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THE FDIC: LIQUIDATION ACTIVITY

Address by

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before the

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Over the last few months, I have given a series of talks on the major functions of the Federal Deposit Insurance Corporation. These talks have discussed as frankly and as openly as possible some of the problems and issues raised by our existing procedures and policies, and have explored various proposals for change. These talks have covered our deposit insurance function, bank examination and supervision, our handling of consumer protection regulations, and our responsibilities for overseeing financial reporting and disclosure by banks. There is one major area of FDIC activity and responsibility that I have not yet discussed -- the liquidation activity of the FDIC.

When a bank fails, we either pay off the insured depositors or we arrange for another bank to assume the liabilities and to purchase some of the assets of the failed bank. In either case, we have a sizable liquidation task. In the case of a payout, we are left to liquidate all of the assets of the failed bank. In the case of a purchase and assumption, we are usually left with the bulk of the assets to liquidate, including all of the poor quality assets. This responsibility for liquidation of failed bank assets has a number of aspects which I wish to discuss today. The two most striking aspects are the size and growth of that activity.

In terms of assets administered, the FDIC Liquidation Division is the largest REIT in the country, the 17th largest diversified financial firm in the country (ahead of such giants as Beneficial Finance and First Boston), and the 49th ranking conglomerate on the Fortune magazine list of the 500 largest

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corporations in the country (just ahead of Armco Steel, Sperry Rand, and Honeywell). There are 78,000 assets being administered by our liquidators with an aggregate book value of $2.6 billion. Over $900 million of these assets are real-estate related.

To administer these assets, our Liquidation Division employs only 583 men and women while operating in 30 states, covering over 79 liquidations. It operates at a cost of approximately 2% of collections, substantially below the costs of 15-20% found in non-banking corporate bankruptcies.

This massive size is a recent development, albeit in our judgment, not necessarily a temporary one. In 1974, our Liquidation Division consisted of 233 employees and comprised about 7 percent of all FDIC employees. In 1976, its 583 employees account for over 16 percent of all FDIC employees. As recently as 1972, the assets in our liquidations totaled under $300 million.

The recent rapid growth of the liquidation activity can be easily understood when we realize that the 8 largest bank failures in FDIC history have occurred since October 1973. That 1973 failure was the U.S. National Bank of San Diego which left us with $1.2 billion of assets to liquidate, our first massive liquidation. We were trying to absorb that when the Franklin National Bank failure dropped $3.6 billion of assets in our laps. All this can be said as emphatically by saying that these eight largest failures consisted of over five times as many assets as all the 500 banks liquidated by the FDIC from its beginning until the failure of U.S. National Bank. This contrasts with the situation about 15 years ago when our biggest worry in liquidation cases was the problem of how to value and sell the banking house of a failed $5 million bank.

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Our entire liquidation activity is guided by one overriding tenet: we are a fiduciary. That is, we are attempting to liquidate assets so as to recover the funds advanced by the Federal Deposit Insurance Corporation and to recover funds for other creditors and stockholders, all of whom are ultimate beneficiaries of the receivership estate.

In the case of a payout, all insured depositors are paid promptly by the FDIC. Usually, but not always, the FDIC is appointed receiver of the failed bank. The Federal Deposit Insurance Corporation, as a result of subrogation of the insured depositors' claims, becomes a sizable creditor of the bank and, hence, has a sizable claim against the receivership. But there are other creditors who have a claim equal with that of the FDIC. Frequently there will be subordinated creditors that have a claim that ranks behind the FDIC and the other general creditors. There are always stockholders who have a residual claim if the liquidation of the assets generates sufficient funds to meet all of the creditors' claims. Wearing our hat as receiver, therefore, we have an obligation to collect as much as possible on every asset so as to protect the rights of creditors and stockholders of the failed bank.

