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Bank Receivership and Conservatorship

by Walker F. Todd

In the past quarter century, legal and economic distinctions surrounding the viability of depository institutions have become increasingly blurred. Changes enacted since 1987 have made it particularly difficult for the casual observer to detect differences among the three forms of insolvency resolution: receiverships, conservatorships, and bridge banks. This article provides a history of regulatory and statutory responses to failing banks, with special focus on recent changes, including depositor preference legislation, that have had unintended and still-uncertain consequences.

Defining physiological life and death used to be comparatively easy. Under broad definitions, living mammals were considered capable of growth and reproduction and exhibited a variety of vital signs such as positive blood pressure and respiration. Dead mammals lacked these capacities and gradually lost vital signs as death progressed.

In this century, however, such simple distinctions have become vastly more complicated. In some systems of moral philosophy, human life has been held to begin long before live birth. At the other extreme, the prolonging of life by artificial means has led to new concepts like "brain death" to replace prior definitions of death. An organic structure can endure now, for a time at least, even after vital functions have ceased.

Legal and economic distinctions regarding the viability of depository institutions also have become increasingly complicated in this century, with most of the relevant changes concentrated in the last 25 years. It is now difficult to describe with sufficient precision how to characterize a depository institution as a going concern—that is, one capable of satisfying its obligations as they mature. Commercial bank supervisors have been faced with the blending of legal and economic concepts regarding failure resolution into new, hybrid forms.

Confining the analysis to commercial banks, the standard definition of the term "banks" contemplates a set of institutions authorized both to accept demand deposits and to make commercial loans.[1] Following this standard legal definition, failed or failing banks that are no longer viable as going concerns should lack either or both of the deposit-taking and loan-making powers. Before 1933, this generally was true. But the standard forms of supervisory intervention that have evolved since then have increasingly blurred this distinction between living and dead banks.

This *Economic Commentary* examines the changing treatment of troubled institutions in the U.S. banking structure, with particular focus on changes since 1987 affecting receiverships, conservatorships, and bridge banks. Some of those changes, including depositor preference legislation enacted in 1993, have had unintended consequences whose overall effects are still somewhat uncertain.[2]

Background before 1933

The concept of a receiver for failing banks is derived from practices in bankruptcy or other insolvency proceedings even before the advent of a permanent bankruptcy code in the United States in 1898. A receiver is appointed to take over the assets and liabilities of an institution that has failed or has lost its banking charter in order to quickly and efficiently dispose of that institution—in essence, to wind up its affairs.

In pre-Civil War banking, bank charters had limited terms (usually 20 years), so states would appoint a receiver to wind up the affairs of a bank whose charter was not renewed, or which had forfeited its charter prior to expiration. Judicially accountable receivers were created voluntarily by a vote of the partners, shareholders, or other owners of a bank to terminate their responsibility for the bank's liabilities or to make an equitable distribution of its remaining assets. Bank insolvencies generally were treated no differently under state law than the insolvencies of commercial enterprises, with the exception of particular protections for holders of failed banks' circulating currency notes. Unpaid depositors usually had no better rights in the liquidation of a failed bank than did other general creditors, and banks usually were prohibited from giving security for deposits, other than deposits of public funds.[3]

Later, involuntary receivership for banks became embodied in federal law in Section 50 of the National Bank Act of 1864, which provided as follows:

> [O]n becoming satisfied ... that any association [national bank] has refused to pay its circulating notes ..., and is in default, the Comptroller of the Currency may forthwith appoint a receiver ... who, under the direction of the Comptroller, shall take possession of the books, records, and assets of every description of such association, collect all debts, dues, and claims belonging to such association, and, upon the order of a court of record of competent jurisdiction, may sell or compound all bad or doubtful debts, and ... sell all the real and personal property of such association ... [and pay over the proceeds to the Comptroller's order]. And from time to time the Comptroller ... shall make a ratable dividend of the money so paid over to him by such receiver on all such claims as may have been proved to his satisfaction or adjudicated in a court of competent jurisdiction....[4]

Thus, under applicable federal law, the potentially incomplete repayment of depositors' and other general creditors' claims was a concept embedded within the appointment of a receiver for a national bank.[5]

Prior to 1933, receiverships under state law, for state-chartered banks, were by no means administered in accordance with national bank receivership principles. As late as 1895, for example, the Comptroller of the Currency reported to Congress, "In nearly all of the states insolvent banks are managed in the same manner as other insolvent concerns."[6] Only California provided for supervision of the liquidation of insolvent state banks by the state *bank* supervisory authority. Thus, *insolvency*, a concept that included but was more than mere failure to repay depositors or general creditors, was the principal determinant of the fate of a failing bank or other business, whose owners turned to *voluntary receivership* to limit their liability to depositors and general creditors.

