AN ANALYSIS OF FEDERAL RESERVE DISCOUNT WINDOW LOANS TO FAILED INSTITUTIONS

June 11, 1991

by the Staff of

THE COMMITTEE ON BANKING, FINANCE AND URBAN AFFAIRS

THE UNITED STATES HOUSE OF REPRESENTATIVES

BACKGROUND

The Committee on Banking, Finance and Urban Affairs is currently considering legislation (H.R. 2094) which would reform the process by which banking regulators handle troubled and insolvent insured depository institutions. With the collapse of the savings and loan industry estimated to cost the taxpayers $500 billion and bank failures increasing, such reform is considered a top priority. The process must ensure that insolvent institutions are resolved in a manner which strictly results in the least possible cost to the insurance fund and the taxpayers.

There are two dimensions to implementing a least cost resolution program. The first is the pre-failure or takeover stage, which is the period prior to the formal declaration of insolvency and takeover by the regulator; the second is the post-intervention stage, which involves the process of liquidating or selling the institution and its assets. The least cost resolution program contained in H.R. 2094 alters the latter stage by revising the cost test contained in the Federal Deposit Insurance Act to (1) ensure that all institutions are in fact resolved in the least costly manner, (2) prevent the insurance coverage of uninsured deposits, and (3) abolish the too-big-to-fail doctrine.

The pre-failure stage is modified by curtailing excess regulatory discretion to keep open insolvent institutions long beyond the point of viability. The program requires prompt regulatory action, as set forth in H.R. 2094, to promote the rehabilitation of a failing institution. But if the institution becomes insolvent, then the regulator must act in a timely manner to place the institution in conservatorship or receivership so that additional losses are limited.

The question then arises of the extent to which the least cost resolution program is circumvented by the lending practices of the Federal Reserve discount window. The discount window serves an important stabilizing function by satisfying the short term liquidity needs of viable depository institutions. Under the Federal Reserve Act the discount window can be used for seasonal, adjustment or extended credit needs. Our analysis shows that when a nonviable or insolvent depository institution receives open-ended extensions of credit at the discount window in order to remain open long beyond the point of viability, then the Federal Reserve is effectively increasing the cost of ultimately resolving the institution.

Since discount window loans are at least 100% collateralized, the Federal Reserve assumes no risk of loss and has no incentive to shut the window and contain the insurance funds' losses. The collateral is in the form U.S. Treasury notes, other government securities, commercial loans and other assets.

The borrowed funds can be used by the institution during the pre-takeover period to allow uninsured depositors to withdraw their funds. The insurance fund must then absorb the loss that these account holders would have otherwise been forced to share. In addition, the delay in closing the institution causes operating losses to escalate and increases losses from the decline in asset values.

In order to better understand the practice and pattern of Federal Reserve discount window lending and its impact on the regulatory treatment of insured depository institutions, the Banking Committee requested and received from the Federal Reserve extensive data on the scope of discount window lending to insured depository institutions.

SUMMARY

The Committee requested data on all insured depository institutions which borrowed funds from the discount window from January 1, 1985 through May, 10, 1991. The information was divided into two groups: Group 1 consisted of institutions which had been placed into conservatorship or receivership, or received assistance under Section 13(c) of the Federal Deposit Insurance Act, and Group 2 consisted of all other institutions. The requested information included a schedule of the type and amount of loans extended, the CAMEL ratings of each institution, and the amount and type of collateral taken. A copy of the letter requesting the information is attached as Exhibit A.

An analysis of the data supports the following findings:

1. **90% OF ALL INSTITUTIONS WHICH RECEIVED "EXTENDED" CREDIT SUBSEQUENTLY FAILED.**

2. **THE FEDERAL RESERVE ROUTINELY EXTENDS CREDIT TO INSTITUTIONS WITH A CAMEL 5 RATING.**

3. **A CAMEL 5 RATED INSTITUTION WHICH BORROWED FROM THE DISCOUNT WINDOW REMAINED OPEN FOR AN AVERAGE PERIOD OF 10 - 12 MONTHS.**

4 **BORROWING FROM THE DISCOUNT WINDOW INCREASES DRAMATICALLY AS AN INSTITUTION'S FINANCIAL CONDITION DETERIORATES.**

5. **THE FEDERAL RESERVE TAKES THE HIGHEST QUALITY ASSETS OF THE INSTITUTION IN AN AMOUNT SUBSTANTIALLY IN EXCESS OF THE LOAN AMOUNT AS COLLATERAL.**

STATISTICAL ANALYSIS

Group 1, the insured depository institutions which borrowed from the discount window within three years of failure, consisted of 530 institutions. Group 2, all other institutions which borrowed for five or more consecutive days, consisted of 2,460 institutions. Of the 530 Group 1 institutions, 87 (or 16%) had assets greater than or equal to $100 million, and 443 (or 84%) had assets less than $100 million.