When we arrange a purchase and assumption transaction, the FDIC becomes the major creditor with a claim against the estate of the failed bank. But even in this case, there are claimants, such as subordinated creditors and stockholders, who are entitled to any funds remaining after payment of all general creditors and after the FDIC recovers the full amount of its advance (plus interest). In either case, therefore, whether we have a payout or a purchase and assumption transaction, the FDIC is operating as a fiduciary with

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an obligation to recover as much as possible for the ultimate claimants on the estate of the failed bank.

The Federal Deposit Insurance Act itself provides some specific instructions to the Corporation in its liquidation activity. Our liquidations are to be conducted "having due regard to the condition of credit in the locality." Essentially, this means that the disposition of assets of a failed bank is to be conducted in an orderly manner, rather than on a forced-sale basis. This is consistent with both concern for the impact of forced liquidation on the local community, and concern with recovering the maximum amount possible for the beneficiaries of the liquidation. Receiverships of failed banks, like any receivership, are conducted under the jurisdiction of the courts, and sales of assets by the receiver are subject to approval by the courts.

The receiver's actions, as you would expect, are more circumscribed and subject to more limitations than an on-going bank would have in dealing with the same assets. That is, a bank can take account of its whole business relationship with a customer in dealing with the treatment of a particular loan. For example, in making a decision whether to foreclose or extend a loan in default, an operating bank may consider the deposit business it gets from the borrower, or the existence of trust business, or the business of associates of the borrower that may be promoted or endangered depending on the decision on the particular loan. The receiver can make no such trade-offs and consider no such outside factors. He must make a credit decision on the best way to handle a particular loan so as to maximize recovery on

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that asset. These characteristics of the liquidation pose some knotty problems for us to which I will return later in this talk.

One reason why our liquidation activities have not been discussed very much in public by past Chairmen of the FDIC is that until rather recently our liquidation activity was modest in size and scope. It was also a rather simple and straight-forward activity, not requiring direct and frequent involvement by the Board of Directors of the FDIC (other than final approval of sales of assets). One illustration of that is the fact that during World War II our entire liquidation activity was moved to Chicago and operated very well eight hundred miles away from the Board of Directors of the Corporation. Now, however, liquidation activities are bigger and more complex and require the frequent involvement of FDIC Board members.

I have described the massive size of our liquidation activity and its extremely rapid growth. These facts, however, impressive as they may be, do not adequately convey the change that has taken place in our liquidation operations. Now we have not only a higher dollar amount of assets, but we are getting assets which are much more complex to administer, let alone sell or liquidate.

Our philosophy of an orderly liquidation frequently requires us to manage assets for lengthy periods before they can be sold or collected. In pursuing that philosophy, we have operated a sizable navy, with a fleet consisting of tuna boats, shrimp boats and oil tankers. Running a navy is a complicated business. We have even had difficulty keeping our boats afloat. We had an oil tanker run aground off Havana, and we had a shrimp boat blown into the main street of Aransas Pass, Texas by Hurricane Celia.

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We have acquired a loan to the distributor of movies, one of whose properties is a major X-rated film. Our prospects for ultimate collection of that loan depend on good attendance at that film. We became creditor of an individual whose main source of income to repay our loan was rental paid for the use of a property as a bawdy house. We had interests in taxi cab fleets in California, Arizona and New York, and with real estate of literally all kinds in all forms of development and non-development throughout the United States.

We have faced the problems of abandoning or developing farm properties such as citrus orchards or vineyards in all stages of development. We have bought 47 wind machines to protect our citrus crops from freezing (at a total cost of $427 thousand) and have had to purchase beehives to assure pollination of our almond trees. Religion has been part of our business also. We have foreclosed on abandoned churches and synagogues although, fortunately, we have never had to evict a congregation. We also have possession now of a copy of the Koran valued in seven figures.

