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STATEMENT ON

FDIC PROCEDURES IN HANDLING FAILED OR FAILING BANKS

PRESENTED TO

COMMERCE, CONSUMER, AND MONETARY AFFAIRS SUBCOMMITTEE
COMMITTEE ON GOVERNMENT OPERATIONS
HOUSE OF REPRESENTATIVES

BY

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FEDERAL DEPOSIT INSURANCE CORPORATION

9:30 A.M.
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RAYBURN HOUSE OFFICE BUILDING

I am pleased to respond to your request for information on how the FDIC handles its responsibilities in cases of troubled or failed banks.

First of all, I wish to report that the Federal Deposit Insurance Fund exceeds \$11.5 billion and is growing.

But the Corporation's most important asset is its staff of 3,500 trained, capable, and dedicated employees who are engaged in the day-to-day tasks attendant to bank supervision, as well as the infrequent but more visible activities involving failed or near-failing institutions.

Since the FDIC commenced operations on January 1, 1934, it has handled 572 bank failures, including two involving mutual savings banks.* In 311 of those cases, insured depositors were paid off, including 29 cases where Deposit Insurance National Banks were established to facilitate the payoff. In the remaining 261 cases, the FDIC permitted third parties to purchase certain assets and assume certain liabilities of the failed banks. In addition, capital infusion was made in five instances to avert a failure.

Bank failures have averaged seven per year since 1965. Ten banks failed in 1979, ten failed in 1980, and thus far in

* Winooski Savings Bank (1938)

Winooski, Vermont

\$2.5 million in deposits -- pay-off

St. Joseph County Savings Bank (1939)

South Bend, Indiana

\$1.6 million in deposits -- purchase and assumption

1981, four have failed. I personally have been involved in FDIC activities related to 47 bank failures and three cases of assistance to avert a failure during my two terms on the FDIC Board.

Some 210 insured banks were considered supervisory problems on June 30, 1981, compared with 217 at the end of 1980. The amount of assets represented by those banks increased during the six-month period. We do not use these totals as important indicators or significant planning tools and we caution you against attributing too much value to them. Our emphasis is on problem banks, not problem lists.

This Subcommittee has posed a number of questions about the manner in which the FDIC handles failed or near-failing institutions. The Subcommittee also asks about the use of futures, forwards and standby contracts in the banking industry. My remarks will address these questions and cover other aspects of the bank regulatory scene today.

BANK MONITORING

We consider a bank to be a potential failure when it appears that it will involve the Corporation in the near term in some form of financial outlay: deposit payoff, assistance under Section 13(c) of the FDI Act, or an assisted purchase and assumption under Section 13(e) of our Act. The bank is expected to reach insolvency within a short time and management likely will be unable to recapitalize the bank or

cure other problems which are contributing to its decline. Our entire examination program, plus our monitoring system, bank reporting requirements and our working relationships with other regulators are all pointed to identification of banks in a deteriorating condition.

A bank that is regarded as a potential failure is under constant supervision. The bank at minimum is subject to frequent examinations or visits, and examiners may be present in the bank on a fulltime basis. There are frequent meetings involving the FDIC Regional Director and staff and the bank's board of directors and senior management. In some instances, daily reports on the bank's condition are made to the Regional Director and, in turn, are forwarded to the Washington Office. If the failing bank is a national or State member bank, the FDIC staff works with its partner Federal regulators in the various national bank regions or Federal Reserve District Banks, as appropriate, and the Washington offices of these agencies. In the case of State member and nonmember banks, we maintain close contact and coordination with the appropriate State banking authority.

MUTUAL SAVINGS BANKS

The inflation-caused plight of the thrift industry has been well publicized. The FDIC insures 79 mutual savings banks having assets in excess of \$500 million, of which 42 sustained operating losses during fiscal year 1980. This year the number

of institutions of this size experiencing losses has accelerated, and during the first five months of 1981, sixty-five operated at a loss. The problem is concentrated in New York City but not limited to that city.

There still remains an extremely large pool of mutual savings bank capital available to sustain the industry for a considerable period of years, although individual institutions may well be troubled earlier if the present inflation and interest rate environment continues.

Mutual savings banks are not beset with the problems of poor asset quality and exorbitant loan losses which have typically characterized commercial banks that fail. The problem of most mutual savings banks is the result of an imbalance in the maturity and interest rate sensitivity of their assets (basically long-term, fixed rate mortgages and investment securities) and liabilities (largely short-term deposits). The escalating level and volatile nature of interest rates over the past few years has resulted in a high cost of funds which cannot be fully offset by restructuring or repricing of asset portfolios.

Since we cannot predict the future course of interest rates, we are unable to predict, as you requested, if any banks or \$500 million or more in deposits face the prospect of failure or when such a prospect might begin to materialize. We are, however, watching developments within the industry

generally and within individual banks, and are confident of our ability to deal with whatever eventuality might arise.

FAILED OR NEAR-FAILING BANK OPTIONS

The FDIC now has seven options for handling failed or near failing banks. First, FDIC can pay off insured depositors of a failed bank. This was done, for example, earlier this year in the failure of The Des Plaines Bank, Des Plaines, Illinois, and it was done in three bank failures in 1980 and three in 1979. In the Des Plaines case, the bank had total deposits of \$42.9 million in 15,000 accounts. In a payoff, depositors are paid to the statutory limit of \$100,000. Account holders with deposits exceeding the limit and other creditors receive a pro rata share of the proceeds from the liquidation of the bank's assets over a period of years.

FDIC's second option is what we call a purchase and assumption (P&A) transaction between banking organizations in the same State. Healthy existing banking organizations or new organizations bid to assume the deposit liabilities of the failed bank and to purchase certain assets and the failed bank's goodwill. Such transactions have been arranged in three cases this year and seven times each in 1980 and 1979. One notable example of this procedure occurred in 1973 when the \$1.3 billion United States National Bank of San Diego, California, failed. There, FDIC as Receiver of the bank, arranged a purchase and assumption transaction in which Crocker National Bank was the successful bidder. A purchase and assumption transaction by

law must be projected to be less expensive than a payoff. In practice, such transactions have also proved to be less disruptive. Depositors and other general creditors recover all their funds, and banking service continues with little or no interruption, normally at the same location.

