TESTIMONY OF

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ON

FDIC EXPERIENCE WITH FAILING AND FAILED BANK RESOLUTIONS

BEFORE THE

COMMITTEE ON BANKING, FINANCE AND URBAN AFFAIRS
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Mr. Chairman and members of the Committee, I am pleased to be here today to report on past and present mechanisms employed by the Federal Deposit Insurance Corporation to resolve failed or failing insured banks. I am the Associate Director, Supervision and Enforcement for the Division of Supervision at the FDIC. For the past few years I have served a lead role in the larger assistance transactions for failing or closed banks.

STATUTORY AUTHORITIES

Under the Banking Act of 1933, in the event of closure of an insured bank, the FDIC was authorized to pay depositors up to the insurance limit. In 1935, the FDIC was provided with a second method of protecting depositors of failed banks. That provision permitted the FDIC to provide assistance in order to facilitate the acquisition of a failing institution by another institution.

In 1950, the FDIC was given new authority that permitted the FDIC, under specified circumstances, to provide assistance in order to prevent the failure of an insured bank when the Board of Directors of the FDIC determined that the failing bank's services are essential to its community. In 1982, the FDIC's authority was expanded to permit assistance to facilitate an acquisition or to prevent a closing if in either instance it is less costly than a payoff or the failing institution is essential to its community. The 1982 legislation also expanded the grounds for assistance to include not only failed or failing banks but also where severe financial conditions exist that threaten a significant number of financial institutions or financial institutions with significant resources.

The FDIC has interpreted this severe condition criteria as being tantamount to "essentiality." The "essentiality" and "severe financial conditions" authorizations have been used sparingly by the FDIC. In most cases, the FDIC instead provides assistance only where the cost of assisting or arranging the acquisition of a failing or failed institution is less than a payoff of the insured depositors.

In 1987, the FDIC was granted new authority to establish a bridge bank when an insured institution is closed. A bridge bank can be established if the cost test is met, if the continued operation of the insured bank is essential to provide adequate banking services to its community or if continued operation of the bank is in the best interest of the depositors and the public. The bridge bank authority is a particularly important tool for the FDIC because it provides time to sell a large or "essential" bank that does not have a ready buyer at the time of closing.

FDIC's ROLE AND TRANSACTION ALTERNATIVES

Let us 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 -- so called "open bank assistance." As stated earlier, this approach is available only if the Board of Directors of the FDIC finds that the assistance required is less costly to the appropriate insurance 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 provided to keep a bank open, outside investors usually join with the FDIC in recapitalizing the bank to ensure 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, as well as other general creditors, are paid -- to the extent possible -- only after the failed bank's assets are liquidated (in so called "depositor preference" states, uninsured depositors are given a preference over other general creditors). In a variation on a direct payoff, termed an "insured deposit transfer," 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.

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 or substantially 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. As described in more detail below, the current FDIC policy is to try to arrange, wherever possible, so-called "whole bank" purchase and assumption transactions where the assuming bank acquires all or almost all of the assets of the failed bank, including troubled loans.

As mentioned above, a new temporary solution now available to the FDIC is a "bridge bank." In this case, the FDIC, with a new bridge charter, can operate the failed institution, for up to five years, until a buyer can be found.

FDIC RECENT EXPERIENCE

To translate the above authorities and types of transaction's undertaken by the FDIC to actual practice, the following numbers provide the more recent experience of the FDIC:

- In 1986, the FDIC resolved 145 institutions with total assets of $7.7 billion through 98 purchase and assumption transactions, 40 payoffs or insured deposit transfers and 7 open bank assistance transactions.

- In 1987, the FDIC resolved 203 institutions with total assets of $9.5 billion through 133 purchase and assumption transactions, 51 payoffs or insured deposit transfers and 19 open bank assistance transactions.

- In 1988, the FDIC resolved 221 institutions with total assets of $53.8 billion through 164 purchase and assumption transactions, 36 payoffs or insured deposit transfers and 21 open bank assistance transactions.

- In 1989, the FDIC resolved 207 institutions with $29.2 billion in total assets through 174 purchase and assumption transactions, 32 payoffs or insured deposit transfers and 1 open bank assistance transaction.

