDIC's experience with deposit-taking institutions during the 1980s and 1990s and presents a number of early warning indicators of financial distress. Early warning indicators do not eliminate bank failures. However, they should lead to early intervention and consequently help reduce losses to deposit insurance funds or governments.

To be effective, early warning indicators should be used in conjunction with professional judgement. Judgement must be exercised in choosing the relevant indicators and in interpreting the data derived from the early warning measures.

The effectiveness of an early warning indicator also depends on the quality of the data. For example, many deposit-taking institutions that failed in Canada had inadequate information systems that generated unreliable data. The inaccurate data led management (and regulators) to believe the institution was healthy, resulted in poor decision making, delayed intervention by regulatory agencies, and eventually led to failure. Also, traditional cost valuation methods for preparing accounting information may not be appropriate for early warning data. For example, a "marked-to-market" valuation of assets and liabilities of financial institutions can lead to sounder decision making and is more appropriate for assets such as marketable securities and derivative products.

Furthermore, for an early warning indicator to be effective, indicators need to be supplemented by information that is not of a financial nature. On-site examinations provide crucial first-hand information on management's strategy and competence, the adequacy of internal controls and the accuracy of financial reporting. Moreover, macro- and micro-economic data, market trend indicators (i.e., real estate values, stock market indices) and industry-specific data can explain how external forces have affected the institution in the past and how they can affect it in the future.

Finally, early warning systems must cover all the key functions of a bank's operations and potential areas of risk, namely (among many others) internal audit, cash management and liquidity, securities operations, loan portfolio, other assets, deposit liabilities, capital adequacy, profit and loss and market risks. This paper provides early warning signs and indicators for the above dimensions.

1.2 Internal Audit

Internal audit is a critical function of a bank. It ensures compliance with the bank's internal policies and procedures, determines the soundness of accounting practices and the internal control environment, as well as the adequacy of the management processes.

A breakdown in the internal audit function should be of concern. For example, a reduction in the scope of internal audit work is a signal that potential problems may not be identified on a timely basis (or worse yet are being intentionally concealed). A lack of independence of the internal audit function can also lead to serious problems, such as concealment of loss or excessive risk taking. The internal audit function should report to the top management levels of the financial institution and at the same time be supervised by the audit committee of the board of directors to ensure independence from management. Internal audit staff must be knowledgeable in the operations, policies and procedures of the financial institution in order to identify activities that are inappropriate or poorly managed.

Negative conclusions from the internal audit group constitute a strong early warning indicator of problems at a financial institution. The internal audit function has access to details and history that external auditors and regulatory examiners may not have. As a result, a negative conclusion by an internal audit department is serious and should be followed up immediately and dealt with appropriately.

1.3 Cash Management and Liquidity

The determination of a prudent level of liquidity depends on the nature and complexity of an individual bank's operations and risk profile. Every institution must ensure that liquid assets — cash on hand, deposits with banks and marketable securities (and availability of liquidity through lines of credit) — are sufficient to satisfy all short-term

liabilities. The institution must honour all cash outflow commitments (both on- and off-balance sheet) on a timely basis, while meeting statutory liquidity and reserve requirements.

The bank's liquidity must be managed in such a manner as to avoid having to raise funds at market premiums or through the forced (distress) sale of assets at a discount. Consequently, a bank must frequently and accurately measure its liquid resources. It must often analyse the term profiles of current and upcoming cash flows for both on- and off-balance sheet items. A bank must also evaluate its ability to borrow or access discretionary funding sources in the event of unmatched cash outflows.

Conceptually, liquid assets must be well-diversified and have maturities that appropriately match those of the liabilities. Moreover, assets used for liquidity purposes should be readily marketable and have minimal credit risk. Finally, concentrations in funding sources require larger amounts of liquid assets. Therefore, concentration limits should be imposed on funding from individual depositors, type of deposit instrument, market source of deposit, term-to-maturity and foreign currency.

In addition to the above, liquidity can be affected by other factors, namely, risks of clearing payment systems (local and international), deposits with banks or due from banks (credit quality, concentration risks in less than "A"-rated banks, exposure limits), and operating issues (reconciliation, Electronic Fund Transfer, items in transit, self-dealing).

The following liquidity measures should encompass both on- and off-balance sheet liabilities and are early warning indicators of potential liquidity difficulties (illiquidity).

- Liquid assets < 10% of total assets.
- Liquid assets < 20% of deposits and other liabilities due within 100 days.
- Liquid assets < 30% of deposits, other liabilities and commitments due within 100 days.

On the other hand, financial institutions should ensure that liquidity is not constantly excessive. Liquid assets normally have a low rate

of return, and, as a result, continuous excessive liquidity negatively impacts on profitability.

Finally, financial institutions should always have in place a contingent liquidity and funding plan to guard against unforeseen calls on liquid resources.

1.4 Investment in Securities

The securities portfolio management should reflect the bank's appetite for risk and as such establish minimum quality expectations and rate of return as well as acceptable securities dealers and counterparties.

All concentration and exposure limits should be clearly and regularly communicated to senior management. The institution must have limits for the types of securities, as well as geographic, industrial sector and counterparty concentrations. Such limits need to be established in the context of the bank's aggregate exposure to single issuers or groups of associated issuers.

No statutory limits restrict the types of securities that can be held by banks in Canada. Some other limits do exist. For example, individual large exposures cannot exceed 25 percent of regulatory capital (on a risk-weighted basis). Special rules exist regarding investments in securities of subsidiaries and affiliates. In addition, banks are not allowed to invest in their own securities (equity or debt).

In Canada, securities are divided between securities held for trading purposes and those held for investment, which are treated differently for accounting purposes. Trading securities are readily marketable (i.e., easily transformed into cash) and are marked-to-market for accounting purposes. Individual securities in the trading portfolio should be monitored to identify those that are not trading or are held for inordinately long periods of time. The investment portfolio should be monitored for "over trading" or "gain trading" (i.e., a rapid turnover of securities with unrealised gains while those with unrealised losses remain). This could result in a security portfolio with extended maturities, lower credit quality, high market depreciation and limited liquidity.

Exhibit 1.1

SOME EARLY WARNING INDICATORS WITH RESPECT TO SECURITIES PORTFOLIOS ***(including securities held for investment purposes and trading)***
• Total corporate debt and equity > 30% of the security portfolio. • Security portfolio in "corporate equity" > 20% of regulatory capital. • Security portfolio in "private placement" > 10% of regulatory capital. • Unrealised losses in the security portfolio > 20% of regulatory capital. • Less than "A"-rated securities > 20% of regulatory capital.

Appropriate policies and procedures for securities held for trading and investment purposes should be complemented by a strong internal control audit function. Further, banks trading derivatives must fully understand how such activities fit into the bank's overall strategy. Banks engaged in derivative trading should have a methodology such as value at risk (VAR)[1] or risk-adjusted return on capital (RAROC)[2] to monitor exposure on a daily basis. This activity, as well as the other securities activities, should be monitored by a risk management group or unit comprised of individuals with full understanding of the associated risks. This group has a monitoring role as well as a crucial reporting role to executive management and the board of directors.

1.5 Loan Portfolio

Credit risk is the risk of financial loss resulting from the failure of a debtor to fully honour its financial contractual obligation to the lender (i.e., bank).

A bank's credit policies must contain, at a minimum:

- a credit philosophy governing the extent to which the bank is willing to assume credit risk;
- general areas of credit in which the bank is prepared to engage or is restricted from engaging;
- clearly defined and appropriate levels of delegation of approval, and provision or write-off authorities; and

1. VAR is an estimate of the potential loss that could result from holding a position for a specified period of time (with some level of statistical confidence).
2. RAROC should facilitate the comparison, aggregation and management of market, credit and operational risks across a bank.

- sound and prudent portfolio concentration limits.

Concentration occurs when a bank portfolio contains an excessive level of credit to a single counterparty, a connected or group of associated counterparties, an industry, a geographic region, an individual foreign country or class of countries, one type of credit facility, or a class of security.

The credit approval process can be relaxed to accommodate growth, increase in market shares, or profitability. This could result in a decrease of credit quality standards, the provision of credit with overgenerous terms, conditions or amounts, an adjustment of target market criteria, and the entrance into untested markets or products.

An appropriate categorisation of credit portfolios by credit characteristics, risk rating, and a regular review of credit exposure are essential. At a minimum, a rating system should be able to classify individual credits as:

- satisfactory or acceptable;
- especially mentioned;
- below-standard;
- unsatisfactory risk or credit loss; or
- non-accrual or impaired (and interest revenue recognition should be stopped).

Exhibit 1.2

EARLY WARNING INDICATORS OF POTENTIAL PROBLEMS WITH RESPECT TO CREDIT
• Loans rated below-standard, unsatisfactory or credit loss (on a net basis) represent greater than 50% of the institution's regulatory capital (warning signal).
• Loans rated below-standard, unsatisfactory or credit loss (on a net basis) represent greater than 100% of the institution's regulatory capital (advanced signal).

In Canada, an impaired loan is one for which (i) there is serious doubt as to the ultimate collectability (based on the net present value

of cash flows) of the principal and/or interest, (ii) there is a provision for loss recorded against the account, and (iii) the interest or principal owing remains uncollected 90 days or more following its scheduled date of payment.

Exhibit 1.3

EARLY WARNING INDICATORS WITH REGARD TO NET IMPAIRED ASSETS ***(i.e., net of specific provisions for loan losses)***
• Net impaired assets > 25% of regulatory capital (warning signal). • Net impaired assets > 50% of regulatory capital (advanced signal). • Net impaired assets > 100% of the regulatory capital (viability is questionable).

Deposit-taking institutions tend to focus mostly on known problems (i.e., the non-accrual or impaired loans) rather than target the weak credits that can become impaired in the future. As an example, the arrears schedule should be more important for monitoring purposes than the non-accrual loans or impaired loans schedule.

Specific and general allowances for the institution's credit losses should also be monitored. Specific allowances should reflect the present value of expected future cash flows of impaired or non-accrual loans (and any other loans that need a specific allowance). The determination of the general allowance should be based on the operating environment of borrowers, the economic cycle, historical and expected default rates, concentration of exposures, and historical and expected loss experiences.

Exhibit 1.4

EARLY WARNING INDICATORS OF THE INADEQUACY OF ALLOWANCES FOR LOAN LOSSES
• A decrease in the general allowance for credit losses although the loan portfolio has increased. • A decrease in the general allowance for credit losses that will result in an overall net income for the bank (rather than a loss). • Specific allowances that do not match increases in the level of non-accrual or impaired loans.

1.5.1 Commercial Loans

Commercial loans typically include loans to foreign banks, business and government loans, agricultural loans, factoring, lines of credit to businesses, loans to individuals for business purposes, working capital and term loans to businesses, and acceptances (claims against businesses like letters of credit, guarantees, etc.).

The following are typical indicators of potential problems of commercial loan portfolios:

- "evergreen loans," which are loans that are repaid at the end of the term through the funding of another loan;
- large non-reconciliation of the "suspense account";
- loans that are secured by a bank's shares or subordinated debt;
- credit to insiders; and
- self-dealing or related-party transactions.

Furthermore, reporting and documentation on all commercial loans must include concentration reports, arrears reports, interest-only loan reports, non-accrual or impaired loan reports, charge-off reports, etc. It is worthy to note that in most cases, loan or credit commitments in Canada are normally considered legal liabilities of the bank and therefore should not be granted lightly.

The credit underwriting process for commercial loans should include the proper approval authority level and appropriate security. In summary, success in commercial lending depends on sound policies and procedures and effective controls over the lending, credit (i.e., good credit judgement) and reporting systems.

1.5.2 Lease Financing

Lease financing from a credit viewpoint is similar to a loan. However, small ticket item leases probably require more extensive operating and administrative procedures than does a loan portfolio. Thus, an institution should ensure that these leases are priced accordingly. In addition, leasing portfolios are usually more affected by an economic downturn than are other types of credits (at least this has been the experience in Canada). Leasing is becoming very popular in Canada and is very competitive, especially in the auto industry (retail level).

Exhibit 1.5

EARLY AND ADVANCED WARNING INDICATORS OF PROBLEMS WITHIN AN INSTITUTION'S COMMERCIAL LOAN PORTFOLIO
(calculated on a risk-weighted basis)

- The aggregate of industrial sector (regulators in Canada use 27 industrial concentration sectors) asset concentrations in excess of 10% of regulatory capital > 250% of regulatory capital (warning indicator).
- The aggregate of industrial sector asset concentrations in excess of 10% of regulatory capital > 500% of regulatory capital (advanced indicator).
- The aggregate of counterparty[3] (including connected or associated groups) asset concentrations in excess of 10% of regulatory capital > 200% of regulatory capital (warning signal).
- The aggregate of counterparty[3] (including connected or associated groups) asset concentrations in excess of 10% of regulatory capital > 400% of regulatory capital (advanced signal).

Leveraged leases can be very complex. Indicators of possible problems for a leasing portfolio include high residual values, inappropriate accounting methods (i.e., acceleration of the unearned income), unrealistic tax benefits, and the lack of adequate insurance coverage (i.e., public liability).

1.5.3 Consumer Loans

Consumer loans typically include consumer lines of credit, collateral loans, instalment loans, retail leasing, floor plan loans, bank overdrafts, and credit card operations. In Canada, an increasing number of consumer credit decisions are made using computer-related tools (i.e., credit scoring).

Administrative controls are the key to monitoring problems with consumer loans, especially with credit cards, lines of credit and overdrafts. Early warning indicators are difficult to establish; however, an institution's charge-off policy for consumer loans should be investigated if more than 7 percent of the average loan balance outstanding is charged off in a given year.

3. Counterparty exposures include exposure to all types of credit (i.e., securities, mortgage loans, guarantees, letters of credit, derivatives, leasing, etc.)

1.5.4 Mortgage Loans

Most of the failures in Canada were related to institutions with excessive concentrations in mortgages and real estate exposures.

Banking laws in Canada do not allow loan-to-value ratios for mortgages to exceed 75 percent. In other words, the equity of the borrower in the property must represent 25 percent of the total value of the property.

Properties are typically valued using one or all of the following approaches:

- cost approach (e.g., the replacement cost of the property);
- direct sale comparison approach;
- capitalisation of income approach (capitalisation rate of the future cash flow is key); and
- discounted cash flow approach (similar to the previous approach but the estimated sale price of the property at the end of the holding period is also discounted).

A bank's appraisal policy for real estate-related financial transactions should specify criteria for selection and engagement of appraisers, required content of all appraisers' reports (including environmental risk), and accepted valuation methods. The appraiser must be independent (i.e., appraiser's fee should not be contingent on the value of the property or the approval of the loan).

Real estate is subject to fluctuating markets and therefore the bank's real estate loans should not depend on the saleability of the underlying properties. In Canada, home equity lines of credit are becoming increasingly popular. These types of loans, however, tend to increase the loan-to-value ratio and squeeze the borrowers debt-to-income ratio.

When monitoring mortgage loans, it is important to assess the secondary support provided by guarantors and endorsers, the institution's method of accounting for fees (fees are often capitalised - e.g., part of the loan balance) and the terms of the repayment schedule of such loans (e.g., interest-only loans and discounted mortgages).

In Canada, mortgage loans are rarely made for a term in excess of five years. Similarly, deposits or other funding sources with terms greater than five years are rare in Canada. Further, deposits of up to $60,000 for terms of up to five years are insured by CDIC.

Exhibit 1.6

1. Early Warning Indicators for Excessive Concentrations or Risk for Mortgage Loans

- Residential mortgages < 50% of total mortgages.
- Single-family dwelling mortgages < 35% of total mortgages.
- Loans for hotels/motels > 7% of total mortgages.
- Land loans > 7% of total mortgages.
- Loans on recreational properties > 5% of total mortgages.
- Loans on industrial properties > 10% of total mortgages.
- Construction loans > 5% of total mortgages.
- Second or subsequent mortgages > 5% of total mortgages.

2. Advanced Warning Indicators for Excessive Concentrations or Risk for Mortgage Loans

- Residential mortgages < 35% of total mortgages.
- Single-family dwelling mortgages < 25% of total mortgages.
- Loans for hotels/motels > 10% of total mortgages.
- Land loans > 10% of total mortgages.
- Loans on recreational properties > 10% of total mortgages.
- Loans on industrial properties > 15% of total mortgages.
- Construction loans > 10% of total mortgages.
- Second or subsequent mortgages > 10% of total mortgages.

3. Other Early Warning Indicators

- Average loan-to-value ratio > 75% (warning signal).
- Average loan-to-value ratio > 90% (advanced signal).
- Cash flow coverage of commercial real estate loans < 115% (warning signal).
- Cash flow coverage of commercial real estate loans < 105% (advanced signal).
- Real estate market indicators (e.g., vacancy rates, rental rates) are very important in the assessment of commercial real estate loan portfolios.

Construction loans are particularly vulnerable to a wide variety of risks, such as a variance in the project's costs to completion, completion date, saleability and take-out financing. Excessive exposure to these types of loans has caused the failure of many deposit-taking institutions in Canada. The character and expertise of the developer as well as the control processes for advances on the loan commitment play a very important role in the management of such loans.

The assessment of an institution's construction loan portfolio should cover the following elements:

- the bank's overall expertise in this type of lending;
- the bank's role being limited to only lending and not developing the project;
- the bank's understanding and overall monitoring of real estate markets; and
- the presence of "soft" pre-lease or pre-sales that are not binding agreements for lease or sale.

1.6 Other Assets

The "other assets" category typically includes such items as deferred charges, furniture, fixtures and equipment, goodwill, and other tangible and non-tangible assets. Because the "other assets" category tends to hide sub-quality assets, this category should not represent more than 10 percent (excluding investment in subsidiaries) of assets. If it exceeds this threshold, the individual components of the other assets should be investigated. In Canada, goodwill and other intangible assets (e.g., appraisal surplus) are deducted from capital to determine regulatory capital adequacy calculations.

High "other real estate owned" (REO) can be associated with asset quality problems. In this case, REO would include a high level of foreclosed loans and properties held for sale, likely on the books above market value. Furthermore, assets with "servicing contracts" are often associated with "excessive accounting" (i.e., acceleration of profit). Finally, the level and the purpose of a bank's investments in subsidiaries should also be monitored very carefully.

1.7 Deposit Liabilities

Funds management is a key element of a bank's operations: it must support the objective of maximising the spread between interest earned and paid while ensuring liquidity is maintained to pay liabilities as they come due and to fund new assets.

The diversification of a bank's deposit liability base (geographic, type, counterparty, etc.) is as important as the diversification of assets. Deposit liabilities typically constitute the single largest item on a bank's balance sheet. The mix of deposit terms affects the spreads earned and the institution's exposure to interest rate risk. Funding is cheaper with a larger deand deposit base but is also more volatile. When a bank offers interest rates as much as 100 - 200 basis points above competitors, it is a signal that the bank must have higher-yield and riskier assets to ensure minimum spreads. In that case, the bank should be required to maintain a larger capital base to compensate for its riskier profile.

Retail deposits are typically more stable and cheaper than wholesale deposits. However, they may require an expensive branching network. Wholesale funds, on the other hand, are typically more volatile because depositors of large amounts are usually well informed, more willing to be attracted by marginally higher rates of competitors and react more quickly to signs of potential financial problems.

A declining deposit base or increasing rate on deposits are warning signals that a bank may have a funding problem.

1.8 Capital Adequacy

Capital adequacy is a key element of CDIC's proposed Differential Premium System. As shown in the following table, each capital adequacy criterion will be scored based on its range of results. A member institution will need to meet all three capital benchmarks (Assets-to-Capital Multiple, Tier 1 Risk-Based Capital Ratio, and Total Risk-Based Capital Ratio) to obtain a specified rating.

Table 1.1

Capital Adequacy for Differential Premium Purposes

Range of Results

Assets-to-Capital Multiple	Tier 1 Risk-Based Capital Ratio	Total Risk-Based Capital Ratio	Rating
<= 17 times (if authorised multiple >= 20 times), or <= 85% of the member's authorised multiple (if less than 20 times)	>= 7%	>= 10% or >= 125% of the member's required total risk-based capital ratio (if greater than 8%)	Well Capitalised
> 17 times but <= 20 times, or > 85% but <= 100% of the member's authorised multiple (if less than 20 times)	>= 4% but < 7%	>=8% but < 10% or >= 100% but < 125% of the member's required total risk-based capital ratio (if greater than 8%)	Adequately Capitalised
> 20 times or > 100% of the member's authorised multiple (if less than 20 times)	< 4%	< 8% or < 100% of the member's required total risk-based capital ratio (if greater than 8%)	Under Capitalised

Capital provides a stable resource to absorb any losses and thus provides a measure of protection to depositors and other creditors in the event of liquidation. Individual elements of an institution's capital components should be (i) permanence, (ii) freedom from mandatory fixed charges against earnings, and (iii) legal subordination to the rights of depositors and other creditors.

The strength of an institution's capital base is a function of its access to capital, its generation and preservation capacity, and its future capital needs. These needs should be assessed in light of possible future charges against capital (potential or unrealised losses that might be embedded in financial assets) or future growth in assets and business activities.

Warning signs of potential capital problems include:

- a flight from permanent to non-permanent capital;
- difficulty to meet minimum regulatory/legislative capital requirements; and

- actual leverage continuously close to the authorised maximum leverage.

Exhibit 1.7

EARLY WARNING INDICATORS RELATED TO CAPITAL ADEQUACY

a. **Reported Net Losses Coverage Ratio**
Measured by the total regulatory capital less total net losses sustained during the last fiscal year (if any), expressed as a percentage of its minimum required regulatory capital.

• *< 100%*	*Warning signal*
• *< 80%*	*Advanced signal*

b. **Relative Capital Generation Ratio** (calculated for institutions with asset growth during the past fiscal year)
Measured by the percentage increase in regulatory capital during the current fiscal year divided by the growth in assets (in percentage) over the year.

• *< 1*	*Warning signal*
• *< 0.8*	*Advanced signal*

c. **Relative Capital Preservation Ratio**
(calculated for institutions that experienced a decline in assets during the past fiscal year)
Measured by the percentage decline in regulatory capital during the current fiscal year (if any) divided by the percentage decline in its assets over the past year.

• *> 1*	*Warning signal*
• *> 1.5*	*Advanced signal*

d. **Dividend Payout Ratio**
Measures the percentage of earnings paid out to shareholders in the form of dividends.

• *over 60% of profit paid out on a regular basis*	*Warning signal*
• *100% of profit paid out on a regular basis*	*Advanced signal*

An unsafe and unsound practice occurs when payment of dividends by a bank does not enable it to meet its minimum capital requirements.

1.9 Profit And Loss

A financial institution with sufficient and stable earnings will likely not have to resort to its capital to cover losses. Net interest income, provision for loan losses, non-interest income, non-interest expenses, and taxes are sub-elements of an institution's earnings. The adequacy of a bank's earnings must be assessed in light of the risk-return relationship, the volatility of income, and the impact of severe shocks.

Exhibit 1.8

INDICATORS OF POTENTIAL PROBLEMS IN EARNINGS

- a declining trend in earnings
- unstable revenues
- a high dependency on one product, a local economy or industry
- narrow interest spreads
- an increase in loan losses and write-offs or an increase in net charge-offs as a percentage of assets
- a heavy reliance on "other income"
- increases in non-interest income that are volatile, cyclical or exhaustible in nature (investment security gains, trading account profits)
- non-interest expenses in excess of 200 - 250 basis points of average assets
- a poor profitability of a subsidiary or parent and/or deteriorating conditions of a financial conglomerate
- high debt servicing requirements
- a high level of management fees/expenses
- changes in accounting standards or material inconsistencies in the application of accounting principles (non-comparability of period-to-period balances)
- actual performance lower than financial budgets
- a severe increase in the income level or expense that is generated by a new business segment

Exhibit 1.9

EARLY WARNING INDICATORS OF THE ADEQUACY AND SUSTAINABILITY OF EARNINGS AND EFFICIENCY OF AN INSTITUTION
(i.e., the efficiency at deploying its resources to generate net income)

a. **Return on Risk-Weighted Assets** (calculated as latest fiscal year after-tax net income divided by its average risk-weighted assets for the period)

- *< 100 basis points* — *Warning signal*
- *< 50 basis points* — *Advanced signal*

b. **Mean-Adjusted Net Income Volatility** (calculated as the standard deviation of net income (after-tax) over a five-year period divided by mean net income (after-tax) over the same five-year period)

- *> 0.75%* — *Warning signal*
- *> 1.5%* — *Advanced signal*

c. **Volatility-Adjusted Net Income** (calculated as the current year's after-tax net income less the standard deviation of after-tax net income over the last five years)

- *(assuming 1 standard deviation) < 0* — *Warning signal*
- *(assuming 2 standard deviations) < 0* — *Advanced signal*

e. Efficiency Ratio
Measured as the percentage of non-interest expenses over gross revenue (calculated as the sum of net interest income stated on a tax-equivalent basis and other income).

- *> 60%* — *Warning signal*
- *> 80%* — *Advanced signal*

1.10 Interest Rate Risk Management

Institutions should have limits for interest rate risk that reflect an institution's overall risk exposure, its capital adequacy, liquidity, credit quality, investment risk and foreign exchange risk. The inability to effectively identify, quantify, assess and monitor interest rate risk can affect an institution's decision making. Moreover, a lack of management skills and experience in the area of interest rate risk management can lead to inappropriate use of hedging techniques and ultimately cause serious financial damage.

The short-term (i.e., maturity of less than one year) gap between assets and liabilities, including hedging, can be used as an early warning indicator of interest rate risk exposure, as follows:

- Gap between short-term assets/liabilities > 20% of total assets or liabilities. — Warning signal
- Gap between short-term assets/liabilities > 40% of total assets or liabilities. — Advanced signal

1.11 Foreign Exchange Risk Management

Foreign exchange risk limits should be set within the institution's overall risk profile, which reflects factors such as its capital adequacy, liquidity, credit quality, position risk, and interest rate risk.

Possible problems within the foreign exchange risk management area of a bank include:

- inexperienced individuals;
- weak supervision or an unenforced code of conduct (i.e., related party transactions);
- inappropriate delegation of authority resulting in unauthorised dealing;
- weak information systems;
- speculation versus hedging; and
- lack of understanding of counterparty and settlement risk.

An institution is at risk of loss when it has a net "long" position (excess of assets over liabilities) and the base currency is depreciating or when it has a net "short" position (excess of liabilities over assets) and the base currency is appreciating.

1.12 Management

The board of directors and senior management of a financial institution are responsible for providing depositors, creditors, shareholders and regulators with reasonable assurance that the institution's operations are appropriately controlled and risks are prudently and soundly managed.

An institution with a weak management will often demonstrate some of the following signs:

- weak corporate governance, which leads to an uninformed, inattentive or passive board of directors and/or senior management, or the opposite: overly aggressive activity by the board of directors or management;
- board resignation and management turnover;
- inappropriate corporate structure;
- presence of related-party transactions and indications of self-dealing;
- inadequate policies and procedures and inadequate reporting systems;
- limited disclosure or clouding of important quantitative or qualitative information to regulators/deposit insurers;
- poor response by management to recommendations from auditors and supervisory authorities;
- unsound business and financial practices;
- lack of focus on business strategy and inadequate business plans;
- mismanagement of new technology (e.g., computer system and applications);
- excessive weaknesses within subsidiary operations (e.g., brokerage activities, insurance, trust, custodian);
- appetite for risk taking/high-risk business philosophy;
- lack of appropriate technology to monitor risks to various business segments;
- lack of qualified and competent staff, insufficient compensation arrangements;
- inadequate supervision of key officers/departments;
- lack of succession plan/contingency planning;
- lack of compliance with legal/regulatory/legislative requirements; and
- mismanagement and fraud.

Exhibit 1.10

More than three-quarters of the failures in Canada over a 10-year period ending in 1996 were caused by mismanagement. The lack of business plans and a coherent strategy for dealing with the risks facing these institutions were generally the causes. Many of the other failures were a result of a parent's financial distress. In a few cases, fraud appeared to be at the heart of the failure. Other factors that contributed to failure included rapid growth, excessive loan concentration in certain segments of the real estate industry, poor controls, and violations of laws and regulations.

A common characteristic of many failed institutions was a lack of control systems. In particular, this included inadequate credit rating systems and review processes and an absence of documented policies and procedures related to concentration limits.

Mounting provisions for loan losses and write-offs required to reflect the depressed real estate values in the 1990s eroded the earnings of most financial institutions in Canada. Many of the failures and problems experienced by other institutions were related to an excessive exposure to distressed segments of the real estate market.

Deregulation, technological advances, and globalisation in the financial sector have increased the volatility and risks to which financial institutions are now exposed. Lessons of the past suggest that managers of financial institutions will have to continue to develop sound and prudent business plans and strategies, avoid over-concentration in any given sector, refrain from excessive risk taking and aggressive market share expansion, and ensure the existence of strong controls and procedures in their institutions.

CAUSES OF FAILURES

Mismanagement
- lack of business plans and coherent strategies
- excessive risk taking in expanding market segments

Control Systems
- inadequate control systems to ensure compliance with internal policies and supervisory rules
- inadequate credit analysis and loan review procedures

Poor Asset Quality
- excessive concentration in a single sector
- excessive loan growth in relation to management, control systems, and funding sources
- overlending (high loan-to-debt serviceability ratio)

Poor Liquidity
- lack of cash to ensure the continuation of operations: caused by mismatch of loans and short-term assets and liabilities

Capital Adequacy
- inadequate capital to meet all applicable regulatory requirements and/or operating losses

Fraud and Concealment
- material fraud generally includes the intent to deceive and/or an attempt to conceal
- insider abuse in self-dealing

Parent (or group contagion)
- difficulties caused by problems elsewhere in the group

1.13 Conclusion

This paper has presented a number of useful early warning indicators that cover some key functions of a bank's operations. The list is not exhaustive and should be supplemented by other indicators specific to areas of potential risks, type of deposit-taking institution, and the financial and regulatory environment.

Early warning indicators of financial distress at deposit-taking institutions, used in conjunction with professional judgement, should lead to early intervention and help reduce losses to deposit insurers or governments. These indicators should signal areas of potential risks and problems and help focus monitoring efforts and intervention. However, the use of early warning indicators will not prevent failures or problems at institutions from occurring. The supervisory system must encourage, even pressure banks to develop sound business strategies, to put in place prudent policies that avoid over-concentration and excessive risk taking, and to operate with a strong control and procedure culture.

PART II

DEPOSIT INSURANCE

2. DEPOSIT INSURANCE AS A MODE OF DEPOSITOR PROTECTION

by Resci Baghawani

Among SEACEN member countries, only the Philippines has a formal deposit insurance system. Patterned after the US Federal Deposit Insurance Corporation (FDIC), the Philippine Deposit Insurance Corporation (PDIC), like most deposit insurers, was created after a series of bank failures (in 1963). This was intended to restore depositor confidence in banks. Today, each depositor is guaranteed insurance cover of a maximum of P100,000 (around US$2,500) in each bank in the Philippines.

