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Acknowledgements

Part I

Chapter 1. Executive Summary

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The FDIC employed various approaches to address the successive waves of bank insolvencies resulting from high interest rates in the late 1970s and early 1980s, energy and agriculture sector problems in the mid-1980s, and collapsing real estate markets at the end of the 1980s and early 1990s. This chapter describes those approaches and traces the expansion of resolution alternatives from traditional deposit payoffs and purchase and assumption transactions to later variations of those methods.

Chapter 4. Evolution of the RTC's Resolution Practices

On August 9, 1989, the Financial Institutions Reform, Recovery, and Enforcement Act of 1989 (FIRREA) abolished the Federal Savings and Loan Insurance Corporation (FSLIC) and the Federal Home Loan Bank Board (FHLBB) and created the RTC. This chapter focuses on an important part of the RTC's overall activity: the evolution of its resolution practices.

Chapter 5. Open Bank Assistance

Open bank assistance occurs when a distressed financial institution remains open with government financial assistance. To prevent an insured depository institution from closing, the FDIC provided open bank assistance in the form of loans, contributions, deposits, asset purchases, or the assumption of liabilities. This chapter provides the history of the open bank assistance transaction.

Chapter 6. Bridge Banks

A bridge bank is a temporary national bank chartered by the Office of the Comptroller of the Currency and organized by the FDIC to take over and maintain banking services for the customers of a failed bank. It is designed to “bridge” the gap between the failure of a bank and the time when the FDIC can implement a satisfactory acquisition by a third party. This chapter discusses the formation of Bridge Banks.

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Loss sharing is a feature that the FDIC first introduced into selected purchase and assumption transactions in 1991. The original goals of loss sharing were to (1) sell as many assets as possible to the acquiring bank and (2) have the nonperforming assets managed and collected by the acquiring bank in a manner that aligned the interests and incentives of the acquiring bank and the FDIC. This chapter discusses various aspects of the Loss Sharing transaction.

Chapter 8. The FDIC's Role as Receiver

The FDIC has three main responsibilities: (1) to act as an insurer, (2) to act as a supervisor, and (3) to act as a receiver. The roles of insurer and receiver require that the FDIC play an active role in resolving failing and failed FDIC insured institutions. The FDIC's role as receiver is discussed in this chapter.

Chapter 9. The Closing Process and the Payment of Insured Depositors

Before federal deposit insurance, depositors typically would recover 50 percent to 60 percent of their money from a failed bank's receivership and depositors often were not able to obtain those funds for several years. Consequently, public confidence in the banking system wavered, and depositor runs became more frequent, thus triggering more bank closings. This chapter discusses that federal deposit insurance was designed to provide greater protection to depositors, thereby enhancing public confidence and leading to greater financial stability.

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In the late 1980s and early 1990s, the RTC and the FDIC became custodians of a tremendous and unprecedented number of assets from failed banks and thrifts. The agencies therefore had to develop innovative methods to manage and dispose of the assets. One of the RTC's methods, known as the equity partnership, was a joint venture between the public and private sectors. This chapter discusses aspects of the various equity partnerships.

Chapter 18. The FDIC's Use of Outside Counsel

This chapter describes the FDIC's use of outside counsel from 1980 to 1996. It covers the increased use of outside counsel from 1989 to 1993 during the peak of the financial institution crisis, payments to outside counsel during the period, the advent of the

FDIC's Minority and Woman Outreach Program, the formation of a section to oversee the use of outside counsel, the development of uniform policies and procedures governing the use of outside counsel, the use of information systems, and the various statutory provisions that relate to the FDIC's use of outside counsel.

Chapter 19. Internal Controls

Internal controls provide management with reasonable assurance that its programs are effectively and efficiently executed; waste, fraud, and abuse and misappropriation of assets are minimized; financial statements are reliable; and compliance with the law is ensured. This chapter provides an overview of the evolution and implementation of internal control programs at the FDIC and the RTC.

Part II, Case Studies of Significant Bank Resolutions

Case Studies of Significant Bank Resolutions presents case studies of the 10 most notable problem banks to illustrate some of the FDIC's resolution processes. The case studies also show the effects on the FDIC of changes in banking legislation in the 1980s and 1990s.

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A. Legislation Governing FDIC's Roles as Insurer and Receiver

This appendix focuses on the FDIC from 1980 to 1994. To provide a historical context for that period, however, the appendix begins with a brief overview of some earlier, significant legislation passed by the U.S. Congress.

B. Glossary of Terms/Abbreviations

This list of abbreviations and glossary of terms is compiled from terminology that is used in this publication.

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This appendix provides graphical illustrations of the data presented in the study.



CHAPTER 1

Executive Summary

What This Study Is About

Managing the Crisis: The FDIC and RTC Experience examines the challenges faced by the Federal Deposit Insurance Corporation (FDIC) and the Resolution Trust Corporation (RTC) in resolving troubled banks and thrifts during the financial crisis of the 1980s and early 1990s. This study reviews the resolution and asset disposition strategies developed and implemented by the FDIC and the RTC in response to the crisis and describes the evolution of the methods used.¹ It also reflects on the effectiveness of these methods, as well as the lessons learned. This study does not discuss the reasons for the upsurge in the number of bank and thrift failures during this period, nor does it explore the regulatory responses to the crisis. Those issues are addressed in *History of the Eighties—Lessons for the Future: An Examination of the Banking Crises of the 1980s and Early 1990s*, a study that was compiled and published by the FDIC in December 1997.

This study is organized into six functional areas. The first area, Chapters 2 through 7, covers the evolution of the resolution process, including specific information on the use of open bank assistance (OBA), bridge banks, and loss sharing. The issues discussed in Chapters 8 through 11 are the receivership management process, including the FDIC's role as receiver, the closing process and payment of insured depositors, the treatment of uninsured depositors and other creditors, and the pursuit of professional liability claims. Chapters 12 through 17 discuss the asset disposition process, including an overview of the evolution of the asset disposition process and descriptions of the primary

1. The term "resolution" throughout this study means a disposition plan for a failed or failing institution. It is designed to (1) protect insured depositors, and (2) minimize the costs to the relevant insurance fund that are expected from covering insured deposits and disposing of the institution's assets. Resolution methods include purchase and assumption transactions, insured deposit transfer transactions, and straight deposit payoffs. A resolution can also refer to an open bank assistance plan provided to an institution to help prevent it from failing.

methods used, such as auctions and sealed bids, asset management contracting, securitization, partnership programs, and the Affordable Housing Program (AHP). The topic of Chapters 18 and 19 is internal operations, which includes the legal process and internal controls. Part II includes 10 case studies of significant bank resolutions. Finally, an appendix contains sections describing the legislation governing the FDIC's roles as receiver and insurer, statistical analysis over the period in the form of charts and graphs, and a glossary of frequently used terms and abbreviations.

Magnitude of the Problem

The U.S. banking and thrift industry in the early 1980s was facing a financial crisis of a magnitude not seen since the Great Depression years of 1929 through 1933, when depositors lost \$1.4 billion with the closing of 9,755 banks.² The banking and thrift crisis of the 1980s and early 1990s bore certain similarities to banking conditions leading up to the Great Depression. With the notable exceptions of Continental Illinois National Bank and Trust Company (Continental), Chicago, Illinois, and the New York savings banks, the early 1980s bank and thrift failures were generally small institutions, many with roots in the agricultural or energy sectors. Continued problems in the energy sector and a collapse in several major real estate markets greatly increased the number and cost of failures. As a result, in 1988, the Federal Savings and Loan Insurance Corporation (FSLIC) insurance fund was reported to be at minus \$75 billion, and the ratio of losses to all insured deposits rose to 1.48 percent, a level that had only been exceeded in 1933.³ The insolvency of the FSLIC fund and the continued weakness in the thrift industry led to creation of the Resolution Trust Corporation in August 1989. Before that year ended, 318 failed thrifts had been taken over by the RTC.

How large was the problem? Between 1980 and 1994, 1,617 federally insured banks with \$302.6 billion in assets were closed or received FDIC financial assistance. During this same time, 1,295 savings and loan institutions with \$621 billion in assets also were either closed by the FSLIC or the RTC, or received FSLIC financial assistance.⁴

The failure of 2,912 federally insured depository institutions is equivalent to one failure every other day over the 15-year period. The combined total of \$924 billion in assets from the failed institutions is equivalent to \$168 million in failed bank or savings and loan assets that had to be liquidated or otherwise resolved each day for the 15-year period. The timing of the bank and savings and loan failures between 1980 and 1994, however, was not evenly distributed. At the height of the crisis, which was the five-year

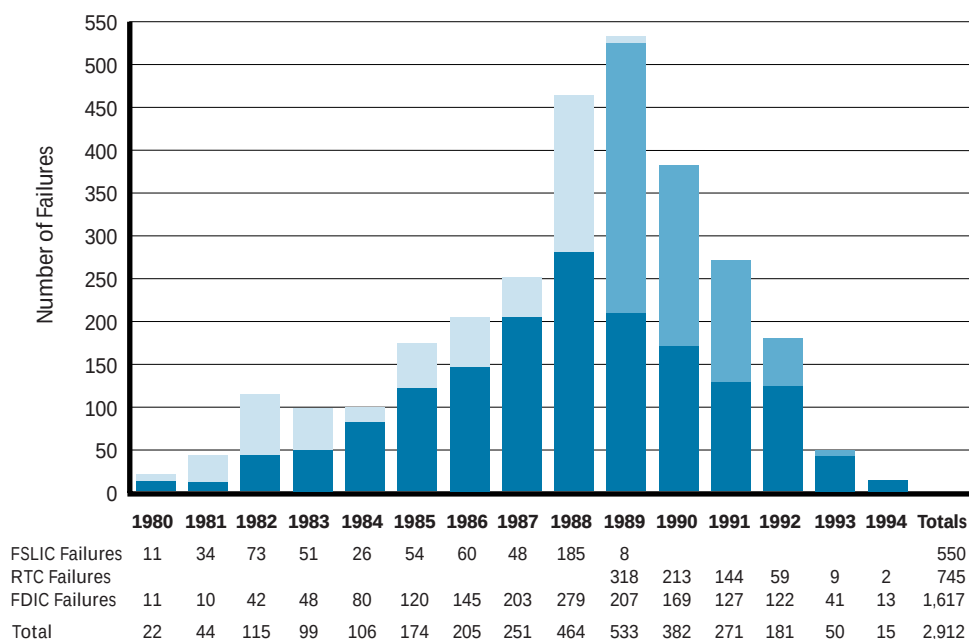
2. Federal Deposit Insurance Corporation, *The First Fifty Years: A History of the FDIC, 1933-1983* (Washington, D.C.: FDIC, 1984), 36.