Between the Civil War and the end of World War I, many new banks were created. Active U.S. banks numbered 8,030 in 1897 and 29,417 by 1921, but more than 12,000 of them failed between 1921 and year-end 1933, focusing renewed attention on the legal and institutional structures of bank receiverships.[7] In 1933, as an alternative to receiverships, conservatorships for national banks were created under Title II of the Emergency Banking Act of March 9, 1933.[8] The condition then provided for appointment of a conservator "whenever the Comptroller shall deem it necessary in order to conserve the assets of any bank for the benefit of the depositors and other creditors thereof..." (former 12 U.S.C. Section 203). In other words, no explicit finding of actual or potential insolvency or existing violation of the National Bank Act was required—findings that would have been required for the appointment of a receiver. However, that former version of the national bank conservatorship statute provided explicitly that a conservator was to have all the powers of a receiver, in addition to powers necessary to operate the failing bank. The principal significance of the 1933 conservatorship statute for our purposes is that it established a new regime allowing a receiver-like entity to take control of a national bank's affairs *involuntarily* and for the explicit purpose of protecting depositors and general creditors.

Jesse Jones, the chairman of the former Reconstruction Finance Corporation, wrote that in drafting the conservatorship statute, the Hoover Administration and involved Federal Reserve officials believed that the title *conservator* was "akin to receiver but less harsh on the public ear," adding that the original object of conservatorship was "to stave off creditors long enough to rehabilitate a bank rather than let it go into receivership."[9] Thus, the first blurring of the distinctions between living and dead or dying banks was introduced into federal banking law in 1933.

An important provision of this statute required conservators to segregate new deposits (those received after appointment) from previously existing deposits, to make such prior deposits available for withdrawal only on a ratable basis (which could be estimated), and not to use new deposits to liquidate any indebtedness of the bank existing prior to appointment.[10] This provision enabled the conservator to satisfy old claims only insofar as they would have been satisfied in receivership, while still preserving the option of handing over the entire bank to new ownership (or even returning the bank to the former management) with a body of protected new deposits intact.

The investments for which a conservator could use new deposits were limited to safe assets like government securities. In the low-interest-rate environment of 1933, the asset values backing new deposits in conservatorships were not expected to fall below par, while the ratable distributions to prior depositors could have required substantial discounts from par values due to impaired creditworthiness.[11] In any case, while about 1,100 conservatorships were created for national banks during 1933, they were rare afterward until the 1980s.[12]

Regulatory and Statutory Responses to the 1980s Crises

The decline of federal deposit insurance funds for the thrift and commercial banking industries in the 1980s was the first occasion since the 1930s for a crisis-related review of receivership and conservatorship structures. Confronting large-scale but officially unrecognized insolvency in the thrift industry in the early 1980s, the industry's regulators and Congress initially attempted to avoid creating large numbers of conservatorships and receiverships. Instead, they responded by allowing regulatory accounting principles that diverged widely from generally accepted accounting principles and by issuing Federal Savings and Loan Insurance Corporation certificates that generated positive net worth under regulatory accounting.[13] After the failure of Continental Illinois Corporation and its banking subsidiary in 1984 and the demise of several large southwestern banks after 1986, federal bank regulators began to explore ways to enable failing banks to continue to offer banking services without having to reduce the ultimate payouts to prior uninsured depositors.[14] For commercial banks and, after 1987, mutual savings banks, the first new device for this purpose was bridge banks.

Bridge banks share many common attributes with and serve many of the same economic objectives as national bank conservatorships, but are more amorphous. Because bridge banks provide no segregation of post-organization deposits or "safe bank" restrictions on the investment of those deposits, an accounting and legal nightmare can ensue if these banks are not sold or recapitalized as going concerns. The principal difference in legal authority is that bridge banks are organized and administered by the Federal Deposit Insurance Corporation (FDIC), while the Comptroller of the Currency appoints national bank conservators.

In effect, a bridge bank is a hybrid creation that enables the FDIC to take over and maintain ongoing banking services at failing banks, including the commingling of post-organization with pre-organization deposits, even though the FDIC does not issue bank charters.[15] This additional power is important to the FDIC because before 1987, it had no statutory way to induce state regulators to close failing state-chartered banks while ensuring that their banking services would continue.[16] Large bridge banks created since 1987 include First Republic (1988) and M Corp (1989), both in Texas, and Bank of New England (1991).