A third option takes the form of a purchase and assumption transaction involving foreign interests. This has occurred six times, the most highly publicized in 1974 after the failure of the Franklin National Bank in New York. Franklin, at the time of its failure, had over \$3.6 billion in assets and \$1.4 billion in deposits. It was sold to European American Bank & Trust Company, which is owned by a consortium of European banks.

A fourth option, also a variation of the purchase and assumption procedure, is to partition the failed bank's assets and liabilities and arrange for the transfer of asset-liability packages to more than one participating bank. This occurred after the 1978 failure of the \$607.6 million Banco Credito y Ahorro Ponceño of Ponce, Puerto Rico. FDIC divided the bank between two assuming banks which lessened the anti-competitive effects of the transaction.

FDIC's fifth option, under very limited circumstances, is to provide assistance in order to prevent the failure of a troubled bank. This has occurred only five times since FDIC received the power in 1950, most recently last year when FDIC, along with 27 banks, loaned the First Pennsylvania Bank \$500

million to avert its failure. As a condition to receiving FDIC assistance, all directors and principal officers serve subject to FDIC approval, and FDIC must approve their compensation. FDIC also must sanction any dividends and the bank's "plans and objectives". FDIC also received warrants for the purchase of First Pennsylvania Corporation's common stock. These are some of the key conditions which we tailored for the First Pennsylvania assistance. In another such case, we would expect to develop a similar but separate set of terms and conditions as necessary to meet the situation.

A sixth option, under Section 13(e) of the FDI Act, involves assistance to facilitate the merger of a failing bank into a healthy bank prior to actual failure, but this procedure is rarely used for a variety of reasons. The most recent instance was in November, 1975, when the Corporation authorized a loan of up to \$10 million to facilitate the merger of Palmer First National Bank and Trust Company of Sarasota, Florida, into a newly formed national bank subsidiary of Southeast Banking Corporation of Miami, after written confirmations were received from the Comptroller of the Currency and the Board of Governors of the Federal Reserve System that such assistance was essential to effect the proposed acquisition and to prevent the imminent failure of the Palmer Bank.

A seventh option is a Deposit Insurance National Bank (DINB). The DINB would serve solely as a vehicle for the orderly payoff of insured deposits. In 1975 the Corporation established

two DINB's in connection with the closings of the Swope Parkway National Bank, Kansas City, Missouri, and The Peoples Bank of the Virgin Islands, St. Thomas, Charlotte Amalie, Virgin Islands.

PROPOSED LEGISLATION

We have proposed to the Congress and solicit your active and aggressive support for legislation to provide an eighth and ninth option: to modify the statutory Section 13(c) test to enable us to make capital infusions more easily, particularly in the New York thrifts, and to permit FDIC as the Receiver of a large failed FDIC-insured bank to arrange a Section 13(e) purchase and assumption transaction with an out-of-State institution, but only if the failed bank had \$2 billion or more in assets. Only 107 banks in the Nation would be eligible -- 89 commercial and 18 savings banks in 26 States, concentrated in New York, California, Ohio, Texas, Pennsylvania and Illinois. The qualifying size is indexed so inflation will not artificially increase the universe of eligible institutions. The other 15,000 smaller banks in the nation would not be affected and have no reason whatsoever to oppose our seeking a large bank solution.

Our legislation is designed to give FDIC powers which are similar to those that the Federal Savings and Loan Insurance Corporation (FSLIC) already has. Currently, FSLIC may provide assistance to an insured S&L even if the association is not essential to its community and FSLIC may assist the merger of a failing insured S&L with an out-of-State Federal S&L. The proposed legislation gives FDIC similar capabilities. Because of

the unique nature of the various financial institutions, total comparability between FSLIC and FDIC powers probably is not desirable. Our legislation, however, will provide greater comparability between the two insuring agencies.

In the case of the failure of a bank of qualifying size, FDIC could consider this new alternative for arranging a purchase and assumption transaction, together with all the other possible courses of action. The interstate option would permit the FDIC to consider a course that would produce a meaningful purchase premium for assets, avoid anticompetitive effects and continue banking service.

Under the interstate option the FDIC would be required to inform the State banking superintendent in advance whenever the FDIC determines that the interstate option might be used. This is true whether a national or State-chartered bank is involved. If the State superintendent objects to an out-of-State transaction and FDIC agrees with the superintendent's reasons, then FDIC would abandon the interstate option and attempt to arrange an in-State purchase and assumption transaction or proceed with an insurance payoff. The FDIC can go forward with the interstate option, the superintendent's objections notwithstanding. However, before any out-of-State transaction may be made, the Board of Directors of the FDIC must unanimously agree on the decision. The Board also must provide the superintendent with a written certification of its determination.

Under the interstate option, FDIC as the Receiver of a failed bank of qualifying size would solicit offers from any bank and bank holding companies in the country that the FDIC determines are qualified and capable of acquiring assets and liabilities of the failed bank. If the highest acceptable bid is from an out-of-State bank or bank holding company, the FDIC must provide the highest in-State offeror an opportunity to make a higher offer. If the in-State offeror offers more, then FDIC must accept. If the in-State offeror does not, FDIC must give the same opportunity to the highest offeror from a State adjoining the State in which the closed bank was located. If the adjacent State offeror also declines, then the FDIC may accept the high bid, regardless of the location of the bidder.

This section of the bill would provide that a winning out-of-State bidder may reopen a closed bank only as a subsidiary so that no interstate branching will result. State banking law will prevail in the operation of the subsidiary. The section would authorize operation of the subsidiary, the Douglas Amendment notwithstanding. The section also would require that before any sale may be accomplished, appropriate State and Federal approvals must be obtained. For instance, a bank holding company must have approval of the Federal Reserve to acquire assets of a closed bank as a subsidiary. The section would prohibit FDIC from making any sale that would have serious anticompetitive results. Finally, the section has a five-year sunset provision.