While these may appear to be unusual assets to be acquired as a result of bank failures, it is important to realize that we never get to liquidate the assets of a normal bank. We are always liquidating the assets of failed banks, and banks that fail tend to be unusual and into some odd-ball financial ventures. Back in the 1950s and early '60s, when it was mostly small rural banks that were failing, the liquidation activity was a simpler one. We took over an assortment of loans (consumer loans, home mortgage loans, farm loans, small business loans) with which our liquidators built up some familiarity and expertise. We may have had to wait several years to collect the final payment of a home mortgage loan, and there may have been some

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difficult work-out situations on farm loans, but our liquidators developed expertise in appraising farm property in many parts of the country and determining the best way to deal with those loan situations. Oil tankers, movies, vacation home condominiums, taxi cab fleets and international loans were a different kind of activity. The liquidator who was perfectly comfortable in dealing with a loan secured by 300 acres of cotton in Texas was not so comfortable in dealing with 30,000 acres in California on which oranges, avocados, and grapes were being grown, and wine produced.

In this talk, I can describe the scope of our liquidation activities and tell you how we have been operating. The scope and nature of our operation have changed so dramatically in the last few years that it is unlikely that the management or procedural approach that was best for the 1960s is still optimal today. We have a number of studies of our liquidation effort under way, and I expect that there will be both organizational and procedural changes introduced in the near future. Clearly the speed with which we have been forced to deal with larger and more complex assets has necessitated going outside our organization to hire consultants with knowledge in some of these particular areas, rather than try to develop our expertise internally. The costs associated with this approach disturb all of us at the FDIC because we have always taken pride in our low collection expenses. I suspect that we must be very careful not to be penny-wise and pound-foolish in this area, however.

Our administrative and collection costs have run 2.3% of collections over the years. That is an extremely low figure compared with any similar business. I recognize that that is not a completely fair comparison since the

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FDIC bears some costs that could reasonably be charged to liquidations but, in any case, a 2.3% cost ratio is impressively low. I might note that one reason for the low costs is that our salary structure is comparatively low -- our liquidators would be happy to switch to the 1.5 to 2.0% or more commission basis that private firms in the liquidation business are awarded.

Up until the failure of the U.S. National Bank of San Diego, the FDIC recovered, through its liquidation efforts, 90% of its total cash outlay. That record has deteriorated recently because of the U.S. National Bank failure, a failure which left in the receivership a lot of very poor quality assets. If all our liquidations had assets like that, our recovery record would be miserable. As to realization on classified assets, our collections have averaged about 30 percent recovery on loans and other assets classified as "loss" by examiners. We have collected 50 percent of assets classified as "doubtful" and about 68 percent of assets classified as "substandard." As an aside, I would suggest that this might show that examiners' evaluation of assets is pretty accurate.

Because they represent 62% of the assets in the liquidation inventory, it is worth reviewing our current status with respect to our largest failures, Franklin National Bank and U.S. National Bank.

The Corporation has succeeded in collecting $1.06 billion on the assets acquired in the Franklin liquidation, and has paid over $1 billion of this amount to the Federal Reserve Bank of New York, thereby reducing the principal amount due on the "window" loan extended to FNB at the time of closing October 8, 1974, from $1.7 billion to $707 million. Interest at the rate of 7.52 percent per annum on the note will not be due until the note matures on

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October 8, 1977. The principal book value of assets remaining to be liquidated is $1.25 billion compared with the principal and accrued interest on the FDIC's outstanding debt to the Federal Reserve Bank of New York of $901 million.

On October 8, 1977, it will probably be necessary for the Corporation to advance an estimated $465 million to $665 million from its accumulated trust fund in order to pay the Federal Reserve Bank the remaining balance due on the original $1.7 billion obligation which was owed by FNB as of its closing. Based on a number of assumptions as to the duration of the receivership, the pace of collections and the results of matters in litigation, it appears that the Corporation itself will not suffer any loss in this liquidation.

In the case of U. S. National, the Corporation has collected $73 million on the assets acquired and has used $53.3 million of this amount to repay the Corporation for monies advanced to the receivership. The principal book value of assets remaining to be liquidated is $392 million. The question in this liquidation is how large the loss to the Corporation will be, not whether there will be one. At the present time, we have estimated a $150 million dollar loss.