A survey among SEACEN members revealed that despite existence of a formal deposit insurance system, Philippine depositors may in fact enjoy the least deposit guarantee against bank failures. This is because the rest of SEACEN countries provide implicit deposit protection whenever deemed necessary. Thus, governments guarantee deposits, mostly in full. In some instances, government also guarantees other bank creditors.

During these times of uncertainties in the Asian financial markets, when numerous banks have been failing, the issue of whether a formal deposit insurance system should be set up in lieu of the prevailing implicit scheme resurfaces. This paper seeks to summarise the major features critical to the effectiveness of deposit insurance, and how these were evident from Philippine experience.

2.1 Depositor Protection: State Responsibility

The best form of depositor protection is providing depositors information necessary for them to discriminate among banks, enabling them to avoid problem banks. Unfortunately, banking is one industry where information is opaque. On one hand, we have banks who have difficulty in evaluating borrowers. On the other hand, we have depositors, creditors, supervisors, and other outsiders who have difficulty in discerning the bank's true financial condition, such that problems are detected usually too late. This is compounded by the generally limited public disclosure requirements in most SEACEN countries.

The unsophisticated depositors, who have no access to information on banks' financial condition, are least able to guard themselves against and sustain losses from such failures. In contrast, the rich are able to hire financial analysts and acquire information necessary to distinguish between sound and insolvent banks. The prevalent lack of information, particularly to small depositors, on bank operations such as the quality of loan portfolio and concentrations of risks, either prevents depositors from moving their funds away from failing banks to better banks, or discourages savings altogether.

Because of its fiduciary nature, banking is an industry like no other. In most businesses, a client shells out his money in exchange for goods or services. In banking, the depositor gives his money, in exchange for which is a promise to get back his funds plus the agreed income anytime he needs it. This is why banking is the most regulated industry. The State, therefore has a social obligation to regulate and supervise banks in order to ensure that only well capitalised and professionally managed banks are allowed to operate. By doing so, savers are encouraged to channel their excess resources into productive use through the financial intermediation function of banks.

2.2 Deposit Insurance: Definition and Rationale

Deposit insurance is a system of guaranteeing the value of a saver's deposit in the event of bank failure. It can be in the form of a mutual insurance system among the insured banks themselves, administered either through a government institution or a privately held one.

The objectives for the establishment of a deposit insurance scheme is primarily to safeguard the payments system, protect small depositors, promote savings and foster development of the financial intermediation process.

Deposit insurance does not involve "insurance" in its common meaning, as it is more accurately deposit protection. Normally the insurer is able to manage its risks by combining the exposures of the insured clients, through which combination, the insurer improves its ability to predict expected losses and consequently impute such expectation in the premium structure. Deposit insurance does not typically allow the risk transfer advantage. The method by which the insurance

risk can be viewed as both having homogeneity and predictability has not been satisfactorily designed. The premium collected does not reflect the insurer's risk on a particular bank nor the insurer's overall historical loss experience. Thus, deposit insurance has usually involved some government participation to allow premium rates to vary over time and make up for any losses incurred without fear of losing any of the insurance cover.

By raising the crisis of confidence threshold of the general public, systemic risks arising from irrational runs in healthy banks may be averted, thereby enhancing stability in the banking system. It is not a means of providing liquidity support to solvent banks. While it seeks to maintain a sound and efficient banking system, it cannot by itself prevent bank failures, nor can it address problems arising from systemic failures. It cannot prevent a bank from getting into serious difficulties, neither can it entirely eliminate irrational runs. Deposit insurance does not substitute for effective bank supervision; it will in fact be ineffective without it. Deposit insurance compensates for government lapses in bank supervision.

2.3 Implicit Deposit Protection

An implicit depositor protection scheme involves government extending partial or full guarantee to depositors. This is not mandated by law but is resorted to in pursuit of public policy goals. It is done on an ad hoc basis. The undefined coverage and unclear expectations under this scheme tend to erode market discipline and could lead to slow and inefficient resolutions. This scheme provides flexibility as to mode, amount of protection and source of funding. This is normally funded from government budget or through the central bank, and as such, has unlimited funding potential.

The government may provide implicit deposit protection by reimbursing depositors either through direct payments or though another bank assuming the deposits. In lieu of immediate cash payment, the reimbursement could be paid in staggered cash or in government bonds, which effectively reduce the net present value of amounts paid.

Financial support may be given for the merger of the failing bank with another financial institution as a means of averting bank closure. This effectively results in full protection for all the depositors. In some

cases, governments rehabilitate banks through purchase of non-performing assets or direct capital infusion. The depositors may also be made to cover some of the cost of rehabilitation by converting some or all of the deposits into equity.

2.4 Formal Deposit Insurance System

Formal deposit insurance is usually mandated by law. The law specifies types of financial institutions and deposits eligible for insurance, whether membership is voluntary or compulsory, the maximum amount of insurance cover, how the fund would be financed, and the modes by which the deposit insurer can resolve failing bank situations. Because rules and regulations are predetermined, its implementation is usually faster, smoother and predictable. The presence of clear guidelines elicits more confidence in the system. Its losses are usually limited to the extent of the fund and ability to borrow. It may utilise the same failure prevention tools as the implicit scheme. The cost of operation is normally covered by premiums paid by member banks.

With small financial institutions allowed to fail, the use of implicit depositor protection is biased against depositors of such institutions. Further, with an implicit system, banks are not made to underwrite the cost of depositor protection from which they greatly benefit, resulting in taxpayers subsidising the banks. That deposit insurance increases moral hazard is questionable since most countries who do not have it resort to financing bank assistance and protecting depositors anyway. Thus, moral hazard is a function of the extent this type of intervention is applied.

2.5 Major Features of Deposit Insurance

In establishing a formal deposit insurance system, decisions have to be made on which of the alternative modes of structuring the system should be adopted, particularly with regard to the following features:

(i) Types of institutions covered
(ii) Public versus private funded systems
(iii) Compulsory versus voluntary membership
(iv) Single versus multiple funds
(v) Fixed versus variable premium rate
(vi) Extent of insurance coverage

Table 2.1

Summary of Basic Differences of an Implied Deposit Protection System (IDPS) and an explicit Deposit Insurance System (DIS)

Feature	Implied	Explicit
1. Administrative Handling of Failed Banks	- discretionary - tends to be slow and inefficient	- follows predetermined set of rules & regulations - fast, smooth & efficient operation
2. Risk Implications	- likely to erode market discipline due to undefined coverage & unclear expectations	- elicits more confidence in the system due to presence of clear guidelines
3. Legal Obligation	- not bound	- mandated
4. Capacity to Absorb Losses	- unlimited potential - undetermined/actual	- limited to the extent of the Deposit Insurance Fund & ability to borrow
5. Financial Cost	- no cost to banks - taxpayers bear the cost	- banks pay insurance premium

The determination on the specific features will depend greatly on the purpose of the deposit insurance. Policy makers should have control over the amount, form and timing of the insurance protection offered.

2.6 Critical Features of Deposit Insurance

The major problem with having a deposit insurance system is when the deposit insurer is not given strong financial and organisational structure. In developing countries where banking systems are unstable, and many bank failures are expected, there is a strong attraction to establish a formal deposit insurance. But because of the large losses that loom in such a situation, it may be best to defer such creation.

Deposit insurance should be considered only in countries that: (i) have at least a fairly stable banking system; (ii) have an effective

banking regulation; (iii) exhibit a willingness to adequately fund the system and give it the necessary government back-up support that may be required to get the system through a period of stress.

For those that do not meet these conditions, the emphasis should be placed on trying to get the banking system under control by stabilising the macro-economic environment; strengthening banking laws and bank supervisory and examination systems, and continuing to rely on an implicit system to protect depositors and restructure the banks.

As learned painfully in the Philippines, the following features are critical to help ensure effectiveness of the deposit insurer.

2.6.1 Adequate Funding

The credibility of deposit insurance depends largely on its ability to finance pay-off of insured deposits. When funding of bank closures is inadequate, regulators may be unwilling to close insolvent banks. When such inadequacy is apparent, the depositor confidence is likely to be eroded. The insurer should have ready access to funds to immediately finance pay-off, either through a stand-by credit line or through budgetary allocation.

The common manner of financing the deposit insurance fund is through seed funding by government either through a loan or an equity. The member banks then make periodic premium payments to the fund. The deposit insurer should have the authority to borrow from the Central Bank or the Treasury to promptly meet all obligations.

The PDIC was not adequately funded after its creation. Thus, after the series of bank closures involving 140 banks accounting for 6% of total bank deposits, PDIC had to borrow extensively from the central bank to meet its obligations. It increased premium rates at a time when banks could least afford it. It also avoided providing for reserve for probable insurance losses in order to report a positive net worth and not cast doubt on its credibility. It was only in late 1980s when the Government injected capital into PDIC. In 1992, the annual premium rate was more than doubled from one-twelfth of 1 percent to one-fifth of 1 percent of deposits. This significantly boosted the Deposit Insurance Fund.

2.6.2 Limited Insurance Coverage

The main objective of deposit insurance is the protection of small unsophisticated depositors. The bigger depositors should be given limited cover. There are various factors considered in determining coverage: the number of accounts covered as a percentage of the total, prevailing consumer price index, level of total deposit liabilities of the banking system, and bank closure experience.

Full insurance coverage increases moral hazards as depositors will chase after high interest paying banks without regard for risk of failure. This will also give bank deposits undue competitive advantage over other investment channels. Additionally, it would weaken bank management incentives to pursue policies conducive to the protection of depositors.

2.6.3 Independent Supervisory Powers

Since the deposit insurance premiums charged may not be fully commensurate to the risk of failure, and since the probability of failure is strongly influenced by the bank managers, the insurer should have independent supervisory powers over insured members. The deposit insurer should have access to all information on the condition and operation of member banks to allow for accurate estimation of risk of closure. This will allow implementation of prompt corrective action to more effectively guard against failure.

The insurer should likewise have the power to screen prospective members and revoke insurance cover of members unable to meet sound and safe banking standards. It should be empowered to handle bank failures and extend assistance if necessary, provided the cost of such assistance should be less than estimated cost of closure (claims payment less recoverable value of assets).

Until recently, PDIC had no power to conduct independent examination of banks. The Central Bank then had the sole power to examine banks. It also had authority to lend to problem banks. And if banks were closed, central bank personnel became receivers and liquidators. The situation somehow involved breakdown in supervision controls because of the supervisor's propensity to assist the bank it supervises to avoid closure. And in case of closure, there will be no

incentive to identify lapses in supervision in order to avoid them. This deprived PDIC of the critical tool to manage its insurance risk through implementation of corrective measures. In 1992, when PDIC was strengthened, it was vested the authority to undertake independent examination and to terminate bank membership for uncorrected unsafe and unsound practices or condition.

Examination powers for deposit insurer should allow access to any and all information about the bank. At present the effectiveness of PDIC is seriously hampered by its inability to look at deposit accounts as contained in the Law on the Secrecy of Deposits. With a significant portion of the liabilities not validated by the examiners, the true condition of the bank cannot be ascertained.

2.6.4 Ability to Quickly Pay Claims

Depositor confidence in the deposit insurer will be eroded if payment of insured claims is delayed. Insured depositors must be paid promptly to avert personal losses and inconveniences stemming from inaccessibility to own funds, even if only temporary. In order to spare the depositing public the trauma of bank closure, the service to depositors should be least disrupted, and if possible, avoided. In more developed countries, as in the US, a bank may be closed on a Friday and opened the next Monday. In Canada, depositors of failed institutions are able to access their funds in a few days. When this is achieved, bank runs could become a thing of the past.

Due to the law on the secrecy of deposits, PDIC is able to have access to bank deposit accounts only upon closure. By this time, problems in recording are usually uncovered. This results in very protracted determination of which deposits are legitimate as basis for processing claims. Thus, with the uncertainty of restoration of access to savings, even depositors with full insurance cover rush to withdraw their funds at the slightest hint of trouble.

2.6.5 Adoption of Clear Exit Policies

Just as there are clear criteria for granting bank licences, the revocation of such should likewise be guided by clear rules and procedures. Bank closure if not handled properly may entail serious displacement of resources. The bigger the bank the bigger the displace-

ment. Employees will be displaced. The community will be deprived of banking services. Even collection of loans will be disrupted. Much of the bank's assets may be idle for some time. For this reason, regulators will tend to avoid big closure or simultaneous bank closures.

The trauma experienced by the Philippine Central Bank when the Supreme Court reversed the decision to close the biggest thrift bank (Banco Filipino) left the Central Bank officials who recommended its closure saddled with court cases for which they have to incur legal costs. This has muddled exit policy for banks. In order to avoid court cases filed by owners of closed banks, recommendation to close is usually deferred until it can be established beyond reasonable doubt that the bank is indeed insolvent. This means that the value of the assets of the bank would have been seriously dissipated before it is actually closed, thereby allowing the distressed bank to continue funding losses from deposits.

2.7 Summary and Conclusion

The complexity of deposit insurance systems, particularly in addressing the attendant moral hazard issue, necessitates deliberate design to achieve effectiveness. As pointed out by Talley and Mas "they generally function well if they are public; if they are adequately funded and have government backup support in a crisis; if bank membership is compulsory; if deposits are not fully insured; and if the insurer can resolve bank failures in a variety of ways". It is important to stress, however, that no deposit insurance can be viable without power to examine and to a certain extent supervise member banks.

Ricki Heilfer as Chief Executive Officer of FDIC once said: "Over three generations, deposit insurance has brought peace of mind to tens of millions of depositors, who no longer had reason to fear the failure of their banks. More importantly by insulating banks from runs and panics, deposit insurance stabilised the U.S. financial system and helped facilitate the Federal Reserve's efforts to manage the money supply Moreover, as events not many years ago again remind us, the safety and soundness of banks influences the economy. That influence is substantial, direct and often immediate. Therefore, our efforts to strengthen the safety and soundness of banks

are aimed not just at protecting the deposit insurance fund—as important as that is—they also look to stabilising and strengthening the economy as a whole. If the FDIC did not exist, it would only be logical to create it.

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PART III

METHODS FOR RESOLVING FAILED FINANCIAL INSTITUTIONS

Division of Resolutions and Receiverships,
U.S. Federal Deposit Insurance Corporation

3. OVERVIEW: THE RESOLUTION HANDBOOK AT A GLANCE

The Federal Deposit Insurance Corporation (FDIC) learned many lessons about resolving failing financial institutions as it managed the crisis that beset the bank and thrift industries beginning in 1980. The sheer number of failing institutions and their varied businesses and asset sizes afforded the FDIC a wide range of resolution experiences. Finally, because the crisis lasted a relatively long time, the FDIC had to conduct resolutions at all phases of various economic cycles. Following is a brief outline of the material presented in this handbook which is a compilation of the lessons learned by the FDIC during those crisis years.

3.1 The Resolution Process

In order to minimise disruption to the local community, the resolution process must be performed as quickly and smoothly as possible. The FDIC employed three basic resolution methods: purchase and assumption (P&A) transactions, deposit payoffs, and open bank assistance transactions.

3.1.1 Resolution Strategy

The FDIC's resolution activities begin with the receipt of the Failing Bank Letter. After a planning team has contacted the chief executive officer of the failing bank or thrift, the FDIC sends in a team of specialists to complete an information package. Part of the information package is an asset valuation review. The appropriate resolution structures are then chosen, and the FDIC conducts an on-site analysis to prepare and plan for the closing.

3.1.2 Marketing a Failing Institution

Once all the possible resolution methods have been selected, the FDIC begins to market the failing bank or thrift as widely as possible to encourage competition among bidders. An information meeting is held to discuss the details of the failing institution with the approved bidders. All bidders performing due diligence are provided the same information, so no one bidder has an advantage.

3.1.3 Bid Submission

Bids are submitted in two parts: the first amount is the premium for the franchise value of the failed institution's deposits, and the second amount is for all or part of the institution's assets.

3.1.4 Least Cost Analysis

In 1991, to comply with legislation, the FDIC amended its failure resolution procedures to decrease the costs to the deposit insurance funds. The new procedures require the FDIC to choose the resolution alternative that is the least costly to the deposit insurance fund of all possible methods for resolving the failed institution. Bids are forwarded to the FDIC headquarters where the bids are reviewed and the least cost determination is made.

3.1.5 Calculation of Cash Amount Due to Acquirer

The FDIC in its corporate capacity transfers cash to an acquiring or agent institution in an amount equal to the liabilities assumed minus the amount of assets purchased and minus the amount of the premium (if any).

3.1.6 FDIC Board of Directors Approval

The FDIC staff submits a written recommendation to the FDIC Board of Directors requesting approval of the resolution transaction. The FDIC Board may direct that the winning bid determination be delegated to the appropriate division director. Once the FDIC Board of Directors has approved the transaction, FDIC staff notifies the acquirer(s), all unsuccessful bidders, and their respective regulatory agencies.

3.1.7 Closing the Institution

The final step in the resolution process occurs when the institution is closed and the assets and deposits are passed to the acquirer. The chartering authority closes the institution and appoints the FDIC as receiver.

3.1.8 Resolution Time Line

The entire resolution process is generally carried out in 90 to 100 days, not including the post-closing settlement timeframes.

3.2 Purchase and Assumption Transactions

The most common resolution method for failing banks or thrifts is the P&A transaction. In a P&A, a healthy institution assumes certain liabilities of the failed institution in exchange for certain assets of the failed institution plus financial assistance from the FDIC in its corporate capacity. There have been a variety of P&A transactions as the basic agreement is conducive to change. Since each failed bank situation is unique, the terms of the agreements should be flexible enough to obtain the highest value for the receivership. Variations include loan purchase P&As, modified P&As, P&As with put options, P&As with asset pools, and whole bank P&As. Two of the more specialised P&As are loss sharing transactions and bridge banks.

Loss sharing was designed to address the problems associated with marketing large banks with sizeable commercial loan and commercial real estate portfolios by limiting the downside risk of those portfolios to the acquirers. In a loss sharing transaction, the FDIC absorbs a significant portion of any credit losses on commercial loans and commercial real estate loans, typically 80 percent, and acquiring institutions assume the remaining 20 percent of loss. A bridge bank is a full-service national bank chartered by the Office of the Comptroller of the Currency and controlled by the FDIC. It can be operated for two years, with three one-year extensions. A bridge bank provides the FDIC time to arrange a permanent transaction, and is especially useful in situations in which the failing bank is large or unusually complex.

3.3 Deposit Payoffs

A deposit payoff is only executed if the FDIC does not receive a bid for a P&A transaction that meets the least cost test. There are two types of deposit payoffs. The first type is a straight deposit payoff, in which the FDIC in its corporate capacity ensures that each depositor is paid the amount due, up to the insured limit. Depositors may come to the failed bank premises to collect their checks, or the FDIC may mail the checks to the depositors. The second type is an insured

deposit transfer, in which insured deposits and secured liabilities of a failed bank or thrift are transferred to a healthy institution, and service to insured depositors is uninterrupted.

3.4 Open Bank Assistance Transactions

The FDIC may provide open bank assistance to prevent an insured depository institution from closing, however, such proposals face significant policy, cost, and administrative obstacles when compared to alternative types of transactions. As a result, open bank assistance has not been used since 1992.

3.5 Other Resolution Alternatives

3.5.1 Net Worth Certificate Programme

Net worth certificates were used to provide non-cash assistance to troubled institutions. The purpose of this programme was to buy time for banks, thrifts, and savings banks to correct temporary problems caused by interest rate imbalances.

3.5.2 Income Maintenance Agreements

Income maintenance agreements were used to adjust for the effect that deregulation of interest rates was having on some of the larger savings banks. The FDIC used income maintenance agreements to facilitate mergers of troubled savings banks with healthy institutions.

3.5.3 Capital Forbearance Programme and Loan Loss Amortisation Programme

The FDIC implemented these two programmes to assist well-managed, economically sound institutions that were suffering because of the agricultural or energy crises or both.

3.5.4 Resolution of Savings and Loan Associations Prior to FIRREA

Mergers were a common method of resolution for the Federal Savings and Loan Insurance Corporation (FSLIC). Assistance in mergers included yield maintenance, which guaranteed a market rate of return on non-performing assets; capital loss coverage on certain assets, which

reimbursed the acquirer for losses that occurred when the assets were sold; negative net worth payments, which made the assets and liabilities of a failed thrift balance for the acquirer; and indemnifications, which protected the acquirer for legal expenses.

5.5.5 Control of Management

In 1985, a new FSLIC programme called the Management Consignment Programme placed troubled thrifts under new management in an attempt to strengthen the financial positions of the institutions for future sales or mergers.

3.6 The FDIC's Role as Receiver

The federal statutory framework governing the resolution of failed depository institutions promotes the sound and effective operation of receiverships, with the goal of reducing losses to depositors and creditors. The FDIC plays a predominant role as principal administrator of insured institutions' resolutions.

3.6.1 Comparison with Bankruptcy Law

The powers of the FDIC as receiver of a failed institution are similar to those provided to a bankruptcy trustee.

3.6.2 Why the FDIC Acts as Receiver

Prior to the creation of the FDIC, the Office of the Comptroller of the Currency supervised national bank liquidations. Liquidations of state banks varied considerably from state to state, but most were handled under the provisions for general banking insolvencies. The U.S. Congress created the FDIC in an effort to simplify the procedures, to eliminate duplication of records, and to vest responsibility for liquidation in the largest creditor, whose interest was to obtain the maximum possible recovery.

3.6.3 How the FDIC Becomes a Receiver

The FDIC must be appointed a receiver for insured federal savings associations and national banks. For state chartered and Federal Reserve member banks, the chartering authority has the option of ap-

pointing the FDIC as receiver, although rarely has another entity been appointed. In certain instances, the FDIC may appoint itself a receiver for a depository institution. Courts have long recognised the dual and separate functions of the FDIC in its corporate capacity as insurer and of the FDIC as a receiver.

3.6.4 The FDIC's Functions as Receiver

The FDIC is expected to maximise the return on the assets of the failed bank or thrift and to minimise any loss to the insurance fund that may result from closing the institution. A receivership is designed to market the institution's assets, liquidate them, and distribute the proceeds to the institution's creditors. The FDIC as receiver succeeds to the rights, powers, and privileges of the institution and its stockholders, officers, and directors. A receiver also has the power to merge a failed institution with another depository institution or to form a new nationally chartered institution, known as a bridge bank. The receiver is not subject to direction or supervision of any other regulatory authority.

3.6.5 The FDIC's Closing Function

After failure, the first task of the receiver is to take custody of the failed institution's premises and all its records. The next step is to inform the public of the institution's closing. The FDIC closing staff works to bring the general ledger in balance as of the closing date and, when there is an assuming institution, creates two sets of books: one for the assuming institution and one for the receivership.

3.6.6 Resolution of Claims Against the Failed Institution

All claimants must file proof of their claims with the receiver by a specified deadline. Once a claim has been filed, the receiver has 180 days to determine if the claim should be allowed. If the claim is allowed, the claim will be paid on a pro rata basis with other allowed claims of the same class. If the claim is denied, the claimant may file suit or continue pending litigation.

3.6.7 Payment of Claims

The National Depositor Preference Amendment and related statutory provisions provide that claims are paid in the following order:

(i) Administrative expenses of the receiver;
(ii) Deposit liability claims (the FDIC claim takes the position of the insured deposits);
(iii) Other general or senior liabilities of the institution;
(iv) Subordinated obligations; and
(v) Shareholder claims.

Claimants are sometimes issued an advance dividend based on the projected recovery value of the failed institution's assets. Advance dividends usually range between 50 cents and 80 cents on the dollar of receivership claims.

3.6.8 Special Receivership Powers

The FDIC as receiver has a number of special powers that have been granted by federal law.

A receiver may repudiate contracts of the depository institution that it deems are burdensome.

The receiver is substituted as a party in litigation pending against the bank or thrift. However, a court must stay the litigation at the request of the receiver; this allows the receiver to evaluate the facts to decide how to proceed. The receiver also has the right to remove litigation from state court to federal court.

The receiver has the power to avoid certain fraudulent transfers made by an institution's obligors within the period beginning five years before and ending five years after the receiver's appointment if there was an intent to hinder, delay, or defraud the institution;

Federal statutes provide certain "special defences" to the FDIC in its role as receiver to allow for the efficient resolution of a failed institution's affairs. Both statutes and court decisions recognise that, unless an agreement is properly documented in the institution's records, it cannot be enforced against the receiver, either to make a claim or to defend against a claim by the receiver. The U.S. Congress also provided the FDIC as receiver with additional protection by prohibiting courts from issuing injunctions or similar equitable relief to restrain the receiver from completing its resolution or liquidation activities.

3.6.9 Settlement with the Assuming Institution

A settlement date may be from 180 days to 360 days after the bank or thrift closing, depending on the institution's size.

3.6.10 Disposal of Assets and Termination of Receivership

In order to have funds to disburse, the FDIC works to dispose of the remaining assets of a failed institution in a timely manner through a variety of methods. Receivership termination represents the final process of winding up the affairs of the failed institution.

3.7 Other Significant Issues

The FDIC discovered many significant issues about resolving failing institutions during the bank and thrift crisis that began in 1980.

3.7.1 Maintaining Public Confidence in the Banking System

One of the FDIC's primary missions is to maintain public confidence in the U.S. financial system. When a bank fails, the FDIC accomplishes this mission through prompt and efficient payment of insured deposits and by minimising the impact of an institution failure on the local economy.

3.7.2 Adequacy of Insurance Funds

Preferably, adequate funds are available for resolving failing financial institutions. When such funds are not available, officials should focus on alternatives that minimise delay in resolutions.

3.7.3 Other Resolution Concerns

Failing financial institutions should be resolved as quickly as possible to preserve franchise values. Bidders' due diligence should be monitored to ensure equal treatment among all bidders. A resolution process that most closely resembles a free market will yield the best economic results for all involved. Resolution structures that provide assistance over a period of time must be carefully crafted to provide appropriate incentives.

3.7.4 Open Bank Assistance

Open bank assistance transactions should be engaged on an exception basis under strict guidelines and be established for minimum time frames. They should be executed under close supervision to

mitigate any negative impact on healthy institutions or the insurance fund, and for the appropriate treatment of creditors and shareholders of the subject institution.

3.7.5 Receivership Issues

Assistance can be gained and goodwill can be created by sharing information with the local media about how a resolution will be conducted. When planning for any closing, whether there is to be an acquiring institution or not, it is important to make arrangements for direct deposits coming into the failing bank or thrift and to coordinate with the on-line debit servicers concerning ATM transactions. Arrangements must be made to take care of failed institution customers who have concerns about uninsured deposits and loans retained by the receiver. Consideration must be given to ongoing business concerns and the availability of other credit sources in the local area. Creation of policies for dealing with borrowers of failed institutions is critical to maximising recovery on their loans.

4. INTRODUCTION

The United States of America provides protection to depositors in its banks, savings and loan associations, and credit unions. One of the key players in this process is the Federal Deposit Insurance Corporation (FDIC), which oversees the insurance funds for banks and for savings and loan (S&L) associations (also known as thrifts).

The FDIC's primary mission is to maintain stability and public confidence in the United States financial system by insuring deposits up to the legal limit[4] and promoting sound banking practices. In its unique role as deposit insurer, and in cooperation with other federal and state regulatory agencies, the FDIC promotes the safety and soundness of insured depository institutions and the U.S. financial system by identifying, monitoring, and addressing risks to the deposit insurance funds through its bank examination practices.

The FDIC promotes public understanding of banking and sound public policies by providing financial and economic information and analysis. It minimises disruptive effects from the failures of banks and savings and loan associations, and it assures fairness in the sale of financial products and the provision of financial services. The FDIC is responsible for effectively managing receivership operations and for making sure that failing institutions are resolved in the manner that will result in the least cost to the deposit insurance funds.

To fulfil its mission, the FDIC performs three functions:

- In its capacity as insurer, the FDIC maintains, manages, and controls risks to two deposit insurance funds.[5] Whenever a federally insured depository institution fails, the FDIC pays off insured deposits or, more frequently, it arranges for the transfer of accounts from the failed institution to a healthy one.

4. The limit for deposit insurance was initially set at $2,500; this limit was raised to $5,000 on 30 June 1934; $10,000 in 1950; $15,000 in 1966; $20,000 in 1969; $40,000 in 1974; and $100,000 in 1980, where it remains to this day.

5. The Financial Institutions Reform, Recovery, and Enforcement Act of 1989 established two separate deposit insurance funds, the Bank Insurance Fund (BIF) and the Savings Association Insurance Fund (SAIF).

- The FDIC shares responsibility for the supervision and regulation of banks and thrifts in the United States with other federal regulators and with state banking authorities. Of the federal banking agencies, the Office of the Comptroller of the Currency is responsible for supervising national banks; the Federal Reserve System is responsible for supervising both state member banks and holding companies; and the FDIC is responsible for supervising state nonmember banks and FDIC insured savings bank.[6]

- The FDIC acts as the receiver or liquidating agent for failed federally insured depository institutions. In its role as receiver, the FDIC has a fiduciary obligation to all creditors of the receivership[7] and to stockholders of the failed institution to maximise the amounts recovered as quickly as possible.

The FDIC has learned a great deal about the regulation of bank and thrift institutions since it was created in 1933. An important part of that experience has been learning how best to resolve failed financial institutions. By "resolving" a failed bank or thrift, the FDIC meets its obligations to the failed institution's customers who had insured deposits and helps maintain the stability of the banking system.

The **resolution process** involves valuing a failing federally insured depository institution, marketing it, soliciting and accepting bids for the sale of the institution, determining which bid is least costly to the insurance fund, and working with the acquiring institution(s) through the closing process (or ensuring the payment of insured deposits in the event there is no acquirer).

The **receivership process** involves performing the closing function at the failed bank or thrift; liquidating any remaining failed institution assets; and distributing any proceeds of the liquidation to the FDIC, to the failed institution's customers who had unin-

6. FDIC, History of the Eighties—Lessons for the Future: An Examination of the Banking Crises of the 1980s and Early 1990s (Washington, D.C.: Federal Deposit Insurance Corporation, 1997), 463.

7. A failed institution's creditors include the FDIC (in its corporate capacity), which essentially stands in the place of the failed institution's customers with insured deposits.

sured deposit amounts, to general creditors, and to those with approved claims.

The United States has confronted massive bank failures more than once in its history. One notable time was in the midst of the Great Depression, when 9,096 banks failed from 1930 through the first three months of 1933. The FDIC was created in response to this crisis, and the foundation was laid for our current system of deposit insurance.

The success of the U.S. deposit insurance system through the 1950s and 1960s may be partly attributed to the generally stable and prosperous economic climate that prevailed, as well as to the regulated environment in which banks operated. During that 20-year period, 75 banks failed, an average of fewer than four banks per year. While this number of failures may seem large in comparison to bank failures in most other countries, it is important to note that the United States banking system consists of a large number of small, independent banks that serve their communities. For example, in 1979, there were 14,364 insured commercial and mutual savings banks in the United States and 4,363 S&Ls.

The banking economy began to change in the 1970s, leading up to the banking and thrift industry crisis of 1980 through 1994 during which time 1,617 banks and 1,295 savings and loan institutions failed or required financial assistance. By 1995, the number of financial institutions ha decreased, leaving 9,040 insured commercial and mutual savings banks in the United States and 2,030 S&Ls.