The other basic change in our law would enable the FDIC to provide assistance to institutions whose problems stem principally from such causes as the interest rate squeeze.

Currently, the FDIC can provide assistance to a bank only when it is in danger of failing and its continued operation is essential to provide adequate banking services in the community. The bill would modify FDIC powers to permit it also to act when it finds that severe financial conditions exist which threaten the stability of a significant number of insured banks and it is probable that any assistance to one of these threatened banks will substantially reduce the risk of loss or avert a threatened loss to the FDIC. This new test for assistance provides the FDIC with the needed flexibility to react to severe financial conditions as they arise. Unlike the current test which focuses exclusively on the essentiality of a single failing institution, the proposed new test focuses on severe financial conditions affecting the stability of a significant number of insured banks. Significance may be measured not only in terms of the total number of institutions, but also in terms of the total resources of the threatened institutions. In every instance, FDIC could provide assistance only where such action "will substantially reduce the risk of loss or avert a threatened loss to the Corporation". Essentially, this means that to qualify for assistance a bank must be among a significant number of banks whose stability is threatened by severe financial conditions, there must be a clear threat that without assistance the bank will fail, and it is probable that assistance will be "substantially" less expensive to the FDIC than other methods of handling the potential failure.

In addition to the two basic FDIC provisions, the proposed legislation makes related changes in our law to make the total process more workable. These are:

(A). A provision that would clarify that foregone earnings resulting from FDIC loans to insured institutions are insurance losses. Currently, FDIC may deduct from assessments received from insured banks any insurance losses it experiences before calculating the proportion of the assessments to rebate to the banks. For example, in a typical purchase and assumption transaction, that portion of projected losses not recovered by the purchase premium would be established as a reserve account and charged against assessment income. In other words, the FDIC would experience an insurance loss that may be deducted from assessments. A below-market-rate loan also would result in a loss to the FDIC of the difference between what FDIC could earn on the funds if left in FDIC's portfolio and what it is earning from the loan. This opportunity loss is no different from a loss arising from a P&A. The structure of the transaction should not determine whether a loss can be recognized for insurance fund purposes. The FDIC seeks to clarify that this opportunity loss also is deductible from assessments. The FDIC is totally self-funded -- that is, funded by bank assessments and interest income rather than by public monies. This amendment will facilitate that result continuing.

(B). A provision that would broaden the field of institutions which may purchase the assets and assume the liabilities .

of a failed bank. In addition to FDIC-insured banks, under the proposal associations or banks insured by the Federal Savings and Loan Insurance Corporation would become eligible bidders.

BUDGET IMPACT

We are fully aware of the budget problems facing our government and we believe our proposed legislation will minimize the budgetary impact of future bank failures. While we have a separate fund, every expenditure of the FDIC represents a Federal expenditure and has a budgetary impact. We believe the powers we are asking for will result in a smaller outlay and lower cost to the FDIC than if we are forced to use only the alternatives now available to us. By minimizing FDIC's costs, we will, in turn, minimize the potential budgetary impact of future failures.

THE NEED FOR ACTION

We are talking today about emergency legislation to meet a specific need. The Congress will also be considering broad, comprehensive and certainly controversial legislation to greatly expand the authority of thrift institutions with commercial bank powers and to address such questions as due on sale clauses, insurance limits, usury ceilings, plus possibly export trading companies and other matters.

We urge you to keep the issues separate: act now on the limited emergency bill needed now; deliberate and act later on the more comprehensive long term legislation.

The balance of this statement represents our best effort to respond in detail to the sequence of questions from your staff by letter, telephone and personal visit over the past few weeks.

PURCHASE AND ASSUMPTION TRANSACTION

Section 13(e) of the Federal Deposit Insurance Act authorizes the FDIC to arrange purchase and assumption transactions "whenever in the judgment of the Board of Directors such action will reduce the risk or avert a threatened loss of the Corporation" Each prospective purchase and assumption transaction is measured against that fundamental test.

When any insured bank fails, FDIC estimates the extent of the bank's dollar shortfall -- basically, total liabilities minus the collection value of assets. This establishes the book loss. That number is multiplied by the percentage of insured deposits to total liabilities. That calculation yields the estimated loss to the FDIC. The difference between the total loss and FDIC's loss is the amount which will be absorbed by the uninsured and unsecured creditors. If a third party is willing to bid an amount exceeding the estimated amount of loss to be sustained by these creditors, then a purchase and assumption transaction becomes less expensive to the FDIC than a pay-out. If the purchase and assumption transaction occurs under such circumstances, FDIC emerges with less loss than otherwise would have been the case, and, incidentally, all general creditors are made whole.

There are three fundamental constraints to arranging a purchase and assumption transaction: (1) there must be interested and qualified bidders, one of which at least must bid an amount sufficient to make the transaction cost effective for FDIC; (2) the prospective takeover must not represent an unacceptable anticompetitive solution; and (3) the FDIC must be able to determine with reasonable certainty the true financial condition of the failed bank. If there are contingent liabilities of unknown consequence, or if the assets for some reason cannot be accurately evaluated, or if there is a possibility that substantial unbooked liabilities exist, then we cannot accomplish the first step of calculating liabilities minus assets with any reasonable degree of certainty. In such cases, a payoff is usually indicated.

REASONS FOR DEPOSIT PAYOFFS

The following summarizes the reasons for each of the deposit payoffs by FDIC in recent years:

1978 - Faunsdale, Alabama	No interested parties could be found for a P & A.
1979 - Pueblo West, Colorado	FDIC failed to receive an acceptable bid.
Enville, Tennessee	No interested parties could be found for a P&A. Efforts to negotiate a P&A were unsuccessful.
Protection, Kansas	Volume of known and potential contingent liabilities made it impossible to do a P&A. State law limited options.

1980 - Lake Helen, Florida	Volume and uncertain nature of the bank's liabilities made it impossible to do a P&A.
Carrington, North Dakota	Significant degree of uncertainty about the quality of the bank's assets made it impossible to do a P&A.
Viola, Kansas	State law limitations on branching and holding companies precluded an existing banking organization from coming in. State law inhibited chartering of a new bank.
1981 - Des Plaines, Illinois	Significant degree of uncertainty about nature and quality of the bank's assets and the existence of significant contingent liabilities made it impossible to do a P&A.