I have mentioned the complexity of the current liquidation activities and mentioned the requirement we now have for greater expertise in particular lines of business and types of loans. We have also had a great need for massive legal expertise not only because of the great number of legal problems, but also because of the legal complexities of the new liquidations. Obviously, we have had to employ private attorneys to assist our own staff.

In arranging a purchase and assumption transaction, we retain private counsel for advice and assistance with respect to questions of state law and to present the transaction to the local court. In every liquidation we need expertise

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in specialized areas of state law in connection with collection litigation and foreclosures. Some of these claims involve the Bankruptcy Act or arrangement of complex loan restructurings or workouts. In the recent large liquidations we have been involved in unusual and specialized areas of law. These include class actions, violations of securities laws, common law fraud, obligations under letter of credit, attorney's and accountant's malpractice and admiralty law.

We spent $4.3 million in legal fees in connection with liquidation activities in 1975 and expect to spend about $7 million in 1976. While these figures seem large, if we relate them to the assets we are liquidating, it appears that legal fees run well under one-half of one percent of the assets being administered, and under one percent of collections. I think this is an impressively low figure when we compare it with the legal fees involved in corporate bankruptcies and receiverships. In fact, the legal fees individual home buyers incur in the course of an ordinary sale of a home, uncomplicated by bankruptcy or receivership, tend to be higher. We are concerned about the magnitude of these costs, however, and have been giving some consideration to whether we should expand our own in-house legal staff to handle some of these legal matters, rather than relying, as we do now, primarily on hiring local counsel. One problem with doing the legal work in-house is that we are conducting liquidations in a variety of different states and successful work on these liquidation matters requires a knowledge of local law. It may be cheaper for us to hire local counsel with the knowledge of local law at hourly rates than to attempt to educate, and maintain the fixed costs of, an in-house staff to deal with particular local situations.

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Another problem that arises frequently in liquidation activities involves further extension of credit. Federal deposit insurance arose because of concern about bank depositors. We have been so successful in our major function that bank depositors rarely lose when banks fail. Now it frequently turns out that the injury to borrowers is more significant than losses to depositors. In many cases, borrowers are not affected when a bank fails. If a borrower has a mortgage loan from a bank that fails, the FDIC may end up taking over that loan but the borrower's rights are not affected at all. There is a greater problem for the business borrower who is expecting to borrow on a continuing basis from a bank.

A receivership, of course, is not in the money lending business. While most business borrowers are able to shift their business to another bank and are not significantly inconvenienced or injured by a bank failure, some borrowers are faced with a real problem, or even risk of financial ruin, in the case of a bank failure. The borrower who has run into difficulty with his loan and would like additional funds advanced is going to have a hard time dealing with a receiver. There may be some cases in which a receiver will extend additional credit, but they are infrequent. Take the situation of a builder who has a project underway with construction financing being provided by the failed bank. He may need additional funds to complete the project. The receiver is not inclined to throw good money after bad and is not in a situation of a bank lender who may be reluctant to admit the original mistake. The receiver may feel that if the project is a good one, the builder should be able to get credit somewhere else.

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About the only case in which the FDIC liquidation can advance additional funds to a borrower is when it is concluded that such an advance will improve the net recovery to the estate of the failed bank. Our concern is with protecting the assets that are our responsibility. The FDIC has occasionally been criticized for its tight-fisted attitude on the extension of additional credit. While we can understand and sympathize with the plight of the borrower, such criticism misses the point that we are operating in a fiduciary capacity, with our decision scrutinized by a court from the point of view of the ultimate claimants on the failed bank's estate. It is irrelevant to look at the assets of the FDIC and argue that the FDIC can afford to extend additional credit. In the final analysis, it is not FDIC funds that are being loaned. The funds involved belong ultimately to the receivership estate of the bank.

