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TESTIMONY OF

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ON

THE FDIC-ASSISTED ACQUISITION OF THE SUBSIDIARY BANKS OF
FIRST REPUBLICBANK CORPORATION, DALLAS, TEXAS, BY
NCNB CORPORATION, CHARLOTTE, NORTH CAROLINA

BEFORE THE

COMMITTEE ON BANKING, HOUSING AND URBAN AFFAIRS
UNITED STATES SENATE

10:00 a.m.
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Room SD-538, Dirksen Senate Office Building

Good morning, Mr. Chairman and members of the Committee. I am pleased to testify today on the Federal Deposit Insurance Corporation's assistance transaction involving the subsidiary banks of First RepublicBank Corporation, Dallas, Texas.

First, we will provide some background on First Republic and the interim assistance that was provided in March, 1988. Then, we will turn to a description of the assisted acquisition of the banks by NCNB Corporation, Charlotte, North Carolina, that was approved by the FDIC Board on July 29, 1988. Finally, we will comment briefly on the FDIC's proposed emergency consolidation legislation.

BACKGROUND ON THE FIRST REPUBLIC BANKS

As of year-end 1987, First RepublicBank Corporation was the 14th largest bank holding company in the United States with over 160 banking offices throughout Texas. It also was the largest banking organization headquartered in Texas and in the Southwest with $28.4 billion in assets as of March 31, 1988. First Republic's subsidiary banks had a strong presence in the market areas of Dallas, Fort Worth, Houston, Austin and San Antonio. In addition, First Republic owned a bank in Delaware which was primarily a credit card operation.

The First Republic Banks had major correspondent relationships with almost 1,100 banks located throughout the United States, but principally in the Southwest. They acted as depositories for their correspondents and provided check clearing, transfers of funds, loan participations, and custodial, clearance and investment advisory services.

The First Republic Banks also had many corporate relationships and held uninsured deposits and non-deposit liabilities of about $12 billion, including inter-bank funding of about $6.4 billion. In particular, First RepublicBank Dallas was a major commercial lender in the region. The First Republic system as a whole had approximately 20 percent of the total loans made by commercial banks in the state. It had approximately 125,000 loan customers and unfunded loan commitments of over $9.1 billion. In addition, many corporate customers relied on the First Republic Banks for vital services.

In July, 1988, the First Republic Banks' trust departments represented the largest trust operation in the Southwest. They managed over $50 billion in assets for over 25,000 customers.

Given First Republic's size and presence in the Southwest, it was evident that an abrupt discontinuation of these deposit and other commercial banking services would have had the potential of seriously disrupting those market areas. The potential for widespread trouble in the financial system was more likely in light of the severely depressed economic conditions in the Southwest.

Like many other banking institutions in Texas, First Republic (and its predecessors, Republic Bank Corp. and InterFirst Corp.) suffered serious losses during the past two years, made worse by the troubled regional economy. As these losses first appeared, many of the company's funds providers (particularly Eurodollar funding and other overseas sources) began to abandon the system. In part to replace these funds, the downstream affiliate banks of First Republic supplied their funds to enable the lead bank in Dallas to continue to operate.

In December, 1987, First Republic announced that it expected to suffer a loss of between $325 million and $350 million for the fourth quarter of that year. As a result of the announcement, the holding company and the lead banks in Dallas and Houston began to experience even more significant funding problems. The system began to draw on a back-up credit line aggregating just over $2 billion provided by seven major banking companies.

In late January, 1988, First Republic announced that it had suffered a fourth quarter loss of $347 million, bringing its 1987 losses to a total of $656 million. It also announced that $3.9 billion (16 percent) of the loans in the First Republic system were nonperforming at the end of 1987.

This continual disclosure of adverse information accelerated the decay in First Republic's position in the major funding markets. Retail depositor concerns began to appear. Many of the First Republic Banks were experiencing a steady decline in depositor confidence, and demand-deposit and correspondent business began exiting the system at significantly increased rates.

By late February, First RepublicBank Dallas began experiencing a depositor run. In a five-day period ending February 24, the Dallas bank's customer deposits declined by about $750 million, or approximately 15 percent of its total deposits. By March 1, the First Republic Banks as a whole already had lost more than $1.8 billion in deposits during 1988.