Until 1989, the Federal Savings and Loan Insurance Corporation (FSLIC), which was created in 1934 under the National Housing Act, insured savings and loan associations. The FSLIC insurance fund was declared insolvent in 1987, and the U.S. Congress dissolved that agency in 1989, transferring its failure resolution and receivership responsibilities to the newly created Resolution Trust Corporation (RTC). At that time, the U.S. Congress also gave responsibility for insuring the deposits in S&Ls to the FDIC.

The FDIC was responsible for developing a plan to address the savings and loan crisis of the 1980s and for helping the fledgling RTC begin to manage hundreds of thrift failures. The RTC was an independent temporary government agency created by the U.S. Congress spe-

cifically to handle the savings and loan crisis. At its inception on August 9, 1989, RTC's sunset date was established as 31 December 1996. Because of the efficiency with which it handled its task, the RTC was closed one year early. When the RTC was dissolved as of 31 December 1995, its duties with regard to failure resolution and receivership management for S&Ls were transferred to the FDIC.

Overall, from 1980 through 1994 the United States financial institution crisis resulted in 2,912 failed or assisted financial institutions. By 1995, the number of combined annual failures and assistance transactions had dropped to eight, and to six by 1996. In 1997, there was only one bank failure, and no failures of savings and loan associations. Chart 1.1 shows all the failures and assistance transactions per year, per agency during the crisis years.

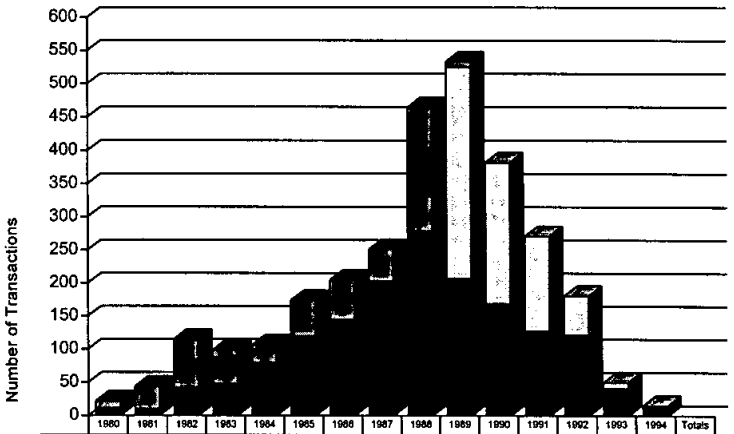
Many countries face difficulties with their financial industries not unlike the ones that the FDIC faced first at its inception and again in the 1980s and the early 1990s. Each year the FDIC provides information and resources to a wide range of foreign and domestic parties interested in the FDIC's resolution experiences. The purpose of this publication is to describe the FDIC's resolution process, to outline the different resolution methods, to provide information on other resolution alternatives, to describe the duties of the FDIC as receiver, and to highlight some important lessons learned through the FDIC's more than 60 years of experience in resolving failing and failed institutions.

The intended audiences for this publication are regulators and chartering authorities of foreign financial institutions, foreign central bankers, and others interested in the bank and thrift industries and their regulation. By sharing this information, the FDIC hopes to contribute to the international dialogue needed to promote stable banking systems and productive economies throughout the world.

A glossary is included in the back of this handbook for easy reference to the terms and abbreviations used herein.

Chart 4.1

Total Failures And Assistance Transactions (Banks and Savings & Loans) 1980-1994



	1980	1981	1982	1983	1984	1985	1986	1987	1988	1989	1990	1991	1992	1993	1994	Totals
Totals	22	45	115	99	10	174	205	251	464	533	382	271	181	50	15	2,912
FSLIC	11	34	73	51	26	54	60	48	185	8						550
RTC										318	213	144	59	9	2	745
FDIC	11	10	42	48	60	120	145	203	279	207	169	127	122	41	13	1,617

Figures include open bank assistance transactions.

Source: FDIC Division of Research and Statistics.

5. THE RESOLUTION PROCESS

Protecting insured deposits in the event of a bank or thrift failure is one of the Federal Deposit Insurance Corporation's (FDIC) most critical roles. When an insured depository institution is about to fail, the FDIC takes immediate action to resolve it. Any resolution process should be performed quickly and smoothly. In the case of a small bank or thrift, swift resolution minimises disruption to the local community. In the case of a very large institution, a failure can have national economic implications, and speed in resolving the problem is critical.

There are three basic resolution methods for failing institutions, which are described in more detail in Chapter 6, Purchase and Assumption Transactions, Chapter 7, Deposit Payoffs, and Chapter 8, Open Bank Assistance Transactions.

- A **purchase and assumption (P&A) transaction** is a closed institution[8] transaction in which a healthy institution (generally referred to as either the acquirer or the "assuming" bank or thrift) purchases some or all of the assets of a failed bank or thrift and assumes some or all of the liabilities, including all insured deposits. Occasionally, an acquirer may receive assistance from the FDIC as insurer to complete the transaction. As a part of the P&A transaction, the acquirer usually pays a premium[9] to the FDIC for the assumed deposits, which decreases the total resolution cost.

- In a **deposit payoff,** as soon as the appropriate chartering authority closes the bank or thrift, the FDIC is appointed receiver. The FDIC as insurer pays all of the failed institution's depositors with insured funds the full amount of their insured deposits.[10] Deposi-

8. A closed financial institution is one whose charter has been revoked by its chartering authority.

9. The premium is the part of a bid for a failing institution's franchise value.

10. The FDIC's insurance limit is $100,000. Any amount over that limit, including interest, is uninsured. The FDIC uses the term "insured depositor" to refer to any depositor whose deposits are under the insurance limit. Similarly, the term "uninsured depositor" is used to refer to those depositors whose deposits are over the insurance limit. It is important to note that customers with uninsured deposits are paid up to the insurance limit; and only that portion of their deposits that is over $100,000 is uninsured.

tors with uninsured funds and other general creditors (such as suppliers and service providers) of the failed institution do not receive either immediate or full reimbursement; instead, the FDIC as receiver issues them receivership certificates. A receivership certificate entitles its holder to a portion of the receiver's collections on the failed institution's assets.

- In an **open bank assistance (OBA) transaction,** the FDIC as insurer provides financial assistance to an operating insured bank or thrift determined to be in danger of failing. The FDIC can make loans to, purchase the assets of, or place deposits in a troubled institution. Where possible, an assisted institution is expected to repay its assistance loan.[11] Due to restrictions imposed under the Federal Deposit Insurance Corporation Improvement Act (FDICIA) of 1991 and under The Resolution Trust Corporation Completion Act of 1993, which amended the Federal Deposit Insurance Act of 1950, OBA is no longer a commonly used resolution method.

During the 1980s, there were a number of adaptations of these basic resolution methods as the nation grappled with a large number of failing banks under challenging economic conditions. Between 1980 and 1994, the FDIC and other financial regulatory agencies developed an array of strategies. Some of these strategies were refined over time, while others were abandoned after they had served their purpose. Although cost considerations determine the ultimate method through which a failed institution is resolved, the FDIC still possesses sufficient latitude to customize particular resolution methods within that framework. Circumstances frequently dictate that the methods be modified considerably.

In every failing institution transaction, the FDIC assumes two roles. First, the FDIC in its corporate capacity as insurer protects all of the failing institution's depositors for the amount of their insured deposits by using one of various resolution techniques. Second, the FDIC acts as the receiver of the failed institution and administers the receivership estate for all creditors. The FDIC as receiver is functionally separate from the FDIC acting in its corporate role as deposit insurer, and the

11. Generally, an OBA agreement includes provisions for the repayment of the assistance in whole or in part.

FDIC as receiver has separate rights, duties, and obligations from those of the FDIC as insurer. U.S. courts have long recognized these dual and separate capacities. More information on this subject is provided in Chapter 10, The FDIC's Role as Receiver.

5.1 Resolution Strategies

In the United States, a bank or thrift institution must obtain a charter from a recognized chartering authority in order to obtain federal deposit insurance and do business. The chartering authority typically closes an institution when the institution becomes insolvent, critically undercapitalized, or unable to meet requests for deposit withdrawals.[12] The chartering authority, which is the individual state banking agency for state chartered institutions, the Office of the Comptroller of the Currency for national banks, or the Office of Thrift Supervision for federal savings institutions, informs the FDIC when an insured institution will be closed.

Although the FDIC monitors troubled banks, its formal resolution activities begin when a financial institution's chartering authority sends a "failing bank letter" advising the FDIC of the institution's imminent failure.[13] Once the FDIC receives a failing bank letter, a planning team from the FDIC contacts the chief executive officer of the failing bank or thrift to discuss logistics, to address senior management's involvement in the resolution activities, and to obtain loan and deposit data from the institution or its data processing servicer. After the FDIC receives the requested data, a team of 5 to 15 FDIC resolution specialists visits the bank or thrift to gather additional information and analyse

12. In 1991, the FDIC was given the authority to close an institution that was considered to be critically undercapitalized (that is, having a ratio of tangible equity to total assets equal to or less than 2 percent) and that did not have an adequate plan to restore capital to the required levels. The FDIC was also given the authority to close an institution that either had a substantial dissipation of assets due to a violation of law, operated in an unsafe or unsound manner, engaged in a willful violation of a cease and desist order, concealed records, or ceased to be insured.

13. In the past, the FDIC was hesitant to undertake much pre-failure activity regarding a failing institution for fear that such action would cause the institution's customers to panic and withdraw their funds, causing a deposit "run" on the bank or thrift. A deposit run erodes an institution's liquidity and can accelerate its failure. Although bank and thrift customers have confidence in the stability of the banking system, the FDIC still maintains confidentiality regarding a failing institution's status.

the institution's condition. The resolution team assigns a value to all the assets of the institution, determines the resolution options the FDIC will offer, prepares an information package for the FDIC to give to potential bidders, and plans for the closing and receivership.

5.1.1 Asset Valuation

Simultaneously, the FDIC begins a review of the failing institution's assets using valuation models to estimate the liquidation value of the assets. This estimate is used in calculating the cost of a deposit payoff. Because the FDIC does not have enough time to assess every asset, it uses a statistical sampling procedure. Loans are divided into categories, such as real estate, commercial, and instalment loans, and within each category the loans are identified as either performing or non-performing. For each subcategory of loans, FDIC specialists identify a sample and carefully review the selected loans to establish an estimated liquidation value for each loan. The liquidation value is driven by the future cash flows and the expenses likely to be incurred during the collection of the loans. Adjustments are made to discount future cash flows and to account for liquidation expenses. The loss factor that results from that estimate is then applied to the sub-category of loans that were not reviewed.

5.1.2 Determining the Resolution Structure

All of the information gathered during the FDIC's review of a failing institution is used to determine the appropriate resolution structures to offer to potential bidders. In developing the marketing strategy, the FDIC considers four factors: (i) the asset and liability composition of the failing institution; (ii) the competitive and economic conditions of the institution's market area; (iii) any prior resolution experience with similar institutions in the same market; and (iv) any other relevant information, such as potential fraud at the institution. Based on this information, the FDIC determines how best to structure the sale of the bank or thrift.

The primary decisions include the following factors:

- How to market the institution; that is, whether to sell it as a whole or in parts. Portions of the bank or thrift, such as its trust business,

its credit card division, or its branches may sell best as separate transactions.

- Which types or categories of assets should be offered to prospective purchasers.
- How to package saleable assets; for example, should the acquirer be required to purchase them, should they be sold with loss sharing, or should they be offered as optional asset pools.[14]
- At what price the assets should be sold; for example, at book value, at a fixed value estimated by the FDIC, or at the reserve price.

In the early to mid-1980s, the FDIC was able to select the resolution method it preferred as long as the cost of the chosen method was less than the estimated cost of paying off the depositors and liquidating the failed institution's assets.[15] As the banking crisis became more acute toward the end of the 1980s, the FDIC tended to choose resolution transactions that passed a large portion of a failing institution's assets to the acquirer. This type of transaction was chosen for a variety of reasons that are described more fully in Chapter 6, Purchase and Assumption Transactions.

Since 1991, the FDIC has been subject to a new provision of the law that requires it to use the resolution type that is the least costly of all possible options. As a result, bidders of failed institutions have been offered a number of options, which tends to increase the number of bids the FDIC receives.

5.1.3 The Information Package

As part of its resolution process, the FDIC develops detailed data for the information package on the amounts and types of assets and liabilities that the failing institution holds. The information varies de-

14. Both loss sharing transactions and optional asset pools are described more fully in Chapter 6, Purchase and Assumption Transactions.

15. The FDIC developed a cost test in 1951 to determine the cost of a proposed resolution. The cost test was used to determine whether a purchase and assumption (or other) transaction would cost less than a deposit payoff. Purchase and assumption transactions resulted in de facto deposit insurance for all depositors, whereas deposit payoffs protected only customers with insured deposits.

pending on each institution's business strategy, as reflected in its asset and liability structure. For example, if a failing bank or thrift is involved primarily in residential mortgage lending, the FDIC will develop information on the basis of that bank's asset characteristics, such as the interest rates and the terms of the loans, as well as the performance status of the portfolio (that is, performing versus non-performing).

5.1.4 Planning for the Closing

Finally, the FDIC conducts an on-site analysis to prepare and plan for the closing. The FDIC estimates the number and dollar amount of uninsured deposits at the institution, determines and analyzes the extent of any contingent liabilities, and investigates whether any potential fraud is present.

5.2 Marketing a Failing Institution

Once the information has been gathered and the resolution options to be offered have been selected, the FDIC, while still cognizant of confidentiality concerns, begins to market the failing bank or thrift as widely as possible to encourage competition among bidders. The FDIC's bank examination force compiles a list of potential acquirers consisting of approved financial institutions and private investors.[16] In compiling the list, the FDIC takes into account the failed institution's geographic location, competitive environment, minority-owned status, overall financial condition, asset size, capital level, and regulatory ratings. Private investors wishing to bid on a failing institution must have adequate funds and be engaged in the process of obtaining a charter to create a new institution.

5.2.1 The Information Meeting

The FDIC invites all approved bidders to an information meeting. After signing confidentiality agreements, bidders receive copies of the information package, which includes financial data on the institution,

16. The bid list is reviewed by the financial regulatory authorities concerned, including the Office of the Comptroller of the Currency, the Federal Reserve Board, the Office of Thrift Supervision, and the appropriate state banking authority to determine which bidders will be approved to acquire the failing institution.

legal documents, and descriptions of the resolution options being offered. At the meeting, the FDIC provides details on the failing institution, the resolution methods being offered, the legal documents, the due diligence process,[17] and the bidding procedures. Typically, the terms of the transaction focus on the treatment of the deposits and assets held by the failing bank or thrift. The FDIC also advises the bidders about the types and amounts of assets that will pass to an acquirer as part of each of the various transactions terms; which assets the FDIC plans to retain; the terms of the asset sale, such as loss sharing arrangements and optional asset pools; and other significant conditions that are part of each proposed resolution method. Chartering authority officials describe the regulatory requirements for bidding, as well as the application process for branches or new charters.[18]

5.2.2 Revealing the FDIC's Reserve Price for Assets

For many years, the FDIC sold assets of failing institutions revealing only the book value of the assets, which is the principal amount shown on the failing institution's books or records. When only the book value was disclosed, bidding institutions were unaware of the FDIC's estimated value for the asset pool. The FDIC establishes the reserve price by estimating the fair market value of the assets in each pool and then deducting any estimated costs of disposition and direct marketing, arriving at a net figure that is known as the liquidation value of the assets. The reserve price is the liquidation value of the assets expressed as a percentage of the book value. For example, a reserve price for a mortgage loan pool might be listed as 94 percent.

The estimated liquidation value of the assets is a part of the FDIC's cost test for the resolution of the institution. Therefore, if a potential acquirer offers an amount at least equal to the FDIC's estimated liquidation value of the assets, that bid will be evaluated as less expensive than the cost of the FDIC's conducting a payoff of the failed institution's

17. Due diligence is a potential purchaser's on-site inspection of the books and records of a failing institution.

18. Private investors who do not already hold a financial institution charter must be approved for a new charter, known as a de novo charter, by the appropriate chartering authority, before they can purchase a failing institution. They cannot purchase a failed institution without the chartering authority's approval.

insured deposits and a liquidation of the assets. If no investor bids an amount at least equal to the FDIC's estimated liquidation value, then the asset pool remains with the receivership.

In the early 1990s, the FDIC attempted to increase the volume of assets sold at resolution by revealing the FDIC's reserve price for the asset pools. There are advantages and disadvantages to this practice. One advantage is that it promotes the sale of the loans. Revealing the reserve price encourages potential acquirers to have confidence that the FDIC's estimates are reasonable and that the time they invest in due diligence will be well spent.

The principle disadvantage to revealing the reserve prices of the asset pools occurs in transactions with few bidders. When bidders know there is little competition, revealing the reserve price may bias the bidding toward the reserve prices. For example, if an asset pool has a book value of $1 million and if the FDIC estimates the fair market value to be only $900,000 and the collection expenses to be another $50,000, the FDIC's reserve price will be 85 percent of the book value of the assets. A potential acquirer, having completed its own due diligence, may have estimated the fair market value of the assets to be $950,000 and its own collection costs as $30,000. That potential acquirer might ordinarily have bid up to 92 percent. However, if the FDIC discloses its 85 percent reserve price, the potential acquirer facing little competition might bid closer to 85 percent than to 92 percent. Although the FDIC's acceptance of the bid at 85 percent is less expensive for the FDIC than the cost of liquidating the assets, the reduced bid results in a loss of income for the receivership estate.

Even though the FDIC requires separate bids for the deposits (franchise value) and for the assets, many potential bidders frequently view a failing institution as a whole and will formulate the total amount they are willing to bid. They submit bids that link their franchise and asset bids into one "all-or-nothing" bid. If the FDIC's reserve price for the asset pools is higher than what a bidder had wanted to pay, a potential acquirer may offer the reserve price of the assets and correspondingly lower the amount it offers for the deposit franchise.

For example, a bidder may have valued a hypothetical failing institution at $1 million by estimating the value of the asset pools (net of collection costs) at $800,000 and the value of the deposit franchise

at $200,000. In this example, the FDIC is offering two asset pools: one has a book value of $500,000 with a reserve price of 85 percent ($425,000), and the second has a book value of $800,000 with a reserve price of 50 percent ($400,000). The bidder must offer at least $825,000 to acquire the two asset pools. The bidder may offer the same $1 million bid for the entire institution by lowering its bid for the franchise to $175,000. Exhibit 5.1 illustrates this example. Such a situation can occur only if competition among the bidders is minimal, because a bidder has a greater risk of losing the deposit franchise if it submits a low bid in a more competitive setting.

Exhibit 5.1

How Revealing the Reserve Price for Asset Pools May Affect Deposit Franchise Bidding

Bidder's calculations after due diligence		**Bidder's calculations to meet reserve price on assets**	
Estimate of asset value	$800,000	Bid for asset pools	$825,000
Estimate of franchise value	200,000	Bid for franchise	175,000
Total bid	$1,000,000	Total bid	$1,000,000

Historically, bankers have been reluctant to purchase assets of failing banks or thrifts unless they received the corresponding deposit base to fund the acquisition of the loans. In transactions completed between 1992 and 1994, virtually all of the assets passed to acquirers were part of asset pool bids that were contingent on the bidding bank winning the franchise. On the other hand, the Resolution Trust Corporation (RTC) experienced little difficulty in marketing the deposit franchise separately from the assets. Both methods should be offered to determine what the market will bear in a particular area. Exhibit 5.2 shows the benefits and other considerations of disclosing the reserve price on optional asset pools.

5.2.3 Branch Breakups

Some financial institutions may be worth more if sold in pieces. In certain failing institution situations, there may be few, if any, acquirers willing to assume the deposits of all branches of a multi-branch bank or thrift. A solution to this problem is to offer individual branches along with their deposits as a resolution option. The RTC used this

Exhibit 5.2

DISCLOSING THE RESERVE PRICE ON OPTIONAL ASSET POOLS

Benefits

- Ensures that at least the minimum is bid for each asset pool.
- Encourages bidders to invest in due diligence.
- Eliminates unrealistic bids and provides serious bidders with information necessary to formulate their bids.

Other Considerations

- May potentially recoup less money for the receivership estate in less competitive situations.

strategy frequently in resolving multi-branch institutions, and the FDIC subsequently adopted this method.

Offering failing institutions on both a whole franchise and a branch breakup basis expands the universe of potential bidders. It allows smaller institutions to participate along with larger institutions that may be interested only in certain branches or markets. The RTC/FDIC experience shows that this process results in more bidders and higher premiums than if failing institutions are only marketed on a whole franchise basis.

Branch breakup transactions have certain disadvantages. Electronic data processing and conversion costs to facilitate the acquisition are generally higher than in whole franchise deals, and it is more difficult to complete transactions quickly and smoothly in branch breakup transactions. Further, branch breakups require one of the acquiring institutions to be the "lead" acquirer and to provide backroom operations (accounting, payment posting, and check processing) for all the other acquirers during the transition period. Failing institutions with little franchise value or with geographically concentrated branches are considered poor candidates for branch breakup resolutions, because there is little marketability for extra buildings and there is not ample opportunity for acquirers to generate new account activity. Exhibit 5.3 shows the benefits and other considerations of branch breakups.

Exhibit 5.3

BRANCH BREAKUPS
Benefits
• Expands universe of potential bidders by allowing smaller institutions to participate in the bidding, which may increase the premiums received. • Increases the resolution options available to the bidders.
Other Considerations
• Electronic data processing and conversion costs are generally higher. • It is more difficult to complete transactions quickly and smoothly. • Requires one of the acquiring institutions to be "lead" acquirer. • Some branches may be undesirable, and a payoff of their insured deposits may have to be completed.

5.2.4 Bidder Due Diligence

Approved bidders who have signed confidentiality agreements are invited to conduct due diligence at the failing institution. Due diligence is the bidder's on-site inspection of the books and records of the institution and the bidder's assessment of the value of the franchise, and is performed so the bidder can submit an educated bid. The failing institution's board of directors must pass a board resolution authorizing the FDIC to conduct on-site due diligence before bidders visit the institution, because the institution is still an ongoing entity under private ownership. All bidders performing due diligence are provided the same information so no one bidder has an advantage.

Occasionally, the reality of the due diligence process spurs the failing bank into action to find sources of capital on their own. When this happens, the resolution process is put on hold. If the failing bank's plan for an unassisted merger or capital injection pans out, the resolution process is terminated; if the plan falls through, the resolution process resumes and all information is updated if there was a significant time lapse.

5.3 Bid Submission

After all bidders have completed their due diligence, bidders submit their proposals to the FDIC. This generally occurs 12 to 15 days before the scheduled closing, but it is often as few as 6 or 7 days before closing. To determine the least cost resolution, all bids, including those that do not conform to the FDIC's previously identified resolution methods (referred to as non-conforming bids) are evaluated and compared with each other and with the FDIC's estimated cost of liquidation.

A bid has two parts: one amount, called the premium, is for the franchise value of the failing institution's deposits; and the second amount is what the bidder is willing to pay to acquire the institution's assets. The first figure generally represents the bidder's perception of the value of the customer base; and the second amount reflects the bidder's perception of the imbedded losses and the level of risk associated with the assets.[19]

5.4 Least Cost Analysis

When selecting a resolution method, the FDIC has changed procedures over the years. Before the passage of FDICIA in 1991, the FDIC could effect any resolution transaction that was less costly than a deposit payoff. While the estimated cost of the resolution method has always been important, the FDIC at times considered other factors before making its final selection. Deposit payoffs were sometimes discouraged because they reduced the availability of local banking services in smaller communities. The FDIC also looked at broad issues such as the effect certain resolution methods may have had on banking stability and on discouraging shareholders and creditors of insured institutions from excessive risk-taking actions. The FDIC also considered the effect the selected method might have on increasing the inventory level of loans being serviced by the FDIC. After FDICIA, the FDIC amended its failure resolution procedures to accept the "least cost" bid.

19. The latter figure results in a net payment from the FDIC to the acquirer. For example, if the acquirer assumes responsibility for $100 in deposits and views the assets with a book value of $100 as being worth $80, then the acquirer will expect a $20 payment from the FDIC to make up the difference.

The new procedures require the FDIC to choose the alternative in which the total amount of the FDIC's expected expenditures (including any immediate or long-term obligation and any direct or contingent liability for future payment) is the least costly to the deposit insurance fund of all possible methods for resolving the failed institution.

The FDIC determines the least costly resolution transaction by evaluating all possible resolution alternatives and computing costs on a net present value basis, using a realistic discount rate. The overall cost to the FDIC of a failed institution depends on a number of factors, including the following:

- The difference between total book value of assets and liabilities of the bank;
- The levels of uninsured and insured liabilities;
- The premium paid by the acquirer;
- Losses on contingent claims;
- The realized value of assets placed in liquidation by the FDIC; and
- Cross guarantee provisions against affiliated institutions.[20]

In most cases, the FDIC will receive at least one bid that is less costly than the estimated cost of liquidation. If the bid includes assumption of all deposits, including uninsured deposits, the premium paid must be at least as large as the losses that would have been incurred by customers with uninsured deposits in a payoff in order for the bid to be considered less costly than liquidation.

The cost to the FDIC of a liquidation and payoff is generally calculated by the formula is shown in Exhibit 5.4.

20. The Financial Institutions Reform, Recovery, and Enforcement Act of 1989 included a cross guarantee provision that allows the FDIC to recover part of its resolution cost by seeking reimbursement from affiliated institutions. That provision was designed to prevent affiliated banks or thrifts from shifting assets and liabilities among themselves in anticipation of the failure of one or more of the institutions.

Exhibit 5.4

FDIC's Least Cost Test Calculation
FDIC's Cost = (loss to depositors) x (the loss factor)
Or more appropriately shown as
(loss on all assets - equity capital - unsecured creditors' loss) x (insured deposits/total deposits)

The first term in parentheses in the equation (loss to depositors) defines the total expected loss on all receivership assets to be absorbed by the depositors. It includes all loan loss reserves as well as an estimate of the FDIC's receivership expenses. This loss is reduced by the amount of equity remaining and by the amounts owed to unsecured creditors (since they now absorb all losses first before the depositors.)

The second term in parentheses in the equation (the loss factor) accounts for the portion of losses absorbed by customers with uninsured deposits in a payoff. It is important to note that the FDIC shares pro rata with customers who had uninsured deposits. For example, if customers who had uninsured deposits constitute 30 percent of the total deposits, then the FDIC as subrogee[21] has the other 70 percent and will absorb 70 percent of any loss to the depositors.

Savings to the FDIC may come from several sources, such as the premium paid by the acquirer, cross guarantee provisions against affiliated institutions, assets sold to the assuming bank at a smaller discount than that estimated by FDIC staff, and future losses absorbed by the FDIC as a result of loss sharing agreements that are expected to be less than losses incurred through liquidation of assets.

5.5 Calculation of Cash Amount Due to Acquirer

When an open financial institution acquires or assumes the liability for a failing institution's deposits, the FDIC as insurer reimburses it for

21. Subrogee is a term used when the FDIC pays the insured depositors the amounts of their insured deposits and then substitutes itself in the place of the insured depositors in the claims process.

the amount of insured deposits.[22] This occurs in two types of transactions: a purchase and assumption transaction and an insured deposit transfer (IDT).[23]

In a P&A, the institution acquiring the deposits of the failed institution is called the acquiring institution; in an IDT, the institution assuming the liabilities is called the agent institution. The amount of cash to be transferred to the acquiring or agent institution is calculated the same way for both P&As and IDTs, as shown in Exhibit 5.5.

Exhibit 5.5

FDIC's Amount of Cash to be Transferred Calculation
Cash from FDIC = Liabilities Assumed – Assets Purchased – Premium

An example of this calculation is a failing institution with total deposits of $120 million, of which $100 million is insured. The least cost bid submitted contained a $5 million premium to acquire the insured deposits and an offer of $48 million to purchase a package of loans. The FDIC would pay $47 million to the acquiring institution, as shown in Exhibit 5.6.

Exhibit 5.6

Amount of Cash to be Transferred Calculation Example						
Cash from FDIC	=	Liabilities Assumed	–	Assets Purchased	–	Premium
$47 million	=	$100 million	–	$48 million	–	$5 million

22. If the premium is for all deposits (not just insured deposits), the FDIC can reimburse the acquirer for all deposits provided that the transaction is the least costly of all possible transactions.

23. Purchase and assumption transactions are discussed fully in Chapter 6, Purchase and Assumption Transactions. Insured deposit transfers are a form of deposit payoff, and are discussed fully in Chapter 7, Deposit Payoffs.

5.6 FDIC Board of Directors Approval

The FDIC staff submits a written recommendation to the FDIC Board of Directors requesting approval of the resolution transaction. The recommendation includes a copy of the least cost analysis and information about the share of the estimated loss that should be absorbed by customers with uninsured deposits. It also addresses whether an advance dividend[24] should be paid to customers with uninsured deposits so that they can receive a portion of their claim while the FDIC proceeds with the resolution and disposition of the remaining assets.

The FDIC Board of Directors is ultimately responsible for determining the least costly transaction. The board may direct that the winning bid determination be delegated to the appropriate division director. Once the Board has approved the transaction, the FDIC staff notifies the acquirer(s), all unsuccessful bidders, and the chartering agency. The FDIC then arranges for the acquirer(s) to sign the appropriate legal documents before the institution's closure. At that time, the FDIC staff meets with the acquirer(s) to coordinate the mechanics of the closing procedures.

5.7 Closing the Institution

The final step in the resolution process occurs when the institution is closed, and the assets that the acquirer purchased and the deposits that it assumed are transferred to the acquirer. The chartering authority closes the institution and appoints the FDIC as receiver (usually on a Friday).[25] The FDIC as receiver is then responsible for settling the affairs of the closed bank or thrift. Such activities include balancing the accounts of the institution immediately after closing, transferring certain assets and liabilities to the new owner, and determining the exact amount of payment due the acquirer. The settling of various accounts between the receiver and the acquirer is called "settlement." This

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24. Advance dividends are payments made to uninsured depositors soon after a bank fails based on the estimated value of the receivership's assets. Advance dividends typically range between 50 cents and 80 cents on the dollar of the receivership claims.

25. Friday closings give the FDIC time to work over the weekend. Generally, the new institution opens for business on Saturday and resumes normal operations the following Monday.

process takes from 6 to 12 months, depending on the size of the failed institution. See Chapter 10, The FDIC's Role as Receiver for more information.

The acquirer reopens the bank or thrift usually by the next business day, and the customers of the failed institution automatically become customers of the acquiring institution with access to their insured funds. As receiver, the FDIC is responsible for operating the receivership, including collecting on the failed bank's assets retained by the receiver, and to the extent possible, satisfying the creditor claims against the receivership. In cases where the FDIC provides continuing assistance, such as in a loss sharing transaction, the FDIC will monitor the assistance payments for the duration of the agreement, typically over several years.