3. Federal Home Loan Bank Board 1988 reports.

4. The RTC did not provide open bank assistance.

Chart I.1-1

**Combined Number of Failures
(Banks and Savings & Loans)
1980–1994**



Figures include open bank assistance transactions.

Sources: Reports from FDIC Division of Research and Statistics.

period between 1988 and 1992, a bank or savings and loan failed on an average of once a day, bringing with it a daily influx of \$385 million in assets. (See chart I.1-1.)

Another perspective on the crisis is that over the 15-year period, about one out of six federally insured depository institutions were either closed or needed financial assistance. Those institutions held 20.5 percent of the assets in the banking system.⁵

Role of the FDIC and the RTC

As an independent deposit insurance agency for member banks and savings associations, the FDIC has three primary responsibilities: to act as an insurer, a receiver, and a super-

5. The “6:1” ratio was calculated by taking the number of open federally insured banks and savings and loan associations at the end of 1987 (the mid-point of the crisis period) and dividing by the number of institutions that failed or received assistance over the entire 15-year period from 1980-1994 (17,325/2,912).

visor.⁶ Two of these roles—those of insurer and receiver—require that the FDIC play an active role in resolving failing and failed FDIC insured institutions. Those roles are the subject of this study. The interaction between the FDIC as insurer and the FDIC as receiver is important in promoting the efficient, expeditious, and orderly liquidation of failed banks and thrifts to maintain confidence and stability in the U.S. banking system.

First and foremost, the FDIC was established to insure bank deposits. This role of insurer helps ensure the stability of the financial system by guaranteeing the timely funding of insured deposits and the consequent faith in the U.S. banking system in times of stress. The FDIC fulfills this role when a bank fails by paying insured depositors either by direct payment or arranging for the assumption of the deposits by another financial institution. The importance of this role was critical in the bank and thrift crisis of the 1980s and early 1990s. Despite the huge number of bank and thrift failures during this period, there was no evidence of serious runs or credit flow disruptions at federally insured institutions. Most importantly, no depositors suffered any loss of their insured deposits.

When a depository institution fails, the FDIC is normally appointed receiver of the institution by the courts or other authority having jurisdiction. The FDIC's role as receiver is important because it holds the responsibility to the creditors of the receivership to efficiently recover for them the maximum amount possible on their claims. The FDIC itself also becomes a creditor of the receivership. By paying the insured depositors or by arranging their assumption by another institution, the FDIC steps into the shoes of the depositors as a creditor (the FDIC is the subrogee). By returning a significant portion of the failed institution's assets to the private sector quickly, the FDIC as receiver helps replenish the insurance fund while contributing to the stabilization of weakened local economies. When acting as receiver, the FDIC has broad statutory authority and expansive powers to ensure the efficiency of the receivership process. These powers allow the FDIC to expedite the liquidation process for failed institutions and maximize the cost-effectiveness of the receivership process.

Although not a part of the FDIC's primary role, Congress passed various initiatives to further national policy goals. To this end, for example, the FDIC has operated an Affordable Housing Program (AHP) that provides assistance in the form of credits or grants to low- and moderate-income households that purchased lower-valued housing owned by the FDIC as receiver. In addition, the FDIC operated a program during the crisis period to promote the use of minority- and women-owned businesses for various contracted services.

The RTC existed from August 1989 through December 1995 and was established by Congress as a temporary federal agency to clean up the savings and loan (S&L) crisis after the FSLIC fund became insolvent. The RTC's two main roles were to act as conservator and receiver of the insolvent thrifts.⁷ It had a third role, also required by law, to

6. Detailed information about the FDIC's supervisory role during the 1980s and early 1990s can be found in the FDIC's *History of the Eighties—Lessons for the Future: An Examination of the Banking Crisis of the 1980s and Early 1990s*.

7. A conservatorship is established when a regulatory authority appoints a manager, such as the RTC, to take control of a failing institution to preserve assets and protect depositors.

preserve affordable housing held by the receiverships and to facilitate sales to qualified individuals and organizations.

In its role as conservator, the RTC took control of the operations of hundreds of insolvent S&Ls. These institutions remained open, but their operation and their employees came under control of the RTC until the best method for resolution could be determined and implemented. The objectives of the conservatorship were to establish control and oversight while promoting consumer confidence; to evaluate the condition of the institution and determine the most cost-effective method of resolution; and to operate the institution in a safe and sound manner pending resolution by minimizing operating losses, limiting growth, eliminating any speculative activities, and terminating any waste, fraud, and insider abuse. Shrinking an institution by curtailing new lending activity and selling assets also was a high priority. Although a conservatorship is a temporary solution to gain control of a failing institution and to reduce resolution costs, many S&Ls were in conservatorship for long periods of time because the number of insolvent thrifts was large, staff resources were limited, and funding was periodically interrupted.

The RTC's role as receiver is very similar to that of the FDIC's, as described above. It held the same type of special powers, such as the ability to repudiate burdensome contracts and eliminate certain contingent liabilities. A pass-through receivership was usually established at the time that the RTC became conservator or sometime during the conservatorship.⁸ When the conservatorship was finally resolved, the institution was then placed into a (second) receivership.

The RTC also was under a statutory obligation to ensure the preservation and disposition of available affordable housing. Thrifts in the United States are a primary provider of mortgages for single and multi-family housing. The drafters of the Financial Institutions Reform, Recovery, and Enforcement Act (FIRREA) of 1989 recognized that an unprecedented amount of affordable housing would come into the hands of the RTC and could be made available for very low-, low-, and moderate-income families. In response to that, the RTC established a national program to meet the objectives of the legislation.

Major Objectives of the FDIC and the RTC

In its unique roles as deposit insurer of banks and savings associations and also as receiver of failed institutions, the FDIC seeks to maintain stability and the public confidence in the nation's banking system. In the event of institution failures, the FDIC maintains

8. A pass-through receivership is when all deposits, substantially all assets, and certain nondeposit liabilities of the original institution instantly "passed through the receiver" to a newly chartered federal mutual association, subsequently known as the "conservatorship."

stability and public confidence in the system by providing the public with ready access to their insured funds. The FDIC helps ensure the stability of the financial system in times of stress by providing timely or quick resolution of failed institutions. This stability helps promote public confidence in the system and restores liquidity to the economy.

To further minimize disruption to the public during the resolution of failed institutions, the FDIC tries to dispose of the remaining assets of a failed institution as soon as practicable. This allows for quicker payments to the remaining creditors of the failed institution.

As a federal agency with a statutorily limited life, the RTC had a narrower focus than the FDIC. FIRREA gave the RTC the responsibility of managing and resolving all failed depository institutions previously insured by the FSLIC and for which a conservator or receiver was appointed from January 1, 1989, through August 8, 1992. (This was later extended to June 30, 1995.) The main objectives of the RTC defined by FIRREA were (1) to maximize the net present value return from the disposition of failed thrifts and their assets, (2) to minimize the effect of such transactions on local real estate and financial markets, and (3) to maximize the availability and affordability of residential real property for low- and moderate-income individuals.

Each of the three RTC objectives was, in some important way, at odds with the other two. The goal of maximizing the return for the receiverships often meant selling the assets as quickly as possible for the highest price. The goal of minimizing the effect on local markets, however, would imply a measured, if not conservative, approach to the timing of the sale and careful pricing of the thousands of properties before placing them in their respective markets. Finally, to comply with FIRREA, affordable housing sales had to be closely monitored before and after the sale, and a significant portion of the owned real estate portfolio was reserved for lower income individuals. These requirements increased holding and disposition costs, which to some extent put the RTC at odds with its first two objectives.

Compounding the challenge was the fact that from its creation in August 1989, the RTC was responsible for an unprecedented workload. By December 31, 1990, the end of its first full year of operation, the RTC had been appointed conservator of 531 thrifts that contained \$278.3 billion in assets. In contrast to the FDIC, which could rely on insurance premiums paid by banks, the RTC had no internal source of funds. It relied on congressional appropriations and other indirect sources to fund its operations. Also, because appropriations to pay for insolvent thrifts were not popular, the RTC was hampered by delays in obtaining funding. Funding came in stages and each stage required separate legislation and congressional approval. The legislative involvement made long-term planning of the resolution process difficult.

To meet its first two objectives of maximizing the return on the failed thrift assets and minimizing any economic disruption to affected communities, the RTC engaged in the conservatorship process, and drew on the experiences of the FDIC for dealing with the disposition of numerous receiverships with a large volume of assets. The RTC was given conservatorship powers in FIRREA as a means to get the failed and failing thrifts

under government control for as little cost as possible. As conservator, the RTC could begin reducing the expenses of the thrift, curtail new lending to lessen demands on liquidity, and sell assets to raise the working capital necessary to keep the thrift open until government funds were available to fully resolve the thrift.