Discount Window Loans. The Federal Reserve categorizes discount window loans into three types: seasonal, adjustment, and extended. A Federal Reserve description of each one is attached as Exhibit B. A summary of the use of each by the failed institutions follows:

- 320 (or 60%) of the Group 1 institutions were borrowing at the time of failure.

- 292 Group 1 institutions were borrowing extended credit at the time of failure.

- 26 Group 1 institutions were borrowing adjustment credit at the time of failure.

- 2 Group 1 institutions were borrowing seasonal credit at the time of failure.

Extended Credit. The borrowing patterns of Group 1 institutions reveal that prior to failure, many insolvent institutions will enter into a period of continuous or intermittent extended credit borrowing well beyond the short term periods viable institutions will need to borrow for liquidity purposes. The outstanding amount increases daily as the balance due is rolled over with new borrowings. 418 (14%) of the 2990 institutions studied received extended credit. 377, or 90%, of these 418 institutions subsequently failed. Thus, the extended credit offered by the Federal Reserve appears to operate in practice as a form of open assistance or forbearance.

CAMEL Ratings. The term "CAMEL" represents the following performance standards: Capital adequacy, Asset quality, Management, Earnings and Liquidity. The ratings given to an institution range from a high of 1 to a low of 5. A description of what each level of CAMEL rating represents as far as the health of an institution is contained in Exhibit C.

The reported CAMEL ratings of Group 1 institutions at the time of failure were as follows:

CAMEL 5:	437	(82%)
4:	51	(10%)
3:	11	(2%)
2:	5	(1.1%)
1:	1	(0.2%)
not available:	25	(4.9%)
Total:	530	

The length of time an institution with a CAMEL 5 rating was allowed to remain open ranged from less than a month to as long as 56 months:

Months	Number of Institutions
0 - 3	74
4 - 6	53
7 - 9	62
10 - 12	92
13 - 15	58
16 - 18	37
19 - 21	28
22 - 24	16
25 - 27	2
28 - 30	5
31 - 33	2
34 - 36	7
56 - 58	1

The average length of time that an institution with a CAMEL 5 rating was allowed to remain open was 10 - 12 months.

Amount of Credit. Regarding the amount of credit extended:

- 320 Group 1 institutions had a total of $8.325 billion in Federal Reserve loans outstanding at the time of failure.

- $7.943 billion of this credit was extended when the institutions were operating with a CAMEL 5 rating.

According to one Federal Reserve Bank document, the Banks normally receive notice of composite CAMEL 1, 2 and 3 ratings with a 4 to 6 month lag from the time of examination; however, composite CAMEL 4 and 5 ratings are normally known with little lag time as a result of simultaneous holding company inspections or conversations with regulators. Peak borrowing for all 530 Group 1 institutions in the three months prior to failure totaled $18.1 billion.

REPRESENTATIVE CASE STUDIES (Summaries, See Appendix for detailed information)

First RepublicBank Dallas, N.A. (Dallas, TX). With assets of $16,379,600,000, this was the largest institution in Group 1. Its borrowing from the discount window began on March 15, 1988, with an extended credit loan in the amount of $2.6 billion. The loans continued uninterrupted for 4 1/2 months until First Republic was closed on July 29, 1988. Peak borrowing during this period was $3.275 billion and its last CAMEL rating was a 3 on September 30, 1986. The collateral taken was customer notes, and commercial and industrial loans with a book value of $6.4 billion and Federal Reserve estimated "lendable" value of $4.0 billion. The book value of the collateral represented 39% of the bank's assets.

Boston Trade Bank (Boston, MA). Boston Trade Bank was a medium-sized institution with assets of $352.9 million, which failed on May 3, 1991. It illustrates the classic scenario of a financially deteriorating institution which begins borrowing from the discount window at the same time the regulator gives it a CAMEL 5 rating. The uninterrupted borrowing increases for five straight months until it is finally closed with outstanding loans of $53.6 million, representing 15% of its assets.

