TESTIMONY OF

DAVID C. COOKE
DEPUTY TO THE CHAIRMAN
FEDERAL DEPOSIT INSURANCE CORPORATION
WASHINGTON, D.C.

ON

TAXATION AND ASSISTANCE TRANSACTIONS

BEFORE THE

SUBCOMMITTEE ON TAXATION AND DEBT MANAGEMENT
COMMITTEE ON FINANCE
UNITED STATES SENATE

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EXECUTIVE SUMMARY

FDIC's purpose in testifying is twofold:

(1) Reemphasize the need to help the FSLIC enhance its insurance fund by asking that Congress extend tax provisions for financial assistance transactions and reorganizations of troubled thrift institutions by the FSLIC that now expire 12-31-88.

(2) Ask that Congress extend these provisions to comparable transactions of FDIC.

Enactment of these provisions should result in a yearly reduction in budget outlays for the FDIC of between $435,000,000 and $870,000,000.

FDIC insures deposits in over 14,000 commercial and savings banks nationwide. Record bank failures in the last few years have placed stress on the banking system. FDIC attempts to reduce bank payoffs, in which the bank is permanently closed, by giving direct assistance to keep a bank from failing or by finding a purchaser to buy the failed bank's assets and assume its liabilities.

The FSLIC tax provisions that should be extended to the FDIC include:

(1) Section 597 Assistance payments are not included in income and no reduction of basis of assets transferred is required.

(2) Section 368(a)(3)(D)(ii) Tax free reorganization status is allowed for assistance transactions.

(3) Section 382(l)(5)(F) Allows preservation of net operating losses of failed banks.

Important results to the FDIC from extending these provisions to the FDIC include:

(1) Reduction of confusion in the tax treatment of FDIC assistance to prevent bank failures and to sell banks after they have failed.

(2) Reduction of cost of such transactions to the FDIC and in FDIC outlays, thus preserving the insurance fund.

(3) Ensure continuation of banking services in all communities, and enhance stability in the banking system.

In closing, mention the consolidated return issue now facing the FDIC, in hope that it can be addressed.

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Good morning, Mr. Chairman and members of the Subcommittee. I am David Cooke, Deputy to the Chairman of the Federal Deposit Insurance Corporation ("FDIC"). I appreciate the opportunity to testify today on an issue of importance to this nation's federal deposit insurance funds.

My appearance here today is for two purposes. First, I urge the Congress to extend the tax provisions governing the tax treatment of financial assistance transactions and reorganizations of troubled thrift institutions by the Federal Savings and Loan Insurance Corporation ("FSLIC"). The FSLIC is working diligently to solve the serious problems it faces. The stability of our financial system and public confidence in that system requires that every effort be made to minimize the cost to the FSLIC insurance fund. Extending these tax provisions will provide a significant benefit for the FSLIC as it proceeds with its important task.

Second, I also recommend that those same provisions be extended to comparable transactions of the FDIC. Extension of these provisions to the FDIC will eliminate present confusion concerning the tax treatment of these transactions and permit the FDIC to more effectively perform its role in the financial system. This can be done, we believe, while producing a net positive impact on the budget due to the reduction in outlays for the FDIC.

The FDIC was established by Congress in 1933 for the primary purpose of restoring public confidence in banks by establishing a system of federal deposit insurance. The FDIC fund currently insures the deposits of millions of Americans in over 14,000 commercial and savings banks. The FDIC has served the nation and this nation's bank depositors well throughout the 55 years of its existence.

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We now are facing the greatest challenge in the history of the FDIC. During 1987, 184 banks failed and 19 more required assistance in order to stay open. This is the greatest number of bank failures and assistance transactions in any single year since the FDIC began operation. The record 184 failures in 1987 eclipsed the prior record of 138 bank failures in 1986, which was up from 116 in 1985. These numbers are in clear contrast to an average of about 10 closings per year throughout most of the post-World War II period. The FDIC is experiencing another record or near record year in 1988 and does not foresee a significant reduction in its responsibilities in the foreseeable future.

Let me briefly explain the FDIC's role in a bank failure. The determination of whether an insured bank is insolvent is made by the Comptroller of the Currency in the case of national banks and by the state banking authority in the case of state chartered banks. Typically, after such a determination has been made and the bank is closed, the FDIC is appointed receiver for the failed bank.

When a bank's failure is imminent, the FDIC must consider how it will discharge its obligations as both the insurer of the bank's deposits and the likely receiver of the failed bank. Although the response of the FDIC to each possible bank failure has its own unique characteristics, there are generally three categories of alternatives available. First, the FDIC can consider direct financial assistance to keep the bank from failing. This approach is available only if the Board of Directors of the FDIC finds that the assistance required is less costly to the FDIC fund than any other alternatives available to the FDIC or that continued operation of the bank is essential to provide adequate banking service in the community. When financial assistance is

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provided to keep a bank open, outside investors usually join with the FDIC in recapitalizing the bank to insure its continued viability.

The second alternative available to the FDIC is a direct payoff of the insured deposits. In this situation the bank is closed and the FDIC is named receiver. The depositors are paid off up to the $100,000 limit of insurance protection and the institution is liquidated. Depositors above the insurance limit are paid, to the extent possible, only after the failed bank's assets are liquidated. A variation of a direct payoff is when insured deposits are transferred to another bank which acts as paying agent for the FDIC. A direct payoff is the least desirable, and usually most costly, alternative. It results in an interruption of vital banking services to the community served by the failed bank. In addition, because the failed bank's main office and branches are permanently closed, virtually all of the failed bank's employees lose their jobs.