The RTC reduced expenses by engaging in a strategy early on of not renewing conservatorship depositors' interest-bearing deposits above the current market rates, thus eliminating much of the high cost of funds. As conservator, the RTC could openly market the assets and the franchise because the troubled status of the thrifts under conservatorship was public knowledge. The FDIC, on the other hand, was more secretive in its bank pre-failure marketing efforts because it was dealing with an ongoing franchise that might not fail and too much negative publicity could cause a run on deposits, thereby bringing about the closing of the bank unnecessarily.

Because of the delays in funding, which forced institutions to stay in conservatorship for extended periods of time, the RTC's asset disposition strategy also became very different from the FDIC's. The FDIC emphasized the sale of the maximum amount of the failed bank's assets to the bank acquirer at resolution. The RTC, on the other hand, focused on selling the assets directly from the conservatorship or receivership, and only a limited amount of assets were passed to the acquirer at resolution.

Because of the size of the S&L problem, one of the RTC's earliest challenges was dealing with the requirement of selling assets quickly without being accused of "dumping" them for perceived too low prices. The language in FIRREA concerning this issue led to lagging sales and burgeoning inventories. By 1991, the language of FIRREA was amended to allow the RTC to sell properties more quickly.⁹

As mandated in FIRREA, the RTC also began contracting with private asset management and disposition firms to dispose of the assets. Because of its limited life, the RTC did not have the time or resources to develop the necessary experienced staff. The RTC expanded on the FDIC's methods of using large private firms and developed a number of innovative techniques to meet its objectives. The RTC also developed national sales centers to sell assets in bulk and partnerships with private asset management firms. In the area of securitization, the RTC created markets for securitizing less traditional assets, such as commercial loans. These securitization efforts made it possible for the RTC to dispose of a large volume of thrift assets under difficult time constraints and at prices that might not have been realized in whole loan sales markets.

The RTC was not faced with the same set of resolution circumstances as the FDIC. Because of the RTC's funding limitations and its having so many thrifts in conservatorship, the RTC had to set priorities in its resolution schedule. It selected those institutions that presented the best opportunity for minimizing costs to the RTC or those with

9. FIRREA included language requiring the RTC to sell real estate for no less than 95 percent of its appraised (market) value. In 1991, in response to growing criticism about low sales and congressional concern with the cost of maintaining the rapidly growing inventory of properties, FIRREA was amended to reduce the minimum sales price to no less than 70 percent of appraised value.

a higher rate of deterioration because of operating losses, eroding core deposit bases, and loss of key personnel.

The RTC was innovative in separating the sale of assets from the sale of liabilities in its franchise marketing efforts, and it developed new methods that allowed it to sell a large number of institutions in a short time. The RTC's focus on branch breakup transactions increased bidder participation, competition, and flexibility in the resolution process and ultimately led to increased premiums.

To meet the objective of fulfilling the affordable housing mandate, the RTC developed a formal program for this area. In the process, the RTC established working relationships and partnerships with many public and private entities across the country to achieve their goals. By its sunset date of December 31, 1995, the RTC had sold over 100,000 units of affordable housing.

Legislative Framework

Until the 1980s, most of the FDIC's resolution powers were generated from legislation enacted in the 1930s and 1950s. As the banking and thrift crisis deepened the FDIC and the RTC needed expanded and improved powers to meet their resolution objectives. Congress focused on these banking problems throughout the 1980s and 1990s by enacting legislation that provided new resolution tools, re-capitalized the depleted insurance funds, and promoted stronger supervision and less regulatory discretion.

One of the first significant pieces of banking legislation passed in response to the banking and thrift problems in the late 1970s was the Depository Institutions Deregulation and Monetary Control Act (DIDMCA) of 1980. With a goal of improving the competitiveness of banks and thrifts, DIDMCA began the process of deregulating the interest rate ceilings that could be offered to depositors and raised the deposit insurance limit from \$40,000 to \$100,000.

The next major banking legislation of the 1980s occurred when Congress passed the Garn–St Germain Depository Institutions Act (Garn–St Germain) of 1982. This act was aimed at resolving problems in the S&L and savings bank industries by further expanding their powers, allowing them to compete in the area of commercial lending. It also provided them with direct investment authority. The deregulation of restrictions on interest rates and their subsequent increase led to some well-managed institutions becoming significantly undercapitalized. To temporarily augment the capital of these select institutions, a type of regulatory forbearance was included in the act in the form of net worth certificates (NWC). In addition, Garn–St Germain broadened the FDIC's ability to use OBA, which occurs when a distressed financial institution remains open with government financial assistance. The FDIC no longer had to prove that an institution was essential to the community for it to be allowed to receive OBA. The FDIC could use OBA if its use was less costly than the estimated cost of liquidating the subject institution.

Both bankers and regulators were not prepared for the affects that deregulation would have on the banking industry. This led to a series of banking legislation enacted in the 1980s and 1990s to attempt to mitigate and control the crisis that followed.¹⁰

As the thrift crisis worsened and commercial bank failures increased, Congress passed the Competitive Equality Banking Act (CEBA) of 1987. This act contained several provisions that were particularly significant for the FDIC. It expanded the FDIC's emergency interstate acquisition authority and permitted the FDIC to establish a temporary bridge bank.¹¹ (A bridge bank is a chartered national bank that operates under a board appointed by the FDIC; it assumes the deposits and certain other liabilities and purchases certain assets of one or more failed banks.) CEBA also authorized a forbearance program for agricultural banks that allowed them to amortize their losses on agricultural loans over seven years, rather than deduct the amount of loss from capital as soon as the loss was identified.

Because of the extent of the thrift crisis, the FSLIC reserves were exhausted and its insurance fund became insolvent. Congress passed FIRREA in 1989, at a time when the FSLIC was confronted with some 600 seriously troubled savings associations with assets of about \$350 billion. FIRREA dissolved the FSLIC, authorized use of taxpayer funds to resolve failed thrifts, and established the RTC. The RTC was mandated to merge or liquidate savings associations previously insured by the FSLIC that would be declared insolvent during the period from January 1, 1989, through August 8, 1992 (later extended to June 30, 1995), with the FDIC named as the manager of the RTC.

FIRREA also significantly changed the financial institution regulatory structure and strengthened the authority of federal supervisors to require adequate capital, promote safe banking practices, and ensure compliance with applicable laws. The powers and duties of the FDIC in particular were greatly expanded. Some of the key provisions of FIRREA included: eliminating the existing thrift regulatory structure and creating the Office of Thrift Supervision (OTS) in its place, moving the responsibility of thrift deposit insurance to the FDIC, authorizing the FDIC to assess insured depository institutions whose affiliated insured depository institutions had failed (that is, cross guaranty assessment authority), and authorizing the FDIC and the RTC to appoint themselves as sole conservator or receiver of any insured state depository institution, provided certain criteria were met.

The next act that had a significant impact on the FDIC was the Federal Deposit Insurance Corporation Improvement Act (FDICIA) of 1991. While the law touched a wide range of regulatory areas, certain provisions—particularly those pertaining to

10. For more information see Appendix A, Legislation Governing the FDIC's Roles as Insurer and Receiver.

11. CEBA extended and expanded the FDIC's emergency interstate acquisition authority so that when the FDIC was resolving institutions with assets greater than \$500 million, bank holding companies could be sold in whole or in part and out-of-state holding companies would be permitted expansion rights in the state of acquisition. This authority came at a critical time as the size of institution failures was increasing and fewer intrastate acquirers of sufficient size and strength were available.

prompt corrective action (PCA) for failing institutions and to least cost resolutions—had profound effects on the way the FDIC conducted failed bank resolutions. Federal regulators were required by FDICIA to establish five capital levels, ranging from well-capitalized to critically undercapitalized, that serve as the basis for PCA. As an institution's capital declines, the appropriate regulator must take increasingly stringent measures. One of the aspects of PCA that most directly affects the FDIC's approach to resolutions prescribes mandatory measures for critically undercapitalized institutions, which are banks with tangible equity equal to or less than 2 percent of total assets. Provisions of FDICIA also require that a conservator or receiver must be appointed no later than 90 days after an institution falls into the critically undercapitalized category. The appropriate federal regulatory authority can grant up to two 90-day extensions of the PCA period if it determines that those extensions would better protect the relevant insurance fund from long-term losses.

FDICIA also requires that if the FDIC does not liquidate a failing institution (conduct a deposit payoff), then it must pick the least costly resolution alternative. All bids must be considered together and evaluated on the basis of comparative cost; other policy considerations, regarding which regulators previously had some discretion, cannot be factored into the determination of the appropriate transaction. FDICIA compelled the FDIC to consider more transaction options than in the past to make certain that all feasible least cost structures were offered.

Revisions to the FDIC's OBA authority were the subject of two separate FDICIA provisions. First, the FDIC could provide OBA only if it had determined that grounds for the appointment of a conservator or receiver exist and that the institution's capital is not likely to be increased without assistance. Second, the FDIC had to determine that the institution's management was competent and not the cause of its problems.

As the banking and thrift crisis peaked in the early 1990s, the RTC Refinancing, Restructuring, and Improvement Act (RTCRIA) of 1991 was passed and further segregated the RTC from the FDIC. The restructured RTC was to be headed by a chief executive officer appointed by the president with the advice and consent of the Senate, instead of the FDIC chairman and Board of Directors. The RTC Oversight Board was recast into the Thrift Depositor Protection Oversight Board, made up of five government officials and two private sector representatives. RTCRIA provided the RTC with \$25 billion more in funding through April 1, 1992, and extended the RTC's ability to accept appointment as conservator or receiver from August 9, 1992, to September 30, 1993.