Bridge banks may create moral dilemmas regarding the distinctions between living and dead banks because a bridge bank has many of the attributes of a living institution: It may accept new deposits and make new loans, commingling them with existing accounts; it is deemed a new, insured national bank from the time it is chartered; it may exercise all the corporate powers of a national bank; it may exist for up to two years, subject to renewals for up to three additional one-year terms; and it is explicitly encouraged to accommodate existing borrowers and depositors.[17] However, it also shares many characteristics with dying or dead institutions: It is created in a manner analogous to that of a conservatorship or receivership; it is in default for the legal purpose of abridging certain contractual obligations of the former bank; it operates without capital and need not observe normal capital adequacy requirements; the FDIC exercises close control over its asset and liability powers; and it exists only for a limited term, with the appointment of a receiver required if the bank is not merged, sold, or otherwise disposed of during that term.[18] Legally, a bridge bank is like a new national bank, but it serves the economic function of an improperly operated conservatorship because of the commingling of deposits.

Some significant revisions of the national bank conservatorship statute were enacted by the Financial Institutions Reform, Recovery, and Enforcement Act of 1989 (FIRREA). The most important change for the purposes of this article was that the formerly explicit statutory requirement that new deposits be segregated from pre-appointment deposits was dropped in favor of new language providing that the Comptroller of the Currency may require any conservator to set aside amounts that can be withdrawn safely by all depositors and creditors similarly situated.[19] While the Comptroller still might require a conservator to segregate new from old deposits, in the conservatorships created for banks and thrifts since enactment of FIRREA, new deposits have not been so divided.

As with bridge banks, post–FIRREA conservatorships create moral dilemmas regarding the status of a conservatorship as a living or dead institution: The absence of the segregation of deposits (formerly a hallmark of conservatorships) and the indefiniteness of the duration of a conservatorship may convey the impression that no useful distinction can be drawn between conservatorships and ordinary banks. At the same time, this blurring of distinctions may serve to maintain public confidence in the viability of the overall banking system in regions where a comparatively large share of the banks are failing.[20]

Insolvency Resolutions after FDICIA

The enactment of the Federal Deposit Insurance Corporation Improvement Act of 1991 (FDICIA) and one subsequent statutory revision have made some potentially significant changes in bank insolvency resolution procedures. Critically undercapitalized institutions must be placed into conservatorship or receivership within 90 days, unless the appropriate supervisory agency grants an extension that may be renewed only once.[21] In that sense, the moral dilemma of distinguishing between living and dying banks should eventually be resolved.

Under FDICIA, the standards for appointment of conservators of national banks were unified with those for appointment of the FDIC as conservator of insured state-chartered banks; previously, appointment of the FDIC as conservator of state banks was a matter entirely governed by state (not federal) law. The principal new feature of the revised standards is an explicit recognition of a balance-sheet test (an excess of noncapital liabilities over assets) as sufficient grounds; previously, only a going-concern (ability to satisfy maturing claims) test was used.[22]

FDICIA also modified the receivership section of the National Bank Act (now 12 U.S.C. Section 191) to provide for appointment of the FDIC as receiver of national banks *without prior notice or hearings* on the same unified grounds as for its appointment as conservator, including explicit recognition of a balance-sheet test of insolvency. The Comptroller of the Currency is now authorized to appoint a receiver even without a prior examination of the failed bank. These changes should have the effect of reducing any public confusion about the status of banks not yet in receivership: If a bank is really dead on a balance-sheet basis, there is no longer any reason for supervisory forbearance based on its lingering capacity to satisfy maturing claims.

Finally, on August 10 of last year, the Omnibus Budget Reconciliation Act of 1993 was enacted. Among other things, it amended Section 11 (d)(11) of the FDIC Act (12 U.S.C. Section 1821 [d][11]) to establish a revised set of priorities for payment of claims (other than secured claims) by receivers of failed depository institutions. The new priorities are (a) administrative expenses of the receiver; (b) any deposit liability of the institution; (c) general or senior liabilities of the institution; (d) subordinated obligations; and (e) shareholder claims.

The principal change from the previous list of priorities is that depositors' claims (to which the FDIC as receiver would succeed) were advanced from the same level as general and senior liabilities to a preferential class of their own, following only the receiver's administrative expenses. In order to prevent the FDIC from increasing its share of the receivership estate, general creditors probably will attempt to take increased amounts of collateral from failing institutions in order to become secured claimants and thereby avoid subordination to the new depositors' preference.[23] The probable effect of federal depositor preference legislation should be to reduce depositors' confusion about the status of their claims (it appears that many of them believed that they already had such a preference under federal law, even though that was not so before 1993), at the expense of the possibly increased confusion of general creditors.