- Through March 23 of this year, the FDIC had resolved 32 institutions with total assets of $1.9 billion through 29 purchase and assumption transactions, 3 payoffs or insured deposit transfers and no open bank transactions.

Recapping, in the last four plus years the FDIC has resolved 808 cases with assets of $102.1 billion; the majority -- 598 -- were purchase and assumptions, 162 were payoffs or insured deposit transfers, and 48 were open assistance transactions.

SMALL INSTITUTION TRANSACTIONS

The vast majority of bank failures, in terms of number of banks, are smaller institutions. In these instances, the FDIC handles the resolution process in a "structured" fashion. The process is termed structured because of the relatively short time that the FDIC has from notification by the chartering authority to the actual closing date. In these situations, the FDIC is compelled to expedite the resolution process by standardizing the financial package provided to acquirors in order not to disrupt the community and depositors affected.

In the case of a purchase and assumption transaction, a new institution will be quickly reopened to replace the failed institution. If a payoff is necessary, insured depositors will be issued checks promptly. If the failed bank is closed, the FDIC insists that the buyer have the institution's doors open the next business day, or in no case more than two business days later. If a payoff is involved, our Division of Liquidation has now streamlined its process to the point that checks can be issued to depositors in almost all cases within the same time frame -- no more than two business days.

In these less complex cases, we provide standardized bid packages to potential acquirors at bid meetings, and require that bids be submitted, so that the only bid determinant or variable is a single dollar amount. In most cases, we first offer a "whole bank" purchase and assumption transaction in which the bidders bid on most, if not all, of the failed bank's assets. If no acceptable bids that meet the cost test are received, we fall back to a "clean" purchase and assumption transaction in which small loans -- those under $100,000 -- are retained by the buyer. Next we consider a totally clean, essentially all cash transaction and, lastly, an insured deposit transfer.

WHOLE BANK TRANSACTIONS

Under Chairman Seidman's direction, the FDIC steered away from our previous manner of handling purchase and assumption transactions on a clean bank basis only and attempted "whole bank" transactions whenever possible. As our inventory of failed bank assets was mounting (growing at that time to approximately $11 billion), it became clear that the public would be better served by transactions in which debtor-creditor relationships are retained in the private sector. Further, collections on assets are enhanced when handled on site at the point of origination by a private sector institution that can extend additional credit.

Most chartering authorities now work closely with the FDIC to accommodate the whole bank concept. Since the advent of the whole bank transaction, bid meetings are in most cases no longer held the same week the bank is scheduled to close. Bid meetings are now held three weeks or more before closing to allow potential bidders sufficient time to conduct onsite due diligence reviews. Occasionally, closing dates are extended by the chartering authorities to allow all qualified bidders the necessary time for reviews.

While in whole bank transactions most of the assets are purchased by the new or restructured institution, the FDIC may hold back insider loans, loans that may possess some potential fraudulent activity, and loans that exceed legal lending limits. Generally, however, in other than some of the largest transactions discussed further below, buyers purchase the assets with no further recourse to the FDIC.

The FDIC has successfully completed many whole bank deals since they were first attempted in 1987. The following are the statistics on whole bank deals since their inception and negotiated transactions which are discussed further below:

- In 1987 -- 20 whole bank and negotiated transactions involving $1.114 billion in assets.

- In 1988 -- 112 whole bank and negotiated transactions with $37.7 billion in assets.

- In 1989 -- 87 whole bank and negotiated transactions with $23.1 billion in assets.

- Through March 23 of this year -- 10 whole bank transactions with $1.4 billion in assets.

LARGE INSTITUTION TRANSACTIONS

In certain larger or more complex cases the scope of the required due diligence is so great that it virtually precludes a straight forward whole bank transaction. At the same time a "clean" bank would require excessive amounts of up front cash. In these situations the FDIC handles resolutions through what is termed "negotiated" transactions. Rather than have the FDIC structure the precise financial terms of these cases, we advise potential acquirors of our broad preferences and allow the private sector to structure and put forth their own deals within a competitive framework. The innovation this system has provided to the process has served to reduce cash outlays and costs to the insurance fund. Congress can share the credit since it provided FDIC with the authority to create bridge banks which provide the necessary time and opportunity to structure innovative transactions.