Of particular importance to the deposit insurance funds was a major provision in the Omnibus Budget Reconciliation Act of 1993. The act included a national depositor preference provision, which pertained to all insured depository institutions that closed on or after August 10, 1993. This provision stipulates that a failed institution's depositors (including the FDIC standing in the place of insured depositors it has already paid) have priority over general creditor claims. It was established to standardize the claims process and to reduce the FDIC's and the RTC's cost of resolutions. Previously, asset

proceeds were distributed according to the law of the jurisdiction that chartered the failed institution.

In terms of the mission of the RTC and the FDIC, after FIRREA, the most significant banking statute was the RTC Completion Act (Completion Act) of 1993. From April 1, 1992, through December 17, 1993, the RTC did not have sufficient funding to resolve additional failed savings and loan institutions. The Completion Act removed the April 1, 1992, deadline for the use of funds that had previously been established, thus permitting the RTC to use the remaining \$18.3 billion authorized under RTCRRRIA to resolve the remaining insolvent thrifts. The act also extended the September 30, 1993, deadline for appointment of the RTC as conservator or receiver for savings associations to a date between January 1, 1995, and July 1, 1995, to be determined by the chairperson of the Thrift Depositor Protection Oversight Board. The transfer of the RTC operations to the FDIC and termination of the RTC was accelerated from December 31, 1996, to December 31, 1995. The RTC was required to adopt a series of management reforms and implement provisions designed to improve the agency's record in providing business opportunities to minorities and women when issuing RTC contracts or selling assets. The AHP was amended to add the requirement that the FDIC and the RTC provide tenants a right of first refusal to purchase one-to-four family residences owned by the FDIC or the RTC. The changes also required the agencies to give limited preference to offers from nonprofit corporations, government agencies, and others that would provide for use of a property by homeless individuals and families.

Methods of Handling Bank and S&L Failures

The FDIC and the RTC used different approaches to find the most efficient way of managing bank and thrift failures. The resolution process itself went through a series of changes and adjustments throughout the crisis period because of ever-changing market conditions and legislation that prompted innovative cooperation between the government and the private sector. Until the early 1980s, the FDIC most often relied on the purchase and assumption (P&A) resolution process in which an acquirer purchased some or all of the assets and assumed certain liabilities. If an acquirer could not be found, the FDIC used a deposit payoff resolution where the depositors were paid an amount equal to their insured funds and all other liabilities and assets were held by the FDIC as receiver. These resolution options were later expanded to include ones that allowed for financial assistance to weakened, open institutions (open bank assistance) and maximized opportunities to get failed institutions' assets into private hands as efficiently and quickly as possible.

The types and sizes of the assets and liabilities of the failed banks influenced the resolution methods that were created and used. In the 1970s and the early 1980s, there had been few closings and the FDIC was more concerned about the safety and soundness of the newly created bank than whether the assets of the failed bank passed to the acquirer.

The acquiring bank generally purchased only the cash and cash equivalents of the bank, which left all the other assets for the FDIC to resolve. The resolution process changed as bank failures grew in the mid-1980s and traditional resolution methods proved inadequate. The FDIC determined that a strategy of passing as many of the assets as possible at resolution to acquirers would reduce the strain on the liquidity of the insurance fund and on its limited staffing resources while moving the assets more quickly back to the private sector.

The resolutions used by the RTC were similar to those used by the FDIC. The RTC also used P&A transactions and deposit payoffs, although it did not have the authority to engage in OBA. The RTC's methods of handling institution failures, however, were different from the FDIC's primarily due to the situation that the RTC had inherited. When the RTC was established in August 1989, it immediately assumed responsibility for 262 thrift institutions in conservatorship with assets of \$115 billion. Because of sporadic funding, the RTC often had to delay its resolution plans.

As a result of provisions in a series of legislation, beginning with FIRREA, the RTC also developed resolution programs to preserve and, if possible, to increase the number of minority-owned institutions. The programs were structured to give preference to potential acquirers of the same ethnic identification as the previous owners' if the bids were less costly than a payoff would be. The programs were expanded in 1993 to give bidding preference to a minority acquirer making an offer for any thrift or any of its branches, located in a neighborhood where 50 percent of the residents were minorities. The number of minority-owned thrifts that failed was relatively small. Of those that did fail, however, minority ownership was preserved in approximately 50 percent of those that were purchased.

The RTC resolution process evolved into a simpler process than the FDIC's. Because the public was already aware that the RTC had control of an institution, there was no need for the secrecy that was required when the FDIC took bids on open institutions. The RTC was able to widely market the thrifts by placing advertisements in national publications. It developed ways to market and sell large numbers of thrifts in a short time. It simplified its process by making a conscious decision to separate the marketing of the assets from the marketing of the deposit franchise. The RTC completed resolutions on 747 thrifts.

The three primary methods of resolutions, the P&A transaction, the deposit payoff, and the OBA option, are described in more detail below.

Purchase and Assumption Transactions

A P&A is a resolution transaction where a healthy insured institution purchases some or all of the assets and assumes, at a minimum, all insured deposits and may assume all of the deposit liabilities of a failed bank or thrift. The P&A was the favored resolution policy of the FDIC. From 1980 to 1994, the FDIC handled 1,188 of the 1,617 failing and failed institutions, or 73.5 percent, through P&A transactions. Similarly, of the \$302.6

billion in assets and \$233.2 billion in deposits, \$204 billion of the assets (67.4 percent) and \$161.3 billion of the deposits (69.2 percent) were in the 1,188 institutions handled through P&A transactions.

Like the FDIC, the RTC's emphasis during its resolution history generally was on P&A transactions. Of the 747 institutions resolved by the RTC, 497 institutions, or 66.5 percent, were handled through P&As. Similarly, of the \$220.6 billion in deposits at those 747 institutions, \$161 billion of the deposits, or 73 percent, were in the 497 institutions handled through P&A transactions.

As the number of failures increased and resources were stressed, the P&A transaction evolved. In early P&As, the acquiring bank generally assumed all of the failed bank's deposit liabilities (including uninsured funds) and certain secured liabilities. The acquirer also purchased a limited amount of "clean" assets (like cash and cash equivalents). The FDIC generally did not sell loans to an acquiring institution, thereby retaining the assets' associated risk.

When the amount of assets it received began to overwhelm the FDIC, it tried to transfer as many assets as possible to the acquiring banks by using a "put" option. To induce the acquirer to take more assets, the FDIC required the acquirer to take assets, but allowed them to put back to the FDIC those assets they did not wish to keep within a specified timeframe. While the put option was a way to pass more assets to the acquirer, thereby lowering the initial cash payment to the acquiring bank, there were several significant problems with this feature. First, acquirers were able to "cherry pick" the assets, choosing to keep only those with market values above book value or assets having little risk, while returning all other assets. Second, assets tended to be neglected by the acquirer during the put period before being returned, which adversely affected their value. Finally, the limited due diligence before bidding did not allow acquirers to include the potential profits in their bids. The FDIC discontinued use of the put option as a resolution tool in late 1991. The RTC also used put options in an attempt to pass more assets. Put options were used extensively during the first year of the RTC's existence and their results were similar to those experienced by the FDIC. Although approximately \$40 billion of assets were sold subject to put options, over \$20 billion of those assets were subsequently returned to the RTC.

Another method used by the FDIC to induce acquirers to retain assets was to give priority to bidders that proposed taking the largest number of assets at resolution. That policy led to the use of the whole bank P&A transaction. This type of transaction passed to the acquirer virtually all of a failed bank's assets and deposits. The FDIC made a one-time payment to the winning bidder and in return the acquirer assumed all of the risk associated with ownership of the assets and liabilities of the institution.

Whole bank sales were widely used from 1988 to 1991 and during that period represented 23 percent of the FDIC's total resolution transactions. At that time (pre-FDICIA), whole bank bids simply had to be less expensive to the FDIC than the cost of liquidation; after the least cost provisions were mandated, though, whole bank bids could no longer remain competitive. While the FDIC maximized its transfer of assets

back to the private sector and most significantly preserved liquidity, this strategy likely came at the expense of somewhat higher overall resolution costs.

By the early 1990s, the FDIC was having difficulty obtaining reasonable bids from acquirers for portfolios of commercial loans from large bank failures. To convince reluctant acquirers to purchase these loans, the FDIC developed P&As with a loss sharing feature. In those transactions, the FDIC reduced the acquirer's risk by covering the majority of the loss (and receiving the majority of the recovery) on certain pools of problem assets, and the acquirer agreed to take responsibility for the remainder of the loss on those asset pools. Between 1991 and 1993, the FDIC implemented loss sharing a total of 16 times, primarily at large bank failures, to resolve 24 failed banks. (See table I.1-1.)

Loss sharing transactions kept failed bank assets in the banking sector. The loss share transactions were able to pass \$18.5 billion, or 45 percent, in failed bank assets under loss sharing and another \$17.8 billion, or 43 percent, to the acquirer without loss sharing, which left only \$5.1 billion, or 12 percent, of residual assets retained by the FDIC for liquidation. In comparison, the 175 P&A transactions during 1991 and 1992 that did not involve loss sharing accounted for \$62.1 billion in failed bank assets and were able to pass just \$24.3 billion, or 39 percent, of the failed bank assets to the acquirers.