P&A FOR INSURED DEPOSITS ONLY

It is perhaps legally feasible to structure an assistance transaction involving the assumption of insured deposits only. However, such a transaction would not be a traditional P&A, and in fact, such a transaction would be no more than a payoff of insured depositors through another bank, rather than directly through the FDIC or through the use of a Deposit Insurance National Bank. We can see no advantages in structuring an assistance transaction in this way and we can see several disadvantages.

First, the premium offered by the assuming bank would undoubtedly be less than it would offer to assume all of the deposit liabilities of the failed bank.

Second, the initial cash outlay by the FDIC to the assuming bank would likely be much more than a normal P&A transaction and could be as much as a straight payoff. Usually the assuming bank takes a substantial amount of the failed bank's assets as part of the transaction, thus reducing the FDIC's cash outlay (which is the difference between the deposit liabilities assumed and the assets purchased, less the premium). The National Bank Act and many State banking laws require ratable distributions to all creditors of failed banks. By transferring good assets from the receivership, FDIC would dilute the estate for the creditors (resulting in a distribution which would not be ratable) unless the receivership received full value for these assets. Therefore, FDIC itself would have to transfer cash into the receivership to cover the assets transferred to the assuming bank. This cash outlay would be in addition to the cash which would be paid to the assuming bank to cover the unacceptable assets normally kept by the FDIC and liquidated and this would result in a transaction that makes little economic sense.

Finally, with respect to depositors who have deposits in excess of the insured limit, and whose deposits consist of a mixture of demand, savings and time deposits, it would be difficult to allocate which of these various deposits, or which portions of these deposits, would be assumed. Moreover, FDIC would incur the additional expense of calculating insured deposits for individual account holders, a procedure that is not necessary for a full P&A and that at present is done only for payoffs. Depositors would also have to be notified of

their insured and uninsured balances, and that can be expected to engender customer ill will and confusion as well as dollar costs.

The major selling point of the traditional P&A to the assuming bank has been the fact that the transaction is easy for the depositors to understand -- depositors continue to do business with the assuming bank without any interruption in service.

In general, purchase and assumption transactions have worked exceptionally well because the assuming banks have acquired a going concern, including any goodwill left with the closed bank. The operation is substantially similar to a merger, with little customer disruption.

P&A FOR A LARGE SAVINGS BANK

Increasing attention is focusing on our ability to arrange a purchase and assumption should one of the large mutual savings banks fail. The major problem in the event of the failure of a large MSB would be finding a qualified bidder big enough to absorb the increased size and having sufficient capital strength and management ability to acquire it. Our options in seeking an acceptable purchaser would be expanded if we could look to other industries or to interstate acquisitions. We have authority to approve a P&A of a closed MSB by a commercial bank and, in fact, intend to include commercial banks from the same State on lists of potential bidders should the occasion arise.

The cost test of the statute is the basic criterion FDIC must meet in deciding on a P&A versus a payoff. The test is the same for a large or a small bank or a commercial bank or savings bank. Reduced cost to the FDI fund is the test that must be met. Implicit in meeting the cost test is the practical problem of finding a willing and acceptable bidder. That is why we seek legislation and see no reason for the Congress to deny us this option. If it is not needed, no harm is done. If it is needed, it will really be needed.

THE FIRST PENNSYLVANIA BANK TRANSACTION

In providing assistance under Section 13(c) of the FDI Act, the FDIC Board must find that the continued operation of the bank is essential to provide adequate banking service to the community. In the case of First Pennsylvania Bank, FDIC's determination was not based on any single factor. Instead, FDIC considered various services rendered by the bank and determined that the continued operation of First Pennsylvania was essential to provide these services at an adequate level in its community (the five-county Delaware Valley area in and around Philadelphia). The FDIC considered the following aspects of the bank's operations significant:

(1) At the time, the bank was the largest bank in Philadelphia, the second largest bank in Pennsylvania, and the twenty-third largest bank in the United States.

(2) The bank had 69 offices, with 40 offices in the Philadelphia area.

(3) The bank had approximately 583,000 depositors.

(4) The bank had over 270,000 consumer loans and credit card customers with total outstanding balances of \$425 million.

(5) The bank had approximately 2,000 borrowers serviced by its small business unit (customers with sales of \$5 million and under), with total outstanding balances of \$80 million.

(6) The bank had been involved in several major programs to help in the revitalization of the City of Philadelphia, including the Philadelphia Mortgage Plan, which carried over 1,000 residential mortgage loans in inner city neighborhoods.

(7) The bank was heavily involved in construction and land loans in the Delaware Valley market; at the time, it had over \$100 million in commitments to local builders.

(8) The bank had a permanent mortgage portfolio with companies located in the Delaware Valley of \$223 million.

(9) Commercial lending in the bank's region was approximately \$500 million, plus unfunded commitments of \$500 million.

(10) Each year the bank cleared 10 million share drafts for credit unions and had a full-time staff serving credit unions.

(11) The bank was the largest lender to the City of Philadelphia and the Philadelphia School District.

(12) The bank had a subsidiary which handled direct delivery of welfare checks and the distribution of food stamps in the City of Philadelphia.

(13) The bank's Trust and Investment Group managed approximately 8,500 personal fiduciary accounts with \$1.8 billion in assets for 24,000 beneficiaries, most of whom resided in the bank's trade area.

(14) The bank employed 4,000 people in the Philadelphia area, paying annual salaries of over \$60 million to these employees.

In addition, the FDIC considered the disruptive effects that paying off 583,000 depositors would have on the community, the potentially serious anticompetitive problems associated with a purchase and assumption transaction involving another Pennsylvania bank, and the willingness of other banks in the Philadelphia area to provide financial assistance to keep First Pennsylvania afloat.

The bank's essentiality to its community was the controlling factor in the FDIC's decision to extend assistance. However, some other practical considerations are worth noting.