5.8 Resolution Time Line

The entire resolution process is generally carried out in 90 to 100 days, not including the post-closing settlement timeframes. It officially begins when the chartering authority advises the FDIC that an insured institution is in imminent danger of failing (although the FDIC monitors troubled institutions on an ongoing basis, the letter is a formal requirement), and ends when the chartering authority appoints the FDIC as receiver. Sometimes the usual resolution process cannot be fully completed before the institution fails, such as in cases of sudden or severe liquidity problems, for example, a systemic deposit run. In those instances, the FDIC usually does not have the time to prepare a review of the assets on site,[26] leaving a greater likelihood that the FDIC will retain the failed institution's assets while structuring a more immediate solution for the institution's deposits and other liabilities. Three primary alternatives available in the face of such time pressure are a transfer of only the insured deposits, a payoff of the insured deposits, or the formation of a bridge bank. Insured deposit transfers and deposit payoffs are discussed in Chapter 7, Deposit Payoffs; bridge banks are discussed in Chapter 6, Purchase and Assumption Transactions.

A timeline of a typical resolution process is shown on Table 5.1.

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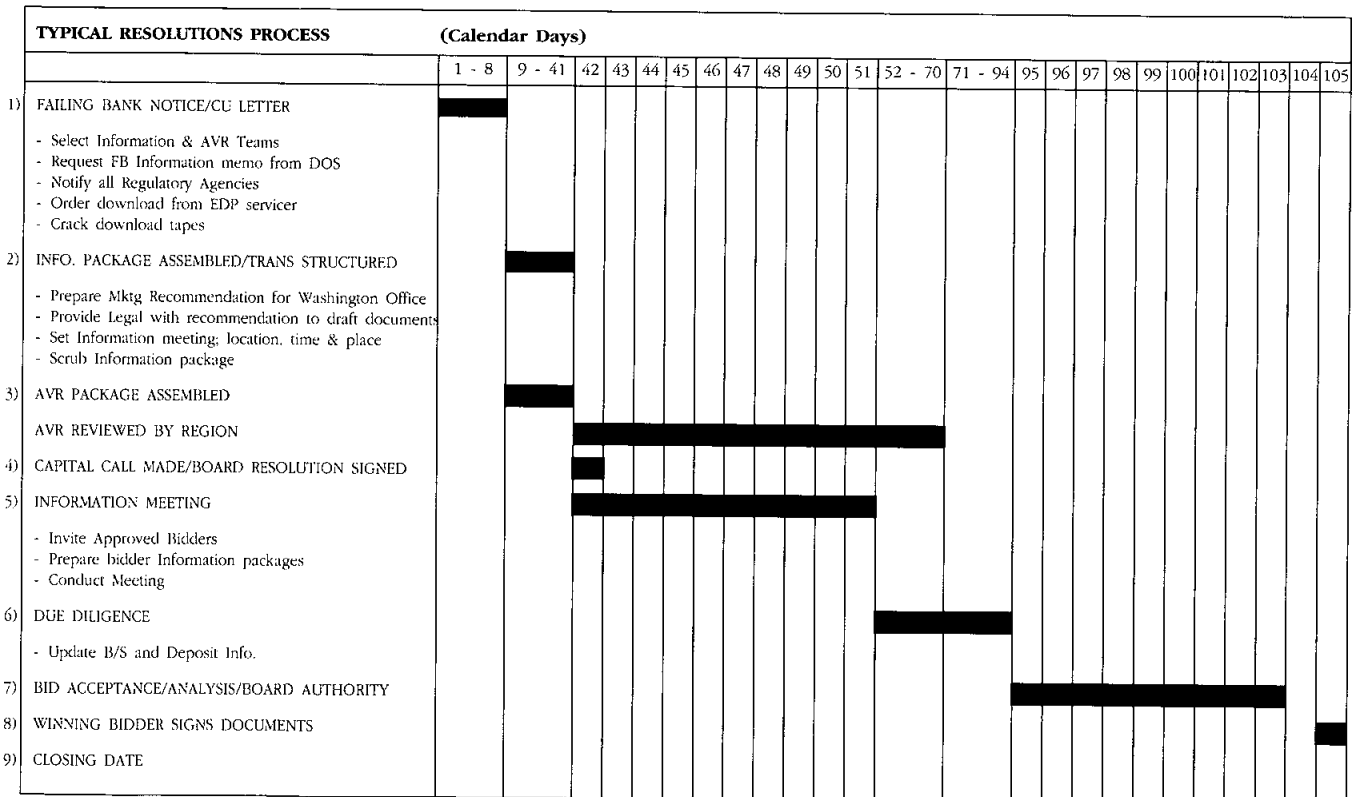
26. When there is insufficient time to perform an on-site review, the FDIC uses its research model to value all or most of the assets. The research model is based on the FDIC's historical recovery experience for six broad categories of assets as reflected by a sample of prior bank failures.

Table 5.1


TYPICAL RESOLUTIONS PROCESS
(Calendar Days)
1 - 8
9 - 41
42
43
44
45
46
47
48
49
50
51
52 - 70
71 - 94
95
96
97
98
99
100
101
102
103
104
105
1) FAILING BANK NOTICE/CU LETTER
- Select Information & AVR Teams
- Request FB Information memo from DOS
- Notify all Regulatory Agencies
- Order download from EDP servicer
- Crack download tapes
2) INFO. PACKAGE ASSEMBLED/TRANS STRUCTURED
- Prepare Mktg Recommendation for Washington Office
- Provide Legal with recommendation to draft documents
- Set Information meeting; location, time & place
- Scrub Information package
3) AVR PACKAGE ASSEMBLED
AVR REVIEWED BY REGION
4) CAPITAL CALL MADE/BOARD RESOLUTION SIGNED
5) INFORMATION MEETING
- Invite Approved Bidders
- Prepare bidder Information packages
- Conduct Meeting
6) DUE DILIGENCE
- Update B/S and Deposit Info.
7) BID ACCEPTANCE/ANALYSIS/BOARD AUTHORITY
8) WINNING BIDDER SIGNS DOCUMENTS
9) CLOSING DATE

6. PURCHASE AND ASSUMPTION TRANSACTIONS

Historically, the Federal Deposit Insurance Corporation (FDIC) has used three basic resolution methods: purchase and assumption (P&A) transactions, deposit payoffs, and open bank assistance (OBA) transactions. Of the three, purchase and assumption transactions are the most common.

6.1 Structure of a Purchase & Assumption Transaction

A P&A is a resolution transaction in which a healthy institution purchases some or all of the assets of a failed bank or thrift and assumes some or all of the liabilities, including all insured deposits. P&As are less disruptive to communities than payoffs. There are many variations of P&A transactions; two of the more specialised P&As are loss sharing transactions and bridge banks. Each type of P&A, including loss sharing and bridge banks, are discussed separately on the following pages.

In a P&A, the liabilities assumed by the acquirer include all or some of the deposit liabilities and secured liabilities, for example, deposit accounts secured by U.S. Treasury issues and repurchase agreements.[27] The assets acquired vary depending on the type of P&A. Some of the assets, typically loans, are purchased outright at the bank or thrift closing by the assuming bank under the terms of the P&A. Other assets of the failed institution may be subject to an exclusive purchase option by the assuming institution for a period of 30, 60, or 90 days after the bank or thrift closing.[28]

Some categories of assets *never* pass to the acquirer in a P&A; they remain with the receiver. These include claims against former directors and officers, claims under bankers blanket bonds and director and

27. Repurchase agreements, also known as "repos," are agreements between a seller and a buyer whereby the seller agrees to repurchase securities, usually of U.S. Government securities, at an agreed upon price and, usually, at a stated time. When a bank uses a repo as a short-term investment, it borrows money from an investor, typically a corporation with excess cash, to finance its inventory using the securities as collateral. Repos may have a fixed maturity date or may be "open," meaning that they are callable at any time.

28. These assets include premises owned by the failed institution, some categories of loans, rights to an assignment of leases for leased premises, data processing equipment, and other contractual services.

officer insurance policies, prepaid assessments, and tax receivables. Subsidiaries and owned real estate (except institution premises) pass infrequently to the acquirer in P&A transactions. Additionally, a standard P&A provision allows the assuming institution to require the receiver to repurchase any acquired loan that has forged or stolen instruments.

Before the banking crisis of the 1980s, the price paid by the assuming institution for assets other than cash was based on the value at which the assets were shown on the failing institution's books. Because asset values are generally overstated in a failing bank or thrift, the FDIC's ability to sell assets to an acquiring institution based on book value was limited. As the number of failures increased and liquidity and workload pressures grew, the FDIC began to base the purchase price of assets on their value as established by an asset valuation review performed by FDIC staff.

Until the late 1980s, it was common for an acquiring institution to bid on and purchase a failing institution without performing any review (also known as due diligence) of the failing institution's books and records, especially the loan portfolio. An acquirer was not even selected before the institution was closed. There were two reasons for this. First, the FDIC wanted to maintain secrecy about impending failures to avoid costly deposit runs; it was concerned that allowing due diligence teams access to a failing bank's premises would arouse fears about an imminent closing. The second reason was that, in the vast majority of transactions, only assets such as cash and cash equivalents[29] were passed to the acquirer, or assets were passed with a put option (discussed later in this chapter). In these circumstances, franchise bidders[30] did not require on-site due diligence. Bidders determined the potential value of the bank based on their knowledge of the local community and upon deposit information provided by examiners.

29. Cash equivalents are assets that readily convertible to cash, such as accounts of the failed institution in other banks, known as "due from" accounts, and marketable securities.

30. Franchise bidders are potential acquirers bidding only to acquire the failed institution's deposits or the "franchise."

In a P&A transaction, acquirers may assume all deposits, thereby providing 100-percent protection to all depositors.[31] In contrast, in a deposit payoff the FDIC does not cover the portion of a customer's deposits that exceeds the insured limit.[32] In the two decades prior to the 1980s, most failing banks were resolved through P&As which passed all deposits to the acquiring institution. Critics observed that customers with uninsured deposits in large failed banks were less likely to suffer losses than those in small banks because the FDIC preferred to arrange P&A transactions to resolve large failures and because there was usually more market interest in large institutions. The increased market interest for larger institutions resulted in higher bids and smaller losses to the FDIC. The result was that customers with uninsured deposits rarely suffered losses in P&A transactions, and the FDIC essentially provided unlimited insurance coverage to the depositors. This subjected the FDIC to criticism that its resolution policies were inconsistent and inequitable, since smaller banks were more likely to be paid off.

Critics also indicated that when depositors had no fear that the uninsured portion of their deposits would be forfeited at a failure and others (for example, general creditors) with uninsured liabilities at the institution were certain of being paid, then there was essentially limitless deposit insurance which destroyed any market discipline. Although P&As minimised disruption to local communities and to financial markets generally, they appeared to provide inequitable protection for uninsured depositors in large institutions.

6.1.1 Preference for Passing Assets

As the banking crisis became more acute toward the end of the 1980s, the FDIC tended to choose transactions that allowed a large proportion of the assets of a failing institution to pass to the acquirer.

31. All resolution methods, including P&A transactions which pass all deposits to the assuming institution must pass the "least cost" test; see Chapter 5, The Resolution Process.

32. The owners of uninsured claims are given receiver's certificates that entitle them each to a share of collections from the receivership estate. The percentage of the claims they eventually receive depends on the value of the institution's assets, the total dollar amount of proven claims, and the claimant's relative position in the distribution of claims. See Chapter 10, The FDIC's Role as Receiver for more details.

Those transactions were chosen for a variety of reasons. First, FDIC management became concerned that the accumulation of assets would drain the liquidity of the insurance fund. Former FDIC Chairman L. William Seidman (1985-1991), noting that prior to that time emphasis had not been placed on the sale of assets at resolution, wrote:

> This was not a serious problem in an agency with very few failed banks, and when the FDIC insurance fund had lots of cash... But it could be disastrous as the number of bank failures increased... The strategy of holding on to assets would swallow up all our cash very quickly... Cash had never been a problem at FDIC, with billions in premium income on deposit at the Treasury. But my calculations showed that on the basis of the way we were doing things, if you took the FDIC forecast of bank failures from 1985 to 1990, our cash reserve of $16 billion would be wiped out well before the end of the decade.[33]

Second, although there is no empirical evidence, it was generally believed that after an asset from a failing bank was transferred to a receivership, the asset almost immediately suffered a loss in value.[34] This loss of value arose from several sources.[35]

> Loans had unique characteristics, and prospective purchasers had to gather information about the loans to evaluate them. This "information cost" was factored into the price outside parties paid for loans. This cost tended to be greater when assets were from failed institutions.
>
> Another reason for loss in value was disruption in financing for semi-completed projects. If the parties that made the financing loans were not available, it took time and effort to

33. L. William Seidman, *Full Faith and Credit: The Great S & L Debacle and Other Washington Sagas* (New York: Times Books, 1993), 100.

34. This loss of value is known as the "liquidation differential," Frederick S. Carns and Lynn A. Nejezchleb, "Bank Failure Resolution: The Cost Test and the Entry and Exit of Resources in the Banking Industry," the *FDIC Banking Review* 5 (fall/winter 1992): 1-14.

35. Testimony of John F. Bovenzi in the United States Court of Federal Claims, Civil Action No. 90-733C, *Statesman Savings Holding Corp. v. United States of America.*

make decisions about further credit extensions. These delays may have caused disruptions in timing for operating or construction loans and may have contributed to a loss of asset value.

There was a natural reluctance on the part of receivers to make additional credit extensions, although they sometimes did so to preserve the value of the original loans. Receiverships were entities with limited life and did not operate to risk creating additional losses; receivers told borrowers of failed depository institutions to find new financing institutions. The time it took borrowers to find new lenders may have had an adverse effect on asset value.

Borrowers, who did not need future business dealings with receivers, had more incentive to resolve problem loans with open banks or thrifts than with receivers. Borrowers from failed institutions frequently negotiated with receivers for reduced payments because they knew receivers were interested in expeditiously winding up the affairs of the failed institutions. The receivers calculated the losses of prolonged litigation versus the losses of reduced payoffs and chose the options with the highest net present value.

Some assets lost their value simply because they were from a failed institution. Buyers were less comfortable purchasing assets of a failed institution than from ongoing entities. Assets of failed institutions were described as "tainted." Prospective purchasers felt greater risk in such purchases and made lower purchase offers.

Receivership administrative costs may have reduced asset values. Things like operational costs, defence of litigation, and payment of claims reduced asset values (or correspondingly raised overall costs).

There was also the idea of supply and demand. In a time when many institutions were failing, there were many receivership assets for sale. That situation may have created downward pressure on prices for those assets.

Third, as the FDIC began managing an extremely large portfolio of failed bank, several logistical problems began to develop. It became more desirable to pass assets to acquirers rather than to incur additional costs of acquiring, maintaining, and subsequently remarketing or collecting those assets.

Fourth, it was simply considered more appropriate for private assets to remain within the private marketplace.

Finally, the FDIC saw the sale of the higher percentages of assets at resolution as a way to minimize disruption in the communities where failing banks were located.

From 1980 through 1994, the FDIC used P&A transactions to resolve 1,188 out of 1,617 total failures and assistance transactions, or 73.5 percent. Chart 6.1 shows the distribution of P&A transactions per year for this period.

6.2 Types of Purchase and Assumption Transactions

The P&A resolution structure has evolved over time to incorporate procedures and incentives to entice acquirers to take more assets of the failed institution. The following discussion describes some of the variations of the purchase and assumption transaction that the FDIC used under differing circumstances as appropriate.

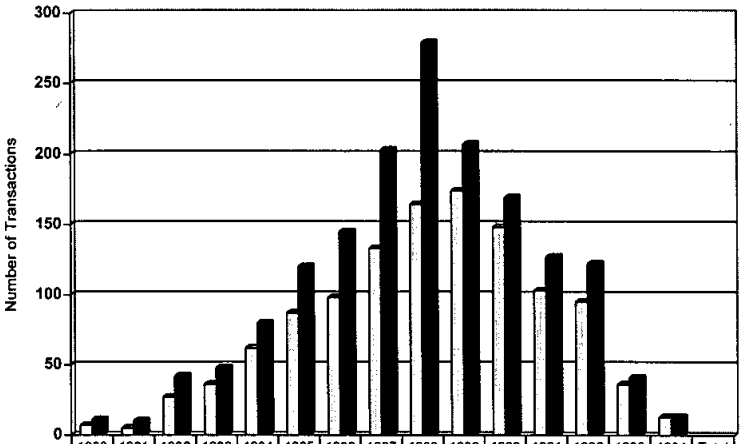
6.2.1 Basic P&A Transactions

In basic P&As, assets that pass to acquirers generally are limited to cash and cash equivalents. The premises of failed banks and thrifts (including furniture, fixtures, and equipment) are often offered to acquirers on an optional basis; the price is based upon a post-closing appraisal that is mutually acceptable to the FDIC and the acquirer. The liabilities assumed by the acquirer generally include only the portion of the deposit liabilities covered by FDIC insurance.[36] The basic P&A was

36. After the Federal Deposit Insurance Corporation Improvement Act (FDICIA) of 1991 was signed, the FDIC was required to select the least costly resolution method available. The requirement had a significant effect on the FDIC's resolution practices. Previously, the FDIC had structured most of its transactions to transfer both insured and uninsured deposits along with certain failed bank assets. Under FDICIA, however, when transferring the uninsured deposits was not the least cost solution, the FDIC began entering into P&A transactions that included only the insured deposits.

Chart 6.1

FDIC Purchase and Assumption Transactions Compared to All Bank Failures and Assistance Transactions 1980-1994



	1980	1981	1982	1983	1984	1985	1986	1987	1988	1989	1990	1991	1992	1993	1994	Total
P&As	7	5	27	36	62	87	98	133	164	174	148	103	95	36	13	1,188
Total	11	10	42	48	80	120	145	203	279	207	169	127	122	41	13	1,617

Source: FDIC Division of Research and Statistics.

a valuable resolution method in the early 1980s before the FDIC began allowing due diligence. Once the practice of due diligence was established, other variations of the P&A were used more frequently. Exhibit 6.1 shows the benefits and other considerations of basic P&As.

Exhibit 6.1

BASIC P&As

Benefits

- Customers with insured deposits suffer no loss in service.
- Customers with insured deposits have new accounts with new bank or thrift, but old checks can still be used.
- Customers with insured deposits do not lose interest on their accounts.
- Acquiring bank has the opportunity for new customers.
- Can be used when there is not enough time to complete due diligence.
- FDIC costs are reduced compared to a deposit payoff.
- Reduces the FDIC's initial cash outlay.

Other Considerations

- Receivership must liquidate the majority of the assets of the failed bank or thrift.
- Uninsured depositors may or may not suffer losses

Because of the tremendous increase in bank and thrift failures during the 1980s, the FDIC began to consider techniques and incentives to sell substantially more of the failed institution's assets to the acquirer. P&A transactions were restructured accordingly.

6.2.2 Loan Purchase P&As

In a loan purchase P&A, the winning bidder assumes a small portion of the loan portfolio, sometimes only the installment loans, in addition to the cash and cash equivalents. Installment loans are rarely the cause of the failing bank's troubles. Therefore, the installment loan portfolio is usually easy to transfer to the assuming institution. Loans that are past due 90 or more days may or may not be retained by the receiver. Typically, a loan purchase P&A transaction would pass between 10 percent and 25 percent of the failed institution's assets. Exhibit 6.2 shows the benefits of loan purchase P&As.

Exhibit 6.2

LOAN PURCHASE P&AS
Benefits
• All the benefits of the basic P&A, plus • The FDIC passes a large number of small balance loans that are time-consuming for FDIC account officers to service.

6.2.3 Modified P&As

In a modified P&A, the winning bidder purchases the cash and cash equivalents, the instalment loans, and all or a portion of the mortgage loan portfolio. As with the instalment loan portfolio, single family residential loans are rarely the cause of a bank's failure and, therefore, can be transferred to the assuming institution easily. Although in a period of rising interest rates, concessions may have to be made to guarantee a certain yield. Instalment loans and mortgage loans usually provide the acquirer with a base of loans tied to the deposit accounts. Typically, between 25 percent and 50 percent of the failed bank assets are purchased under a modified P&A structure. Exhibit 6.3 shows the benefits of modified P&As.

Exhibit 6.3

MODIFIED P&As
Benefits
• All the benefits of the loan purchase P&A, plus • The FDIC passes a portion of the mortgage loan portfolio; mortgage loans are time-consuming for FDIC account officers to service.

6.2.4 P&As with Put Options

To induce an acquirer to purchase additional assets, the FDIC offered a "put" option on certain assets that were transferred. Two option programmes for purchasing assets that the FDIC typically offered to acquirers were the "A Option," which passed all assets to the acquirer and gave them either 30 or 60 days to put back those assets they did not wish to keep, and the "B Option," which gave the acquirer 30 or 60 days to select desired assets from the receivership. Structural problems existed, however, with both of the option programmes, because an acquirer was able to "cherry pick" the assets, choosing only those with market values above book values or assets having little risk while returning all other assets. Also, acquirers tended to neglect assets during the put period, before returning them to the FDIC, which adversely affected their value.

In late 1991, the FDIC discontinued the put structure as a resolution method and replaced it with the loss sharing structure and loan pool structure. During the mid-1980s, however, the put option was seen as a way to preserve the liquidity of the insurance fund, by passing more assets to acquirers, thus lowering the amount of cash payments to assuming banks. Exhibit 6.4 shows the benefits of and other considerations of P&As with put options.

Exhibit 6.4

P&As WITH PUT OPTIONS
Benefits
• All the benefits of the modified P&A, plus • Fewer assets were retained by the FDIC. • Allowed the acquirer time to complete due diligence after the P&A was finalised.
Other Considerations
• Acquirer was able to "cherry pick" the assets. • Acquirers tended to neglect assets during the put period. • Delayed the transfer of assets between the acquirer and the receiver.

6.2.5 P&As with Asset Pools

In an effort to maximise the sale of assets during the resolution process and keep them in the local banking community, in 1991 the FDIC began offering a P&A transaction with optional asset pools for failing institutions with total assets under $1 billion. For banks with a diverse loan portfolio, the FDIC believes that it is preferable to break the loan portfolio into separate pools of homogeneous loans (that is, those with the same collateral, terms, payment history, or location) and to market those pools on an optional basis separately from the deposit franchise. The FDIC also groups non-performing loans, owned real estate, and other loans that do not conform with one of the established pool structures into a single pool, which, depending on the overall quality of the pool, might be offered for sale. Bidders are able to bid (as a percentage of book value) on those loan pools that interest them, thus improving the marketability of the pools.

Potential acquirers are allowed to submit proposals for the franchise (all deposits or only insured deposits) and for any or all of the pools. The bidders may link the options as a package or they may bid on various combinations of pools.[37] The linked bid is evaluated as one "all-or-nothing" bid. The flexibility of this resolution method has allowed the FDIC to market a failing institution to significantly more potential acquirers, to transfer a higher volume of assets at resolution, and to allow for multiple acquirers.

This resolution strategy is designed to provide additional flexibility since each acquirer has a different interest. Some acquirers believe it is essential to acquire a substantial portion of the assets with the deposit franchise; other acquirers may prefer to purchase assets but do not believe it is essential to acquire the franchise. There may be acquirers who do not want to purchase any assets, whereas other acquirers are willing to purchase assets only.

One problem with optional asset pools continues to be that many banking institutions are reluctant to acquire commercial assets, even at a discount, without a significant credit enhancement. Such enhance-

37. The largest number of bids ever submitted to date for one failing institution was 126 bids that were placed by only six potential acquirers.

ments may include the FDIC sharing in a credit loss, repurchasing assets that are found at some later date to have been misrepresented, or guaranteeing a specific rate of return on the acquirer's investment. Exhibit 6.5 shows the benefits and other considerations of P&As with optional asset pools.

Exhibit 6.5

P&As WITH OPTIONAL ASSET POOLS

Benefits

- All the benefits of the modified P&A, plus
- Improves marketability of loans.
- Fewer assets are retained by the FDIC.

Other Considerations

- Many institutions are reluctant to purchase commercial credits without credit enhancements, even if the assets are purchased at a discount.
- Borrowers may have "split" lines of credit, that is, some loans with the acquirer and some with the FDIC, or even loans with multiple acquirers.
- Requires much pre-closing work for FDIC staff.

6.2.6 Whole Bank P&As

The FDIC's preference for passing assets to acquirers became formal corporate policy on 30 December 1986.[38] The FDIC Board of Directors established an order of priority, known as "sequential bidding," for six alternative transaction methods based on the amount of assets passed to the acquirer.[39]

38.The policy was called the Robinson Resolution (named after Hoyle Robinson, executive secretary of the FDIC from 7 May 1979 to 3 January 1994). The resolution provided delegations to FDIC staff that allowed prioritizing the types of resolutions to be considered. The Robinson Resolution was revised and reissued in July 1992 and again in May 1997 to reflect the changes mandated by the Federal Deposit Insurance Corporation Improvement Act of 1991.

39. The six transaction types named were, in order of preference, whole bank purchase and assumption, whole bank deposit insurance transfer and asset purchase, purchase and assumption, deposit insurance transfer and asset purchase, deposit insurance transfer, and straight deposit payoff.

The whole bank P&A structure emerged as the result of an effort to induce acquirers of failed banks or thrifts to purchase the maximum amount of a failed institution's assets. Bidders were asked to bid on all assets of the failed institution on an "as is", discounted basis (with no guarantees). This type of sale was beneficial to the FDIC for three reasons. First, loan customers continued to be served locally by the acquiring institution. Second, the whole bank P&A minimised the one-time FDIC cash outlay, and the FDIC had no further financial obligation to the acquirer. Finally, a whole bank transaction reduced the amount of assets held by the FDIC for liquidation.

The FDIC offered 313 whole bank transactions from 1987 through 1989 and received 130 successful bids. Whole bank P&As were consummated for 43 failing institutions in 1990. During this period when sequential bidding was in effect, bids for whole bank P&As were opened first and the highest whole bank bid that was less costly than a payoff was accepted. Bids for other resolution methods were returned unopened. If there were no acceptable whole bank bids, the next type of P&A bids were opened, followed by insured deposit transfer bids. Even though whole bank transactions passed the maximum amount of assets to the acquirers, the least costly resolutions may not have been chosen. With the introduction of the least cost test by the Federal Deposit Insurance Corporation Improvement Act (FDICIA) of 1991, however, the number of successful whole bank bids declined. Because a whole bank bid constitutes a one-time payment from the FDIC, bidders tended to bid very conservatively to cover all potential losses. Conservative whole bank bids could not compete with other transactions on a least cost basis. As a result, only 29 whole bank transactions were completed in 1991 and 1992.

Since FDICIA required the FDIC to open all bids received and to select the resolution determined to be least costly to the insurance fund, the FDIC abandoned sequential bidding. Indeed, it could no longer have been used even if viewed as desirable given FDICIA and its least cost test provisions. Exhibit 6.6 shows the benefits and other considerations of whole bank P&As.

Exhibit 6.6

WHOLE BANK P&AS
Benefits
• All the benefits of the P&A with optional asset pools, plus • Loan customers continue to be served locally by the acquiring institution • Minimises the one-time FDIC cash outlay. • Greatly reduces the amount of assets held by the FDIC for liquidation.
Considerations
• Seldom proves to be the least cost method in comparison to other types of resolutions.

6.2.7 Loss Sharing P&As

A loss sharing P&A uses the basic P&A structure except for the provision regarding transferred assets. Instead of selling some or all of the assets to the acquirer at a discounted price, the FDIC agrees to share in future loss experienced by the acquirer on a fixed pool of assets. The FDIC learned from its experiences in the late 1980s and early 1990s that it is more desirable to keep the assets of a failed bank or thrift in the private banking sector than to take them over for liquidation.

Assets left in the banking sector retain more value than those placed in liquidation. Once assets are placed in receivership or liquidation, they lose value because of a break in the customer/ institution relationship (the concept of liquidation differential was discussed earlier). Keeping the assets in the private banking sector softens the impact on the local community. The acquiring institution can work more easily with the borrowers to restructure the credits and advance additional funding where appropriate.

The FDIC originally developed the loss sharing concept in 1991 as a resolution tool for handling failed institutions with more than $500 million in assets. The FDIC designed loss sharing to address the problems associated with marketing large institutions with sizeable commercial loan and commercial real estate loan portfolios. In the

past, acquiring institutions had been extremely reluctant to acquire commercial assets in the FDIC transactions for three reasons. First, the time allowed to perform due diligence is most often limited. The FDIC tries to accommodate a number of potential acquirers who wish to perform due diligence at the failing institution, and all acquirers must complete their reviews prior to the bid submission date. This allows very little time for any given bidder to perform more than a cursory review of an often complex loan portfolio.

Second, many acquirers are reluctant to purchase large portfolios of loans that they did not underwrite. In many cases, the underwriting standards of the failing institution are poor and may be a primary reason for the institution's failure. Also, information in the bank file may be limited or inaccurate. Acquirers wish to avoid the additional costs associated with managing and working out these potentially problem assets.

Finally, almost every region of the United States experienced declining commercial real estate markets in the late 1980s and early 1990s, causing considerable uncertainty about collateral values. Even when acquiring institutions were willing to purchase the commercial real estate loan portfolios, they incorporated large discounts into their bids to compensate for the additional risk of anticipated market declines.

Loss sharing P&As address these concerns by limiting the downside risk associated with acquiring large loan portfolios. The FDIC absorbs a significant portion of credit loss on commercial loans and commercial real estate loans, typically 80 percent, and acquiring institutions assume the remaining 20 percent of loss.[40] By having the acquirer absorb a limited amount of credit loss, the FDIC hopes to pass most of the failed institution's commercial loans and commercial real estate loans to the acquirer while still receiving a premium for the institution's deposit franchise. By having the acquirer absorb a portion of the loss, the FDIC is also attempting to induce rational and responsible credit management behaviour from the acquirer. The FDIC also reimburses acquiring institutions for 80 percent of expenses, except overhead and personnel expenses, incurred in relation to the disposition or collection of the shared loss assets.

40. The percentage amounts to be split between the FDIC and the assuming institution can vary and are determined with every transaction.

During the shared recovery period, which runs concurrently with the loss share period, the acquiring bank pays the receiver 80 percent of any recoveries (less any recovery expenses) on shared loss assets previously experiencing a loss. The shared recovery period generally lasts another one to three years beyond the expiration of the loss sharing period. Loss sharing provisions apply to all loans in a designated shared loss category, for example, commercial loans or commercial real estate loans, whether the loans are performing or not.

Loss sharing was also structured to include a "transition amount" so that if losses exceeded a projected amount, the FDIC would absorb a higher percentage of the losses beyond the projected amount, typically 95 percent. The transition amount was defined as the FDIC's estimate of the loss on the shared loss assets purchased by the acquirer. The FDIC used the transition amount to address the acquirer's concerns about catastrophic losses resulting from limited time for due diligence and uncertain collateral values stemming from deteriorating markets.

There are some negative aspects of the loss sharing structure. It requires both the FDIC and the acquirer to take on additional administrative duties and costs in managing the shared loss assets throughout the life of the agreement. Some acquirers may find these added administrative duties and costs unacceptable, and the acquirers may lose interest in bidding.