As with the smaller "structured" transactions, in the larger "negotiated" transactions the FDIC provides assistance necessary to "fill the hole" -- i.e. cash from FDIC and assets from the bank at fair market value equal to deposits and other liabilities assumed. Extensive discussions are conducted involving such things as administration of the assets, future asset puts, collection incentive arrangements, indemnifications, management, etc. Dependent on individual circumstances, potential bidders are allowed varying time frames for onsite due diligence that is controlled and monitored by the FDIC. We have been able to accommodate multiple parties conducting due diligence reviews on a concurrent basis facilitated by preliminary reviews of data provided in the FDIC's Washington or Regional Offices.

While with small institutions whole bank purchasers generally have no further recourse to the FDIC, occasionally in larger transactions the FDIC provides back-up guarantees in various forms and at various levels to the new banks. These guarantees include appropriate incentives for the new institutions to maximize collections on behalf of the FDIC. Through our experience over the past few years, the FDIC believes we have designed collection incentive arrangements that best serve the insurance fund and the public.

The FDIC has instituted thorough monitoring and oversight procedures and tracking systems to measure progress toward collection goals. Additionally, the FDIC maintains the ultimate control over these assets -- the ability to remove them from the servicing institution at our sole discretion. In many instances the better "troubled" credits have "relationship value" to the buyer (i.e. other account relationships such as deposits, trust accounts) and these credits can be reworked and rehabilitated into valued customer relationships.

OPEN ASSISTANCE TRANSACTIONS

Unfortunately, not all transactions have been successful. In 1987 and 1988, we assisted BancTexas and two banks in Alaska on an open bank basis and the resulting entities have since failed. In those instances -- which involved one-time fixed amount assistance -- the economies of Texas and Alaska had far from bottomed out and the assistance provided by the FDIC proved to be insufficient.

The cost to the FDIC fund, however, did not increase as a result of these particular failures. Had we originally structured the transactions as we did in subsequent cases -- such as First Republic and MBanks -- we would have had about the same cost that we ultimately bore. The new ownership/management did not induce new losses of significance but rather the value of the assets they acquired continued to deteriorate. Thus, the investors in those transactions bore some of the loss that otherwise would have been that of the FDIC.

During the same period we had a similar experience with a small Kansas bank. In this case, local individuals aware of the hazards ahead of them were willing to invest along with our assistance to keep the bank open. While the investors later lost their investment when the bank failed, at the time of failure the bank was in much better shape (file documentation, operations, etc.) than when it was acquired with FDIC assistance.

All open bank assistance cases are conducted through competitive bidding and the marketplace dictates the ultimate price tag. It is important to point out that the FDIC does not restrict open bank assistance to large banks. Assistance over the past five years has been provided to small banks as well, some of which have been restored to viable entities and are once again serving their communities.

More recent experience, however, has caused the FDIC to shift back to closed bank negotiated transactions in the larger bank failure cases. We learned much from the last large bank open assistance case that was consummated -- i.e. the First City transaction. In this case, holding company creditors (including arbitrageurs) doubted the FDIC's ability to handle multiple bank failures in a single holding company in a non-disruptive fashion to the public and communities. Accordingly, creditors and arbitrageurs attempted to hold the insurance fund hostage until their demands were met.

Only a few months after First City, however, the markets were shown that multiple failures (First Republic, MCorp) could in fact be handled in a non-disruptive fashion. Twenty MBanks were closed on a Tuesday night and the new bridge bank was up and running the next day -- customer service and the payments system were not interrupted. Contrary to the belief of some, First Republic and MCorp holding company creditors and bailed out -- a fact they will readily admit today and are currently contesting in court. In the First City case, creditors and shareholders were offered fractions of par value in order to accommodate an open bank solution.

Given the lack of cooperation by shareholders and creditors and the potential added costs of open assistance it is expected that open bank and open thrift assistance cases will be rare. However, we will continue to pursue any least cost solution short of a bailout of creditors or shareholders.

My colleague at the FDIC, Mr. Poling, will be addressing questions regarding FDIC management of the FSLIC Resolution Fund. I am pleased to address any questions raised by my testimony today.