The P&A transactions with loss sharing were less expensive than those without it, including whole bank transactions. The 24 failed loss share banks were resolved by the FDIC at a cost of \$2.5 billion, or 6.1 percent of assets. The 175 banks resolved by P&As without loss sharing during the period were resolved by the FDIC at a cost of \$6.5 billion, or 10.4 percent of assets. A further comparison of costs of loss share transactions and conventional P&A transactions has been made on both large banks (total assets over \$500 million) and small banks with assets under \$500 million. In both small and large banks that failed during the same period, the costs in relation to total assets were less expensive on the loss share transactions.

Under the various P&A asset purchase structures offered post-FDICIA, bidders were given the option of bidding on only the insured deposits. Because an "insured deposit only" bid did not have to compensate the FDIC or the RTC for the additional cost of covering 100 percent of the uninsured depositor's claim, it was easier for an insured deposit only bid to pass the least cost test. Additionally, as the FDIC and the RTC began offering this option on an increasingly regular basis, acquirers discovered that the effects of not covering the uninsured depositors were less detrimental than they had once believed.

The results of this change in acquirer bidding behavior were immediately apparent. Chart I.1-2 displays the number of failed banks where the uninsured depositors were both protected and unprotected from 1986 through 1995. On average, 82 percent of all banks failing from 1992 to 1995 were resolved in a manner that did not provide full protection to uninsured depositors, compared with 17 percent from 1986 to 1991. Perhaps more significantly, 85 percent of all the deposits in banks that failed from 1986 to 1991 were in banks where all deposits were protected. By comparison, only 15 percent of the deposits in failed banks from 1992 to 1995 were in banks where all deposits were

Table I.1-1

FDIC Loss Share Transactions 1991–1994

(\$ in Millions)

Transaction Date	Failed Bank*	Location	Total Assets	Resolution Costs	Resolution Cost as Percentage of Total Assets
09/19/91	Southeast Bank, N.A.†	Miami, FL	\$10,478	\$0	0.00
10/10/91	New Dartmouth Bank	Manchester, NH	2,268	571	25.19
10/10/91	First New Hampshire	Concord, NH	2,109	319	15.14
11/14/91	Connecticut Savings Bank	New Haven, CT	1,047	207	19.77
08/21/92	Attleboro Pawtucket S.B.	Pawtucket, RI	595	32	5.41
10/02/92	First Constitution Bank	New Haven, CT	1,580	127	8.01
10/02/92	The Howard Savings Bank	Livingston, NJ	3,258	87	2.67
12/04/92	Heritage Bank for Savings	Holyoke, MA	1,272	21	1.70
12/11/92	Eastland Savings Bank‡	Woonsocket, RI	545	18	3.30
12/11/92	Meritor Savings Bank	Philadelphia, PA	3,579	0	0.00
02/13/93	First City, Texas-Austin, N.A.	Austin, TX	347	0	0.00
02/13/93	First City, Texas-Dallas	Dallas, TX	1,325	0	0.00
02/13/93	First City, Texas-Houston, N.A.	Houston, TX	3,576	0	0.00
04/23/93	Missouri Bridge Bank, N.A.	Kansas City, MO	1,911	356	18.62
06/04/93	First National Bank of Vermont	Bradford, VT	225	34	14.97
08/12/93	CrossLand Savings, FSB	Brooklyn, NY	7,269	740	10.18
Totals/Average			\$41,384	\$2,512	6.07

* The banks listed here are the failed banks or the resulting bridge bank from a previous resolution; however, it is the acquirer that enters into the loss sharing transaction with the FDIC.

† Represents loss sharing agreements for two banks: Southeast Bank, N.A., and Southeast Bank of West Florida.

‡ Represents loss sharing agreements for two banks: Eastland Savings Bank and Eastland Bank.

Source: FDIC Division of Research and Statistics.

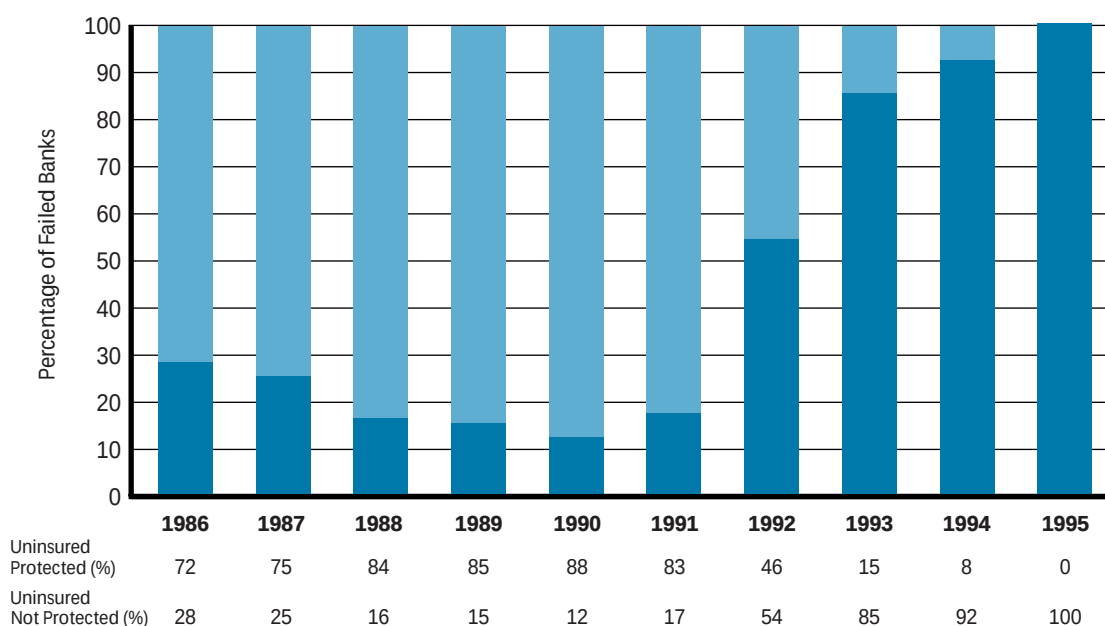
protected. One of the intentions of FDICIA was that uninsured depositors bear more of the cost of bank failures. This result appears to have been achieved. Uninsured depositors did, however, receive some relief as the Omnibus Budget Reconciliation Act of 1993 included a national depositor preference provision giving them priority over general creditors of the receivership.

Deposit Payoffs

Deposit payoffs were used when no acquirer could be found or if the FDIC or the RTC did not receive a less costly bid for a P&A transaction. Generally, deposit payoffs occurred in smaller bank failures when there was little interest in the banking franchise. In a deposit payoff, no liabilities are assumed and no assets are purchased by another institution. The FDIC or the RTC would pay depositors of the failed institution the amount of their insured deposits either directly (known as a straight deposit payoff) or through a healthy institution that acts as the FDIC or the RTC's agent (called an insured deposit transfer, or IDT). Depositors with uninsured funds and other general creditors

Chart I.1-2

Uninsured Depositor Treatment 1986–1995



Source: FDIC Division of Finance, *Failed Bank Cost Analysis, 1986–1995*.

of the failed institution were given receivership certificates entitling them to a share of the net proceeds from the sale of the failed institution's assets.¹²

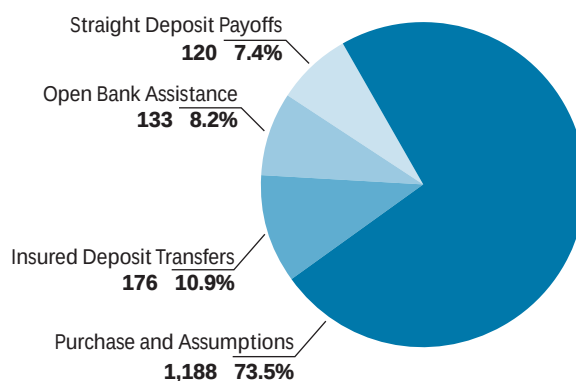
In 1983, the FDIC introduced the insured deposit transfer. An IDT involves the transfer of insured deposits and secured liabilities of the failed bank to a healthy institution that agrees to act as the FDIC's agent. The agent bank makes available to the depositors of the failed bank a "transferred deposit" account. The IDT saved the FDIC considerable overhead expense while providing an opportunity for the agent bank to introduce their services to potential new customers.¹³ Because this type of transaction reduced the disruption caused by a deposit payoff to insured depositors and to the local community, it was considered more consumer-friendly than a straight deposit payoff and was employed whenever practicable. At times, however, certain circumstances precluded its use, such as when no other bank was interested in performing the "as agent" role, when perhaps too many deposits were tied to loans, or when the FDIC had to act so quickly that there was no time to set up such a transaction with another bank.

Of the 1,617 failing and failed institutions handled by the FDIC between 1980 and 1994, deposit payoffs were used 296 times, or 18.3 percent of the total. These transactions represented only 5.3 percent of the assets and 6.1 percent of the deposits of the banks handled by the FDIC for this period. IDTs accounted for 176 of the 296 deposit payoffs, or 59.5 percent of the total number of transactions. (See chart I.1-3.)

At the RTC, deposit payoffs were more common because many of its early conservatorships consisted of institutions that had been insolvent for some time, were located in declining real estate markets, and had little franchise value because of industry conditions. Of the 747 institutions resolved by the RTC, 158, or 21.2 percent, were handled through IDTs and 92, or 12.3 percent, involved straight deposit payoffs. (See chart I.1-4.)