In early March representatives of First Republic formally sought assistance from the FDIC. On March 15, 1988, as a result of continuing outflows, the Dallas bank's funding needs exceeded its $2 billion line of credit with the lending banks. To meet its funding requirements and repay the lending banks, the Dallas bank was forced to borrow $2.6 billion from the Federal Reserve Bank of Dallas.

By March 16, First RepublicBank Dallas was about to fail as news of the move to the Fed window accelerated fund withdrawals. This raised a concern that an uncontrolled collapse of the First Republic system might present a real threat to the financial system in Texas and nationally.

INTERIM ASSISTANCE

On March 17, 1988, the FDIC, after consultation with the Federal Reserve and the Comptroller of the Currency, announced its interim assistance plan for First RepublicBank Corporation, Dallas, Texas, involving a $1 billion six-month loan to the two largest banks in the First Republic system. The announcement included an assurance to depositors and general creditors of the First Republic Banks that in resolving the First Republic situation, bank depositors and bank creditors would be protected and that services to customers would not be interrupted. The FDIC specifically provided no assurance to creditors of the First Republic holding company or other non-banking subsidiaries. Further, these assurances related only to depositors and creditors other than the First Republic Banks themselves. That is, the inter-bank funding from one First Republic bank to another was not protected by the FDIC assurances.

In exchange for the assistance, the First Republic holding company guaranteed the $1 billion loan and collateralized that guarantee by pledging the shares of 30 of its bank subsidiaries. This loan was further guaranteed by each of the First Republic Banks. First Republic also agreed to substantial restrictions on its operations, management, and policies.

The nature of the assurances provided by the FDIC were that, as it acted to provide a long-term solution for the First Republic situation, the FDIC would arrange for a transaction that resulted in the depositors and creditors continuing to have deposits in and claims against an operating bank as a result of open-bank assistance transactions or a variation of one of its traditional purchase-and-assumption transactions.

It is important to understand the legal basis for the granting of such assurances. Section 13 of the Federal Deposit Insurance Act specifies the various alternatives available to the FDIC in assisting failing or failed banks. Two of the alternatives are: (1) providing direct assistance to the banks to prevent their closing, or (2) providing assistance to another entity to facilitate the acquisition of the banks. Such alternatives generally have the effect of protecting depositors and other creditors of the banks. If any alternative other than paying off insured depositors and liquidating the assets of the failed bank is to be exercised, normally the FDIC's cost in exercising such alternative must be no greater than the cost of liquidating the banks.

However, the FDIC also may grant assistance in those instances where the failing bank is found to be essential to the community in which it operates. Based upon the facts and circumstances described above, the FDIC Board made the determination of essentiality.

With respect to First Republic, the FDIC, in consultation with the Comptroller of the Currency and the Board of Governors of the Federal Reserve System, determined that severe financial conditions existed that threatened the stability of a significant number of insured banks, as well as insured banks possessing significant financial resources. In making this determination, the FDIC Board of Directors did not extend deposit insurance coverage to uninsured depositors and creditors. Instead, the Board committed itself to accomplishing a long-term resolution of the First Republic problem in a manner that would not result in loss to depositors or other general creditors of the bank.

The interim assistance accomplished its desired effect. Deposit outflow slowed considerably. However, First Republic's overall financial condition continued to deteriorate due primarily to nonperforming real estate loans. First Republic reported a 1988 first quarter loss of $1.5 billion and a second quarter loss of $758 million.

ASSISTED ACQUISITION BY NCNB CORPORATION

On July 29, 1988, the Texas subsidiary banks of First RepublicBank Corporation were closed and the FDIC agreed -- after considering the various bid proposals -- to sell the banks to NCNB Corporation. Upon the banks' closings, the FDIC organized a bridge bank, NCNB Texas National Bank, to assume the banks' deposits and other liabilities and to acquire certain of the banks' assets.

The bridge bank will be run under contract by NCNB management for two to three months, until the requisite legal documentation is prepared and a final accounting of the banks' financial condition is completed. At that time, NCNB will acquire a 20 percent interest in NCNB Texas National Bank. The assurances given by the FDIC in March, 1988, to protect all depositors and general creditors of the banks also will continue until that time.