On March 31, 1980, First Pennsylvania Bank had almost \$8 billion in domestic and foreign assets and about \$2.9 billion

in domestic deposits. If it had been forced to close its doors, First Pennsylvania would have been by far the largest bank failure in the history of the U. S. financial system.

The closing of a bank of this size would have required the devotion of significant personnel and financial resources on the part of the FDIC. Whether payoff or purchase and assumption, the FDIC would have been required to provide a fair amount of cash up front, and would have been faced with the task of liquidating some portion of the asset portfolio over a number of years. Based on our experience with the Franklin National Bank liquidation, this activity could last 15 or more years.

While it is always difficult to precisely determine the loss that will be incurred in a closed bank situation, paying off or arranging a purchase and assumption transaction for First Pennsylvania would have resulted in significant expenses. FDIC foregone interest on our cash outlay could have been as high as \$500 million and administrative expenses could have run as high as \$70 million. Over the course of the liquidation, we would expect some of these expenses to have been recovered.

Although these were the practical considerations that confronted us at the time, the FDIC also had before it a request for Section 13(c) assistance and made a finding of the bank's essentiality to its community. Moreover, the bank had not been closed by the Comptroller of the Currency, the primary supervisor.

Yet another factor was the additional exposure to the FDIC's insurance fund if a failure of this magnitude, in a generally unstable financial environment, were to undermine confidence in our banking system. Although we did not attempt to calculate this potential impact, we recognized the possibility as real nonetheless.

It must be remembered that in mid-March of last year, the Federal Reserve System imposed a series of credit controls on financial institutions. This took place as interest rates were rising rapidly in the first quarter of the year to the record levels set at the end of March and early April. A prime rate of 20 percent and a three-month Treasury Bill rate of 15.61 percent were recorded only a month before our April 28 announcement of financial assistance to First Pennsylvania. The combination of credit controls and record high interest rates was prompting some economists to forecast a recession deeper than any since the Great Depression. The commodity markets, notably silver, were in disarray.

Financial markets were able to absorb the previous billion dollar bank failures (U. S. National Bank in October 1973 and Franklin National Bank in October 1974) with little noticeable disruption. However, those failures occurred when interest rates were slightly more than half the levels reached in the Spring of 1980. First Pennsylvania was suffering from interest rate sensitivity problems which were becoming pervasive throughout the banking and thrift industries. Since these problems

received some publicity at the time, a failure of First Pennsylvania could have triggered deposit withdrawals from other institutions, and this in turn under certain circumstances might have caused some of these banks and/or thrift institutions to require financial assistance or fail. The resulting demands on our insurance fund could have been greater than the specific impact of the First Pennsylvania assistance.

The determination of the Corporation's opportunity cost for the First Pennsylvania assistance transaction is a subjective matter, based primarily on the rates of return we could otherwise have obtained via investments in U.S. Treasury securities. The assistance provided for a five-year loan of \$325 million with no interest payments during the first year and quarterly interest payments during the succeeding four years, at a rate of 125 percent of the Corporation's portfolio yield to maturity at purchase. This yield will change quarter to quarter as the composition of our investment portfolio changes. To deal with the question concretely, we have divided the transaction into two parts. First, we will estimate the opportunity cost for the first year of the transaction. Secondly, we will explain the considerations in assessing the costs of the remaining four years of the transaction.

We estimate the opportunity cost of the first year at between \$29.6 and \$41.8 million. This disparity results from the use of two different assumptions in estimating costs and stems largely from extreme volatility in rates during the first

year of the transaction. The lower figure results from the use of our average internal rate of return of 9.13 percent on our investment portfolio for the period June 1, 1980 to May 31, 1981. The higher figure, and perhaps more realistic estimate, results from the assumed employment of the \$325 million in six-month U.S. Treasury bills during the first year of the loan.

As to the remaining years of the loan, the linkage of the interest rate on the note to 125 percent of our portfolio yield to maturity at purchase makes a precise quantification of the opportunity gain/loss to maturity exceedingly difficult. If interest rates on U.S. Treasury securities over the next few years fall significantly, the Corporation may incur a gain from the transaction for years two through five due to the portfolio's average maturity which currently approximates three and one-half years. However, should interest rates continue to rise, it is likely that an opportunity loss for years two through five would result because the 125 percent of the portfolio historic yield to maturity at purchase would remain less than alternative market investments.

FACTORS CONSIDERED IN 13(c) FINDINGS

Factors the FDIC would consider in making a future determination of essentiality under Section 13(c), either in the case of a savings bank or a commercial bank, will vary because no two banks occupy precisely the same place in their respective communities. In two previous instances FDIC made assistance available under Section 13(c) to banks which played a unique, if

limited, role in their communities. In 1971, FDIC loaned \$1.5 million to Unity Bank and Trust Co., Boston, Massachusetts, after determining that the continued operation of Unity, a minority-owned bank, was essential to provide adequate banking service in two minority communities of Boston, Roxbury and Dorchester. In 1976, FDIC purchased \$40 million worth of questionable assets from Farmers Bank of the State of Delaware, Dover, Delaware, for \$32 million. The continued operation of this bank was deemed essential because it was the sole depository for funds belonging to the State of Delaware and its closing would have had a seriously adverse financial impact on the State. By contrast, the granting of Section 13(c) assistance to the Bank of the Commonwealth, Detroit, Michigan, in 1972, and to First Pennsylvania in 1980 involved the consideration of a variety of banking services and, in the case of BOC, more than one "community".

Structuring of a 13(c) assistance transaction requires careful balancing. Sufficient assistance must be provided, yet care must be exercised to assure that shareholders and management do not unduly benefit. Our purpose is to protect depositors and assure the maintenance of adequate banking services in the community. The stockholders and management are expected to bear the consequences of the bank's financial difficulties. As was the case with First Pennsylvania, severe restrictions are placed on management and on the rights of shareholders as a part of any 13(c) transaction until such time as the FDIC's financial commitment has been repaid and

the bank's viability restored. While these restrictions are not punitive in nature, they usually are onerous. Because of the Corporation's limited use of its 13(c) powers as well as the strict limitations placed on management and ownership in connection with its use, the industry does not regard 13(c) assistance as a "bail-out" which would justify the assumption of excessive risk in other institutions. We have been very selective and careful in our use of this power in order that such a perception would not arise.