Chart I.1-3

**FDIC: Bank Failures by Resolution Method
1980–1994**



Total Bank Failures = 1,617

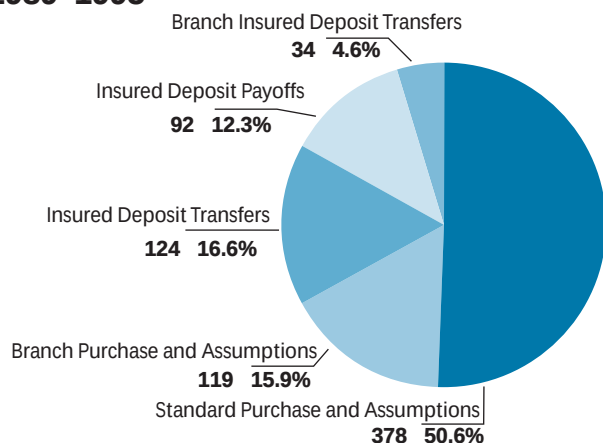
Sources: FDIC Division of Research and Statistics and FDIC annual reports.

12. The FDIC's insurance limit is \$100,000. Any amount over that limit, including interest, is uninsured. The FDIC uses the term "insured depositor" to refer to any depositors whose total deposits are under the insurance limit. Similarly, the term "uninsured depositor" is used to refer to those depositors whose total deposits are over the insurance limit. It is important to note that customers with uninsured deposits are paid up to the insurance limit, and only that portion of their deposits over the insurance amount is uninsured.

13. FDIC, *1983 Annual Report*, 12.

Chart I.1-4

RTC: Savings and Loan Failures by Resolution Method 1989–1995



Total Savings and Loan Failures = 747

Sources: FDIC Division of Research and Statistics and FDIC annual reports.

In addition, in an effort to alleviate an uninsured depositor's liquidity problems caused by the unexpected loss of their funds, both the FDIC and the RTC issued advance dividends.¹⁴ This type of transaction, originally known as a "modified pay-off," allowed the FDIC or the RTC to provide depositors with at least a portion of their uninsured funds more quickly.

Open Bank Assistance

Open bank assistance was a resolution method in which the FDIC provided an insured bank at risk of failure with financial help in the form of loans, contributions, deposits, asset purchases, or the assumption of liabilities. Generally, the majority of a failing institution's assets remained intact.¹⁵ While the term "open bank assistance" gained national recognition with the Continental transaction in

1984, the FDIC had been authorized to provide OBA since 1950.¹⁶ OBA occurred when a distressed financial institution remained open with the aid of the financial assistance from the government.¹⁷ Generally, the FDIC required new management, ensured that the shareholders' interest was diluted to a nominal amount, and called for a private-sector capital infusion. OBA also was used to facilitate the acquisition or merger of a failing bank or thrift by a healthy institution. A major criticism of OBA has been that shareholders of failing institutions have benefited from government assistance, even though historically most of the OBA transactions required the shareholders of the failing institutions to significantly dilute their ownership interests.

The FDIC has not used OBA transactions frequently. From 1950 to 1982, the FDIC could grant OBA only if the institution's continued existence was determined to

14. An advance dividend is a payment made to uninsured depositors immediately or soon after a bank fails, based on the estimated value of the receivership's assets.

15. The RTC was not permitted to use OBA.

16. For further information, see Chapter 5, Open Bank Assistance and Part II, Case Studies of Significant Resolutions, Chapter 4, Continental Illinois National Bank and Trust Company.

17. Several types of assistance to open banks include forms of cash and noncash assistance. To the FDIC, the term "open bank assistance" refers specifically to a resolution method whereby the FDIC gives financial assistance to a troubled bank or thrift to prevent its failure.

be “essential” to providing adequate banking services in the community. The FDIC’s authority to provide OBA, however, changed over time. Authority was broadened in the 1980s and then restricted in the 1990s. From 1980 through 1994, the FDIC provided OBA to 133 institutions out of the 1,617 total banks handled by the FDIC, or only about 8.2 percent of the total. OBAs were, however, used for some of the larger failures in the 1980s and represented approximately 27 percent of the assets of the banks handled by the FDIC during this period. Beginning with 1989, the FDIC moved away from providing OBA and entered into only seven OBA transactions from 1989 to 1992. One of the reasons for this was that FDICIA, passed in 1991, required the FDIC to establish that OBA was the least costly resolution option to the insurance fund prior to providing assistance to the failing institution. The FDIC could deviate from the least cost requirement only to avoid systemic risk to the banking system. Finally, under the Completion Act, passed in 1993, insurance funds could not be used to benefit shareholders of the failing institution. There have been no OBA transactions since 1992. (See chart I.1-3.)

Forbearance Programs

Other resolution techniques were developed in the 1980s that were used to stabilize certain regional and economic sector problem situations. The early 1980s were a period of high and volatile interest rates, which particularly affected mutual savings banks (MSB) because those institutions held large portfolios of long-term fixed-rate mortgages. By 1982, MSBs were losing \$2 billion annually. In many instances, the market value of the savings banks’ assets fell 25 to 30 percent below outstanding liabilities.¹⁸ The FDIC faced the possibility of incurring significant losses for a problem that was believed to be transitory—high interest rates.

Income Maintenance Agreements. One of the FDIC’s resolution strategies in the early 1980s was to force weaker savings banks to merge into healthier banks or thrifts by guaranteeing a market rate of return on the acquired assets through an income maintenance agreement. The FDIC paid the acquirer the difference between the yield on acquired earning assets and the average cost of funds for savings banks, thereby assuming the interest rate risk. If interest rates declined to where the cost of funds was below the yield on earning assets, the acquirer was required to pay the FDIC.

Between 1981 and 1983, income maintenance agreements were used to resolve 11 of the assisted mergers of FDIC insured mutual savings banks as detailed on table I.1-2. These banks did not technically fail because they were merged into operating institutions. Depositors and general creditors, therefore, suffered no loss. In most cases, however, the failing bank’s senior management was requested to resign, and subordinated note holders only received a partial return of their investment. Because there are no stockholders in a mutual savings bank, the FDIC did not have to concern itself with the

18. FDIC, *The First Fifty Years*, 99.

Table I.1-2**Income Maintenance Agreements**

(\$ in Millions)

Date	Bank Name	Location	Assets	Acquirer	Comments
11/4/81	Greenwich Savings	New York, NY	\$2,475	Metropolitan S.B. * (Renamed CrossLand in 1984)	Failed in 1992
12/4/81	Central S.B.	New York, NY	910	Harlem S.B. (Renamed Apple Bank for Savings in 1983)	
12/18/81	Union Dime S.B.	New York, NY	1,453	Buffalo S.B. (Renamed Goldome Bank for Savings in 1984)	Failed in 1991
1/15/82	Western NY S.B.	Buffalo, NY	1,025	Buffalo S.B. (Renamed Goldome)	Failed in 1991
2/20/82	Farmers & Mechanics S.B.	Minneapolis, MN	1,002	Marquette National Bank	
3/11/82	Fidelity Mutual S.B.	Spokane, WA	703	First Interstate National Bank	
3/26/82	New York Bank for Savings	New York, NY	3,404	Buffalo S.B. (Renamed Goldome)	Failed in 1991
4/2/82	Western Savings Fund Society	Philadelphia, PA	2,126	Philadelphia Savings Fund Society (Renamed Meritor S.B.)	Failed in 1992
10/15/82	Mechanics Savings Bank	Elmira, NY	55	Syracuse Savings Bank	Failed in 1987
2/9/83	Dry Dock Savings Bank	New York, NY	2,452	Dollar S.B. (Renamed Dollar Dry Dock Savings Bank)	Failed in 1992
10/1/83	Auburn Savings Bank	Auburn, NY	133	Syracuse Savings Bank	Failed in 1987
Totals	11 Institutions		\$15,738		

* Savings Bank

Sources: FDIC annual reports, 1981 to 1993.

interests of existing stockholders. While the cost savings of the program are difficult to quantify, the income maintenance agreement program provided participating mutual savings banks time to restructure their balance sheets and remain solvent until interest rates became more favorable.

Net Worth Certificates. Another resolution strategy was the Net Worth Certificate (NWC) Program. The program's purpose was to buy time for savings banks to correct rate sensitivity imbalances and restore capital to acceptable levels. Garn–St Germain enabled insured institutions that met statutory requirements to apply for capital assistance in the form of net worth certificates.

Under the program, eligible institutions received promissory notes from the FDIC representing a portion of current period losses in exchange for certificates that were to be considered as part of the institution's capital for reporting and supervisory purposes. Although Garn–St Germain did not prescribe a formula based on specific capital levels, the FDIC established a working formula to purchase certificates equal to between 50 percent and 70 percent of the institution's net operating loss.

The NWC Program allowed solvent, well-managed institutions to survive until the results of restructured balance sheets produced profitable operations or until unassisted mergers with stronger institutions could be arranged. The effectiveness of the NWC Program was largely the result of the drop in interest rates after 1981. In addition, the FDIC was generally able to contain the risks associated with the continued operation of banks having little or no equity. Most of the savings banks were free of serious credit-quality problems, and the relatively small number of savings banks in the program simplified supervision and helped control potentially risky behavior.

Of the 29 savings banks in the plan, 22 required no further assistance and eventually extinguished their net worth certificates. Seven savings banks required additional financial help from the FDIC, four repaid all assistance, and three merged into healthy institutions with additional monetary aid from the FDIC.¹⁹

Other Forbearance Programs. By the mid-1980s, many regional banks with a concentration of assets, mainly loans in the energy and agricultural sectors, began having serious credit problems and began failing. To save some of these banks, the FDIC developed a resolution strategy of forbearance, which exempted certain distressed institutions that had been operating in a safe and sound manner from capital requirements.