The bank will be operated as a bridge bank until the earlier of three years or the time at which NCNB acquires a majority interest in the bank. The bridge bank authority was created as part of the Competitive Equality Banking Act of 1987 in order to permit the FDIC to "bridge" the gap between a failed bank and a completed purchase-and-assumption or other transaction.

The obligations of the failed banks' parent companies, First RepublicBank Corporation and IFRB Corporation, including approximately $1.2 billion in debt and preferred stock, will remain with the parent companies. NCNB Texas National Bank will not assume any of the obligations of the holding companies.

Capital Infusion. NCNB Corporation will acquire 100 percent of the voting stock of NCNB Texas National Bank. The stock will represent 20 percent of the total equity, for a minimum investment of $210 million in cash and a maximum of $240 million. The FDIC will acquire nonvoting stock representing 80 percent of the total equity, for a minimum investment of $840 million in cash and a maximum of $960 million. The equity infusion of at least $1.05 billion and the direct assistance, described below, that will be provided by the FDIC will create an institution with at least 6.0 percent primary capital.

NCNB Corporation will have the exclusive, nontransferable option, exercisable at any time during the first five years, to purchase the FDIC's 80 percent interest. The exercise price per share will be the amount of the FDIC's original investment per share plus, in the first three years, 115 percent of the net increase in book value per share, with the premium increasing to 120 percent in the fourth year and 125 percent in the fifth year.

FDIC Assistance and Cost. Once the assistance program is implemented, all loans, real estate properties and other assets acquired by NCNB Texas National Bank, including all performing and nonperforming assets, will be written down to their market value, as agreed between the bank and the FDIC. The FDIC will provide direct assistance to NCNB Texas National Bank in a combination of cash, notes, and debt relief, in an amount sufficient to eliminate the negative net worth. The FDIC's initial outlay for the transaction is expected to be approximately $2 billion, in addition to the $1 billion loaned to the First RepublicBank banks in March, 1988. An additional $1 billion is estimated to be required to meet the writedown of additional loans found to be classifiable and thus "put" to the special asset pool (described below).

Thus, the Corporation's total outlay after consummation of the permanent assistance program is estimated to be $4.0 billion. The FDIC's net cost for the transaction, however, is expected to be significantly lower than its total outlay. Our preliminary estimate of the net cost is $2 to $3 billion. But, we must emphasize that this is a preliminary estimate subject to change as a result of a number of factors which are not fully quantifiable at this time. The ultimate cost to the FDIC will depend on the amount of collections on and the value of the assets in the "special asset pool"; the amount of troubled assets transferred to the separate asset pool; the amount of dividends received by the FDIC while it holds stock of NCNB Texas National Bank; and the price the FDIC receives on the sale of its stock in NCNB Texas National Bank to NCNB or, should NCNB fail to exercise its option to purchase the FDIC's stock, on sale to the public or to a third party.

Separate Asset Pool. The assets transferred to NCNB Texas National bank from the First Republic banks included a substantial volume of troubled loans, real estate properties and other troubled assets. A major feature of the financial assistance program is the transfer of most of those assets to a separate asset pool in the new bank. The troubled assets will be transferred to the pool, marked down to fair market value, and accounted for by separate bookkeeping entry within NCNB Texas National bank. The assistance agreement also includes a provision permitting NCNB Texas National Bank to transfer subsequently classified assets to the separate asset pool. This "put" provision may be exercised at the end of the one-year and two-year periods after the date the assistance transaction is consummated. Any disputes on whether an asset should be classified and therefore "put" will be decided by arbitration.

NCNB Texas National bank will be responsible for the administration and collections of the asset pool under the supervision and direction of the FDIC. While the pool remains owned by NCNB Texas National Bank, it will be administered as a separate profit center. The new bank will assign a full-time dedicated management team to manage collection and liquidations of the assets in the pool, with incentive programs based on performance of the pool assets. In addition, the new bank's share of any ultimate gains on the pool will be tied to efficiency of pool administration and pool performance.

At the end of three years, if, as expected, NCNB Corporation has increased its ownership of NCNB Texas National Bank to 51 percent, the entire remaining asset pool may be spun off to a new FDIC-owned liquidating bank operated by NCNB Texas National Bank under continuing incentive programs.

NCNB Corporation's Management. As an essential part of the program to revitalize the First Republic banks, NCNB Corporation immediately assigned an initial team of more than 250 experienced staff to work with existing management and staff of the former First Republic banks.