■ Conclusion

Since 1989, it has become increasingly difficult for casual observers to make useful functional distinctions among receiverships, conservatorships, and bridge bank administrations for failing or failed banks and thrifts. Also, legal distinctions among those three forms of insolvency resolution that were fairly sharp before 1987 have become blurred. Under federal law, since 1991, the standards for appointment of a receiver or a conservator have been unified, and since 1987 (bridge banks) and 1989 (conservatorships), previous legal barriers to the commingling of pre-insolvency and post-insolvency deposits have been removed.

The economic effect of failure to segregate deposits in an insolvent or prospectively insolvent institution is to spread the cost of repaying uninsured claims across all funders of the federal safety net instead of limiting these recoveries to the estimated amounts to be realized from the eventual liquidation of conservatorship or bridge bank assets. In effect, this condition gives uninsured depositors time to flee but also, together with the new depositor preference legislation, reduces their incentives to flee. The failure to segregate deposits effectively creates an accounting pyramid scheme in which the existing shortfall between historic cost (book value) and current market values of assets is merely rolled forward into the new asset pool supporting the mixture of both old and new deposits.

The original federal policy intention regarding receiverships and conservatorships could be restored without modification of the new depositor preference statute if the relevant sections of the FDIC Act and the National Bank Act were amended to provide for the mandatory segregation of pre-appointment from post-appointment accounts and to prohibit the use of post-appointment deposits to satisfy pre-appointment claims in conservatorships and bridge banks. The pre-1989 language of 12 U.S.C. Section 206 would be adequate for such a purpose.

■ Footnotes

1. This definition is a paraphrase of the statutory definition of the term "bank" in Section 2 (c)(1) of the Bank Holding Company Act of 1956, as amended, 12 U.S.C. Section 1841. For purposes of the analysis here, the "nonbank banks" issue is ignored. See Board of Governors v. Dimension Financial Corporation, 474 U.S. 361 (1986).

2. See 12 U.S.C. Section 1821 (c)(5), amended by the Omnibus Budget Reconciliation Act of 1993. See also James B. Thomson, "The National Depositor Preference Law," Federal Reserve Bank of Cleveland, *Economic Commentary,* February 15, 1994.

3. See generally Bray Hammond, *Banks and Politics in America, from the Revolution to the Civil War,* Princeton, N.J.: Princeton University Press, 1957. On the general prohibition of pledging security for deposits, other than municipal and other public entity deposits, see cases cited under New York Banking Law Section 96 (7).

4. Herman E. Krooss and Paul A. Samuelson, eds., *Documentary History of Banking and Currency in the United States,* vol. 2, New York: Chelsea House Publishers, 1977, pp. 1405–06. In 1876, new grounds were added to the statute for appointment of a receiver, including failure to satisfy a judgment within 30 days "or whenever the Comptroller should become satisfied of the bank's insolvency," and afterward other grounds were added that involved violations of the National Bank Act and "false certification of checks by any officer, clerk, or agent." By 1930, a new ground for appointment of a receiver was enacted: discontinuation of banking operations for a period of 60 days. See Cyril B. Upham and Edwin Lamke, *Closed and Distressed Banks: A Study in Public Administration,* Washington, D.C.: Brookings Institution, 1934, p. 19. Also, receivers of national banks were not supposed to confront problems regarding the commingling of pre-appointment with post-appointment accounts, a principle that was carried over into the conservatorship statute in 1933 but was lost in the bridge bank statute in 1987. Knowing violations of the National Bank Act prohibited under 12 U.S.C. Section 93 included the acceptance of deposits after the commission of an act of insolvency, or in contemplation of such an act. See 12 U.S.C. Section 91.

5. New York Banking Law, Section 606, contains analogous but different provisions for possession of banks by the superintendent of banks. Notably, the superintendent is not required to segregate post-possession from pre-possession deposits or other claims and may surrender possession and permit a seized bank to resume business.

6. New York Banking Law, Section 663, p. 30.

7. See Upham and Lamke (1934, footnote 4), pp. 245–50.

8. See 12 U.S.C. Sections 201–211.

9. Jesse H. Jones with Edward Angly, *Fifty Billion Dollars: My Thirteen Years with the RFC (1932–1945),* New York: Macmillan Company, 1951, pp. 21–22. The conservatorship statute was more than a mere public relations maneuver, however. During 1933, it was unclear for several months how many gravely damaged banks eventually would have to be closed, and conservatorship offered a vehicle for postponing some of those decisions to enable supervisors to see how matters turned out.