In 1986, the Capital Forbearance Program was established for banks that were weakened as a result of lending to the agricultural and energy sectors. Federal regulators issued a joint policy allowing capital forbearance programs for agricultural banks and banks with a concentration of energy credit. The program was directed at well-managed, economically sound institutions. Eligible banks had to have a capital ratio of at least 4 percent, and their weakened capital position had to be the result of external problems in the

19. FDIC, Office of Research and Statistics, "Open Bank Assistance: A Study of Government Assistance to Troubled Banks from the RFC to the Present" (May 1990), 12.

Table I.1-3

**Results of the Capital Forbearance Programs*
Agricultural and Energy Sector Banks**

	Regulatory Joint Policy	CEBA Loan Loss Amortization
Number of Banks in Program	301	33
Assets (\$ in Billions)	\$13.0	\$0.5
Avg. Size of Bank (\$ in Millions)	\$43.2	\$15.2
Number of Banks that Survived†	236	29
Number of Banks that Failed	65	4

* Banks that participated in both programs are included only in the regulators' program.

† Banks that left programs as independent institutions or were merged without assistance.

Source: FDIC Division of Research and Statistics.

economy and not mismanagement, excessive operating expenses, or excessive dividends. Ultimately, 301 agricultural and energy sector institutions with assets of approximately \$13 billion participated in the Capital Forbearance Program; 236 of these banks survived or merged without FDIC assistance, while 65 of these banks subsequently failed.

Congress's passage of CEBA in 1987 provided the FDIC with another forbearance program aimed at defusing the agriculture crisis. The Agricultural Loan Loss Amortization Program was Congress's initiative to allow "fundamentally sound banks to weather [the current] storm."²⁰ This program provided additional relief to agricultural lenders by permitting small banks serving predominantly agricultural customers to defer accounting recognition of agriculture-related loan losses. The program allowed those banks to amortize losses over a seven-year period. Only institutions with less than \$100 million in total assets with at least 25 percent of their total loans in qualified agricultural credits were eligible for the program. Qualified institutions had to be considered economically viable and fundamentally sound except for needing additional capital to carry the weak agricultural credits.

These temporary forbearance programs were successful; overall, the capital ratio and return on assets of the banks in the programs improved by year-end 1989, a trend that mirrored improving economic conditions in the agricultural and energy markets. Of the 33 banks in this program, 29 survived while 4 failed. (See table I.1-3.)

There are many risks in offering forbearance, but carefully managed programs can prevent institution failures and reduce costs to the insurance fund. Without proper over-

20. *Congressional Record*, 100th Congress, 2d session, March 26, 1987, S.3941.

sight, however, forbearance can create the opportunity for further deterioration and result in increased resolution costs as operating losses accumulate. This is what occurred in the savings and loan industry in the 1980s when forbearance was applied broadly to the whole industry. This did not occur in the bank forbearance programs because a smaller number of institutions were involved and, unlike the FSLIC, the FDIC had the resources to more closely monitor and supervise the participants.

Other Resolution Strategies

The FDIC and the RTC employed other strategies to resolve institutions. Some of those strategies included the use of bridge banks, conservatorships, and branch breakups.

Bridge Banks/Conservatorships. Beginning in 1987 with passage of CEBA, the bridge bank structure became an important part of the FDIC's bank resolution process for large banks with complex financial structures in danger of failing. A bridge bank is a temporary banking structure that is controlled by the FDIC and designed to take over the operations of a failing bank and maintain banking services for the customers. Initially, the FDIC organizes bridge banks for up to two years, with the possibility of up to three one-year extensions. As the name implies, the bridge bank structure is designed to "bridge" the gap between the failure of a bank and the time when the FDIC can implement a satisfactory resolution of the failing bank. The temporary bridge structure provided the FDIC time to take control of a failed bank's business, stabilize the situation, and determine an appropriate permanent resolution. It also enabled the FDIC to gain sufficient flexibility for reorganizing and marketing the bank.

The FDIC used the bridge bank powers sparingly because of its complexity and the fact that smaller banks, which constituted the bulk of the failures, did not require an interim bridge before resolution. Between 1987 and 1994, the FDIC used its bridge bank powers 10 times; most of those instances, however, involved multiple, related bank failures. The 10 situations in which the FDIC used its bridge bank authority resulted in creation of 32 bridge banks into which the FDIC placed 114 individual banks. Those banks had total assets of about \$90 billion. During this period, bridge banks made up 10 percent of the total number of bank failures, but they represented 45 percent of the total assets of failed banks. Table I.1-4 summarizes the FDIC's use of its bridge bank authority.

Although the RTC did not have bridge bank authority, FIRREA did empower both the RTC and FDIC with conservatorship authority. Whether a bridge bank or a conservatorship is established, they operate in a similar manner and have the same purpose. Because of the circumstances, however, there are distinct differences in the way that the two agencies used these resolution techniques. On its inception in 1989, the RTC assumed responsibility for 262 failed savings and loan associations already in conservatorship, and resolution loss funding was an immediate problem. Unlike the FDIC's use of bridge banks as a temporary control measure, the RTC was forced to hold many conservatorships open indefinitely. Conservatorships allowed the RTC to take control of a large number of institutions and to begin the process of liquidating their assets until

Table I.1-4

The FDIC's Use of Bridge Bank Authority 1987–1994

(\$ in Thousands)

Bridge Bank Situations	Failure Date	Bridge Banks	Number of Failed Banks	Total Assets	Total Deposits
1	10/31/87	1 - Capital Bank & Trust Co.	1	\$386,302	\$303,986
2	07/29/88	2 - First RepublicBanks (Texas)	40	32,835,279	19,528,204
	08/02/88	3 - First RepublicBank (Delaware)	1	*582,350	*164,867
3	03/28/89	4 - MCorp	20	15,748,537	10,578,138
4	07/20/89	5 - Texas American Bancshares	24	*4,733,686	*4,150,130
5	12/15/89	6 - First American Bank & Trust	1	1,669,743	1,718,569
6	01/06/91	7 - Bank of New England, N.A.	1	*14,036,401	*7,737,298
	01/06/91	8 - Connecticut Bank & Trust Co., N.A.	1	*6,976,142	*6,047,915
	01/06/91	9 - Maine National Bank	1	*998,323	*779,566
7	10/30/92	10 - First City, Texas-Alice	1	127,990	119,187
	10/30/92	11 - First City, Texas-Aransas Pass	1	54,406	47,806
	10/30/92	12 - First City, Texas-Austin, N.A.	1	346,981	318,608
	10/30/92	13 - First City, Texas-Beaumont, N.A.	1	531,489	489,891
	10/30/92	14 - First City, Texas-Bryan, N.A.	1	340,398	315,788
	10/30/92	15 - First City, Texas-Corpus Christi	1	474,108	405,792
	10/30/92	16 - First City, Texas-Dallas	1	1,324,843	1,224,135
	10/30/92	17 - First City, Texas-El Paso, N.A.	1	397,859	367,305
	10/30/92	18 - First City, Texas-Graham, N.A.	1	94,446	85,667
	10/30/92	19 - First City, Texas-Houston, N.A.	1	3,575,886	2,240,292
	10/30/92	20 - First City, Texas-Kountze	1	50,706	46,481
	10/30/92	21 - First City, Texas-Lake Jackson	1	102,875	95,416
	10/30/92	22 - First City, Texas-Lufkin, N.A.	1	156,766	146,314
	10/30/92	23 - First City, Texas-Madisonville, N.A.	1	119,821	111,783
	10/30/92	24 - First City, Texas-Midland, N.A.	1	312,987	289,021
	10/30/92	25 - First City, Texas-Orange, N.A.	1	128,799	119,544
	10/30/92	26 - First City, Texas-San Angelo, N.A.	1	138,948	127,802

Table I.1-4

The FDIC's Use of Bridge Bank Authority 1987–1994

(\$ in Thousands)

Continued

Bridge Bank Situations	Failure Date	Bridge Banks	Number of Failed Banks	Total Assets	Total Deposits
	10/30/92	27 - First City, Texas-San Antonio, N.A.	1	\$262,538	\$244,960
	10/30/92	28 - First City, Texas-Sour Lake	1	54,145	49,701
	10/30/92	29 - First City, Texas-Tyler, N.A.	1	254,063	225,916
8	11/13/92	30 - Missouri Bridge Bank, N.A.	2	2,829,368	2,715,939
9	01/29/93	31 - The First National Bank of Vermont	1	224,689	247,662
10	07/07/94	32 - Meriden Trust & Safe Deposit Co.	1	6,565	0
10	Totals	32	114	\$89,877,439	\$61,043,683

Data for Total Assets and Total Deposits are as of resolution.

Data marked with an asterisk (*) are from the quarter before resolution.

Source: FDIC Division of Research and Statistics.

appropriated funds to finally resolve them became available. The conservatorship function gave the RTC additional time to lower the thrift's high cost of funds and stabilize it while reducing the amount of assets.

The RTC also used conservatorships to a much greater extent than the FDIC used the bridge bank option. From its inception to June 30, 1995, the RTC managed a total of 706 institutions through the conservatorship program, with the number of conservatorships peaking at 353 in 1990. By the end of June 1995, the RTC had resolved all 706 institutions in the program. The FDIC operated only one conservatorship.

The bridge bank and conservatorship resolution methods provided the FDIC and the RTC broad powers to operate and manage large, complex failing financial institutions. Both are temporary measures designed to facilitate organization and stability. The management goal of the newly organized institution was to preserve any existing franchise value of the failing institution, reduce the ultimate cost to the insurance funds, and lessen any disruption to the local community.

Branch Breakups. In certain large failing institutions, there were few, if any, acquirers willing to assume the deposits of a multi-branch bank or thrift. This became a major concern to the RTC in the early 1990s as the size of many of the conservatorships and the general health of the banking and thrift industries limited the amount of competition during the resolution process. In response, the RTC initiated the branch breakup

transaction to enhance the franchise value by increasing bidder participation, competition, and flexibility for the resolution process. The FDIC also used the strategy of selling portions of a failed institution to more than one buyer.