Another concern in offering loss sharing is that many healthy, small financial institutions may not have the appropriate experience in working out problem assets. They may not have an interest in bidding if this is the only option, or they may acquire the assets but not manage them in the best interests of all involved. If this occurs, the FDIC loses control of the assets but is obligated to absorb a significant portion of the risk. In recognition of the different skills and interests of potential acquirers, the FDIC normally offers other resolution methods simultaneously with the loss-sharing structure to encourage more institutions to bid.

Since it has been used generally in larger transactions, loss sharing has been very successful a number of times at keeping assets in the private banking sector and resulting in lower costs to the FDIC. On average, losses on assets covered by loss sharing have been approximately 6 percent of the beginning balances of the assets.

In cases where loss sharing is determined to be the preferred resolution structure for a transaction, the P&A agreement includes terms describing how charge-offs, recoveries, and expenses will be treated for the different types of assets.

Shared Loss Assets. Shared loss assets are generally commercial loans, commercial real estate loans, and owned real estate although some earlier agreements included additional types of loans.[41] The acquiring institution may subsequently take title to or transfer owned real estate to a subsidiary without forfeiting shared loss coverage.

Shared loss assets are initially recorded by the acquirer at the failed institution's book value. Thereafter, the value of a shared loss asset may be increased by additional advances,[42] capitalised expenditures,[43] and accrued interest (subject to certain limitations); the value may be decreased by the amount of payments received and charge-offs recorded. Advances cannot exceed certain specified percentage limitations (generally 10 percent of the book value as of the agreement date), and are not allowed for any loan on which the acquiring institution has recorded a loss. Capitalised expenditures are only permitted on owned real estate, and such expenditures must be capitalised in accordance with generally accepted accounting principles.[44]

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41. Consumer loans, home equity loans, residential mortgage loans, and loan participations are generally not part of a loss sharing agreement because those loans are-of a better quality. Typically, performing consumer loans and residential mortgage loans pass at book value to the acquirer.

42. Additional advances are funds given to a borrower after the original loan has been finalised; these amounts are added to the principal amount of the borrower's loan. For example, the bank might advance funds to pay taxes or to pay for harvesting a crop in the field.

43. Capitalised expenses are major expenditures that typically involve real estate. The amount of money is treated as an asset by the borrower (increasing the value of the real estate) and not as a one-time expense. For example, the bank might provide funds to pay for remodelling a commercial building to make it more rentable. Expenditures for the remediation of environmentally contaminated real estate are excluded.

44. In the United States, the Financial Accounting Standards Board is a private-sector organisation empowered to establish financial accounting and reporting standards for the guidance and education of the public. These standards are referred to as "generally accepted accounting principles" or GAAP. In keeping with our free enterprise economy, it is appropriate that financial accounting and reporting standards be established by those that rely on them so heavily, that is, the participants in the private sector. Standard setting can remain in the private sector only with the support of its many constituent groups—the financial statement preparers, auditors, and those who make decisions based on information in financial statements.

Shared loss loans may be amended, modified, renewed, or extended, and substitute letters of credit may be issued in lieu of original letters of credit. The amount of principal remaining to be advanced on a line of credit, however, may not be increased beyond the original amount of the commitment. Pay-downs on revolving lines of credit may be readvanced up to the original amount of the commitment. Terms may not be extended beyond the end of the final quarter through which the receiver has agreed to reimburse losses under the agreement.

Shared loss coverage ceases upon the sale of an asset or upon the making of advances or amendments that do not comply with the restrictions described previously. Shared loss coverage also ceases if the acquiring bank exercises collection preference regarding a loan held in its own portfolio that is made to or attributable to the same obligor as a shared loss loan.

Loss Sharing Arrangement. During the shared loss period, generally the first five years of the agreement, the receiver reimburses the acquiring institution for 80 percent of net charge-offs (charge-offs minus recoveries) of shared loss assets, plus reimbursable expenses. During the recovery period, generally the last two-year period of the agreement,[45] the acquiring institution pays the receiver 80 percent of recoveries, less recovery expenses.[46] Charge-offs are defined as write-downs of the principal amount of shared loss assets if such write-downs are taken in accordance with standards used by FDIC examiners. Losses on the sale of owned real estate are included, but losses on the sale of shared loss loans are generally excluded.[47]

45. The term of the shared loss period varies from two to five years. The term of the shared recovery period runs concurrently with the shared loss period for an additional one to three years. The loss sharing and recovery sharing percentages may also vary by transaction and by asset category.

46. For those agreements that include a transition amount, at the termination of the agreement the receiver will also reimburse the acquiring institution an additional 15 percent of the amount by which aggregate charge-offs, reimbursable expenses, and recovery expenses, minus aggregate recoveries, exceeds the transition amount.

47. While losses on the sale of loans are generally excluded to limit the receiver's exposure to interest rate risk, in cases where circumstances indicate that allowing the acquiring bank to sell loans may be in the receiver's best interest, coverage may be extended to include losses on the sale of loans. However, the FDIC establishes limitations regarding the dollar amount of loans that may be sold and the amount of resulting losses that may be eligible for reimbursement.

Recoveries are defined as collections of (i) charge-offs of shared loss assets and reimbursable expenses, (ii) charge-offs recorded by the failed bank (including charge-offs of consumer and residential loans recorded by the failed bank, whether or not such loan categories are designated as shared loss assets under the agreement), and (iii) gains on the sale or disposition of real estate.

Reimbursable expenses are defined as out-of-pocket expenses paid during the shared loss period to third parties to effect recoveries and to manage, operate, and maintain owned real estate. (Expenses are reduced by income received on owned real estate.) An acquiring institution may not claim payments to affiliates. Expenses which are not reimbursable include income taxes; salaries and related benefits of employees; occupancy, furniture, equipment, and data processing expenses; fees for accounting and other independent professional consultants (other than legal fees and consultants retained for environmental assessment purposes); overhead or general and administrative expenses; expenses not incurred in good faith; and any extravagant expenses.

Transition Amounts (Catastrophic Insurance). Agreements included transition amounts, which were the FDIC's estimates of credit loss on the shared loss assets. If losses exceeded the transition amount, the acquirer was responsible for a smaller percentage of the additional loss, typically 5 percent, rather than the 20 percent typically covered for losses up to the transition amount. The FDIC transition amounts were for acquirers concerned about unanticipated losses resulting from limited due diligence time and uncertain collateral values resulting from deteriorating markets.

Certificates and Payments. Acquiring institutions file certificates within 30 days of the end of each calendar quarter during the shared loss period and the shared recovery period. The certificates report charge-offs, recoveries, net charge-offs (charge-offs less recoveries, amount may be negative), and reimbursable expenses (amount may be negative). If the shared loss amount is positive, the FDIC pays the acquirer 80 percent of the amount within 15 days of receipt of the certificate; if the shared loss amount is negative, the acquiring institution remits 80 percent of the amount with the certificate.

Administration of Agreement. The acquiring institution manages, administers, and collects shared loss assets consistent with usual and prudent business and banking practices and in a manner consistent with its own internal practices, procedures, and written policies. It may not contract with third parties for services on shared loss assets if it does not contract with third parties for those services for its own assets. Separate accounting records must be maintained for shared loss assets.

Within 90 days after each calendar year end, the acquiring bank must furnish the FDIC a report signed by its independent public accountants containing specified statements relative to the accuracy of any computations made regarding shared loss assets. It must also perform a semi-annual internal audit of shared loss compliance and provide the FDIC with copies of the internal audit reports and access to internal audit work papers. Additionally, the FDIC may perform an audit, of such scope and duration as it may determine to be appropriate to ascertain the bank's compliance with the assistance agreement. The FDIC provides formal procedures to resolve any disputes that may arise in connection with the loss sharing arrangement.

Loss sharing P&As are sometimes combined with other types of resolution agreements. For example, in the P&A agreements with New Dartmouth Bank, Manchester, New Hampshire, and First New Hampshire Bank, Concord, New Hampshire, the FDIC also agreed to provide shared loss coverage on the instalment loans to ensure that those small balance assets with high service costs stayed with the acquirer. Table 6.1 lists the loss share agreements consummated from 1991 through 1993, and Exhibit 6.7 shows the benefits and other considerations of P&As with loss sharing.

6.2.8 Bridge Banks

The Competitive Equality Banking Act of 1987 provided the FDIC with a new tool to help handle failing institutions: the bridge bank. A bridge bank transaction is a type of P&A in which the FDIC itself acts temporarily as the acquirer. This provides uninterrupted service to bank customers, while it allows the FDIC sufficient time to evaluate and market the institution.

Table 6.1
FDIC Loss Share Transactions, 1991-1993
($ in Millions)

Transaction Date	Failed Bank*	Location	Total Assets	Resolution Costs	Resolution Cost as % of Total Assests
09/19/91	Southeast Bank, N.A.**	Miami, FL	$10,478	$0	0.00
10/10/91	New Dartmouth Bank	Manchester, NH	2,268	571	25.18
10/10/91	First New Hampshire	Concord, NH	2,109	319	15.13
11/14/91	Connecticut Savings Bank	New Haven, CT	1,047	207	19.77
08/21/92	Attleboro Pawtucket SB	Pawtucket, RI	595	32	5.38
10/02/92	First Constitution bank	New Haven, CT	1,580	127	8.04
10/02/92	The Howard Savings Bank	Livingston, NJ	3,258	87	2.67
12/04/92	Heritage Bank for Savings	Holyoke, MA	1,272	21	1.65
12/11/92	Eastland Savings Bank***	Woonsocket, RI	545	18	3.30
12/11/92	Meritor Savings Bank	Philadelphia, PA	3,579	0	0.00
02/13/93	First City, Texas-Austin, N.A.	Austin, TX	347	0	0.00
02/13/93	First City, Texas-Dallas	Dallas, TX	1,325	0	0.00
02/13/93	First City, Texas-Houston, N.A.	Houston, TX	3,576	0	0.00
04/23/93	Missouri Bridge Bank	Kansas City, MO	1,911	356	18.63
06/04/93	The First National Bank of Vermont	Bradford, VT	225	34	15.11
08/13/93	CrossLand Savings, FSB	Brooklyn, NY	7,269	740	10.18
	Total		**$41,384**	**$2,512**	**6.07**

*The banks listed here are the failed banks or the resulting bridge bank from a previous resolution, however, it is the acquirer that enters into the loss sharing transaction with the FDIC.
**Represents loss sharing agreements for two banks: Southeast Bank, N.A., and Southeast Bank of West Florida.
***Represents loss sharing agreements for two banks: Eastland Savings Bank and Eastland Bank.

Source: FDIC Division of Research and Statistics.

Exhibit 6.7

P&As with Loss Sharing

Benefits

- *All the benefits of a whole bank P&A, plus*
- *Reduced risk for the acquirer can lower FDIC's cost.*
- *FDIC's and acquirers' interests in the asset pools are closely aligned.*
- *Assets remain in the private sector.*

Other Considerations

- *Requires additional administrative duties for both the acquirer and the FDIC.*
- *Many healthy, small institutions may not have the expertise to manage a problem loan portfolio.*
- *Time-consuming as agreements generally last five to seven years.*
- *The FDIC does not control the assets yet retains a large portion of the potential loss.*

A bridge bank is a new, temporary, full-service national bank chartered by the Office of the Comptroller of the Currency and controlled by the FDIC. It is designed to "bridge" the gap between the failure of a bank and the time when the FDIC can implement a satisfactory acquisition by a third party.

The original failed bank is closed by its chartering authority and placed in receivership. When appropriate, the FDIC establishes a bridge bank to provide the time needed to arrange a permanent transaction. It also provides prospective purchasers with the time necessary to assess the bank's condition in order to submit their offers. Absent systemic risk, the decision to "bridge" an institution must be based on whether a bridge bank structure will result in the least costly resolution for the failing institution.

The FDIC may establish a bridge bank in either its corporate or receivership capacity. However, the FDIC does not have the authority to bridge a thrift institution; in that instance the FDIC would have to use a conservatorship[48] instead of a bridge bank. A bridge bank can be operated for two years, with three one-year extensions, after which time it must be sold or otherwise resolved.

Although not used very often, a bridge bank resolution is especially useful in situations when the failing bank is large or unusually complex. From the inception of the programme in 1987 through 1994, the FDIC used the bridge bank method a total of 10 times to create 32 bridge banks from 114 separate institutions.[49]

Before establishing a bridge bank, a cost analysis must show that the estimated operating cost of the bridge bank is less costly than a payoff. A resolution timetable and strategy are also completed. The

48. A conservatorship is established when a manager has been appointed to take control of a failing financial institution to preserve assets and protect depositors. Conservatorships were primarily used by the RTC, however, the FDIC does have the power to establish conservatorships.

49. Multiple failing banks in a bank holding company can be combined when creating bridge banks. For example, First Republic Bank Corporation, Dallas, Texas, was a holding company with 41 banks. The FDIC created two bridge banks, one for all the banks in Texas and one for First Republic's bank in Delaware. On the other hand, First City Bancorporation of Texas, Inc., Houston, Texas, had 20 banks, and the FDIC formed 20 separate bridge banks.

resolution strategy for the bridge bank will vary depending on whether the bridge bank is to be held long term (more than nine months) or short term (less than nine months). A bridge bank is established only if it is projected to be the least costly resolution alternative for the FDIC insurance fund.

The FDIC Board of Directors has broad powers to operate, manage, and resolve a bridge bank. A bridge bank operates in a conservative manner while serving the banking needs of the community. It accepts deposits and makes low-risk loans to regular customers. Its management goal is to preserve the franchise value and lessen any disruption to the local community. Performing assets, which are assumed by the bridge bank at their book value, enhance the bank's franchise value. Bank management may attempt to restructure nonperforming assets to increase their value.

The FDIC Board of Directors selects a chief executive officer (CEO)[50] to conduct day-to-day operations and appoints a bridge bank board of directors, composed of senior FDIC personnel and the CEO. The bridge bank board of directors is responsible for reviewing and approving the bank's business plan and for other management and oversight duties. The FDIC Board of Directors retains the authority to effect the bank's final resolution and approve the sale of the bank's assets.

Within 10 days after receiving the charter, the bridge bank's board of directors must develop and implement policies and procedures designed to guide operations safely and soundly, in line with the business plan. An operating budget is prepared to support the business plan's goals. If the CEO and the bridge bank board need assistance or additional expertise in specific areas, consultants may be hired on a short-term basis.

Lending. To prevent a significant outflow of commercial and retail loan customers, the bridge bank strives to maintain a profile in the local community. Specifically, the bridge bank is expected to make limited loans to the local community and to honour commitments made by the previous institution that would not create additional losses for the institution, including advancing funds necessary for the completion of unfinished projects.

50. The CEO is not required to be an FDIC employee.

Assets. The bridge bank officials' primary focus on the asset side is to ensure that the value of the performing loans is retained and to identify problem assets that should be transferred to the receivership. Realistic market values are developed for assets by marking them to market (determining a realistic value based on present market conditions) and assigning appropriate loss reserves. If appropriate, assets may be sold. A complete asset inventory is taken to identify, evaluate, and work out troubled assets of the failed bank. The most problem-ridden assets with the least potential for improvement, including non-performing loans, owned real estate, and fraud-related assets, remain in the failed bank receivership or are transferred to the receivership as soon as they are identified.

For a period of 30 to 90 days after the bridge bank is chartered, assets may be transferred to the receivership or they may be returned to the bridge bank from the receivership (which rarely happens). The bridge bank strives to "work out," or reduce, the volume of non-performing assets. A workout programme can offer a greater chance for recovery than other alternatives, such as foreclosure or litigation. Another cost-effective option is a compromise settlement. If a borrower cannot pay the full amount of the debt and if potential litigation costs are expected to be substantial, then the bridge bank may reach a compromise settlement with the borrower by accepting a repayment of less than the full amount.

Liabilities. Before its chartering authority closes the failing bank, the FDIC decides whether to pass all deposits or only insured deposits (those funds determined to be within the $100,000 insurance limit) to the bridge bank. Usually, only insured deposits are passed when there is an expected loss to the receivership. Customers with uninsured deposits share in any loss in the liquidation of the receivership with the FDIC. The FDIC must notify all depositors that their accounts have been transferred to the bridge bank, and the depositors must contact the bridge bank (or its successor institution) within 18 months to claim their deposits. Unclaimed deposits will be turned over to the respective state government. Typically, customers with deposits in the bridge bank do not lose any funds when an acquirer takes over the bridge bank.

Bridge bank management must decide whether to maintain or lower the interest rates paid on deposits by the failing bank. The FDIC

requires that the rates remain the same for the first 14 days, and depositors must have 7 days' notice of any rate change. Customers with deposit agreements, such as certificates of deposit, may withdraw their funds without penalty until they agree to a new savings agreement.

Liquidity. The FDIC reviews the failing bank's liquidity during the bridge bank preparation phase. It monitors liquidity levels to determine if the bridge bank can meet its own funding needs or if it requires access to the FDIC's revolving credit facility. The bridge bank also attempts to re-establish lines of credit and correspondent banking relationships that were maintained by the failing institution.

Media Relations. Once the FDIC is appointed receiver of the failing bank, the FDIC issues a press release to inform the public of the actions the FDIC has taken and of its plans to resolve the failing bank. The public is kept apprised of all significant events during the bridge bank period. Once the bridge bank has been sold, a press release is issued to the public announcing the sale and the name of the acquirer.

Resolution. The sale and closing of a bridge bank is similar to the sale and closing of other failed banks. The FDIC requires at least 16 to 24 weeks to properly prepare for the sale, which includes gathering information, soliciting interest from potential acquirers, arranging for due diligence by potential acquirers, and receiving and analysing bids. The bridge bank may be resolved through a P&A transaction, a merger, or a stock sale.[51] The most common resolution method for bridge banks is the P&A. Of the 32 bridge banks resolved, all but 2 were short-term, lasting seven months, or less.

The FDIC used its bridge bank authority in 1988 and 1989 to resolve 86 failed institutions of which 85 were affiliated with three large Texas bank holding companies. The FDIC resolved the three Texas bank groups by transferring all the problem assets from the bridge banks to the receiverships and selling the good portfolios to the acquirers with the option to require the FDIC to repurchase certain loans (put option). The acquirers also were given management contracts to ser-

51. A bridge bank is essentially an asset of the receivership. As receiver, the FDIC controls all of the stock in the bridge bank.

vice and to collect on the bad assets in the pools for the FDIC. The bad loan pools included foreclosed loans, classified loans, charged-off loans, and other classified assets.[52] These problem assets were passed to the acquiring banks, which were reimbursed by the FDIC for the administrative costs of managing the pools and for the costs of carrying the problem assets. The FDIC also paid the acquirers incentive fees based on the amounts realised in liquidating the problem assets.

The put option was necessary due to the large size of the loan assets in the bridge bank. No matter how much due diligence was completed before the bid process, the acquirer needs additional time to properly evaluate the performing loan pools and the borrowers. The put options gave the acquirers two to three years to identify other assets that were or became problem assets (based on classification standards used by FDIC examiners) and to put such assets into the bad loan pools.

Some of the initial management contracts were costly for the FDIC and contained some overly generous incentives for the acquirers. Later bridge bank resolutions were modified so that the pools of bad assets were retained by the FDIC as receiver and managed by professional asset managers with more reasonable incentives. Even after this change, the acquirers of the bridge banks were still given limited options to return originally purchased assets to the receiver. Some recent resolution options have included loss sharing provisions. Table 6.2 shows the FDIC's use of bridge bank authority from 1987 through 1994, and Exhibit 6.8 shows the benefits and other considerations of bridge banks.

52. An FDIC examiner reviews assets to assess their credit quality. If an examiner concludes that an asset possesses characteristics or weaknesses that jeopardise the collection of the debt, then the asset is classified in the examination report according to its potential for loss.

Table 6.2

The FDIC's Use of Bridge Bank Authority, 1987-1994

($ in Thousands)

Bridge Bank Situations	Failure Date	Bridge Banks	# of Failed Banks	Total Assets	Total Deposits
1	10/31/87	1 - Capial Bank & Trust Co.	1	$386,302	$303,986
2	07/29/88	2 - First RepublicBanks (Texas)	40	32,835,279	19,528,204
-	08/02/88	3 - First RepublicBank (Delaware)	1	* 582,350	* 164,867
3	03/28/89	4 - Mcorp	20	15,748,537	10,578,138
4	07/20/89	5 - Texas American Bancshares	24	* 4,733,686	* 4,150,130
5	12/15/89	6 - First American Bank & Trust	1	1,669,743	1,718,569
6	01/06/91	7 - Bank of New England, N.A.	1	* 14,036,401	* 7,737,298
-	01/06/91	8 - Connecticut Bank & Trust Co., N.A.	1	* 6,976,142	* 6,047,915
-	01/06/91	9 - Maine National Bank	1	* 998,323	* 779,566
7	10/30/92	10 - First City, Texas-Alice	1	127,990	119,187
-	10/30/92	11 - First City, Texas-Aransas Pass	1	54,406	47,806
-	10/30/92	12 - First City, Texas-Austin, N.A.	1	346,981	318,608
-	10/30/92	13 - First City, Texas-Beaumont, N.A.	1	531,489	489,891
-	10/30/92	14 - First City, Texas-Bryan, N.A.	1	340,398	315,788
-	10/30/92	15 - First City, Texas-Corpus Christi	1	474,108	405,792
-	10/30/92	16 - First City, Texas-Dallas	1	1,324,843	1,224,135
-	10/30/92	17 - First City, Texas-El Paso, N.A.	1	397,859	367,305
-	10/30/92	18 - First City, Texas-Graham, N.A.	1	94,446	85,667
-	10/30/92	19 - First City, Texas-Houston, N.A.	1	3,575,886	2,240,292
-	10/30/92	20 - First City, Texas-Kountze	1	50,706	46,481
-	10/30/92	21 - First City, Texas-Lake Jackson	1	102,875	95,416
-	10/30/92	22 - First City, Texas-Lufkin, N.A.	1	156,766	146,314
-	10/30/92	23 - First City, Texas-Madisonville, N.A.	1	119,821	111,783
-	10/30/92	24 - First City, Texas-Midland, N.A.	1	312,987	289,021
-	10/30/92	25 - First City, Texas-Orange, N.A.	1	128,799	119,544
-	10/30/92	26 - First City, Texas-San Angelo, N.A.	1	138,948	127,802
-	10/30/92	27 - First City, Texas-San Antonio, N.A.	1	262,538	244,960
-	10/30/92	28 - First City, Texas-Sour Lake	1	54,145	49,701
-	10/30/92	29 - First City, Texas-Tyler, N.A.	1	254,063	225,916
8	11/13/92	30 - Missouri Bridge Bank, N.A.	2	2,829,368	2,715,939
9	01/29/93	31 - The First National Bank of Vermont	1	224,689	247,662
10	07/07/94	32 - Meriden Trust & Safe Deposit Co.	1	6,565	0
10	**Totals**	**32**	**114**	**$89,877,439**	**$61,043,683**

Data for Total Assets and Total Deposits is as of resolution.
Data marked with an asterisk (*) are from the quarter before resolution.

Source: FDIC Division of Research and Statistics.

Exhibit 6.8

BRIDGE BANKS

Benefits

- *Provides the FDIC time to arrange a permanent transaction.*
- *Provides prospective purchasers the time necessary to assess the bank's condition in order to submit reasonable bids.*
- *Is an improvement over the deposit payoff or IDT alternatives.*

Other Considerations

- *Duplicates part of the resolution process; the FDIC must complete two closings, one for the original bank and one for the bridge bank.*
- *Takes much FDIC time and effort.*
- *The FDIC becomes responsible for the operation of the bridge bank.*
- *Difficult to retain key employees during this transition period.*
- *Economic conditions may continue to deteriorate, leading to lower premiums.*
- *Best customers may leave institution for more stable environment, thereby reducing the franchise value.*

7. DEPOSIT PAYOFFS

Although purchase and assumption transactions are the most common resolution method, deposit payoffs are used when no acquiring institution can be found. When a bank or thrift is closed by its chartering authority, the Federal Deposit Insurance Corporation (FDIC) in its corporate capacity as deposit insurer makes sure that customers receive the full amount of their insured deposits. Customers with uninsured deposits and other general creditors of the failed institution are given receivership certificates that represent their uninsured claims that will be held against the failed institution's estate. In a deposit payoff, because there is no acquiring institution, the FDIC as receiver must liquidate all of the failed institution's assets.

7.1 Structure of a Deposit Payoff

Deposit payoffs currently have two forms: the straight deposit payoff[53] and the insured deposit transfer. A third form, the Deposit Insurance National Bank (DINB),[54] is rarely used and has not been used since 1982.

In a straight deposit payoff, the FDIC determines the insured amount due each depositor and prepares a check for that amount. Arrangements are made either for the depositors to come to the bank and get the checks or for the FDIC to mail the checks to the depositors.

In an insured deposit transfer, the FDIC also determines the insured amount due each depositor. Arrangements are then made with a healthy institution that is willing to act as agent for the FDIC and to pay insured deposits to customers of the failed institution. The FDIC transfers insured deposit accounts and secured liabilities of the failed bank or thrift, along with an equal amount of cash or other assets, to

53. A straight deposit payoff is frequently referred to simply as a "payoff," since it is the only time the FDIC actually prepares checks for failed institution customers with insured deposits.

54. The Banking Act of 1933 authorised the FDIC to establish a Deposit Insurance National Bank to assume the insured deposits of a failed bank. A DINB had a limited life of two years and continued to insure deposits still in the bank, but could

the healthy institution. Service to customers with insured deposits is uninterrupted. Each of these transactions is discussed on the following pages.

7.2 Straight Deposit Payoff

The straight deposit payoff method is generally the most costly method of resolution, because the receiver must liquidate all of the failed institution's assets, bear the cost of paying off all the customers with insured deposits, and monitor the estate for the creditors.

A straight deposit payoff is only executed if the FDIC does not receive a bid for a P&A transaction or for an insured deposit transfer transaction that will result in a lower cost than the payoff method (as discussed in Chapter 5, The Resolution Process). In a straight deposit payoff, no liabilities are assumed and no assets are purchased by another institution. The FDIC must pay depositors of the failed institution the total of their insured deposits.

In a straight deposit payoff, the FDIC determines the insured amount for each depositor and pays that amount to him or her. In the past, the bank customers would come to the bank to receive their checks from the FDIC. More recently, because of the size of some failed institutions and the geographic dispersion of their customer bases, the FDIC has paid insured deposits by mailing customers checks equal to the amount of their insured deposits. In calculating each customer's total deposit amount, the FDIC includes all the interest accrued up to the date of failure under the contractual terms of the depositor's account. In other words, the FDIC pays the entire principal plus all accrued interest, up to the insurance limit.

For example, a customer with only one individual account, a certificate of deposit in the amount of $80,000 with $15,000 in accrued interest ($95,000 total), would be paid the full $95,000. A customer with only one individual account, a certificate of deposit in the amount of $90,000 with $15,000 in accrued interest ($105,000 total), would be paid only $100,000 because of the insurance limit.

Any checks which a failed institution's customer has written but which have not yet "cleared" the customer's checking account are returned to the payee (person to whom the check was written), be-

cause there is no succeeding bank to pay the check. These checks are stamped "Bank Closed" before they are returned to the payee and are not considered "insufficient funds checks." Even so, this situation causes some disruption to the customers of the failed institution.

The deposit liabilities (both insured and uninsured deposits), together with all other liabilities of the failed bank or thrift, represent claims against the receivership estate. The FDIC as receiver retains all assets and liabilities and liquidates the assets of the failed institution for the benefit of all claimants entitled to payment from the estate.

In the United States, laws provide that all depositors are paid from the receivership estate before any general creditors (such as, suppliers, trades people, or contractors) or other unsecured creditors. The FDIC in its corporate capacity pays the customers with insured deposits up to the insurance limit. These customers actually exchange their claims against the receivership estate for the insurance payments from the FDIC in its corporate capacity, so that the FDIC in its corporate capacity is substituted as the claimant for the amount of insurance payments made. This process is called "subrogation," and the FDIC is the "subrogee." Therefore, claimants against the receivership estate include the FDIC in its corporate capacity as the payer of deposits.

For example, a customer with one individual account, a certificate of deposit in the amount of $80,000 with $15,000 in accrued interest, would be owed $95,000 by the receivership estate. If that customer accepted $95,000 in cash from the FDIC in its corporate capacity, then the customer was paid the full amount due to him. The customer "subrogated" his claim to the FDIC. The customer now has no claim against the receivership estate; instead, the FDIC in its corporate capacity now has the $95,000 claim.

Deposit payoffs occur more often in smaller banks rather than in large banks. Prior to 1982, the largest bank failure handled through a straight deposit payoff was the $78.9 million Sharpstown State Bank, Houston, Texas, in 1971.[55] On 5 July 1982, Penn Square Bank, N.A. (Penn Square), Oklahoma City, Oklahoma, which had $516.8 million in

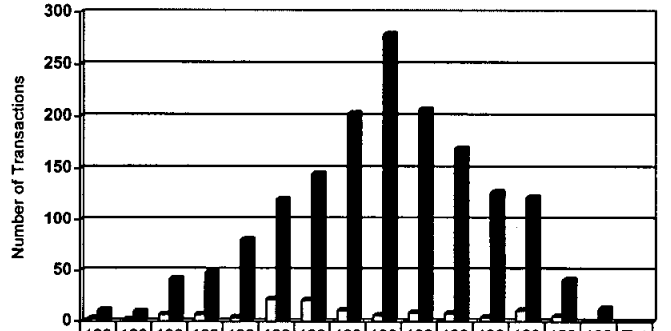
55. Irvine H. Sprague, *Bailout* (New York: Basic Books, Inc., 1986), 117.

total assets, failed. Penn Square, with $470.4 million in deposits in 24,534 deposit accounts, was handled as a DINB. The largest straight deposit payoff since 1982 was for Independence Bank, Los Angeles, California, which failed 30 January 1992. Independence Bank, which had $567.2 million in total assets, had $503.4 million in deposits in 33,677 accounts. The largest straight deposit payoff handled by the Resolution Trust Corporation was Brookside Federal Savings & Loan Association (Brookside), Los Angeles, California, which failed 16 November 1990. Brookside had total assets of $450.1 million and total deposits of $416 million in 15,414 accounts.

From 1980 through 1994, the FDIC managed 120 straight deposit payoffs out of a total of 1,617 failed and assisted banks, or 7.4 percent of all closings. Chart 7.1 shows the distribution of straight deposit payoff transactions per year from 1980 through 1994, and Exhibit 7.1 shows the benefits and other considerations of straight deposit payoffs.

Chart 7.1

Straight Deposit Payoffs
Compared to All Bank Failures and Assistance Transactions
1980-1994



	1980	1981	1982	1983	1984	1985	1986	1987	1988	1989	1990	1991	1992	1993	1994	Total
SDPs	3	2	7	7	4	22	21	11	6	9	8	4	11	5	0	120
Total	11	10	42	48	80	120	145	203	279	207	169	127	122	41	13	1,61

Source: FDIC Division of Research and Statistics.

Exhibit 7.1

STRAIGHT DEPOSIT PAYOFFS

Benefits

- Customers with insured deposits receive money quickly without having to wait for proceeds from the liquidation of receivership assets.