First State Bank of Elgin (Elgin, OR). The majority of the institutions using the discount window to delay closure were small, such as this one with assets of $17.3 million. It operated at a CAMEL 5 rating for two years and was borrowing extended credit from the discount window every day during its last 12 months of operation.

Bank of New England (Boston, MA). BNE was the second largest in Group 1 with assets of $13.9 billion when it was declared insolvent on January 6, 1991. Peak lending reached $2.265 billion over a six month period before a plan of major asset sales and borrowing from affiliates was implemented to replace discount window borrowing. Also, the institution's liquidity position was aided by Department of Treasury deposits of tax receipts.

Lincoln Savings and Loan Association (Irvine, CA). Lincoln S&L had assets of $2,752,800,000 at the time of receivership and was responsible for an estimated $2 billion loss to the taxpayers. Since the institution was placed in conservatorship on April 14, 1989, rather than receivership (which was done 4 months later), uninsured depositors were allowed to withdraw their funds without taking a loss. Federal Reserve loans as high as $98 million over the four month conservatorship period facilitated these withdrawals.

The First National Bank and Trust Co. (Oklahoma City, OK). This is another example of the discount window being used to keep open insolvent institutions. The bank obtained uninterrupted credit for over one year with peak lending of $344 million, all the while operating with a CAMEL 5 rating. The peak loan amount represented 22% of the banks $1.6 billion in assets when it failed on July 17, 1986.

First State Bank (Abilene, TX). This bank received three consecutive CAMEL 5 ratings and was kept open for 17 months before it was placed in receivership on February 17, 1989. Consecutive discount window borrowing began with a $4 million extended loan on May 12, 1988 and ended ten months later with a balance of $95.2 million, or 35% of the bank's $262.3 million in assets.

ATTACHMENTS

Exhibit A: Letter from Chairman Gonzalez to Chairman Greenspan, dated May 9, 1991.

Exhibit B: Overview description (excerpt) of the types of credit extended by the Federal Reserve, from The Federal Reserve Discount Window (1990).

Exhibit C: Description of CAMEL ratings.

Appendix: Detailed information from each case study.

EXHIBIT A

U.S. HOUSE OF REPRESENTATIVES

COMMITTEE ON BANKING, FINANCE AND URBAN AFFAIRS

ONE HUNDRED SECOND CONGRESS

2129 RAYBURN HOUSE OFFICE BUILDING
WASHINGTON, DC 20515

May 9, 1991

The Honorable Alan Greenspan
Chairman
The Board of Governors of the Federal Reserve System
20th and Constitution Avenue, N.W.
Washington, D.C. 20551

Dear Mr. Chairman:

We are writing to you regarding an issue of the utmost concern and urgency to the Committee on Banking, Finance and Urban Affairs: Federal Reserve lending to insured depository institutions.

As you will agree, this Committee and the Congress are obligated to maintain the safety and soundness of the banking industry. We also have a fiscal responsibility to ensure that insolvent insured depository institutions are resolved at the least cost to both the banking industry which pays premiums into the insurance funds and to the taxpayers who guarantee the coverage of insured deposits.

Federal Reserve loans to insured depository institutions have a significant impact on both of these goals. Extensions of credit for liquidity needs, including overnight advances, are important to maintaining the stability of the banking industry. However, when credit is extended to a failing institution by the Federal Reserve as the lender of last resort, the insurance funds and the taxpayers foot the bill.

These Federal Reserve loans, which bear interest, are made in exchange for <u>at least</u> 100% collateral and priority creditor status. The assets being held by the Federal Reserve as collateral are then unavailable to the institution to meet its obligations. This increases the cost of resolving the institution by depleting the institution's assets. When the institution is finally closed, the FDIC repays the Federal Reserve in cash before all other creditors, and the FDIC then takes back from the Federal Reserve the collateral that secured the Federal Reserve advances. Thus, these Federal Reserve loans increase the losses to the insurance funds and the taxpayers standing behind them, and allow insolvent institutions to stay open long beyond the point of viability.