While not as painful as the decision to extend or not extend additional credit to a borrower, a much more common problem is the choice between sale of an asset and continued holding of it. A liquidator is always anxious to sell an asset when he feels he has been offered a good price for it. But if the loan or other asset seems to pose no credit risk, and is paying interest at an acceptable rate, there may be a tendency to hold the asset in the hope that a better offer will materialize or that the accumulated interest on the asset will lead to larger total collections. We are attempting to use the most modern portfolio management techniques to make correct sell or hold decisions, but this is a difficult task, particularly when we are faced with a divergence of interests between those who would like to get their money as soon as possible, and those claimants who recognize that their only hope of

any recovery on their investment is that the liquidation lasts a long time and earns a great deal of interest income.

Although we have always tried to make the optimal decisions in these cases, some years ago our policy favored holding rather than liquidating assets as quickly as possible. Besides that seeming like the best philosophy for ultimate recovery, we had an additional reason for taking that approach. The FDIC did not have a great deal of liquidation activity for a number of years, and we felt some need to maintain trained liquidators so that we would be prepared for any emergency that might arise. This no longer is a problem. We now have more than enough work to be done in our on-going liquidations. In fact, with liquidation assets now amounting to a significant fraction of the insurance fund, we have every incentive to sell assets as quickly as possible, if to do so maximizes recovery.

Perhaps the most difficult areas of decision making with respect to liquidation activity are those choices involving social considerations. We are under an obligation to do as well as we can for the ultimate claimants on the estate of the failed bank. While we try to do well, we would also like to do good. In many cases, the borrower whose loan is in default has faced some adversity, frequently, not of his doing. In many cases, we would like to tell a debtor, after hearing his tale of woe, that because of his hard luck we are going to forgive his repayment of his obligation to us. Unfortunately, we are not in a position to do that.

To stress once again, we have a fiduciary obligation to collect all we can on the assets we inherit from a failed bank. We try to be firm but reasonable and ethical collectors, but collectors we are and collectors we

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must be. While this may be clear in principle, in practice we have great difficulties. Take this example: We have taken over a loan to a private school. The school is in default in its obligation. The school's physical plant and land is security for the loan. We can foreclose and sell off the land and buildings and recover enough to come out whole. We do not want to put an educational institution out of business, yet we have to meet our fiduciary responsibility.

While we may have difficult decisions to make with respect to how hard to press honest borrowers who have fallen on hard times, we have no difficulty in deciding to press our remedies to the fullest in dealing with the people that we feel are responsible for the demise of the bank. In many cases, these are insiders -- managers and directors of the bank. Since 1960, we have filed 32 suits against directors and we have 15 additional cases under consideration. We believe that firm prosecution in these cases not only is a means of adding to our recoveries for the benefit of the bank's creditors and stockholders, but firm action may be a useful deterrent to insiders in similar situations. This aspect of our liquidation activities, thus becomes an intrinsic part of the total program of bank supervision.

In summary, then, the rapid growth of our liquidation assets has fundamentally changed the nature of our liquidation activity. These new liquidations are not only bigger and more complex, they are going to be long-lasting. While we hope and expect that the rapid growth of our liquidation assets is over, we do not expect the size of the operation to shrink back to its 1973 levels in the foreseeable future. It will take a long time to completely wrap up the affairs of Franklin and U. S. National Bank, and in

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the meantime we will inevitably be acquiring other assets. The failure of International City Bank of New Orleans within the last week, for example, added over $100 million to our liquidation portfolio.

In reflection of the size, diversity and complexity of our liquidation activitiy, we are going to continue to adopt modern management techniques and make greater use of outside expertise, even though we recognize that this may add to our costs.

What will be unchanged in the future is the conduct of our liquidation activities in a manner befitting the fiduciary nature of our responsibilities. We expect that our liquidation operations will be carried on as efficiently and effectively in our present complex environment as in the simpler pre-billion dollar failure days.

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