10. See former 12 U.S.C. Section 206, substantially revised in 1989. See also Walker F. Todd, "The Evolving Legal Framework for Financial Services," Federal Reserve Bank of Cleveland, Working Paper 9306, October 1993.

11. Upham and Lamke (1934, footnote 4), pp. 248–49, present tables showing that recoveries by unsecured depositors of failed banks, 1921–1930, inclusive of offsets, were only 55.7 percent of par for 267 national banks studied and 62.0 percent of par for 988 state banks studied.

12. Ibid., pp. 48–56.

13. See descriptions of thrift institution rescue devices used in Edward J. Kane, *The S&L Insurance Mess: How Did It Happen?* Washington, D.C.: Urban Institute Press, 1989, pp. 1–18, 95–104. See also Ned Eichler, *The Thrift Debacle,* Berkeley, Calif.: University of California Press, 1989, pp. 139–44.

14. See Irvine H. Sprague, *Bailout: An Insider's Account of Bank Failures and Rescues,* New York: Basic Books, 1986, pp. 149–264. See also Edward J. Kane, "Long-Run Benefits in Financial Regulation from Increased Accountability and Privatization," in *Rebuilding Public Confidence through Financial Reform,* Columbus: Ohio State University, College of Business, Conference Proceedings, June 25, 1992, pp. 67–77; and James R. Barth and R. Dan Brumbaugh, Jr., "Depository Institution Failures and Failure Costs: The Role of Moral-Hazard and Agency Problems," ibid., pp. 3–19.

15. See Todd (1993, footnote 10), pp. 17–19. Bridge banks were authorized under Section 503 of the Competitive Equality Banking Act of 1987 (now 12 U.S.C. Section 1821 [n]).

16. Since 1989, the FDIC has been authorized to organize bridge banks even without awaiting approval by state bank regulators whenever appropriate findings can be made that one or more insured institutions are either "in default" or "in danger of default," statutory terms meaning generally either that a conservator, receiver, or other legal custodian is actually appointed or that they have exhausted or are likely to exhaust remaining capital or net worth without federal assistance. See Sections 204 and 214 of the Financial Institutions Reform, Recovery, and Enforcement Act of 1989; 12 U.S.C. Sections 1813 (x) and 1821 (n).

17. See 12 U.S.C. Section 1821 (n)(3)(B).

18. See Todd (1993, footnote 10), pp. 18–19.

19. See 12 U.S.C. Section 206 (c).

20. One may infer support for this view, which is akin to a "systemic risk" argument, in Richard F. Syron, "The Fed Must Continue to Supervise Banks," Federal Reserve Bank of Boston, *New England Economic Review* (January/February 1994), pp. 3–8; and in Larry D. Wall, "Too-Big-to-Fail after FDICIA," Federal Reserve Bank of Atlanta, *Economic Review,* vol. 78, no. 1 (January/February 1993), pp. 1–14.

21. Critically undercapitalized institutions have Tier 1 leverage ratios of 2 percent or less. The closing rule for these institutions does not apply to conservatorships and bridge banks, which are permitted to operate without capital.

22. See 12 U.S.C. Section 1821 (c)(5). Regarding the introduction of alternative means to accelerate the appointment of a receiver or conservator for failing institutions in FDICIA, Richard S. Carnell notes that the intention originally was to "safeguard against forbearance," but that Congress "ultimately adopted a weakened time limit" for forbearance with respect to critically undercapitalized institutions." See Carnell, "A Partial Antidote to Perverse Incentives: The FDIC Improvement Act of 1991," Boston University School of Law, *Annual Review of Banking Law,* vol. 12, Boston: Butterworth Legal Publishers, 1993, p. 348. He adds, "the [supervisors' viability] certification requirement will constrain extensions [of forbearance] beyond one year, as regulators will have difficulty—even under the best of circumstances—averring that a critically undercapitalized institution is viable and not expected to fail."

23. See Thomson (1994, footnote 2). Several states previously had similar depositor preference laws, but they were binding on the FDIC as receiver only with respect to failed state-chartered banks.

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The papers in the August 1994 issue of the *Journal of Money, Credit, and Banking* (part 2) were presented at a conference on "Federal Credit Allocation" held at the Federal Reserve Bank of Cleveland on October 18–19, 1993. The purpose of this conference was to stimulate research and discussion of credit allocation and the associated regulations. To order a copy of the conference proceedings, please send $8.00 (U.S.) in a check or money order drawn on a U.S. bank to the Federal Reserve Bank of Cleveland, Research Department, P.O. Box 6387, Cleveland, Ohio 44101. Make checks payable to the Federal Reserve Bank of Cleveland.

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