After implementation of the program and while NCNB Corporation is a minority owner, it will continue to manage the new bank substantially as if it were its subsidiary. Under the controlling agreement, however, NCNB must consult with the FDIC regarding decisions on business operations and strategies, must provide reports to the FDIC and may not take any action objected to by the FDIC.

Upon NCNB Corporation's exercise of the purchase option to increase its ownership to 51 percent or more, it will assume full control of the new bank. Once NCNB Corporation increases its ownership to 80 percent or more, it will be required to purchase the FDIC's remaining interest at the agreed premium.

Chronology of the Transaction. The decision to proceed with the restructuring and recapitalization plan proposed by NCNB Corporation followed extensive negotiations with several interested parties. The FDIC Board of Directors requested and received two separately prepared analyses on the proposed plans. One was prepared by the internal staff of the FDIC and the other by

Dillon, Read & Co., an investment banking firm retained by the FDIC. The conclusions reached in the two separate analyses were substantially similar.

In the late afternoon of July 29, 1988, the FDIC Board of Directors decided that NCNB Corporation's plan represented the most effective, most viable, and least costly approach for preserving existing banking services in the affected communities and promoting stability in the Texas banking system. Following this determination, the FDIC notified the Office of the Comptroller of the Currency and the Texas Commissioner of Banking that it would not provide additional assistance to the subsidiary banks of First RepublicBank Corporation and would not renew its $1 billion loan to the First Republic Banks when it became due in September.

In response to the FDIC's decision, the Comptroller of the Currency notified the Federal Reserve Bank of Dallas that First RepublicBank Dallas, N.A. was no longer a viable bank. The OCC's notice was based on continuing severe loan losses at First RepublicBank Dallas, N.A. which already had more than depleted the institution's equity capital, the FDIC's decision not to provide open-bank assistance, a determination that First RepublicBank Dallas, N.A. would be unable to meet its daily funding needs without the continuing substantial support of the Federal Reserve Bank, and other factors.

The Federal Reserve Bank of Dallas then requested repayment of the Dallas Bank's borrowings. First Republic Bank Dallas, N.A. was unable to repay its obligations, which resulted in its closure by the OCC and the appointment of the FDIC as receiver.

When the Dallas bank closed, virtually all the other First Republic Banks were providing fed funds to the bank. These obligations were not insured, and had been subordinated to the obligations of the Dallas and Houston banks to the FDIC. Receivership certificates were issued for these uninsured, subordinated obligations, which were then valued based upon the losses in the Dallas and Houston banks. Further, under the terms of the emergency assistance from the FDIC, the insolvency of the Dallas bank was an event of default that resulted in the FDIC's demanding immediate repayment of its $1 billion loan. This loan had been guaranteed by the subsidiary banks. The amount of the banks' guarantee was charged against their capital accounts. Losses as a result of these charges and other intracompany transactions rendered the other banks insolvent. Those banks were then closed by their chartering authorities, the FDIC was appointed receiver, and the transfer of assets and liabilities of the failed bank to the newly created bridge bank was approved by the appropriate state and federal courts.

PROPOSED EMERGENCY CONSOLIDATION LEGISLATION

Our experience with First Republic and other recent transactions suggests that the FDIC's proposed emergency consolidation legislation (previously distributed to the Committee members) is urgently required so that all parties will operate under the certainty of federal statutory law. If such a law is not passed, future holding company financing may seek to prevent the FDIC from carrying out the procedures used in the First Republic transaction. The proposed legislative measure would establish special procedures for dealing with failing banks in multibank holding companies to ensure that all banks in the holding company support the insurance fund.

Multibank holding companies generally coordinate their banks' activities so closely that the bank holding company system effectively operates as a single banking enterprise. Yet when a bank within the system fails, the FDIC must deal with that bank individually.

The proposed emergency procedures are designed to ensure that the appropriate banking assets of a multibank holding company system are applied to assist a failing subsidiary bank prior to requiring the expenditure of FDIC funds. In essence, it would facilitate FDIC efforts to prevent the federal safety net from being extended to holding companies and eliminate the increased cost to the insurance fund that banks in unit banking states can impose, when compared with banks in branching states.

Mr. Chairman, I would be pleased to respond at this time to any questions you or the other members of the Committee may have.