DEPOSIT PAYOFF PROCEDURES FOR A LARGE BANK

In the event of a deposit payoff, the FDIC immediately begins making payment in full to each depositor up to the insurance limit and, when designated as receiver, begins liquidating the assets of the failed bank. Such assets include loans and investments, bank buildings and equipment and security from defaulted loans. In a payoff, the FDIC shares any liquidation proceeds proportionately with depositors having accounts in excess of the insurance limit and with other general creditors. The FDIC converts the assets of closed banks to cash as early as practicable and strives to realize maximum recovery.

The largest deposit payoff in the Corporation's history involved the Sharpstown State Bank of Houston, Texas. The bank closed on January 25, 1971, and payment to 27,403 depositors with accounts totalling \$66.9 million began on February 2, 1971.

Subsequent experience has resulted in the conclusion that the most efficient and suitable method to handle the payoff of deposits of a very large institution would be to establish a Deposit Insurance National Bank (DINB), provision for which is contained in Section 11(h) of the FDI Act, as follows:

"As soon as possible after the closing of an insured bank, the Corporation, if it finds that it is advisable and in the interest of the depositors of the closed bank or the public, shall organize a new national bank to assume the insured deposits of such closed bank and otherwise to perform temporarily the functions hereinafter provided for. The new bank shall have its place of business in the same community as the closed bank."

I must emphasize that the law says the DINB will assume the insured deposits. We still are talking about a payoff of insured deposits. This is just another way to do it.

The advantages to depositors and the public of using a limited DINB as a payoff vehicle include the following:

- (1) Depositors will have quicker access to their funds as the time needed for preparation of a payoff will be greatly reduced.
- (2) The continued clearing of demand and/or NOW account checks can continue after the bank opens.
- (3) It will provide for an orderly runoff of deposits.
- (4) We will be able to continue to use the closed institution's data processing equipment to account for the payment of insured deposits.

(5) We will be able to continue to use the closed institution's existing supplies of records, checks, etc.

(6) Depositors will be able to open accounts at other institutions by simply sending a collection draft through existing clearing exchanges for the customer's insured balance. This procedure should reduce long lines of depositors waiting at the closed bank's office for payment from the FDIC.

(7) Employees of the closed institution, under the direction of the FDIC, will be able to handle the routine closing of insured accounts thereby requiring only a fraction of the FDIC force that would be needed using procedures in effect for smaller payoff cases.

The DINB would serve solely as a vehicle for the orderly payment of deposit insurance. There would be a short "freeze" period of approximately five business days to allow for accrual of interest on time and savings deposits to the date of closing, exercising the Receiver's right of offset on past due loans, combining accounts held in the same right and capacity for insurance purposes, and then debiting the accounts of the uninsured depositors for the amount in excess of the insured maximum, and placing holds on pledged deposits or other accounts on which the Receiver may wish to withhold payment.

Once this activity has been completed, the DINB can open and begin making insured deposits available in a relatively short period of time.

The DINB almost invariably would operate from the bank building. As a protracted payout vehicle, the DINB would engage primarily in check clearing activities and receipt of loan payments. There would be no loan generation operations and no deposit taking. The DINB's purpose is to wind up affairs in an orderly fashion. We would expect business for the DINB to slack off sharply after the first two or three months.

Without referring to a specific institution, it is difficult to develop information on staffing requirements for operation of a DINB as a payoff vehicle and liquidation of the closed institution's assets. This will vary from bank to bank depending on the asset mix and the size and number of branches. For the purpose of example we will use a \$2 billion dollar institution with 15 branches. In addition to the employees of the closed institution that will be needed for the operation of a DINB, based upon prior liquidation experience, we anticipate the need for 300 FDIC examiners and/or liquidators. This allows for the assignment of 15 examiners/liquidators at each branch with the remaining force of 75 assigned to the main office. It is anticipated that all personnel will be needed for at least 180 days, with a gradual reduction in force to 90 personnel over the next 180-day period. After the initial stages of the closing, FDIC personnel will concentrate on the liquidation of assets. The numbers in the example are based on the assumption that the FDIC will be able to liquidate the majority of the closed bank's assets within one year.

OPEN BANK MERGER ASSISTANCE

The FDIC has not used the alternative of assistance to facilitate the merger of a failing bank into a healthy bank prior to actual failure in recent years for several reasons. First, such assistance usually involves a financial benefit to stockholders of the failing bank. The FDIC does not believe that the deposit insurance fund should be used to benefit stockholders of failing banks, directly or indirectly through financial assistance to the bank. This concern was largely satisfied in the First Pennsylvania transaction, described in detail earlier in this statement, by requiring that the parent holding company issue warrants for the purchase of stock to the FDIC, thus diluting the interest of the stockholders. A P&A transaction through a receivership cuts off rights of stockholders. Second, in most jurisdictions, stockholder approval is required for such a merger, which involves a full disclosure of the bank's failing financial condition. FDIC has been concerned that such a disclosure would cause the bank's condition to become public knowledge and cause a run on the bank, rendering the bank insolvent from a liquidity test standpoint before the merger could be completed. These first two concerns are not present in connection with a failing mutual savings bank, which has no stockholders. Finally, such a transaction does not involve court approval and subjects the FDIC to the risk of litigation. In a P&A transaction entered into after the FDIC has been appointed receiver of the failed bank, the entire transaction is presented to the receivership court, often in an

adversary proceeding, and the FDIC must convince the court that the P&A is to the best interests of the creditors and depositors of the bank. In the 1970s, case law was developed recognizing this type of transaction, much of it resulting from lawsuits against the FDIC, usually by stockholders of the failed bank. The fact that the transaction was approved by a court has been an influential factor in the ultimate decisions in these cases.

FUTURES, FORWARDS AND STANDBY CONTRACTS

Our analysis of bank failures of the last year and a half reveals no evidence that speculative trading in futures, forward and standby contracts was a factor in these failures.