Other Considerations

- Customers must find a new bank and set up new accounts.
- Customers with uninsured deposits are not paid the uninsured amount.
- Customers experience a loss of service, including the return to payees of checks that had not cleared the customers' accounts.
- Customers lose interest on funds from the date of failure until the FDIC check is deposited in an account elsewhere.
- Community can experience economic disruption from the loss of an institution.
- Receivership bears the cost of liquidating all of the assets of the estate Usually considered a "last resort" resolution method due to its high cost to the insurer.

7.3 Insured Deposit Transfer

In 1983, the FDIC created the insured deposit transfer (IDT) transaction as an alternative to the straight deposit payoff. In an IDT, the insured deposits and secured liabilities of a failed bank or thrift are transferred to a healthy institution (the agent institution), and the FDIC makes a matching payment of cash and/or assets to the institution. The agent institution pays customers with insured deposits the amounts due to them or, if a customer requests it, opens an account in the agent institution. Thus, service to customers with insured deposits continues uninterrupted. All insured deposits are made available to their owners, checks drawn on those accounts are honored, and interest-bearing accounts continue to earn the same amount of interest as they were earning at the failed institution. However, the agent institution may change the interest rate after 14 days; if a change is made, customers must be given at least 7 days' notice.

Alternatively, customers with insu-red deposits may withdraw their balances and close their accounts.[56]

An insured deposit transfer minimises the disruption to customers and to the local community caused by a straight deposit payoff. An IDT also reduces the FDIC's costs to handle the failure since the accepting institution acts as the paying agent on behalf of the FDIC and disburses insured funds to depositors. The agent institution generally pays a premium[57] or this right; although, there have been rare instances when the FDIC paid an agent institution to perform this function. Insured deposit transfers are a way to extract some franchise value for the failed institution's deposits even when an agent bank is unwilling to enter into a purchase and assumption transaction. In an IDT, the receiver retains all the remaining assets and liabilities of the failed institution that are not passed to the agent institution.

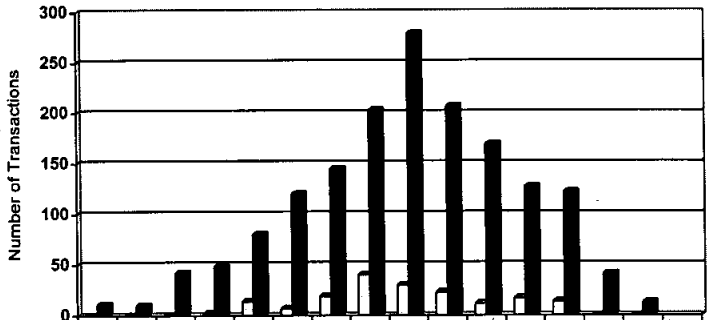
From 1980 through 1994, the FDIC oversaw 176 insured deposit transfers out of a total 1,617 closings, or 10.9 percent of all failed and assisted institutions. Since IDTs were created in 1983, through 1994, they have represented 62 percent of the total deposit payoffs while straight deposit payoffs represented 38 percent. Chart 7.2 shows the distribution of IDTs per year from 1980 through 1994, and Exhibit 7.2 shows the benefits and other considerations of insured deposit transfers.

56. If a depositor does not take action to claim the transferred deposit within 18 months after the failure, the agent institution is required to transfer the funds to the receiver, who then escheats the funds to the state, that is, turns the property over to the state in the absence of legal heirs or claimants.

57. A premium is an amount paid for the franchise value of a failed institution's deposits.

Chart 7.2

Insured Deposit Transfers Compared to All Bank Failures and Assistance Transactions 1980-1994



	1980	1981	1982	1983	1984	1985	1986	1987	1988	1989	1990	1991	1992	1993	1994	Total
IDTs	0	0	0	2	14	7	19	40	30	23	12	17	14	0	0	176
Total	11	10	42	48	80	120	145	203	279	207	169	127	122	41	13	1,617

Source: FDIC Division of Research and Statistics.

Exhibit 7.2

Insured Deposit Transfers

Benefits

- *Customers with insured deposits suffer no loss in service.*
- *Customers with insured deposits have new accounts in a new bank, but old checks can still be used.*
- *Agent institutions have the opportunity for new customers.*
- *Customers with insured deposits continue to earn the same rate of interest on their accounts for at least 14 days.*
- *The FDIC's administrative costs are reduced.*

Other Considerations

- *An institution must be willing and technically able to become an agent bank.*
- *Customers with uninsured deposits are not paid the uninsured amount.*
- *Receivership bears the cost of liquidating all or almost all of the assets of the failed institution.*

8. OPEN BANK ASSISTANCE TRANSACTIONS

The third basic resolution method for failing financial institutions is an open bank assistance (OBA) transaction.[58] In an OBA, the Federal Deposit Insurance Corporation (FDIC) provides financial assistance to an operating insured bank or thrift to keep it from failing. The FDIC can make cash contributions to, make loans to, purchase the assets of, or place deposits in the troubled bank or thrift.[59]

8.1 Structure of an Open Bank Assistance Transaction

Open Bank Assistance can be used to facilitate the acquisition of a failing bank or thrift by a healthy institution. An OBA transaction is very similar to a whole bank purchase and assumption in that the majority of the failing institution's assets remain intact. While an OBA can be structured in several ways, the FDIC's ultimate goal is minimising cost to the deposit insurance funds.

A major criticism of OBA, however, is that shareholders of failing institutions have benefited from the assistance provided by the government, even though most of the OBA transactions required the shareholders of the failing institutions to significantly dilute their ownership interests. Generally, the FDIC required new management, ensured that the ownership interest was diluted to a nominal amount, and called for a private-sector capital infusion. A 1993 amendment to the Federal Deposit Insurance Act (FDI Act) of 1950 prohibited the use of insurance fund monies in any manner that benefits any shareholder of an institution that had failed or was in danger of failing. That amendment made obtaining assistance even more difficult than in the past for open institutions.

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58. There are several types of assistance to open banks, including forms of cash and non-cash assistance. To the FDIC, the term "open bank assistance" refers specifically to a resolution method where financial assistance is given to a troubled bank or thrift to prevent its failure. See Chapter 9, Other Resolution Alternatives for a discussion of other types of assistance to open institutions.

59. In open bank assistance agreements, the FDIC provides a cash contribution to restore deficit capital to a positive level (referred to as "filling the hole"). For a large institution, the FDIC may use a note or loan to fill the hole. Additionally, the FDIC may cover losses for a specific amount on a pool of assets over a specified period of time.

Before the FDIC can provide open bank assistance, it must establish that the assistance is the least costly to the insurance fund of all possible methods for resolving the institution. The FDIC may deviate from the least cost requirement only to avoid "serious adverse effects on economic conditions or financial stability" or "systemic risk" to the banking system.[60] The appropriate federal banking agency or the FDIC must also determine that the institution's management is competent, has complied with all applicable laws, rules, and supervisory directives and orders, and has never engaged in any insider dealings, speculative practices, or other abusive activity.

Since the inception of OBA in 1950,[61] the legislative process and public policy have transformed OBA. Originally, the FDIC could grant OBA only if the institution's continued existence was determined to be "essential" to the community.[62] This was seldom deemed to be the case as only four institutions received OBA from 1950 to 1979. In 1982, the FDIC received broader authority from the U.S. Congress with the passage of the Garn-St Germain Depository Institutions Act (Garn St-Germain) to provide OBA. For example, the FDIC no longer had to satisfy the essentiality test; an institution could receive assistance if the FDIC Board of Directors determined that the amount of assistance was less than the cost of liquidating the institution.

In 1986, the FDIC revised its policy statement on OBA to provide guidance to FDIC insured banks in danger of failing on the general conditions and terms that a request for OBA should include. The policy statement was revised because the number, size, and complexity of bank failures had increased dramatically, as had requests for assistance. The 1986 policy statement required the following:

60. Only the secretary of the Treasury has the power to grant this exception, after consulting with the president of the United States and with the recommendation by two-thirds of the boards of directors of the FDIC and the Federal Reserve System.

61. Federal Deposit Insurance Act, U.S. Code, volume 12, section 1823(c)(1).

62. For a discussion of the history of the essentiality issue, see Henry Cohen, "Federal Deposit Insurance Corporation Assistance to an Insured Bank on the Grounds that the Bank is Essential in Its Community," Congressional Research Service (October 1984).

- The FDIC's cost in providing assistance must be less than if the FDIC took alternative action (which at the time was considered to be the cost of liquidation),
- The assistance proposal must provide for sufficient capitalization including capital infusions from non-FDIC sources, and
- The financial effect of the assistance upon shareholders and subordinated debtholders of the bank or the bank's holding company must approximate the same effect on those parties had the bank failed.

The statement also covered renegotiations of management contracts, avoidance of an equity position for the FDIC in a bank, the FDIC's preference not to acquire or service the assets of assisted banks, the responsibility for pursuing legal claims against bonding and insurance companies, and fee arrangements.[63]

The FDIC completed the majority of the OBA agreements (with 98 institutions) in 1987 and 1988.[64] Those transactions represented approximately 20.3 percent of the total OBA and failure transactions during those years. One reason for the increase in OBA transactions was that the FDIC instituted a policy to communicate to bankers the deficiencies of their assistance proposals and to allow them to make adjustments to conform to the policy statement. If the proposal cost less than liquidation, FDIC staff would recommend the open bank assistance proposal without requesting closed bank bids. Another reason for the increase in OBA transactions was the existence of federal income tax benefits, including relaxed rules for tax-free reorganizations, favorable rules regarding carry forwards of net operating losses, and favorable tax treatment of assistance payments received by the failing banks from the FDIC.[65] In 1989, however, with passage of the Financial

63. FDIC News Release, "FDIC Revises Policy on Assistance to Failing Banks," PR-189-86 (2 December 1986).

64. In 1987, 11 of the 19 assistance transactions were with BancTexas Group institutions. For 1988, 59 of the 79 assistance transactions were with First City Bancorporation of Texas, Inc. institutions.

65. Thomas D. Phelps and Sean M. Scott, "Investment Opportunities Afforded By Open Bank Assistance," Banking Expansion Reporter (6 February 1989), 8-10.

Institutions Reform, Recovery, and Enforcement Act (FIRREA), many potential tax benefits associated with open bank assistance were repealed.[66]

The number of OBA transactions decreased significantly after 1988. Of the 625 failed or failing banks handled by the FDIC from 1989 through 1992, only 7 were resolved by open bank assistance. The decline in OBA can be attributed, in part, to the following factors:

- In 1989, the FDIC began comparing the cost of OBA proposals within a competitive bidding process. In most cases, the closed proposals were less costly to the insurance fund,[67] or the proponents for open bank assistance failed to satisfy the criteria.
- The passage of FIRREA in 1989 repealed many of the potential tax benefits listed above. Furthermore, the FDIC had to consider any tax benefits when evaluating bids, that is, if the transaction resulted in a lower federal tax liability for the acquirers, that decrease in taxes had to be added to the cost of the transaction.
- The Competitive Equality Banking Act (CEBA) of 1987 authorised the FDIC to establish a bridge bank, which allowed the FDIC additional time to find a permanent solution for resolving a failing bank. Furthermore, with a bridge bank the FDIC could simply leave all bondholders' and shareholders' claims behind in a receivership, and the bondholders and shareholders would have no bargaining power. The FDIC handled the three largest bank failures in 1989 using the bridge bank structure.

In April 1990, the FDIC's policy was revised to reflect certain amendments to section 13(c) of the FDI Act and the addition of section 13(k)(5) as enacted in FIRREA. Section 13(k)(5) dealt with providing

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66. FIRREA repealed certain provisions of the Technical and Miscellaneous Revenue Act (TAMRA) of 1988, which allowed purchasers of failing institutions to take advantage of certain tax benefits. While TAMRA was in effect, the FDIC attempted to ensure that the tax benefits effectively accrued to the insurance fund by reducing the amount of assistance provided for both open and closed transactions.

67. Closed bank transactions offer advantages over open bank transactions because, in a closed bank transaction, contingent liabilities can be eliminated, burdensome leases and contracts can be terminated, and troublesome assets can be left in the receivership. Furthermore, uninsured depositors and unsecured creditors can share in the loss.

assistance to troubled savings associations before they were placed into the Resolution Trust Corporation's conservatorship programme. None of the savings and loans that applied to the FDIC for open assistance was approved, however, because they failed to meet the criteria factors.

The FDIC's 1990 Statement of Policy on Assistance to Operating Insured Banks and Savings Associations retained some of the criteria from the 1986 policy statement and added several new factors. Some of the more important factors were that (i) acceptance of proposals by the FDIC would be within a competitive bidding process, (ii) institutions requesting assistance had to agree to unrestricted due diligence by all parties cleared by the FDIC, and (iii) proposals had to quantify limits on indemnities and guarantees.[68] The guidelines and criteria for assistance proposals were flexible and the FDIC was receptive toward innovative ideas from investors in structuring OBA proposals.

In 1992, the FDIC again revised its policy statement for open bank assistance. The revision mainly reflected changes mandated by the Federal Deposit Insurance Corporation Improvement Act (FDICIA) of 1991, which included the possibility of "early resolution" of institutions that were troubled, and the requirement that failing institutions generally be resolved in the manner that was least costly to the deposit insurance fund. The policy statement also required the FDIC to make certain findings with respect to ongoing management of the institution.[69] The 1992 policy statement detailed 19 criteria for evaluating proposals and identified certain information that should be included in a proposal.

With the passage of an amendment to section 11 of the FDI Act in 1993, the FDIC was prohibited from using insurance fund monies in any manner that benefited any shareholder of an institution that had failed or was in danger of failing. The passage of this statute has virtually eliminated the possibility of OBA, except in the cases of a systemic risk determination. Therefore, in 1997 the FDIC Board of

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68. FDIC, Financial Institution Letter, "Policy Statement on Assistance to Operating Insured Banks and Savings Associations," 6 April 1990, FIL-27-90.

69. Section 13(c)(8) requires management of the resulting institution to be competent and to have complied with applicable laws.

Directors decided to rescind the 1992 policy statement and consider proposals from open, failing institutions based only on current statutory requirements (that is, least cost, management competence, and no benefit to former shareholders). Table 8.1 shows the number of open bank assistance transactions completed per year in relation to the significant legislation passed during that year.

8.2 Assistance to Continental Illinois National Bank and Trust, Chicago, Illinois

The term "open bank assistance" gained national recognition in 1984 when the FDIC provided assistance to Continental Illinois National Bank and Trust (Continental), Chicago, Illinois. At its peak in 1981, Continental was the largest commercial and industrial lender in the United States, although it was not the largest bank. As of 31 March 1984, shortly before its resolution, the bank held approximately $40 billion in assets. Continental had followed a high-risk expansion strategy based on the rapid growth of its loan portfolio, which was funded by volatile, short-term liabilities. Continental had purchased energy loan participations from Penn Square Bank, N.A. (Penn Square), Oklahoma City, Oklahoma. These loans contributed significantly to the more than $5.1 billion in non-performing loans Continental held in 1982. After Penn Square's failure, confidence in Continental, particularly among its many international customers, was severely shaken. As a result, a rapid and massive electronic deposit run began in early 1984. The FDIC's options in resolving Continental were either to payoff the customers with insured deposits, to merge the institution, or to provide direct open assistance.

The FDIC ruled out a payoff of customers with insured deposits because of the negative effect it would have had on other banks and the economy. This negative effect included a potential liquidity crisis for other banks with significant foreign deposits, a decrease in foreign investor confidence in U.S. institutions, a severe blow to the unaffiliated depositor banks, and a negative effect on financial markets in general. Many small banks had correspondent bank accounts and federal funds sold to Continental, placing those funds at risk should Continental fail. For the FDIC, permitting Continental to fail and then paying off only the insured depositors was not considered to be a feasible option. With more than $30 billion in uninsured deposits, a liquidity failure would have occurred without FDIC assistance; such a failure could

Table 8.1

Summary of Open Bank Assistance Transactions

Significant Legislation	Year	Number of Banks Receiving Open Bank Assistance	Total # of Bank Failures and Assistance Transactions
FDI Act of 1950	1950-1970	0	82
(essentiality test)	1971-1979	4	73
	1980	1	11
	1981	3	10
GARN ST GERMAIN	1982	8	42
(less costly than a liquidation)	1983	3	48
	1984	2	80
	1985	4	120
	1986	7	145
CEBA	1987	*19	203
(bridge bank authority)	1988	**79	279
FIRREA	1989	1	207
(repeal of tax benefits)	1990	1	169
	1991	3	127
FDICIA (least cost test)	1992	2	122
TOTAL	**1950-1992**	**137**	**1,718**

* Includes 11 BancTexas Group, Inc. institutions that were part of one transaction.
** Includes 59 First City Bancorporation of Texas, Inc. institutions that were part of one transaction.

Source: FDIC Division of Resolutions and Receiverships.

have caused other bank failures and tied up creditors in bankruptcy for years.

The FDIC Board of Directors decided that a payoff of Continental's insured deposits could cause panic in the financial and banking markets. Former FDIC Director Irvine H. Sprague (1969-1972 and 1979-1985) wrote:

> Insured deposits were then estimated at about $4 billion, barely 10 percent of the bank's funding base. At first glance, a payoff might have seemed a temptingly cheap and quick solution. The problem was there was no way to project how many other institutions would fail or how weakened the nation's entire banking system might become. Best estimates of our staff . . . were that more than two thousand correspondent banks were depositors in Continental and some number—we talked of fifty to two hundred—might be threatened or brought down. . . . The only things that seemed clear were not only that the long-term cost of allowing Continental to fail could not be calculated, but also that it might be so much as to threaten the FDIC fund itself.[70]

Merging Continental on a closed basis was not viewed as a viable option because prospective purchasers would have needed a significant amount of time to evaluate the bank. In addition, it would have required significant FDIC financial involvement to protect against uncertainties, such as contingent liabilities.[71]

The FDIC elected to provide direct assistance to Continental. Because of this deposit run, on 17 May 1984, the FDIC gave its assurance to protect all depositors and other general creditors of Continental against loss. A temporary capital infusion of $2 billion was made to provide liquidity and to halt a run on deposits until a permanent solution could be arranged. The permanent solution involved replacing senior management, purchasing $4.5 billion in problem loans for $3.5 billion, and injecting $1 billion in capital. In exchange, the FDIC received the right to purchase 80 percent ownership in the parent

70. Irvine H. Sprague, Bailout (New York: Basic Books, Inc., 1986), 155.

71. Isaac, 3.

company, Continental Illinois Corporation.[72] As a result, the shareholders of the parent company suffered an 80 percent dilution of their investments, and the shareholders further became subject to losing their entire investment depending on the losses suffered by the FDIC in collecting the problem loans.[73]

The assistance agreement with Continental created tremendous outcries from critics for several reasons. First, the FDIC guaranteed all depositors and other general creditors, thus assuming their share of loss and removing the market risk. Second, it was generally believed that the FDIC should have penalised the shareholders to a greater degree.[74] Third, the agreement called for the FDIC to receive a majority equity interest, effectively nationalising the institution. Finally, the issue of "Too Big to Fail"[75] created resentment by many of the smaller institutions due to their belief that the resolutions of larger institutions were treated differently from those of smaller banks. Assisting Continental sowed the seed for future legislation that addressed each of these points. The assistance provided to Continental accomplished the FDIC's objectives of stabilising liquidity, preventing Continental's failure, and restoring Continental's capital to an adequate level. The assistance also proved to be cost-effective for the FDIC.

8.3 Results of Open Bank Assistance

The majority of open bank assistance transactions completed between 1980 and 1983 involved mutual savings institutions. Assistance was in the form of a merger or acquisition, and the remaining institutions were recapitalised on a stand-alone basis. The FDIC's methods for handling these institutions were varied and included contributing

72. Isaac, 4-5.

73. Isaac, 4.

74. The holding company for Continental owned 100 percent of the bank. The shareholders of the holding company suffered an 80-percent dilution with the possibility of losing their entire investment.

75. Most of the institutions considered "Too Big to Fail" were actually closed; however, certain troubled institutions were too large to be resolved by paying off their customers with insured deposits. A straight deposit payoff of such an institution could have had a devastating effect on the deposit insurance fund. A more accurate name might be "Too Big to Pay Off All Deposits."

cash, purchasing assets, offering income maintenance guarantees, issuing FDIC notes, purchasing the institution's stock, and/or indemnifying against certain types of losses. Most of the acquirers adequately capitalised the institutions. In some cases cash was contributed, and in the other agreements the acquirer's current capital position was sufficient to absorb the assisted institutions. The importance of this is that the investors assumed some risk and brought fresh capital into the banking system. Replacement of management and the dilution of shareholders' interest also characterised the open bank assistance transactions.[76]

Since the Continental transaction, an additional 117 institutions received OBA through year-end 1994. All of these transactions were entered into because they were viewed to be less costly than a payoff of customers with insured deposits. Several of the transactions completed in 1984 and 1985 were approved under the FDIC's Voluntary Assisted Merger Plan, under which the FDIC took direct action to arrange a merger of a failed or failing insured bank with another insured bank.

In 1986, former FDIC Chairman L. William Seidman (1985-1991) told the Association of Bank Holding Companies that there are three potential advantages of open bank assistance:

> They can provide substantial savings to the insurance fund when compared with the cost of closing a bank;
> They provide a mechanism for keeping loans and other assets within the banking system since all borrowers would be dealing with bankers instead of liquidators; and
> They can minimise the disruption to the local community that may result from bank failures.[77]

In addition, Chairman Seidman stated: "There is nothing wrong with assisting a bank, but the advantages have to be weighed against the substantial disadvantages of the FDIC's short-term (hopefully) in-

76. There were a few cases where senior management was not replaced. In each case it was determined that the current management was not considered the cause of the problem.

77. L. William Seidman, Perspectives on Open Bank Assistance, (Washington, D.C.: Government Relations Committee of the Association of Bank Holding Companies, 17 September 1986), 5.

volvement in the private sector through its ownership of warrants, preferred stock or loans in the rescued institution."[78]

From 1980 through 1994, the FDIC provided OBA to 133 institutions out of 1,617 total failures and assistances, or 8.2 percent of the total. Nearly 75 percent of all OBA transactions were completed in 1987 and 1988. Public policy has significantly affected OBA, and in many cases the FDIC has had to wrestle between its role as regulator and insurer against that of investor. OBA has been controversial for several reasons.

- First, OBA allowed weak institutions to remain open and compete with non-assisted institutions.

- Second, shareholders and creditors of failing institutions, while losing substantial portions of their investments, did not lose everything because of OBA.

- Third, many of the OBA transactions were used to resolve larger institutions, resulting in resentment by many of the owners of smaller institutions.

- Fourth, some of the OBA transactions provided significant tax benefits to the acquirers at a cost to the U. S. taxpayer that appeared to exceed any financial benefit received by the government.

- Fifth, OBA protected all uninsured depositors, which had the result of reducing depositor discipline.

Because of these controversial issues, legislation has been adopted that makes it extremely difficult to complete an OBA transaction. FDICIA, which requires the FDIC to use the least costly method for resolving a failing institution, is intended to provide greater incentives for shareholders and large creditors of insured banks or thrifts to impose more discipline on the management of insured institutions to operate safely and soundly. Chart 8.1 shows the distribution of open bank assistance transactions per year from 1980 through 1994, and Exhibit 8.1 shows the benefits and other considerations of open bank assistance.

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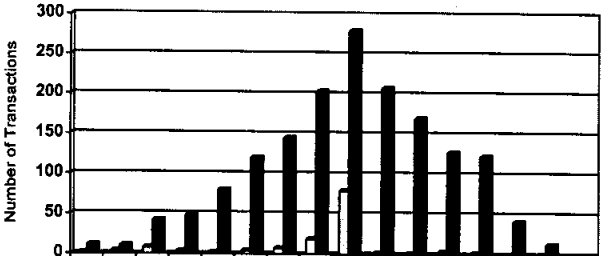
Chart 8.1

FDIC Open Bank Assistance Transactions Compared to All Bank Failures and Assistance Transactions 1980-1994



	1980	1981	1982	1983	1984	1985	1986	1987	1988	1989	1990	1991	1992	1993	1994	Total
OBA	1	3	8	3	2	4	7	19	79	1	1	3	2	0	0	133
Total	11	10	42	48	80	120	145	203	279	207	169	127	122	41	13	1,6

Source: FDIC Division of Research and Statistics.

Exhibit 8.1

OPEN BANK ASSISTANCE TRANSACTIONS

Benefits

- *OBA may represent the most cost-effective method for resolving a failing institution.*
- *The transaction can minimise disruption to the local community.*
- *Investors assume some of the risk and bring new capital into the institution.*
- *Assets are kept in the private sector.*

Other Considerations

- *Contingent liabilities remain with the troubled institution.*
- *Also protects customers with uninsured deposits and general creditors, promoting a belief in "Too Big to Fail."*
- *Time necessary for a troubled institution to put together an assistance proposal is sometimes outside the FDIC's parameters for resolving failing institutions.*

9. OTHER RESOLUTION ALTERNATIVES

In addition to the three basic resolution methods (purchase and assumption transactions, deposit payoffs, and open bank assistance transactions), other resolution methods were used by the Federal Deposit Insurance Corporation (FDIC), the Federal Home Loan Bank Board (FHLBB), and the Federal Savings and Loan Insurance Corporation (FSLIC). These alternatives were used primarily in the 1980s in response to the increasing problems facing the banking and thrift industries. These methods may provide other countries with some alternative resolution options. All of these methods would fit under the general description of forbearance, which is defined as the act of refraining from enforcement of regulatory action. As a result of changes in U.S. banking laws in the early 1990s, there are very limited circumstances in which the FDIC can use forbearance. Most forbearance programmes come at the behest of the U.S. Congress.

Forbearance is a controversial concept. One view is that it should never be used. Proponents of this view look at the high cost to taxpayers from the savings and loan crisis. In large part, these costs were a direct result of delayed action. Another view is that the prudent use of forbearance can be an effective tool in an economic crisis. The responses to the FDIC savings bank problems and the agricultural crisis of the early 1980s are cited as cases in point. Under this view, forbearance can be considered in certain circumstances but should be carefully structured if used. In order to qualify for forbearance programmes, institutions should be well managed and have reasonable chances of survival. Once relief has been granted, regulatory authorities should closely monitor the situations and end the forbearance programme if the situation deteriorates beyond some predetermined point. Forbearance can take many forms and can provide flexibility in resolving problem institutions, but there must be effective governmental oversight controls.

9.1 Net Worth Certificate Programme

In 1982, the U.S. Congress established a programme that allowed banks and thrifts to apply for capital assistance. Deposit rate structures for banks and thrifts, which had been legally restricted for decades, were deregulated. Financial institutions were required to compete for deposit funds in an inflationary setting, which caused interest rates to

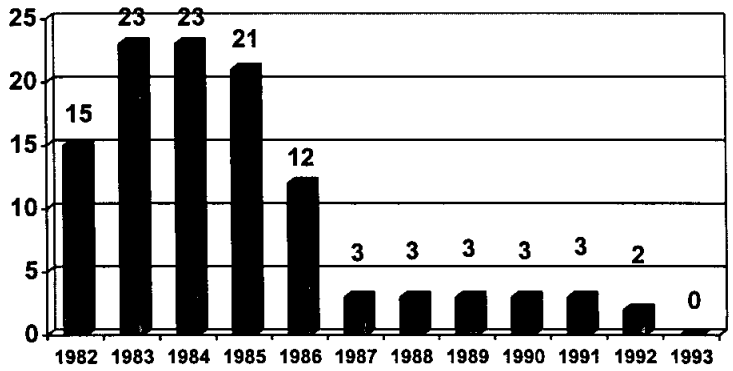
sharply increase. Institutions that had primarily lent funds on a long-term basis, such as for 30-year fixed-rate mortgages or long-term government bonds, suddenly had to pay higher rates for deposits to meet their liquidity needs.

The primary purpose of the Net Worth Certificate Programme was to provide capital forbearance to institutions that were not performing well in the new, competitive, deregulated environment. The FDIC's programme was restricted to institutions with insufficient net worths; that had recurring losses that were not caused by mismanagement; that would agree to establishing a comprehensive, goal-oriented business plan; and that would consider reasonable merger opportunities. The FDIC "bought" net worth certificates (NWC) from participating institutions in exchange for FDIC promissory notes with terms (such as interest rate, amount, and maturity) identical to those of the net worth certificates. In other words, no cash changed hands. The NWCs were considered capital for regulatory purposes, but they did not qualify as capital under generally accepted accounting principles (GAAP).

The NWCs were a temporary form of capital that the institution gradually replaced as it became profitable. Institutions were required to reduce the certificates by one-third of their net operating income each year, and the FDIC could request full payment after seven years. The FDIC constantly monitored banks participating in the programme. The FSLIC had a similar programme for the thrifts. Charts 9.1 and 9.2 show the number of institutions and volume of assets that were involved in the FDIC's Net Worth Certificate Programme by year.

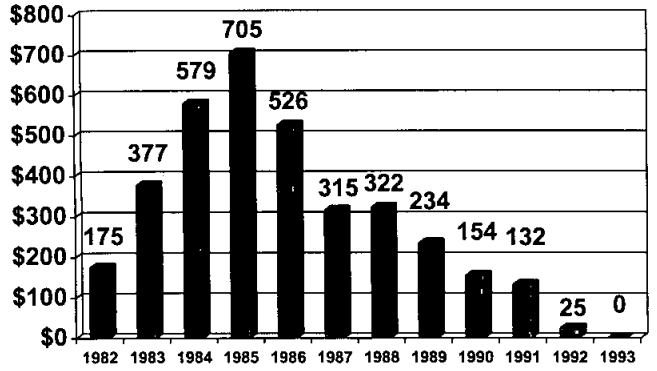
Overall, 29 savings banks with total assets of approximately $40 billion received aid from the programme. Of the 29 savings banks participating in the plan, 22 required no further assistance and eventually paid off their NWCs. The remaining seven institutions required additional assistance and cost the FDIC approximately $480 million. Of these seven, four repaid all assistance, and three were merged into healthy institutions with FDIC assistance. Two institutions failed after paying off their NWCs. Those two failures were the result of actions taken by management after they left the NWC programme. Table 9.1 below shows the effect of NWCs on an institution's balance sheet.

Chart 9.1
FDIC Net Worth Certificate Programme
Number of Banks in Programme
1982-1993



Source: FDIC Annual Reports 1982-1993.

Chart 9.2
FDIC Net Worth Certificate Programme
Dollars in Programme 1982-1993
($ in Millions)



Source: FDIC Annual Reports 1982-1993.

Table 9.1

An Example of How Net Worth Certificates Affect A Financial Institution's Balance Sheet

Prior to Net Worth Certificates				After Net Worth Certificates			
Assets		**Liabilities**		**Assets**		**Liabilities**	
Loans	800	Deposits	1,000	Loans	800	Deposits	1,000
Other Assets	200	Other Liab.	50	Other Assets	200	Other Liab.	50
				NWC	100		
		Total Liabilities	1,050			Total Liabilities	1,050
						NWC	100
		Capital	-50			Capital	-50
						Total Capital	50
		Total Liab.				Total Liab.	
Total Assets	1,000	& Capital	1,000	Total Assets	1,100	& Capital	1,100
		Capital/Assets Ratio	-5.00%			Capital/Assets Ratio	4.55%

9.2 Income Maintenance Agreements

From 1981 through 1983, the FDIC used income maintenance agreements to adjust for the effect that the deregulation of interest rates was having on some of its larger savings banks. These institutions' income was primarily tied to low-yielding, single-family, long-term mortgage loans. The credit quality of the collateral supporting the loans was not a problem.