In order for the Committee to both fulfill its oversight responsibilities and legislate in these important areas, we request that you submit the following information to the Committee:

1. Regarding each insured depository institution that has been placed in conservatorship or receivership, or received assistance under Section 13(c) of the Federal Deposit Insurance Act, during the period of 1985 to date, please provide:

   (A) A schedule indicating each time the Federal Reserve extended credit, directly or indirectly, to the institution during the three year period preceding the appointment of the conservator or receiver, or the provision of the Section 13(c) assistance; and include in the schedule:

      (i) the CAMEL rating of the institution at the time the credit was extended;

      (ii) the type of credit extended, including seasonal credits, adjustment credits, and and emergency liquidity advances;

      (iii) the amount of credit extended;

      (iv) the length of the repayment period;

      (v) the amount and type of collateral taken; and

      (vi) whether repayment was made on time, late or not all, and specify whether in any case an extension of time or rollover occured;

   (B) the date and total of the largest amount of Federal Reserve loans to the institution outstanding at any one point in time; and

   (C) the amount of Federal Reserve loans outstanding at the time the institution was placed into conservatorship or receivership, or received Section 13(c) assistance; together with the book value and estimated fair market value (if known) of the collateral taken for each outstanding loan.

2. Regarding all other insured depository institutions during the period from 1985 to date that are not included in the group defined in (1) above, please provide:

   (A) the date(s), aggregate number and amount of loans extended to those institutions by the Federal Reserve during the past five years, for a period of 0 to 5 days, 6 to 15 days, 16 to 30 days, 31 to 60 days, and 61 days or longer;

(B) the name of each institution which received a loan, directly or indirectly, from the Federal Reserve for a period of 5 days or longer; and include the type and purpose of each such loan; and

(C) the current status and CAMEL rating of each institution described in 2(B) above.

When compiling the information requested include "conduit loans" and, when compiling the information requested in (2) above, exclude non-rolled over loans for a term of less than five consecutive days.

The Committee's concern over this issue has been heightened by reports that the Federal Reserve, in a seeming replay of its lending of approximately $500 million to an insolvent National Bank of Washington, has been extending credit to Madison National Bank even though the officers of the bank have publicly declared that it is insolvent. Furthermore, we understand that this has allowed several large depositors of Madison National Bank to immediately withdraw their uninsured funds.

The Committee will mark up legislation very soon which could affect the lending activities of the Federal Reserve. Therefore, please devote sufficient resources to complying with this request so that we receive a complete response by May 30, 1991. Should you need additional personnel, we stand ready to ask the General Accounting Office to assist you. If you have any questions concerning this request, please contact the Banking Committee Staff Director, Kelsay Meek, as soon as possible.

Sincerely,

Henry B. Gonzalez
Chairman

Frank Annunzio
Chairman
Subcommittee on
Financial Institutions

Gerald D. Kleczka

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FOR IMMEDIATE RELEASE

WASHINGTON, D.C., June 11, 1991---House Banking Committee Chairman Henry B. Gonzalez charged today that the Federal Reserve has "expended billions of dollars of public monies in backdoor bailouts of failing banks."

Mr. Gonzalez said the Federal Reserve's loans had kept brain-dead institutions open for extended periods, increasing losses for the Federal Deposit Insurance funds.

Mr. Gonzalez' comments were based on findings of a Committee study of discount window operations between January 1, 1985 and May 1991.

The findings included:

1. Ninety percent of all institutions which received "extended" credit subsequently failed.

2. The Federal Reserve routinely extends credit to institutions with a CAMEL 5 rating--the lowest possible rating..

3. A CAMEL 5 rated institution which borrowed from the discount window remained open for an average period of 10-12 months.

4. Borrowing from the discount window increases dramatically as an institution's financial condition deteriorates.

The study revealed that 530 institutions failed within three years of borrowing from the Federal Reserve. Some 320 banks were borrowing at the time of failure and had outstanding loans of $8.325 billion when they were closed.

Mr. Gonzalez said the Federal Reserve's loans to terminally ill institutions had allowed uninsured depositors to withdraw funds and had kept banks operating with bad management and risky loan policies.

"This is a massive form of forbearance--granted in secret by the Federal Reserve--at a huge cost to the insurance funds and the taxpayers," the Banking Committee Chairman said. "We hear many complaints about the ills of money brokers who move money into failing institutions, but their operations pale beside the mega-buck operations of the Federal Reserve."

Mr. Gonzalez said it is important that controls be placed on the Federal Reserve's discount window operations if the Congress is "serious about limiting losses to the insurance fund, ending the too-big-to-fail policies, and halting the costly practice of extended forbearance for poorly run banks."