The third and most prevalent alternative is a "purchase and assumption" transaction. Under this alternative, which can be structured in several ways, a healthy bank assumes all of the failed bank's deposit liabilities, including uninsured deposits, and agrees to acquire some or all of the failed bank's assets. The assuming bank receives an infusion of cash from the FDIC to make up the difference between the value of the assets and the liabilities assumed. The current FDIC policy is to try to arrange, wherever possible, so-called "whole bank" transactions where the assuming bank acquires all of the assets of the failed bank, including the bad loans.

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A new temporary solution now available to the FDIC is a "bridge bank." In this case, the FDIC can operate the failed institution, for up to three years, until a buyer can be found.

Under current law, these various categories of assistance transactions have uncertain, but significant, tax consequences. The Congress has under consideration an extension of several tax provisions which apply to financial assistance payments and reorganizations of failed or failing thrift institutions by the FSLIC. These provisions are scheduled to expire December 31, 1988. The FDIC strongly supports legislation to either extend or make permanent those provisions for the FSLIC.

The FDIC performs a role with respect to the banking sector that is comparable to the FSLIC's responsibilities relative to the thrift industry. Like the FSLIC, the FDIC now faces serious stresses due to the record volume of bank failures. Thus, to the extent that the Congress extends the FSLIC's tax provisions, the FDIC recommends that these same provisions be made applicable to the FDIC.

We believe that extending these provisions to the FDIC would have important and positive ramifications for the FDIC, the banking system and the nation. The provisions would reduce the confusion relating to the tax treatment of FDIC assistance, thus facilitating the most efficient resolution to a bank insolvency. They would reduce the cost of assistance and purchase and assumption transactions, thereby helping to preserve the insurance fund. The resulting increased use of assistance or purchase and assumption transactions would enhance the stability of the banking system and help insure adequate banking services to all communities.

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The FDIC is very aware that cost is an important concern. Extending these provisions to the FDIC will have the net effect of reducing the deficit, because the benefits largely would accrue to the deposit insurance fund. We estimate that yearly reductions in FDIC outlays could range from $435 million to $870 million. Moreover, while the reduction in FDIC outlays would be recognized fully at the time of the transaction, any tax revenue cost would be stretched out over a number of years. In the final analysis, we believe the reduction in outlays will exceed whatever tax revenue cost is associated with these provisions.

Generally, there are three provisions being sought. The first provision, Section 597 of the Code, specifically clarifies that FSLIC assistance payments, whether provided through a note or other instrument, are not includable in income of the assisted institution. In addition, Section 597 provides that no reduction in the basis of assets of the recipient institution will occur as a result of the receipt of such assistance.

Section 597 was enacted by the Congress in 1981 to clarify the tax treatment of FSLIC assistance. Extending the application of Section 597 to FDIC assistance transactions will eliminate the confusion that often arises concerning the tax treatment of these transactions. The law in this area is unclear and the transactions frequently are complicated. The FDIC assistance may be structured in a variety of forms including, but not limited to, direct cash infusion, the purchase of notes or the purchase of non-voting preferred stock. Because these transactions often must be consummated quickly, parties to the transaction usually assume the worst-case tax result, thus driving up the cost to the FDIC of rescuing a bank.

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This provision would facilitate purchase and assumption transactions and interim bridge bank transactions. These methods of handling bank failures are highly preferable to closing the bank and paying off the insured depositors with the concurrent loss of jobs and banking services in the community. Moreover, such an approach minimizes the negative impact on public confidence in the banking system and thus helps stabilize the banking industry.

The second expiring provision, Section 368(a)(3)(D)(ii) of the Code, provides that a FSLIC assistance transaction may qualify as a tax free reorganization provided that certain requirements are satisfied. FSLIC must certify that the institution is insolvent, that it cannot meet its obligations currently or that it will be unable to meet its obligations in the immediate future. In addition, substantially all liabilities of the failed institution must be assumed by the acquiring institution.

This section was originally enacted in 1981 to eliminate ambiguity with respect to the continuity of interest requirements which apply generally to tax free reorganizations. It represents a significant benefit to the FSLIC in merging troubled thrift institutions with healthy thrifts. If extended to the FDIC, it would perform a similar beneficial role by significantly improving prospects for a purchase and assumption transaction in a given case, rather than a depositor pay-off and liquidation of the failed bank.

The third expiring provision is Section 382(l)(5)(F). It provides rules governing the treatment of net operating losses of a failed thrift institution with deposit liabilities that have been assumed by a healthy thrift. As a general rule, current law provides special rules for the preservation of net operating losses in Chapter 11 bankruptcy situations.

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The rules provided by Section 382(l)(5)(F) make it easier for the receiver of failed thrift institutions to preserve the failed thrift's net operating losses and thereby reduce the cost to the insurance fund. The FDIC would propose that if these provisions are to be extended, their benefits also be made applicable to similar transactions by the FDIC.

Mr. Chairman, I would like to raise one additional issue not encompassed by the FSLIC provisions. We would like to suggest that the Congress consider an administrative proposal to facilitate the access of the FDIC, as the receiver of failed institutions, to tax refunds to which the FDIC is entitled. This proposal addresses a problem which arises where the FDIC becomes receiver of a bank which was previously part of a bank holding company filing a consolidated federal income tax return. Under our proposal, the FDIC would be permitted to seek directly the refund to which it is otherwise entitled as receiver for the bank by permitting the FDIC to terminate the consolidation and file for the refund directly. This would eliminate a problem frequently faced by the FDIC when the representatives of the holding company of a failed bank seek refunds which are properly due to the failed bank and dissipate them before the FDIC can recover the funds.

Mr. Chairman, thank you for allowing me to testify on this issue. We are available to provide whatever assistance you require in considering these proposals.

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