A major concern to the FDIC was how to resolve these failing savings banks without incurring enormous losses to the insurance fund. The FDIC's resolution strategy was to force the weaker savings banks to merge into healthier banks or thrifts. In order to attract a merger partner, the FDIC guaranteed a market rate of return on the acquired assets through the use of an income maintenance agreement. The FDIC paid a merger partner (the assuming institution) the difference between the yield on acquired earning assets and the average cost of funds for savings banks, plus a "spread" to cover administrative and overhead expenses related to these assets. In effect, the FDIC guaranteed the acquirer a market rate of return on acquired assets with below-market rates. The FDIC entered into these agreements only if the resulting institutions would be viable. In most cases the senior

officials at the troubled institution were required to resign, and subordinated debtholders received only a portion of their investments. There are no shareholders in mutual savings banks, so the issue of an unexpected windfall gain for existing shareholders did not need to be addressed

The FDIC took some risks in issuing net worth certificates and income maintenance agreements and in allowing the institutions to continue to operate. The savings banks were large institutions, and continued depreciation in their loan portfolios would have had a significant effect on the insurance fund if they had failed. The FDIC reduced its risk by preparing the institutions for mergers or by allowing them time to gradually adjust their asset mixes to more profitable structures. Also, the problem for the savings banks was not tied to collateral values but rather the result of the major change of banking deregulation in the country.

9.3 Capital Forbearance Programme and Loan Loss Amortisation Programme

In the early 1980s, the U.S. agricultural economy was in trouble. In 1983, 37 percent of the banks on the FDIC Problem Bank List (a list of banks that could potentially fail) were considered agricultural banks. Over the years, farmers had taken on large sums of debt supported by the rapidly increasing collateral value of their land. As farm income reached a point where it could not support payments on these debts, the loans started to become delinquent. Collapsing land values compounded the problem. Many borrowers' loans had been based on the equity in their land, and this equity had disappeared. Since the borrowers had no way to repay their notes, the banks had no alternative but to begin foreclosure to try to recover at least a portion of their funds. The many foreclosures tended to push land values even lower because as the bank's owned real estate portfolios grew, banks were forced to sell those non-earning assets as quickly as possible. Large numbers of farm foreclosures were quickly followed by large numbers of bank failures in states where the economy depended on agriculture.

As large numbers of agricultural banks failed in the 1980s, methods were developed to save institutions that were historically well-managed but financially troubled as a result of the depressed economy in their

areas. The FDIC instituted two programmes that were called the Capital Forbearance Programme and the Loan Loss Amortisation Programme.

The Capital Forbearance Programme allowed well-managed, economically sound institutions with concentrations of 25 percent or more in agricultural or energy loans to be temporarily exempt from regulatory capital requirements. Eligible banks were required to have a capital ratio of at least 4 percent, and their weakened capital position had to be a result of external problems in the economy and not a result of mismanagement, excessive operating expenses, or excessive dividends.

The Loan Loss Amortisation Programme allowed banks to amortise agricultural losses on their books over a seven-year period. Only institutions of less than $100 million in total assets and with at least 25 percent of their total loans in agricultural credits were eligible for this programme. Qualified institutions were judged to be economically viable and fundamentally sound, except for needing additional capital to carry the weak agricultural credits.

A total of 301 institutions participated in the Capital Forbearance Programme, and an additional 33 were in the Loan Loss Amortisation Programme. Although most of these institutions were either insolvent or close to being insolvent, only 21 percent of these institutions subsequently failed. Table 9.2 shows the distribution of banks among the two programmes.

There are many risks in offering forbearance programmes, but carefully managed forbearance programmes have been used successfully to prevent institution failures. In both the Capital Forbearance Programme and the Loan Loss Amortisation Programme, the participating banks were primarily small institutions that served farm communities. The farm crisis was temporary, and these methods of forbearance allowed banks the time to recover. The risk to the insurance fund was minimal because the banks were small and easily identifiable. The effects on the insurance fund would have been much larger if the farm crisis had continued indefinitely, if the losses had not been recognised early, or if the value of the collateral had continued to erode.

Table 9.2

**Results of the Capital Forbearance Programmes*
Agricultural and Energy Sector Banks**

	Capital Forbearance Programme	Loan Loss Amortisation Programme
Number of Banks in Programme	301	33
Assets of Banks in Programme ($ in Billions)	$13.0	$0.5
Avg. Size of Banks in Programme ($ in Millions)	$43.2	$15.2
Number of Banks that Survived**	236	29
Numberof Banks that Failed	65	4

*Banks that participated in both programmes are included only in the Capital Forbearance Programme.
** Banks that left the programme as independent institutions or were merged without assistance.

Source: FDIC Division of Research and Statistics.

9.4 Resolution of Savings & Loan Associations Prior to FIRREA

In response to the increasing problems facing the thrift industry, the Federal Home Loan Bank Board and the Federal Savings and Loan Insurance Corporation used the following resolution methods.

9.4.1 Easing of Capital Requirements

The cause of failure of most thrifts in the early 1980s was the economic issues faced by the entire industry. The mismatch between the rates generated by the long-term assets (mostly mortgage loans) held by thrifts and the shorter-term liabilities used to fund those assets created what is commonly referred to as a "spread problem." The FHLBB pursued strategies to keep these "spread problem thrifts" open until rates returned to lower, more traditional levels. The FHLBB's first strategy in response to the developing thrift crisis was a general easing of the thrift industry's capital requirements which was accomplished by the following methods.

Lower Capital Requirements. In the early 1980s, the FHLBB lowered thrift capital requirements from 5 percent of liabilities to 3 percent of liabilities.

Deferred Loan Losses. Thrifts were able to amortise certain loan losses attributable to the rise in interest rates over an extended period of time.

Appraised Equity Capital. Thrifts were allowed to report the value of owned premises at the current market value instead of at the typically lower historical value.

Averaging of Liabilities. Thrift capitalisation allowed for five-year averaging of liabilities. Although this capital requirement had been in place long before the thrift crisis, it had the unintended effect in the mid-1980s of allowing aggressive thrifts to grow without a commensurate infusion of capital. This lack of capitalisation in conjunction with more lending and investment freedom resulted in increased risk to the FSLIC insurance fund.

Easing capital requirements can be a useful tool in allowing financial institutions to remain open through temporary periods of operating difficulties. A very diligent examination and supervision function must be maintained to ensure that institutions with capital problems continue to be managed in a prudent manner. In institutions where poor management becomes an issue, corrective action must be taken promptly to bring management under control.

9.4.2 Use of Mergers and Acquisitions

In cases where thrifts failed even with the easing of capital requirements, the FHLBB encouraged mergers between thrifts. The FHLBB used mergers and acquisitions as resolution tools throughout its history. There were two types of mergers and acquisitions: unassisted and assisted.[79]

79. In the unassisted merger, supervisory authorities would encourage a weak thrift to merge with a healthier thrift, with no direct financial assistance from the FSLIC. In an assisted merger, an acquirer would assume all (or nearly all) the assets and liabilities of a failed thrift and would receive assistance from FSLIC. The assisted merger was the most popular form of FSLIC resolution since it deferred FSLIC cash payments.

The FSLIC did not have the cash resources to liquidate what would have been a large percentage of the industry. Mergers and acquisitions were methods of managing the FSLIC's limited resources. Whether a failing thrift was resolved with or without FSLIC assistance depended on a number of factors, including the extent of the thrift's problems, the types of asset problems in the institution, and the perceived market value of the franchise.

Unassisted Mergers. The FHLBB encouraged mergers between failing mutually owned thrifts and other, healthier, mutually owned thrifts without FSLIC assistance. In these mergers, favourable accounting rules allowed the acquirer to count the losses in the acquired thrift's assets as goodwill that could be amortised over a relatively long period of time. In instances where GAAP did not allow for this treatment, the FHLBB allowed the acquiring thrift to report increased capital for regulatory purposes and to amortise the goodwill over a longer period of time than was allowed under GAAP. The majority of these mergers occurred in the early 1980s before many credit problems appeared.

Assisted Mergers and Acquisitions. When an unassisted merger could not be arranged, the FSLIC marketed the failing thrift with the offer of direct FSLIC financial assistance to the acquirer. When a failing thrift was mutually owned, there were no windfalls for stockholders. When stockholders owned a failing thrift, the FSLIC resolved the failing institution with an assisted, whole institution purchase and assumption transaction. Claims of existing shareholders were left with the receiver of the failed institution.

Like the FDIC, the FSLIC used income maintenance and net worth certificates for simple spread problem thrifts in the early 1980s. The FSLIC also provided acquirers with capital assistance by purchasing income capital certificates (ICC), which were similar to cumulative preferred stock.[80] This capital assistance helped reduce the direct FSLIC

80. Income capital certificates were used as a form of noncash FSLIC assistance. A troubled thrift would issue an ICC to the FSLIC in exchange for a FSLIC note. The FSLIC note was an asset on the thrift's books with the offsetting liability (ICC) counting as regulatory capital. If the thrift had earnings and had achieved a certain level net worth, it paid a portion of its net income to the FSLIC in the form of interest (dividends) based on a variable rate. The FSLIC generally paid interest on the note to the institution in cash. The ICC programme was in effect from 1981 through 1986.

assistance payment, and the acquirer was provided with the regulatory capital needed to grow so that it could absorb any losses in the portfolio of acquired assets.

In the mid- to late-1980s, the problems seen at failing thrifts resulted from poor or speculative management decisions that created asset "credit quality" issues. Credit quality problems, coupled with the FSLIC's lack of liquidity, made it necessary for the FSLIC to enter into longer-term assistance agreements with acquirers. These agreements minimised the FSLIC's immediate outlay of cash. If an acquirer took title to all of a failing thrift's assets, the FSLIC agreed to make periodic assistance payments that covered the costs of holding and disposing of the assets. The FSLIC also gave cash or notes equal to the negative net worth on the books of a failing institution and made periodic payments for income maintenance and loss reimbursement.

Assistance agreements can be useful in the resolution process especially when the preservation of liquidity is important and staff is limited. Because the insurance fund continues to bear credit risk, it is important that an acquirer's staff has sufficient asset management expertise and agreements are structured so that the acquirers' interests and incentives are aligned with those of the insurer. This means that the acquirer shares in the losses (and gains) of the portfolio of acquired assets. It is equally important to carefully monitor and oversee the acquirer's management of the assets covered under the agreement.

9.4.3 Use of Tax Incentives in Assisted Transactions

In response to continuing concerns regarding the solvency of the FSLIC, in 1981 the U.S. Congress passed legislation that allowed FSLIC assistance payments to accrue tax-free to acquiring institutions. The tax benefits were intended to reduce the cash assistance required for the FSLIC to complete acquisitions of failed institutions. The FSLIC did achieve cost savings, but it did not always receive a dollar-for-dollar reduction in the cost of assisted transactions.

Merging poorly performing institutions with healthy institutions can be beneficial to an insurer. Healthy banks or thrifts may have better management, there may be cost savings achieved in the operations area, and there may be a reduction in the number of open competing institutions that may allow the survivors to be more profitable. On the

other hand, mergers may delay problems and result in much larger institution failures. The FSLIC's extensive use of forbearance was a result of an inadequate insurance fund in an industry in which many institutions were insolvent. This eventually led to FSLIC's insolvency and demise. However, the FSLIC programmes may be effective in more limited situations, if used with care.

9.5 Management Control

In addition to the various forbearance programmes mentioned above, the FHLBB also used an additional non-cash resource to attempt to resolve the thrift crisis. In 1985, in response to the heavy pace of failures and the lack of FSLIC funding, the FHLBB initiated the Management Consignment Programme (MCP) to immediately address management control. The MCP was, in effect, a conservatorship programme and addressed the FSLIC's lack of staff resources needed to immediately close failing institutions. Under the MCP, new management was brought in to manage troubled institutions; the FHLBB indemnified managers in the MCP. Institutions being managed under the FSLIC's MCP when the Resolution Trust Corporation (RTC) was created became the initial RTC conservatorship caseload. Insurance funds that are strapped for cash might use this method as a temporary means to share industry expertise to stabilise a situation.

10. FDIC'S ROLE AS RECEIVER

Before the creation of the Federal Deposit Insurance Corporation (FDIC), the Office of the Comptroller of the Currency (OCC), which had the authority to appoint the receiver of a failed national bank, supervised national bank liquidations. Liquidations of state banks varied considerably from state to state, but most were handled under the provisions for general business insolvencies.

The U.S. Congress recognised the importance of deposit protection in providing stability in the nation's economy. As such, Congress gave the FDIC special powers to use in the liquidation of assets from failed banks or thrifts and the payment of claims against the receivership estate. Federal laws governing the resolution of failed depository institutions were designed to promote the efficient and expeditious liquidation of failed banks and thrifts. The more significant of those powers are detailed below.

10.1 Comparison with Bankruptcy Law

In many ways the powers of the FDIC as receiver of a failed institution are similar to those of a bankruptcy trustee. Like a bankruptcy trustee, a receiver steps into the shoes of an insolvent party. The receiver may liquidate the insolvent institution or transfer some or all of its assets to an acquiring institution. Although many of the concepts central to the operation of an FDIC receivership are similar to those of the bankruptcy process, federal law grants the FDIC additional powers that lead to critical differences between bankruptcy and the FDIC receivership law. The FDIC's role and responsibilities when serving as receiver are defined by specific statutory provisions contained in the Federal Deposit Insurance Act of 1950. These additional powers allow the FDIC to both expedite the liquidation process for banks and thrifts in order to maintain confidence in the nation's banking system and to maximise the cost-effectiveness of the receivership process to preserve a strong insurance fund. The primary advantage is that the FDIC, in administering the assets and liabilities of a failed institution as its receiver, is not subject to court supervision, and its decisions are not reviewable except under very limited circumstances. A few key differences are:

- **Claims Process.** A receiver has the power to allow or disallow claims. The holder of a disallowed claim may litigate its claim in federal district court. A bankruptcy trustee can object to a claim, but the decision of whether to allow or disallow the claim is made by the bankruptcy court.
- **Contract Repudiation.** A receiver may repudiate any burdensome contract within a "reasonable time" of its appointment. A bankruptcy trustee can repudiate only executory contracts.
- **Stay of Litigation.** A receiver can request a stay of legal proceedings of up to 90 days. The automatic stay in bankruptcy becomes effective immediately upon the filing of a bankruptcy petition.
- **Avoidance Powers.** Both a receiver and a bankruptcy trustee have avoidance powers. A receiver can pursue fraudulent transfers by obligors of a failed financial institution made with the intent to hinder, delay, or defraud the institution. This power applies to transfers made five years before or after the date of the receiver's appointment. A bankruptcy trustee can avoid fraudulent transfers and recover property for the bankruptcy estate.
- **Special Defences.** A receiver has special statutory defences that it can use to defeat the defences of obligors of a failed institution. A bankruptcy trustee generally can use only the defences that were available to the debtor to defeat claims.

A more detailed discussion of the FDIC's special receivership powers follows later in this chapter.

10.2 Why the FDIC Acts as Receiver

To understand why the U.S. Congress gave the FDIC the powers it has, it is necessary to look at the structure of the banking industry and the conditions of the 1930s. The FDIC was created in 1933 to halt a banking crisis. Nine thousand banks — a third of the banking industry in the United States at that time — failed in the four years before the FDIC was established. The failure of one bank set off a chain reaction, bringing about other failures. Sound banks frequently failed when large numbers of depositors panicked and demanded to withdraw their deposits, leading to "runs" on the banks. The behaviour of depositors was not irrational. They had learned from hard experience that if they kept their money in a bank, the money might not be available when they needed it, and they might lose a large portion of it if their bank failed.

Before the creation of the FDIC, the OCC supervised national bank liquidations. Liquidations of state banks were generally handled under the provisions for general business insolvencies. By 1933, most state banking authorities had at least some control over state bank liquidations. However, the increased incidence of national bank failures from 1921 through 1932 created a shortage of experienced receivers. Furthermore, there were concerns that appointments of receivers, both national and state, had been handed out as political favours, with the recipients attempting to make large commissions and to extend the work as long as possible.

In general practice, between 1865 and 1933, depositors of national and state banks were treated in the same way as other creditors — they received funds from the liquidation of the bank's assets after those assets were liquidated. On average, it took about six years at the federal level to liquidate a failed bank's assets, to pay the depositors, and to close the bank's books-although in at least one instance this process took 21 years. Even when depositors did ultimately receive their funds, the amounts were significantly less than they had originally deposited into the banks. From 1921 through 1930, more than 1,200 banks failed and were liquidated. From those liquidations, depositors at state-chartered banks received, on average, 62 percent of their deposits back. Depositors at banks chartered by the federal government received an average of 58 percent of their deposits back. Given the long delays in receiving any money and the significant risk in getting their deposits back, it was understandable why anxious depositors withdrew their savings at any hint of problems. With the wave of banking failures that began in 1929, it became widely recognised that the lack of liquidity that resulted from the process for resolving bank failures contributed significantly to the economic depression in the United States.

To deal with the crisis, the government of the United States focused on returning the financial system to stability by restoring and maintaining the confidence of depositors in the banking system. When it created the FDIC, the U.S. Congress addressed that problem by (i) providing that the FDIC would insure deposits up to the deposit limit, initially up to $2,500,[81] but now up to $100,000; (ii) giving the FDIC

81. Initially set at $2,500 per depositor, this limit was raised to $5,000 on 30 June 1934; $10,000 in 1950; $15,000 in 1974; and $100,000 in 1980, where it remains to this day.

special powers to resolve failed banks; and (iii) requiring the appointment of the FDIC as receiver for all national banks. Congress believed that the appointment of the FDIC simplified procedures, eliminated duplication of records, and vested responsibility for liquidation in the largest creditor (the FDIC in its corporate capacity, as subrogee for the insured deposits it had paid), whose interest was to obtain the maximum possible recovery. For state-chartered banks, the U.S. Congress preferred that the FDIC be receiver, but allowed each state to appoint a receiver according to state law. By 1934, 30 states had provisions under which the FDIC could be appointed receiver but, in practice, most states often did not do so. Today, however, it is the rare exception when the FDIC is not appointed, and most states now require that the FDIC be appointed as receiver.

10.3 How the FDIC Becomes a Receiver

A depository institution's charter determines which state or federal regulatory agency will appoint a conservator or a receiver for a failing institution.[82] For federal savings associations and national banks, the Office of Thrift Supervision and the Office of the Comptroller of the Currency, respectively, are the chartering authorities responsible for determining when the appointment of a receiver is necessary. The FDIC must be appointed as receiver for insured federal savings associations and national banks. For state-chartered savings and loan associations or banks, the FDIC may accept appointment as receiver by the appropriate state regulatory authority, but it is not required to do so. In the case of state-chartered banks that are members of the Federal Reserve System, the state banking authority may also appoint the FDIC as receiver. In certain limited instances, the FDIC may appoint itself as receiver for a state-chartered insured depository institution. In 1991, the U.S. Congress provided the FDIC that additional authority to appoint itself receiver out of concern that the FDIC depended on the judgement of individual state chartering authorities or that of other federal chartering authorities. Also, Congress needed an independent basis to protect the insurance fund in a timely manner.

82. The same authority would appoint the FDIC as conservator for the institution if the imposition of a conservatorship were determined to be the appropriate strategy for dealing with a failing institution. The FDIC rarely serves as a conservator. Its appointment as receiver is more common.

Since receiving that power in 1991, however, the FDIC has closed an institution and appointed itself as receiver only once, in the 1994 failure of The Meriden Trust & Safe Deposit Company, Meriden, Connecticut.

The FDIC as receiver is functionally and legally separate from the FDIC acting in its corporate role as deposit insurer, and the FDIC as receiver has separate rights, duties, and obligations from those of the FDIC as insurer. Courts have long recognised these dual and separate capacities.

10.4 The FDIC's Functions as Receiver

The U.S. Congress has entrusted the FDIC with virtually complete responsibility for resolving failed federally insured depository institutions and has conferred expansive powers to ensure the efficiency of the process. In exercising this significant authority, the FDIC is required by statute to maximise the return on the assets of the failed bank or thrift and to minimise any loss to the insurance funds.

A receivership is designed to market the assets of a failed institution, liquidate them, and distribute the proceeds to the institution's creditors. The FDIC as receiver succeeds to the rights, powers, and privileges of the institution and its stockholders, officers, and directors. The FDIC may collect all obligations and money due to the institution, preserve or liquidate its assets and property, and perform any other function of the institution consistent with its appointment.

A receiver also has the power to merge a failed institution with another insured depository institution and to transfer its assets and liabilities without the consent or approval of any other agency, court, or party with contractual rights. Furthermore, a receiver may form a new institution, such as a bridge bank, to take over the assets and liabilities of the failed institution, or it may sell or pledge the assets of the failed institution to the FDIC in its corporate capacity.

The FDIC as receiver is not subject to the direction or supervision of any other agency or department of the United States or of any state, in the operation of the receivership. These provisions allow the receiver to operate without interference from other executive agencies and to exercise its discretion in determining the most effective resolution of the institution's assets and liabilities.

In many respects, the powers of a receiver and a conservator are similar. Many of the statutory powers of a receiver, however, are expressly conferred upon a conservator, while certain powers are limited to the receiver. The guiding principle is to grant to the FDIC acting in either capacity those powers and obligations most consistent with performance of its statutory role. A conservatorship is designed to operate the institution for a period of time to return the institution to a sound and solvent operation. While in conservatorship, the institution remains subject to the supervision of the appropriate state or federal banking agency. The conservator's goal is to preserve the "going concern" value of the institution. For example, a conservator, like a receiver, is empowered to disaffirm or repudiate contracts such as leases, but it may choose not to do so if the contracts would benefit the open institution.

10.5 The FDIC's Closing Function

When its chartering authority closes a bank or thrift and appoints the FDIC as receiver, the first task for the FDIC is to take custody of the failed institution's premises and all its records, loans, and other assets. After taking possession of the premises, the FDIC posts notices to explain the action to the public and changes locks and combinations as soon as possible. It then notifies correspondent banks and other appropriate parties of the closing.

The FDIC closing staff, working in conjunction with employees of the failed institution, bring all accounts forward to the closing date and post all applicable entries to the general ledger, making sure that everything is in balance. The FDIC then creates two complete sets of inventory books containing an explanation of the disposition of the failed institution's assets and liabilities, one set for the assuming institution (if there is one) and one for the receivership.

10.6 Resolution of Claims Against the Failed Institution

Immediately after its appointment, the FDIC as receiver must notify the failed institution's creditors (which include customers with uninsured deposits) to submit their claims to the receiver. The FDIC arranges for a notice to be published in a local newspaper stating that the financial institution has failed and how claimants may file their claims. The

receiver must also mail notices to file claims to all creditors identified in the institution's records.

All claimants, including those who may have been suing the failed institution, must then file proof of their claims with the receiver by a specified deadline. The receiver may seek to put any pending litigation to which the failed institution was a party on hold.

Once a claim has been filed, the receiver has 180 days to determine if the claim should be allowed. If the receiver is not satisfied that the claim has merit, the claim will be disallowed.

An allowed claim will be paid on a pro rata basis with other allowed claims of the same class, to the extent there are funds available in the receivership after the expenses are paid. If a creditor's claim is denied, the creditor may seek judicial review of the claim by filing a lawsuit or continuing pending litigation within 60 days after the date the claim is denied. If the receiver has not acted on the claim within 180 days of its filing, it is deemed to have been disallowed and the creditor may file suit within 60 days thereafter.

10.7 Payment of Claims

The priority for paying allowed claims against a failed depository institution is now determined by federal law. On 10 August 1993, a uniform distribution plan for depository institutions, the National Depositor Preference Amendment, became effective. The law gives payment priority to depositors, including the FDIC as subrogee, over general unsecured creditors. Inasmuch as most liabilities of a failed institution are deposit liabilities, the practical effect of depositor preference in most situations is to eliminate any recovery for unsecured general creditors. The statute applies to all receiverships established after its enactment. For receiverships commenced prior to that, distribution of the assets of a failed depository institution was determined according to the law of the chartering jurisdiction, either state or federal. A number of states had depositor preference statutes for their state-chartered institutions prior to enactment of the federal statute.

Claims against the failed institution are paid from monies recovered by the receiver through its liquidation efforts. Under the National

Depositor Preference Amendment and related statutory provisions, claims are paid in the following order of priority:

(i) Administrative expenses of the receiver,
(ii) Deposit liability claims (the FDIC claim takes the position of all insured deposits),
(iii) Other general or senior liabilities of the institution,
(iv) Subordinated obligations, and
(v) Shareholder claims.

Payments on these claims are known as dividends. Customers with uninsured deposits are sometimes issued advance dividends based on the estimated recovery value of the failed bank's assets. This provides customers with uninsured deposits some reasonable amount of liquidity protection without eliminating the incentive for large depositors to exercise market discipline.

Advance dividends are based on the estimated value of the failed bank's assets. Advance dividends usually range between 50 cents and 80 cents on the dollar of receivership claims. The FDIC does not pay advance dividends when the value of the failed institution's assets can not be reasonably determined at the closing.

Federal law applicable to all depository institution receiverships provides that a receiver's maximum liability to a claimant is an amount equal to what the claimant would have received if the institution's assets had been liquidated.

10.8 Special Receivership Powers

As mentioned earlier in this chapter, the FDIC as receiver has a number of special powers that have been granted by federal law. A discussion of some of the more significant powers follows.

10.8.1 Repudiation of Contracts

A receiver may repudiate or disaffirm a contract of the depository institution if the receiver (i) deems it burdensome, and (ii) finds that repudiation would promote the orderly administration of the receivership estate. The power to disaffirm or repudiate a contract simply permits the receiver to terminate the contract, thereby ending any

future obligations imposed by the contract. The receiver must act to repudiate a contract within a "reasonable time" after appointment. While the receiver may be liable for damages resulting from the repudiation of a contract, those damages are limited to actual direct compensatory damages determined as of the date of the receiver's appointment.

Slightly different rules apply for contracts that are "qualified financial contracts" (QFC), which include securities contracts, commodity contracts, forward contracts, repurchase agreements, and swap agreements. When the receiver repudiates a QFC, damages are measured as of the date of the repudiation and may include the cost of acquiring a replacement QFC. These special rules are necessary to protect the U.S. financial markets.

10.8.2 Placing Litigation on Hold

The receiver is substituted as a party for litigation pending against the failed bank or thrift. However, because the receiver may need time to assess and evaluate the facts of each case to decide whether and how to proceed, the law permits the receiver to request a court to put on hold, or "stay," the litigation. That power also extends to litigation filed after the institution's failure. The receiver must request the stay for it to become effective. The courts, however, cannot decline to issue the stay once the receiver has filed its request.[83]

When litigation resumes after a stay is lifted, the receiver is generally entitled to have the controversy resolved in either state or federal court. Typically, when the litigation is before a state court, the FDIC has the added flexibility to either keep it in state court or to "remove" it to federal court.

A special statute of limitations exists for actions brought by a receiver. Under the statute, the receiver has up to six years to file a contract claim and up to three years to begin a tort suit.

10.8.3 Avoiding Fraudulent Conveyances

A receiver has the power to avoid certain fraudulent conveyances. Under federal banking law, a receiver may avoid a security interest in

83. A receiver may obtain a stay for 90 days; a conservator is allowed 45 days.

a property, even if perfected, in which the security interest is taken in contemplation of the institution's insolvency or with the intent to hinder, delay, or defraud the institution or its creditors. The receiver may avoid any transfers made by obligors within five years of the appointment of the receiver. Those rights are superior to any rights of a trustee or any other party.

10.8.4 Special Defences

Over the years, federal statutes and court decisions have provided certain "special defences" to the FDIC in its role as receiver to allow for the efficient resolution of a failed institution's affairs.

Improperly documented agreements are not binding on the receiver. Like a bank regulator, the receiver must be able to rely upon the books and records of the failed financial institution to evaluate its assets and liabilities accurately. For the receiver, the ability to rely on the failed institution's records in resolving the institution's affairs is critical in completing cost-effective resolution transactions, such as the sale of assets to third parties and to the effective collection of debts due to the failed bank or thrift.

As a result, both the common law (D'Oench Doctrine) and its statutory counterparts, U.S. Code, volume 12, section 1821(e) and section 1821(d)(9)(A), recognise that, unless an agreement is properly documented in the institution's records, it cannot be enforced either in making a claim or defending against a claim by the receiver. Therefore, an argument by an obligor on a promissory note that an undocumented, unrecorded side agreement with the failed bank, changes or releases the duty to repay the loan will generally be barred.

Courts may not enjoin the receiver. The U.S. Congress has provided the FDIC as receiver with additional protection by prohibiting courts from issuing injunctions or similar equitable relief to restrain the receiver from completing its resolution and liquidation activities. For example, U.S. Code, volume 12, section 1821(j), bars an injunction to prevent foreclosures or asset sales. Similarly, courts are prohibited from issuing any order to attach or execute upon any assets in the possession of the receiver. These statutory provisions, however, do not bar the recovery of monetary damages.

10.9 Settlement with the Assuming Institution

The FDIC and the assuming institution handle most of their post-closing activities through the "settlement" process. Adjustments to the closing books may be made between the date of the closing of the institution and the "settlement date." The settlement date may be from 180 days to 360 days after the bank or thrift closing, depending on the failed institution's size. Adjustments reflect (i) the exercise of options by the acquirer, (ii) either any repurchase of assets by the receiver or any "put back" of assets to the receiver by the assuming institution, and (iii) the valuation of assets sold to the acquirer at market prices.

10.10 Disposal of Assets and Termination of Receivership

In order to have funds to disburse, the FDIC works to dispose of the remaining assets of the failed institution in a timely manner through a variety of methods. In addition, the FDIC conducts an investigation into each failed institution to determine if negligence, misrepresentation, or wrongdoing was committed and, when appropriate, may file a lawsuit to help recover losses caused by these acts.

Receivership termination represents the final process of winding up the affairs of the failed institution. Following payment of eligible claims and final disposition of the assets, the FDIC then proceeds with terminating the receivership. The duration of a receivership varies depending on individual circumstances, such as the type of closing; volume and quality of assets retained by the receivership; and the existence of defensive litigation, environmentally impaired assets, employee benefit plans, and professional liability claims. All significant issues of the receivership must be resolved prior to its termination.

11. OTHER SIGNIFICANT ISSUES

During the bank and thrift crisis that began in 1980, the Federal Deposit Insurance Corporation (FDIC) resolved many institutions under widely different circumstances. The FDIC learned many valuable lessons from these experiences. In response to changes in the banking industry as well as legislative changes, the FDIC has adopted a number of revisions changes in the strategies used to market and sell the assets and liabilities of failing banks and thrifts since the early 1980s. While the techniques have evolved over time, the FDIC's primary resolution considerations remain, conducting the least cost resolution and quickly selling as many assets as possible to the private sector.