Nonetheless, we joined in November 1979 with the Office of the Comptroller of the Currency and the Federal Reserve Board in issuing a policy statement setting precautionary rules and specific guidelines for banks that engage in such activities. The guidelines include directives on the role of bank boards of directors, recordkeeping, accounting and internal audit review. Our policy statement was distributed to all insured nonmember banks and FDIC examiners. Compliance with its provisions is reviewed by examiners at every examination. Also, the banking agencies are contemplating requiring detailed reporting of positions taken in futures, forward and standby contracts. Inclusion of this information in the quarterly call reports will significantly increase our ability to monitor bank activity in these instruments.

FDIC has issued no cease-and-desist orders in the past 18 months directed at speculative trading in futures, forward and standby contracts. Four of our 14 regions have entered into memoranda of understanding with a total of five institutions that have engaged to some degree in speculative trading in forward and standby contracts. Futures activity was also involved to a limited degree in two of these banks. Corrective measures varied according to the circumstances and included prohibition of prospective involvement in forward and standby contracts, discharge of senior bank officers, requirement for written investment policies, infusion of new capital by investors, and in two instances, irregularity reports to the U. S. Attorney's office. While a few commercial and mutual savings banks have engaged in speculative trading activity in moderate proportions, the issuance of the joint policy statement and supervisory criticism regarding speculative trading has been a significant discouragement to this type of activity.

It is our experience that bank involvement in interest rate futures has been very limited -- but interest in such activity is growing. In the last 12 months trade publications and the financial press have given expanded coverage to the benefits to be derived from bank usage of financial futures. This increased interest in financial futures is to be expected, particularly in view of the unprecedented fluctuations of interest rates of recent years. Unstable interest rates increase a financial institution's risk. As indicated in the

May 1979 Treasury/Federal Reserve study of the futures market, banks can effectively use financial futures contracts to hedge their risks of losses due to changes in interest rates.

However, as noted in the study, improper use of the interest rate futures contracts increases, rather than decreases, the risk of loss due to changes in interest rates.

When properly utilized and controlled, financial futures can be productively used to minimize interest rate risk in a banking environment. Banking profits stem directly from earning a spread between the expense associated with liabilities and the return earned on assets. Management of this spread involves minimizing undesired maturity mismatches between the institution's assets and liabilities. An institution can adjust its undesired maturity mismatch without the use of financial futures. But such a transition cannot be made instantly, particularly in a thrift institution that has a preponderance of long-term fixed rate assets that are funded largely by short-term liabilities. In our view, the most productive use of financial futures is to hedge the bank's overall net interest-rate exposure arising from these maturity imbalances. This type of hedge is preferably implemented in conjunction with the repositioning of the composition of the institution's assets and liabilities.

While we see the benefits that can be obtained by judicious use of the futures market, we do not view it as a panacea to the difficulties of the thrift industry.

CONCLUSION

You have asked us to cover a broad range of issues. Our statement has been necessarily detailed. The banking scene today is fast-changing. We at the FDIC remain firm in our commitment to our responsibility to the people. We will continue to do our job monitoring the safety and soundness of the banking system and to be a stabilizing force during a period of challenge and change for the banking industry. We believe that the situation today warrants the modest revision in the tools of our trade that we have outlined. We urge your support.

NOTE: Text of legislation accompanies.

TEXT OF LEGISLATION TO ACCOMPANY STATEMENT ON FDIC PROCEDURES IN HANDLING
FAILED OR FAILING BANKS

A BILL

To provide flexibility to the Federal Deposit Insurance Corporation to deal with financially distressed banks.

Be it enacted by the Senate and House of Representatives of the United States of America in Congress assembled,

ASSISTANCE TO INSURED BANKS

SEC. 1. Section 13(c) of the Federal Deposit Insurance Act (12 U.S.C. 1823(c)) is amended to read as follows:

"(c) (1) In order to reopen a closed insured bank or, when the Corporation has determined that an insured bank is in danger of closing, in order to prevent such closing, the Corporation, in the discretion of its Board of Directors, is authorized to make loans to, or purchase the assets of, or make deposits in, such insured bank, upon such terms and conditions as the Board of Directors may prescribe, when in the opinion of the Board of Directors the continued operation of the bank is essential to provide adequate banking service in the community.

"(2) Whenever severe financial conditions exist which threaten the stability of a significant number of insured banks, the Corporation, in the discretion of its Board of Directors, is authorized to make loans to, or purchase the assets of, or make deposits in, any insured bank so threatened, upon such terms and conditions as the Board of Directors may prescribe, if it is probable such action will substantially reduce the risk of loss or avert a threatened loss to the Corporation.

"(3) Any loans and deposits made pursuant to the provisions of this paragraph may be in subordination to the rights of depositors and other creditors."

PURCHASES OF INSURED BANKS

SEC. 2. (a) Section 13(e) of the Federal Deposit Insurance Act (12 U.S.C. 1823(e)) is amended to read as follows:

"(e)(1) Whenever in the judgment of the Board of Directors such action will reduce the risk of loss or avert a threatened loss to the Corporation and will facilitate a merger or consolidation of an insured bank with another insured depository institution or will facilitate the sale of the assets of an open or closed insured bank to and assumption of its liabilities by another insured depository institution, the Corporation may, upon such terms and conditions as it may determine, make loans secured in whole or in part by assets of an open or closed insured bank, which loans may be in subordination to the rights of depositors and other creditors, or the Corporation may purchase any such assets or may guarantee any other insured depository institution against loss by reason of its assuming the liabilities and purchasing the assets of an open or closed insured bank. Any insured national bank or District bank, or the Corporation as receiver thereof, is authorized to contract for such sales or loans and to pledge any assets of the bank to secure such loans.