11.1 Maintaining Public Confidence in the Banking System

One of the FDIC's primary missions is to maintain public confidence in the U.S. financial system. When a bank fails, the FDIC accomplishes this by ensuring the prompt and efficient payment of customers with insured deposits, by minimising the impact of an institution failure on the local economy, by finding an assuming or agent institution to handle insured deposits, and by transferring as many of the failed bank or thrift's assets as possible back into the private sector.

11.2 Adequacy of Insurance Funds

To efficiently resolve a banking crisis, it is critical to have an adequate insurance fund reserve. If such funds are not available, the problems may become worse as a result of delay. As the Federal Savings and Loan Insurance Corporation (FSLIC) began to experience a greater outflow of funds than it had coming in, it took steps to conserve cash. Although many of its programs were designed to give failing institutions time to work out their problems, some programs had the unintended effect of postponing the problems and actually increasing resolution costs. The FSLIC lacked the financial liquidity to promptly close insolvent institutions, and many of them remained open to compete with healthy institutions. In addition, several state-run insurance funds folded in the 1980s and the 1990s due to liquidity problems and inadequate insurance funds to protect the depositors in their states.

11.3 Other Resolution Concerns

11.3.1 Expeditious Resolutions

Experience suggests that failing financial institutions should be resolved as quickly as possible. Asset and franchise values are preserved and maximised, making them more desirable to healthy institutions. Normally, the more quickly an institution is resolved, the lower the cost. Finally, failing financial institutions can have negative effects on the markets in which they compete, and their quick exit from those markets minimises those effects.

A problem situation should be dealt with immediately. This is an important lesson from the savings and loan crisis. The FSLIC's lack of funds to fully resolve the crisis and the relaxation of accounting and regulatory standards which was intended to give the problems time to correct themselves, only made the situation worse.

11.3.2 Bidders' Qualifications

It has always been the FDIC's practice to offer a failing institution to both operating financial institutions and investors who qualify for and have been given conditional approval for a charter to create a new institution (called a de novo institution). However, the application process may be difficult to complete within the timeframes required for resolving failing institutions. Although de novo charters are granted by the various chartering authorities, the FDIC must also approve the application so that the new institution's deposits can be insured. Currently, all states and federal chartering authorities require FDIC insurance as a condition for granting a new charter.

11.3.3 Bidders' Due Diligence

A concern that arises during the bidders' due diligence is the fair and equitable treatment of all due diligence participants. Bidders should be given as much time as possible to perform their reviews, while keeping in mind the time constraints of the resolution process. If information is revealed late in the due diligence process, all bidders who have already completed their reviews must be contacted and apprised of the additional information. If more than one potential purchaser must be scheduled to perform due diligence during the same

time period (because of bank size limitations or time constraints), it is important to have identical sets of information for each group.

11.3.4 Choosing the Appropriate Resolution Structure

There is no one right way to resolve a failing institution. The method must be chosen to fit the situation at hand. Choosing the appropriate resolution structures can ease the economic dislocation of financial institution failures. Examples of economic dislocations that disrupt orderly economic activity in an industry or region may include: the loss of a local institution in an isolated area, a severe reduction in available credit for an industry or region, and massive government ownership of a failed institution's assets. Transactions that tend to lessen economic dislocations are those that maximise private ownership of assets, preserve franchise values, minimise the time that assets are under FDIC control, and preserve competitive markets.

A resolution process that most closely resembles a free market should yield the best economic results for all involved. Such a process maximises the number of bidders, allows for a wide variety of transaction structures, provides as good information as is available, and provides as much time as possible for due diligence.

11.3.5 Resolution Timeframes

Resolution structures that involve working with an acquirer over a period of time must be carefully crafted to provide appropriate incentives for acquiring institutions. For example, loss sharing transactions have been successful because they align the economic interests of the asset purchasers with those of the FDIC.

11.4 Receivership Issues

11.4.1 Working with the Local Media

Assistance can be gained and goodwill can be created by sharing with the local media as much information as possible about the resolution. Announcements through television, radio, and the local newspapers should provide failed institution customers with information about how the resolution will be handled. For some institutions, especially those in small towns or where there has not been a closing

for some time, it can be beneficial to conduct a town meeting to answer questions about the failure, the resolution process, the closing process, the transfer of insured deposit accounts, and other general questions.

Occasionally, reporters have asked to observe the FDIC as it goes through a resolution and closing process. These reporters are required to sign confidentiality agreements regarding any institution- or borrower-specific information they might see. Although the FDIC does not seek this coverage, every attempt is made to accommodate reporters' requests. It is beneficial to have knowledgeable, experienced reporters familiar with the resolution and closing process, because these reporters can be especially helpful in keeping the public informed.

11.4.2 Closing Matters

When planning for any closing, whether there is to be an acquiring institution or not, it is important to make arrangements for direct deposits[84] coming into the failing bank or thrift. These direct deposits should be routed to another institution so that depositor cash flows are not interrupted. If arrangements for direct deposits are not made, incoming deposits will be returned to the senders, and it can take months for depositors to get their funds.

Another closing issue is automated teller machines (ATM). On-line debit servicers (for example, Cirrus, Bank Plus, and Versatel) must be contacted so that withdrawals from failed institution accounts are not permitted unless the accounts are transferred to an acquiring or agent institution. Additionally, deposits in ATMs on the day of closing must be collected and posted as of the last day of business.

If the failed institution's closing results in a straight deposit payoff, whether by mail or at the failed institution, it is necessary to consider two important things:

84. Direct deposits are funds automatically deposited to a customer's account using electronic fund transfers. These payments are usually repetitive and are normally periodic, such as weekly, monthly, or quarterly. Examples of direct deposits might include paychecks, government assistance payments, and pension payments.

- Large numbers of customers may come to the institution, either to collect their checks that represent the insured portion of their deposits or to discuss their accounts. Long lines may form at the institution's doors many hours before the scheduled opening time if customers fear the insurer will run out of money.
- Customers with uninsured deposits may be confused about the amounts of their insurance checks and will need personal attention from claims agents. Confidential conference rooms should be set up where these customers can have private discussions. It is also necessary to counsel customers with uninsured deposits about how to file claims on the uninsured potion of their deposit.

11.4.3 Value of Assets in Receivership

Assets not sold to acquirers at resolution should be given prompt attention. Assets that are not loans, such as automobiles and furniture, should be sold or otherwise converted to cash as quickly as possible. Loan assets need special handling. It is essential to establish procedures for receivership representatives to work with those who had loans with the failed institution. These borrowers will need to establish new banking relationships with healthy financial institutions that can address their on-going credit needs. One of a receiver's main goals should be to assist borrowers in establishing these new credit relationships.

However, not all borrowers can be refinanced. The receiver should decide if more can be recovered through sale of the asset than through other liquidation means. Assets that should be sold need to be sold quickly, so they retain their value.

Restructuring a loan for a financially distressed borrower is normally more productive for the receiver than foreclosing on the collateral or initiating lawsuits to collect the debt. Maximising recovery on failed institution assets is the receiver's responsibility, and litigation expenses can very rapidly consume any funds recovered.

It is important to note that when liquidating a failed institution's loans, on-going businesses that are borrowers need to continue to operate. The receiver must consider the repayment sources of loans when in determining a liquidation strategy. For example, if a small business loan is secured by all of the furniture and equipment in its

office or factory, but repayment comes from on-going business activity, then it would not be prudent on the part of the receiver to foreclose on the furniture and equipment. This would put the firm out of business and eliminate any further sources of repayment.

12. GLOSSARY

Acquiring institution: A healthy bank or thrift institution that purchases some or all of the assets and assumes some or all of the liabilities of a failed institution in a purchase and assumption transaction. The acquiring institution is also referred to as the assuming institution. (Also see assuming institution.)

Advance dividend: A payment made to an uninsured depositor after a bank or thrift failure. The amount of the advance dividend represents the FDIC's conservative estimate of the ultimate value of the receivership. Cash dividends equivalent to the board-approved advance dividend percentage (of total outstanding deposit claims) are paid to uninsured depositors, thereby giving them an immediate return of a portion of their uninsured deposit. Sometimes when it is projected that all depositor claims will be paid in full an advance dividend will be provided to unsecured creditors.

Agent institution: The healthy bank or thrift that accepts the insured deposits and secured liabilities of a failed institution in an insured deposit transfer, in exchange for a transfer of cash from the FDIC.

Appraised equity capital: A regulatory capital item established by the former Federal Home Loan Bank Board that allowed a savings association to count as part of its regulatory capital the difference between the book value and the fair market value (appraised value) of fixed assets, including owner-occupied real estate.

Asset valuation review: A review of all of a failing institution's assets to estimate the liquidation value of the assets. This estimate is used in the least cost analysis that is required by Federal Deposit Insurance Corporation Improvement Act (FDICIA) of 1991.

Assistance agreement: An agreement pertaining to a failing institution under which a deposit insurer, such as the FDIC, provides financial assistance to the failing institution or to an acquiring institution. The assistance agreement includes the terms of the purchase of assets and assumption of liabilities of the failing institution by the assuming institution; it may also include provisions regarding a reorganisation of the failing institution under new management or a merger of the failing institution into a healthy institution.

Assisted merger: A failing institution is absorbed into an acquiring institution that receives FDIC assistance. In 1950, the FDIC was authorised by section 13(e) of the Federal Deposit Insurance Act (FDI Act) of 1950 to implement assisted mergers. In 1982, when the FDI Act was amended, the merger authority, as amended, was written into section 13(c) of the FDI Act. Such transactions allow the FDIC to take direct action to reduce or avert a loss to the deposit insurance fund and to arrange the merger of a troubled institution with a healthy FDIC insured institution without closing the failing institution. Assisted mergers were the Federal Savings and Loan Insurance Corporation's preferred resolution method.

Assuming institution: A healthy bank or thrift that purchases some or all of the assets and assumes some or all of the deposits and other liabilities of a failed institution in a purchase and assumption transaction. The assuming institution is also referred to as the acquiring institution. (Also see acquiring institution.)

Bank: A financial institution which in the normal course of its business operations accepts deposits; pays, processes, or transacts checks or other deposit accounts; and performs related financial services for the public. Also a bank generally makes loans or advances credit.

Bank Insurance Fund (BIF): One of the two federal deposit insurance funds created by the U.S. Congress in 1989 and placed under the FDIC's administrative control. The BIF insures deposits in most commercial banks and many savings banks. The FDIC's "permanent insurance fund," which had been in existence since 1934, was dissolved when the BIF was established. The money for a deposit insurance fund comes from the assessments contributed by member banks and also from investment income earned by the fund. (Also see Savings Association Insurance Fund.)

Book value: The dollar amount shown on the institution's accounting records or related financial statements. The "gross book value" of an asset is the value without consideration for adjustments such as valuation allowances. The "net book value" is the book value net of such adjustments. The FDIC restates amounts on the books of a failed institution to conform to the FDIC's liquidation accounting practices. Therefore, in the FDIC accounting environment, book value generally refers to the unpaid balance of loans or accounts receivable, or the

recorded amount of other types of assets (for example, owned real estate or securities).

Bridge bank: A temporary national bank established and operated by the FDIC on an interim basis to acquire the assets and assume the liabilities of a failed institution until final resolution can be accomplished. The use of bridge banks generally is limited to situations in which more time is needed to permit the least costly resolution of a large or complex institution.

Branch breakup: A resolution strategy that provides bidders with the choice of bidding on the entire franchise or on individual or groups of branches of the failing institution. Marketing failing institutions on both a whole franchise and a branch breakup basis can expand the universe of potential buyers and may result in better bids in the aggregate. In branch breakup transactions, prospective acquirers are required to submit bids on both the "all deposits" and "insured deposits" options except for bids on the entire franchise. The branch breakup resolution strategy was developed by the RTC to allow smaller institutions to participate in the resolution process and to increase competition among the bidders.

Capital forbearance: The temporary permission for a bank or thrift to operate with capital levels below regulatory standards if the bank or thrift has adequate plans to restore capital. For example, banks suffering because of the energy and agricultural crises in the mid-1980s were permitted to operate with capital levels below regulatory standards if they had adequate plans to restore capital. A joint policy statement issued in March 1986 by the FDIC, the Office of the Comptroller of the Currency (OCC), and the Federal Reserve Board encouraged a capital forbearance programme for agricultural banks.

Capital loss coverage: A form of aid in assistance transactions that provided for a payment equal to the difference between an asset's original value (book value) and the proceeds received when the asset was sold.

Cash equivalents: Assets on the balance sheet of a financial institution that can be readily converted into cash. Examples include accounts due from correspondent banks and federal funds sold.

Charge-off: A book value amount that was expensed as a loss before receivership and that continues to be a legal obligation of the borrower to the institution. A charge-off is technically an off-book memorandum accounting item that represents the book value of an asset that the bank or
thrift previously wrote off.

Chartering authority: A state or federal agency that grants charters to new depository institutions. For state chartered institutions, the chartering authority is usually the state banking department; for national banks, it is the OCC; and for federal savings institutions, it is the Office of Thrift Supervision (OTS).

Claim: An assertion of the indebtedness of a failed institution to a depositor, general creditor, subordinated debtholder, or shareholder.

Conservator: A person or entity, including a government agency, appointed by a regulatory authority to operate a troubled financial institution in an effort to conserve, manage, and protect the troubled institution's assets until the institution has stabilized or has been closed by the chartering
authority.

Conservatorship: The legal procedure provided by statute for the interim management of financial institutions used by the FDIC and Resolution Trust Corporation (RTC). Under the pass-through receivership method, after the failure of a savings institution, a new institution is chartered and placed under agency conservatorship; the new institution assumes certain liabilities and purchases certain assets from the receiver of the failed institution. Under a straight conservatorship, the FDIC or RTC may be appointed conservator of an open, troubled institution. In each case, the conservator assumes responsibility for operating the institution on an interim basis in accordance with the applicable laws of the federal or state authority that chartered the new institution. Under a conservatorship, the institution's asset base is conserved pending the resolution of the conservatorship.

Contingent liability: Potential claims on bank assets for which any actual or direct liability is contingent upon some future event or circumstance. Contingencies usually result from off-balance sheet lending activities such as loan commitments and letters of credit. Other ex-

amples are pending litigation in which the bank is defendant and contingent liabilities arising from trust operations.

Cross guarantee: A provision of the FDI Act added by the Financial Institutions Reform, Recovery, and Enforcement Act (FIRREA) that allows the FDIC to recover part of its costs of liquidating or assisting a troubled insured institution by assessing those costs to the remaining solvent insured institutions which are commonly controlled as defined in the statute. When the FDIC acts to protect its interests under this provision, the assessment can result in a liquidity strain or, in some cases, the immediate insolvency of an affiliated bank.

Deposit Insurance National Bank (DINB): The Banking Act of 1933 authorised the FDIC to establish a "new" bank called a DINB to assume the insured deposits of a failed bank. Passage of the act permitted the FDIC to pay the depositors of a failed FDIC insured institution through a DINB, a national bank that was chartered with limited life and powers. Depositors of a DINB were given up to two years to move their insured accounts to other institutions. A DINB allowed a failed bank to be liquidated in an orderly fashion, minimising disruption to local communities and financial markets.

Deposit payoff: A resolution method for failed FDIC insured institutions that is used when liquidation of the institution is determined to be the least costly resolution or when no assuming institution can be found. Deposit payoffs generally have two forms: (i) a straight deposit payoff, in which the FDIC directly pays the insured amount of each depositor, and (ii) an insured deposit transfer, in which a healthy institution is paid by the FDIC to act as its agent and pay the insured deposits to customers of the failed institution. A deposit payoff is sometimes called a payoff. (Also see insured deposit transfer, payoff, and straight deposit payoff.)

Due diligence: A potential purchaser's on-site inspection of the books and records of a failing institution. Before an institution's failure, the FDIC invites potential purchasers to the institution to review pertinent files so they can make informed decisions about the value of the failing institution's assets. All potential purchasers must sign a confidentiality agreement. In addition, contractors may be hired to perform due diligence work on assets that are earmarked for multi-asset sales initia-

tives. By hiring outside firms to provide and certify the due diligence, investors have the assurance that an independent source provides them with reliable investment information.

Failure: The closing of a financial institution by its chartering authority, which rescinds the institution's charter and revokes its ability to conduct business because the institution is insolvent, critically undercapitalised, or unable to meet deposit outflows.

Federal Deposit Insurance Corporation (FDIC): The federal corporation chartered by Congress in 1933 to promote confidence in the nation's banking system by establishing a federal deposit insurance programme and by acting as the primary federal bank regulator of state chartered banks that are not members of the Federal Reserve System. The FDIC has a five-member board of directors, all of whom are appointed by the president of the United States with the advice and consent of the Senate. The comptroller of the Currency and the director of the Office of Thrift Supervision are two of the five members. The FDIC manages the Bank Insurance Fund and the Savings Association Insurance Fund, insuring deposits in commercial and savings institutions. Additionally, the FDIC acts as the receiver (and occasionally, as conservator) of failed financial institutions. In performing and discharging its role as deposit insurer or as a primary federal bank regulator, the FDIC is considered to be acting in its "corporate capacity," namely, as an agency of the United States government. In contrast, the FDIC acts in a conservatorship or receivership capacity when it performs and discharges its obligations as the conservator or receiver of a failed institution. The FDIC performs its roles in accordance with the statutory conditions, duties, powers, and rights that Congress has imposed on it.

Federal Reserve Bank (FRB): One of the 12 regional banks in the Federal Reserve System. The 12 FRBs and their 25 branches, which are managed by the Board of Governors of the Federal Reserve System, perform a variety of functions, including operating a nationwide payments system, distributing the nation's currency, supervising and regulating member banks and bank holding companies, and serving as banker for the U.S. Treasury. The FRBs supervise and examine state chartered banks that are members of the Federal Reserve System (state member banks).

Federal Reserve System (Fed): The central banking system of the United States, founded by the U.S. Congress in 1913 to provide the nation with a safer, more flexible, and more stable monetary and financial system. Over the years, the Fed's role in banking and the economy has expanded. The Fed administers the nation's monetary policy using three major tools: open market operations, the reserve requirement, and the discount rate. The Fed also plays a major role in the supervision and regulation of the U.S. banking system. The Board of Governors of the Federal Reserve System (the Federal Reserve Board) is made up of seven members appointed to 14-year terms by the president of the United States and confirmed by the Senate. The chairman and vice chairman of the board, however, serve four-year terms. The Federal Reserve Board's policies are carried out by the 12 regional Federal Reserve Banks.

Federal Savings and Loan Insurance Corporation (FSLIC): The federal corporation chartered by Congress in 1934 to insure deposits in savings institutions. The FSLIC also served as a conservator or receiver for troubled or failed insured savings associations. Effective 1 April 1980, for insured savings and loan institutions, the FSLIC insured savings accounts up to $100,000. The FSLIC functioned under the direction of the FHLBB, which provided certain administrative services and conducted the examination and supervision of insured S&Ls. In 1989, Congress abolished the FSLIC, transferring its resolution, conservatorship, and receivership functions to the RTC and its responsibilities for the deposit insurance fund to the Savings Association Insurance Fund, which is administered by the FDIC.

Forbearance: A bank resolution method that exempts certain distressed institutions that are operating in a safe and sound manner, from minimum capital requirements. The forbearance programme used by the FDIC in the mid-1980s was designed for well-managed, economically sound institutions with concentrations of 25 percent or more of their loan portfolios in agricultural or energy loans. Forbearance is also a means of handling a delinquent loan. A "forbearance agreement" is a written agreement providing that a lender will delay exercising its rights (in the case of a mortgage, foreclosure) as long as the borrower performs in accordance with certain agreed-upon terms.

Fund balance: The equity or net worth of each of the primary insurance funds-bank insurance fund or savings association insurance

fund-administered by the FDIC. The fund balance for each fund is annually reflected in financial statements prepared by the FDIC, which are audited and reported to the U.S. Congress by the General Accounting Office.

General creditors: Entities, including uninsured depositors, suppliers, trades people, and contractors, with unsecured claims against a failed financial institution.

Generally Accepted Accounting Principles (GAAP): Accounting rules and conventions established by the Financial Accounting Standards Board that define acceptable practices in preparing financial statements.

Income maintenance agreement: A resolution method used by the FDIC in the early 1980s to guarantee a market rate of return on the acquired assets of failed savings banks. The FDIC paid the acquirer the difference between the yield on assets acquired and the savings bank's average cost of funds of savings banks.

Indemnification: In general, a collateral contract or assurance under which one person agrees to secure another person against either anticipated financial losses or potential adverse legal consequences.

Information package: A collection of detailed information about the amounts and types of assets and liabilities of a failed or failing institution. The information varies, depending on the composition of assets and liabilities of the troubled institution. An information package, which is subject to a confidentiality agreement, is provided to potential purchasers to facilitate their analyses of the failing institution.

Insured deposit: Deposit in an FDIC insured commercial bank, savings bank, or savings association that is fully protected by FDIC deposit insurance. Savings, checking, and other deposit accounts, when combined, are generally insured up to $100,000 per depositor in each financial institution insured by the FDIC. Deposits held in different ownership categories, such as single or joint accounts, are separately insured. Also, separate $100,000 coverage is usually provided for retirement accounts, such as individual retirement accounts. (Also see Uninsured Deposit.)

Insured deposit transfer (IDT): A type of deposit payoff in which the insured and secured deposits of a closed bank or thrift are transferred to a transferee or agent institution in the community, permitting a direct payoff of the failed institution's depositors by the agent institution. The agent institution pays customers of the failed institution the amount of their insured deposits or, at the customer's request, opens a new account in the agent institution for the customer. When no assuming bank can be found for the failed bank, an insured deposit transfer is an alternative to a straight deposit payoff. (Also see deposit payoff, payoff, and straight deposit payoff.)

Least cost test: A procedure mandated by FDICIA that requires the FDIC to implement the resolution alternative that is determined to be least costly to the relevant deposit insurance fund of all possible resolution alternatives, including liquidation of the failed institution. Before enactment of FDICIA, the FDIC could pursue any resolution alternative, as long as it was less costly than a deposit payoff combined with liquidation of the failed bank's assets. (Also see deposit payoff)

Liquidation: The winding up of the business affairs and operations of a failed insured depository institution through the orderly disposition of its assets after it has been placed in receivership.

Loss sharing: A method in a purchase and assumption transaction in which the FDIC as receiver agrees to share with the acquirer losses on certain types of loans. Loss sharing may be offered by the receiver in connection with the sale of classified or non-performing loans that otherwise might not be sold to an acquirer at the time of resolution. The FDIC usually agrees to absorb a significant portion (for example, 80 percent) of future disposition losses on assets that have been designated as "shared loss assets" for a specific period of time (for example, three to five years). The economic rationale for such transactions is that retaining shared loss assets in the banking sector would produce a better net recovery than would the FDIC's liquidation of the assets.

Market discipline: The forces in a free market (without the influence of government regulation) which tend to control and limit the riskiness of a financial institution's investment and lending activities. Such forces include the concern of depositors for the safety of their deposits and

the concern of bank investors for the safety and soundness of their institutions.

Mutual: A savings institution organized in a nonstock business form. Neither mutual savings banks nor mutual savings institutions have stockholders. All depositors in a mutual institution have a share in the ownership of the institution, according to the amounts of their deposits.

National depositor preference amendment: Provisions of the Omnibus Budget Reconciliation Act, that established the priority for paying claims filed against a failed depository institution. The Omnibus Budget Reconciliation Act was enacted on August 10, 1993, and amended section 11(d) of the FDI Act and standardized the assets distribution scheme for all receiverships regardless of the institution's chartering agency. As a result of this act, deposit liabilities of the institution have priority over all claims except the administrative expenses of the receiver.

Net worth certificate (NWC): A capital instrument purchased by the FDIC or the former FSLIC under a special programme created by the U.S. Congress in 1982 to maintain or increase the capital of troubled institutions that qualified for the programme. Under this programme, the FDIC purchased a net worth certificate from a qualified institution in exchange for an FDIC insured promissory note, which was an asset on the bank's books, with the offsetting liability of the net worth certificate counted as regulatory capital. Extended twice by Congress, this programme expired in 1986.

Office of the Comptroller of the Currency (OCC): A bureau within the U.S. Department of the Treasury, established in 1863. The OCC charters, regulates, and supervises national banks, which can usually be identified because they have the word "national" or "national association" in their names. The OCC also supervises and regulates the federally licensed branches and agencies of foreign banks doing business in the United States. The comptroller of the currency, who is appointed by the president of the United States, with Senate confirmation, and who is one of the FDIC's five directors, heads the OCC.

Office of Thrift Supervision (OTS): An organisation within the U.S. Department of the Treasury, established on 9 August 1989, FIRREA. The OTS, with five regional offices located in Jersey City, Atlanta,

Chicago, Dallas, and San Francisco, is the primary regulator of all federal and many state chartered thrift institutions. A director, who is appointed by the president, with Senate confirmation, for a five-year term and who is one of the five FDIC directors, heads the OTS.

Open bank assistance (OBA): A resolution method in which an insured bank in danger of failing receives assistance in the form of a direct loan, an assisted merger, or a purchase of assets. OBA usually entails a change in bank management and requires substantial dilution of shareholder interest in the troubled institution. Originally, as provided in the FDI Act, the FDIC could grant open bank assistance only if the institution's continued operation was deemed "essential." With the passage of the Garn-St Germain Depository Institutions Act of 1982, an institution could receive assistance if the cost of the assistance was less than the cost of liquidating the institution. When FDICIA was enacted in 1991, OBA had to be deemed least costly to the insurance fund of all possible resolution methods. A later amendment to FDICIA prohibited providing assistance to the shareholders of a troubled institution.

Pass-through receivership: A resolution term used when all deposits, substantially all assets, and certain non-deposit liabilities of the original institution instantly "passed through the receiver" to a newly chartered federal mutual association, subsequently known as the "conservatorship."

Payoff: A resolution method for a failed bank or thrift in which the FDIC directly pays the insured amount of each insured depositor. Also known as a deposit payoff. (Also see deposit payoff, insured deposit payoff, and straight deposit payoff.)

Purchase and assumption (P&A): A resolution method in which a healthy insured institution purchases some or all of the assets and assumes the deposit liabilities of a failed bank or thrift. On a case-by-case basis, the assuming institution's bid may be sufficient to allow assumption of all the deposit liabilities of the failing institution, including the uninsured deposits.

Put option: A provision in some purchase and assumption agreements under which an assuming institution has the option of requiring the

FDIC, within a specified time frame, to repurchase certain loans that have been transferred to the acquiring institution under a P&A agreement.

Qualified financial contract (QFC): A type of financial agreement that includes, but is not limited to, securities contracts, forward contracts, repurchase agreements, and swap agreements. When a receiver repudiates a QFC, damages are measured as of the date of the repudiation and may include the cost of acquiring a replacement QFC. Special rules for the repudiation of QFCs exist to protect domestic financial markets.

Receiver: A person or entity, including a government agency, appointed to handle the assets and liabilities of a failed insured depository institution. A receiver succeeds to all the interests and property owned by the failed institution. The U.S. Congress requires the FDIC to be the receiver for insured federal depository institutions. The FDIC may accept appointment as the receiver of a state chartered insured institution and has authority under certain circumstances to appoint itself as the receiver for a state chartered insured depository institution.

Receivership certificate: A document issued by the receiver that represents the total amount of the proved claim that each depositor or unsecured creditor has against a failed bank or thrift in receivership.

Reimbursable expenses: Out-of-pocket expenses paid to third parties during the shared loss period of a loss sharing agreement. The expenses are paid to effect recoveries and to manage, operate, and maintain owned real estate net of income received on that property. Examples of reimbursable expenses include the cost of appraisals, title policies, and environmental site assessments.

Repudiate: A receiver's (or conservator's) right to disaffirm outstanding contractual obligations previously entered into by a failed insured depository institution. The receiver may take such action only if (i) the contracts are considered burdensome and (ii) repudiation will promote the orderly administration of the receivership estate. The FDI Act provides that certain contracts cannot be repudiated.

Reserve price: The minimum price for which one asset or a portfolio of assets can be sold. A reserve price is often expressed as a percentage of book value for which an asset or a pool of assets can be sold.

Resolution: The disposition plan for a failed institution, designed to (i) protect insured depositors and (ii) minimise the losses to the relevant insurance fund, which are expected from covering insured deposits and disposing of the institution's assets. Resolution methods generally include purchase and assumption transactions, insured deposit transfers, and straight deposit payoffs. The term "resolution" can also refer to the assistance plan, through open bank assistance, for a failing institution.

Resolution Trust Corporation (RTC): An entity established in 1989 by FIRREA to oversee the resolution of insolvent thrifts and to dispose of assets acquired from the failed thrifts in the wake of the thrift crisis of the 1980s. The RTC operated from 9 August 1989 to 31 December 1995.

Savings Association Insurance Fund (SAIF): One of the two federal deposit insurance funds created by FIRREA in 1989 and placed under the FDIC's administrative control. Created for the thrift industry, SAIF succeeded the FSLIC as the insurer of deposits to specified limits at savings associations (also called S&Ls) and many savings banks. (Also see Bank Insurance Fund.)

Sequential bidding: The FDIC's practice of reviewing bids for failing banks in the 1980s. On 30 December 1986, the FDIC Board of Directors established an order of priority for six alternative methods of passing assets to acquirers under authority delegated by the FDIC Board of Directors to staff prior to the receipt of the bids.

Straight deposit payoff: A resolution method for failed FDIC insured institutions which can be used when the liquidation, closing or winding up of the affairs is determined to be the least costly resolution of the institution. A straight deposit payoff is one of the two methods of deposit payoffs. (The other is an insured deposit transfer.) In a straight deposit payoff, the FDIC determines the amount of insured deposits and pays that amount directly to each depositor. The FDIC as receiver

retains all assets and liabilities, and the receivership bears the cost of liquidating all of the assets. (Also see deposit payoff, insured deposit transfer, and payoff.)

Subrogation: The process where the FDIC is substituted as the claimant for the insured deposits paid by the FDIC. The claims against the receivership estate include the FDIC, in its corporate capacity, as payer of insured deposits.

Thrift: A financial institution that ordinarily possesses the same depository, credit, financial intermediary, and account transactional functions as a bank, but that is chiefly organised and primarily operates to promote savings and home mortgage lending rather than commercial lending. Also known as a savings bank, a savings association, a savings and loan association, or an S&L.

Uninsured deposit: The portion of any deposit of a customer at an insured depository institution that exceeds the applicable FDIC insurance coverage for that depositor at that institution. (Also see Insured Deposit.)

Yield maintenance: Assistance from a financial institution's insurer that provided a guarantee that certain assets purchased by an acquiring institution in a resolution would yield a prescribed rate of return. In many cases, the yield on these assets could be substantially higher than the institution's cost of funding or cost of carrying the assets. Conceptually, yield maintenance and income maintenance agreements are similar in that they both essentially provide for income protection for non-performing or low-yielding assets acquired in an assistance transaction.

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