(2)(A) Whenever an insured bank that had total assets equal to or greater than 0.12 percent of aggregate assets in domestic (U.S.) offices of insured banks (as determined from the most recently compiled Reports of Condition filed by insured banks) is closed and the Corporation is appointed receiver, then, the Receiver may, in its discretion and upon such terms and conditions as it may determine, and with such approvals as may elsewhere be required by any State or Federal courts and supervisory agencies, sell assets of the closed bank to and arrange for the assumption of the liabilities of the closed bank by an insured depository institution located in the same State as that in which the closed bank was chartered but owned by an out-of-State bank or bank holding company. Notwithstanding subsection (d) of Section 3 of the Bank Holding Company

Act of 1956 or any other provision of law, State or Federal, the acquiring institution is authorized to be and shall be operated as a subsidiary of the out-of-State bank or bank holding company; except that an insured bank may operate the assuming institution as a subsidiary only if specifically authorized by law other than this paragraph.

(B) In determining whether to arrange a sale of assets and assumption of liabilities of a closed insured bank under the authority of this paragraph (2), the Receiver may solicit such offers as is practicable from any prospective purchasers it determines, in its sole discretion, are both qualified and capable of acquiring the assets and the liabilities of the closed bank.

(i) If, after receiving offers, the highest acceptable offer is from a subsidiary of an out-of-State bank or bank holding company, the Receiver shall permit the highest acceptable offeror of any existing in-State insured depository institutions and subsidiaries of in-State bank holding companies to submit a new offer for the assets and liabilities of the closed bank. If this institution reoffers a greater amount than the previous highest acceptable offer, then the Receiver shall sell the assets and transfer the liabilities of the closed bank to that institution.

(ii) If there is no acceptable offer received from an existing in-State depository institution or subsidiary of an in-State bank holding company, or if there is no reoffer greater than the highest acceptable offer, then the Receiver shall permit the highest acceptable offeror of the subsidiaries of the

insured banks chartered in States adjoining the State in which the closed bank was chartered and bank holding companies whose banking subsidiaries' operations are principally conducted in States adjoining the State in which the closed bank was chartered (if its offer was not the highest received by the Receiver) to make a new offer for the assets and liabilities of the closed bank. If this subsidiary reoffers a greater amount than the previous highest acceptable offer then the Receiver shall sell the assets and transfer the liabilities of the closed bank to that institution.

(iii) If no offer under subparagraphs (i) or (ii) is received which exceeds the original highest acceptable offer, then the Receiver shall sell the assets and transfer the liabilities of the closed bank to the highest acceptable offeror.

(C) In making a determination to solicit offers under subparagraph (B), the State bank supervisor of the State in which the closed insured bank was chartered shall be consulted. The State bank supervisor shall be given a reasonable opportunity, and in no instance a period of less than twenty-four hours, to object to the use of the provisions of this paragraph (2). If the State supervisor objects, the Receiver may use the authority of this paragraph (2) only by a unanimous vote of the Board of Directors. The Board of Directors shall provide to the State supervisor, as soon as practicable, a written certification of its determination.

(D) The Receiver shall not make any sale under the provisions of this paragraph (2) — (i) which would result in a monopoly, or which would be in furtherance of any combination or conspiracy to monopolize or to attempt to monopolize the business of banking in any part of the United States; or (ii) whose effect in any section of the country may be substantially to lessen competition, or to tend to create a monopoly, or which in any other manner would be in restraint of trade, unless it finds that the anticompetitive effects of the proposed transaction are clearly outweighed in the public interest by the probable effect of the transaction in meeting the convenience and needs of the community to be served.

(E) Nothing contained in this paragraph (2) shall be construed to limit the Corporation's powers in paragraph (1) to assist a transaction under this paragraph.

(3) As used in this subsection -- (i) the term "Receiver" shall mean the Corporation when it has been appointed the receiver of a closed insured bank; (ii) the term "insured depository institution" shall mean an insured bank or an association or bank insured by the Federal Savings and Loan Insurance Corporation; (iii) the term "existing in-State insured depository institution" shall mean an insured depository institution that is chartered in the same State as the State in which the closed bank was chartered; (iv) the term "in-State bank holding company" shall mean a bank holding company whose banking subsidiaries' operations are principally conducted in the same State as the State in which the closed bank was chartered; and (v) the term "out-of-State bank or bank

holding company" shall mean an insured bank having its principal place of banking business in a State other than the State in which the closed bank was chartered or a bank holding company whose banking subsidiaries' operations are principally conducted in a State other than the State in which the closed bank was chartered."

(b) The provisions of paragraph 2 of section 13(e) of the Federal Deposit Insurance Act shall cease to be effective five years from the date of its enactment. The expiration of the effectiveness of section 13(e)(2), however, shall have no effect on the continued legality of any sale or operation authorized while it was effective.

AGREEMENTS DIMINISHING THE
RIGHTS OF THE CORPORATION

SEC. 3. Section 13 of the Federal Deposit Insurance Act is amended by adding at the end thereof the following new subsection:

"(h) No agreement which tends to diminish or defeat the right, title or interest of the Corporation in any asset acquired by it under this section, either as security for a loan or by purchase, shall be valid against the Corporation unless such agreement (1) shall be in writing, (2) shall have been executed by the bank and the person or persons claiming an adverse interest thereunder, (3) shall have been approved by the board of directors of the bank or its loan committee, and (4) shall have been, continuously, from the time of its execution, an official record of the bank."

FDIC ASSESSMENTS

SEC. 4. The third sentence of section 7(d)(1) of the Federal Deposit Insurance Act (12 U.S.C. 1817(d)(1)) is amended --

(a) by striking out "and" the second place it appears; and

(b) by inserting before the period at the end thereof the following:

"; and (4) any lending costs for the calendar year, which shall be the difference between the rate of interest earned, if any, from each loan made by the Corporation pursuant to section 13 after January 1, 1981 and the Corporation's average investment portfolio yield for the calendar year."

THE BANK HOLDING COMPANY ACT OF 1956

SEC. 5. Section 3(d) of the Bank Holding Company Act of 1956 (12 U.S.C. 1842(d)) is amended by adding after the word "application" the following:

"(except an application filed as a result of a transaction to be accomplished under section 13(e)(2) of the Federal Deposit Insurance Act (12 U.S.C. 1823(e)(2))".