Branch breakup transactions became a successful modification to resolution procedures. Of the 747 resolutions handled by the RTC, 153 of those, or 21 percent, involved branch breakup transactions that resulted in more bidders and higher premiums paid to the RTC.

Charts I.1-3 and I.1-4 (presented earlier in this chapter) illustrate the distribution of the resolution methods employed by the FDIC and the RTC during the crisis period.

Methods for Handling Assets

As the number and size of bank failures increased in the early 1980s, the FDIC had to develop more efficient ways of liquidating failed bank assets. The FDIC historically had utilized its internal staff to resolve the assets on an individual basis. In the early and mid-1980s, although the FDIC continued to maintain a core group of employees to work assets, it began a gradual shift to asset marketing and the utilization of private sector contractors as leverage against the increasing volume of assets from failed institutions.

Unlike the FDIC that saw a more gradual build up of failures to resolve, the RTC was charged with the disposition of hundreds of failed institutions and billions of dollars of assets from its inception in 1989. The RTC placed less emphasis on passing assets at resolution than the FDIC did. It focused instead on selling the more marketable failed thrift assets during conservatorship and retaining the more problematic assets for disposition during receivership.

Throughout the crisis, both agencies employed methods of asset disposition such as regional and national auctions, sealed bid, and bulk sales on a large scale. But, as the size, complexity, and volume of the portfolios grew, each agency had to expand their methodologies and experiment with new techniques. For example, the offering of representations and warranties and seller financing eased bidder concerns about buying large, complex pools of loans and real estate.

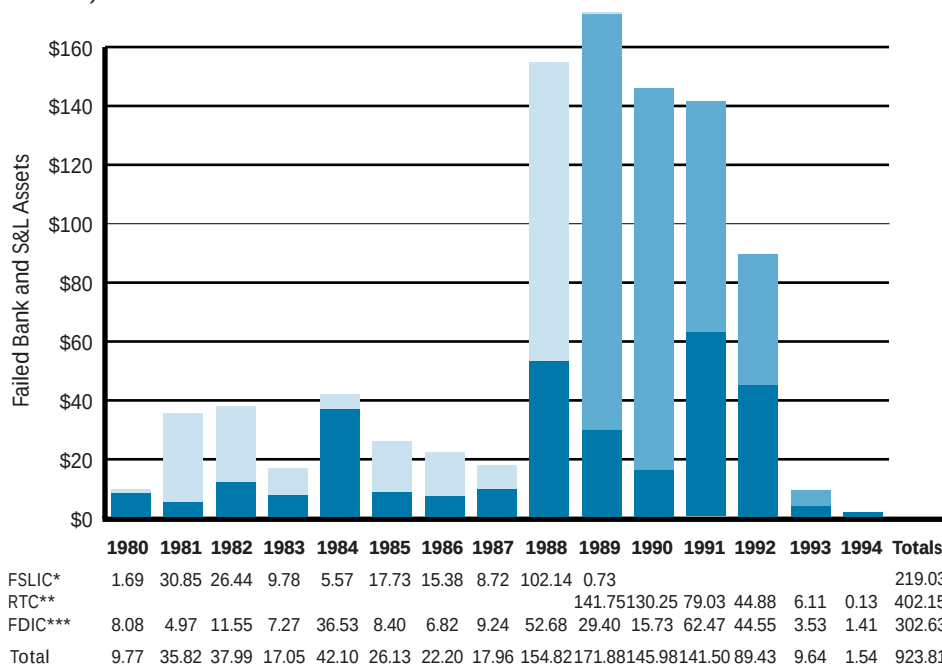
The FDIC and the RTC developed national satellite auctions, contracted with national firms to manage and market complex real estate assets, and created an effective securitization program. By the 1990s, the FDIC and the RTC had developed their early disposition methods into highly sophisticated procedures and strategies. As a result of those efforts, by the end of 1997 the FDIC held less than \$5 billion of the total \$705 billion in assets from FDIC and RTC managed bank and thrift failures.

Volume of Assets

From 1980 through 1994, the FDIC resolved 1,617 failed or failing banks that had \$302.6 billion in assets. About \$230.6 billion, or 76 percent, of those assets were sold to

Chart I.1-5**Failed Bank and S&L Assets
1980–1994**

(\$ in Billions)



* FSLIC assets as reported at resolution.

** RTC assets as reported at time of conservatorship/takeover.

*** FDIC assets as reported at resolution.

Figures include open bank assistance transactions.

Sources: FDIC Division of Research and Statistics, FDIC annual report, RTC Statistical Abstract, and FSLIC annual reports.

the acquiring bank at resolution. From 1989 to 1994, the RTC took over 745 thrifts with total assets of \$402.1 billion. In 1995, the RTC's last year, the RTC took over another two thrifts with \$426 million in assets. Of the total \$402.6 billion in assets, \$157.7 billion or 39 percent were collected or sold during conservatorship, \$75.3 billion or 19 percent were sold to the acquirer at resolution, and \$169.6 billion or 42 percent were retained for disposition during receivership.

From 1980 to 1989, the FSLIC had also acquired a significant volume of assets when it resolved 550 thrifts with total assets of \$219 billion. When the FSLIC was dissolved by FIRREA in August 1989, \$11 billion in thrift receivership assets were transferred to the FDIC. Altogether, from 1980 to 1994 these three agencies resolved 2,912 banks and thrifts with assets of approximately \$924 billion. (See chart I.1-5).

Of the approximately \$705 billion in total assets handled by the FDIC and the RTC, about \$305 billion were sold through the resolution process. The remaining \$400 billion in assets was disposed of through a variety of methods including, but not limited to, auctions and sealed bids, securitizations, equity partnerships, the use of asset management contractors, and especially through the significant efforts of the FDIC and RTC in-house staff.

Auctions and Sealed Bids

Record high interest rates in the late 1970s and early 1980s caused a rapid deterioration in the value of the FDIC's receivership mortgage portfolios. The rise in failing bank activity from the 1980s through the early 1990s caused a corresponding increase in the FDIC's receivership asset holdings. Traditional FDIC asset disposition methods of single asset sales could not keep pace with the volume of assets being received, and by 1976, the FDIC began packaging and selling assets on a limited basis. As the financial crisis developed, the FDIC and the RTC relied heavily on auctions and sealed bids to move large numbers of assets into the private sector.²¹

Loan Sales. In 1984, the FDIC initiated a formal loan sales program to accelerate the disposition of assets acquired from failed banks. The FDIC's asset marketing efforts at that time were directed toward performing loans in pools based on size, asset quality, asset type, and geographic location. As the workload increased, emphasis was placed on the sale of nonperforming loans, especially those with small individual balances (generally under \$10,000). By accelerating the disposition of the small loans, asset specialists could focus on larger loans with higher potential recoveries. From 1986 to 1994, the FDIC sold more than 866,000 loans with a total book value of more than \$20 billion.

The FDIC used in-house staff to evaluate, package, and market loan portfolios. The RTC, in contrast, had a unique mission, a relatively short life, and was a taxpayer-funded agency. As such, the RTC was directed by FIRREA to use the private sector whenever it was deemed to be cost-effective. By 1990, the RTC predominantly contracted with private-sector firms to perform all phases of selling those loan portfolios, which included evaluating, packaging, and marketing the portfolios. Using experienced private-sector firms also relieved the RTC of the necessity to hire and train thousands of employees.

One similarity the agencies shared was that both the FDIC and the RTC stratified loan portfolios into pools based on such criteria as geographic area, asset type, asset quality, and asset maturity. Both agencies provided representations and warranties although the FDIC's were more limited than the RTC's.

The RTC adopted the use of seller financing as an additional tool for portfolio sales. Seller financing developed because most of the RTC's assets were secured by real estate mortgages and their disposition was hampered by a nationwide decline in real estate markets.

21. For further information, see Chapter 13, Auctions and Sealed Bids.

Until the 1980s, FDIC auctions had been used to sell real estate and assets such as equipment and automobiles. In the late 1980s, the FDIC expanded the scope of its auctions to include pools of performing and nonperforming loans, as well as loans previously charged off by failed institutions. In August 1987, the FDIC conducted its first open outcry loan auction that offered pools of loans that had been charged off by banks prior to their failure; it conducted six more through June 1995. Although the FDIC experimented with loan auctions, it primarily continued to sell its loans through the sealed bid process.

In part because of its relatively short lifespan, the RTC adopted an auction policy that was more aggressive than the FDIC and conducted 12 regional loan auctions from June 1991 to December 1992. As an outgrowth of this, the RTC established the National Loan Auction Program in September 1992 to provide a common forum for the RTC field offices to market their hard-to-sell loans. Altogether, the RTC conducted eight national loan auctions, with the last one taking place in December 1995.

The RTC's loan auction experience showed that (1) loan auctions were cost-effective when the asset inventory was above a certain level; (2) small regional auctions were as effective as large-scale national auctions; (3) reserve pricing was critical for the sale of difficult, more complex products as a means to guide the market value; and (4) reserve pricing was not needed for performing loans because the bidders could easily establish a market price for those assets.

Real Estate Sales. The FDIC began holding real estate auctions periodically in the late 1980s to dispose of large inventories of smaller, distressed, and labor-intensive real estate properties, such as condominiums and vacant lots. Because of this, real estate auctions connoted the image of a "fire sale" in which the seller was willing to accept heavily discounted prices to liquidate undesirable real estate. Concern regarding a fire sale mentality, or the "dumping" of assets, was prevalent when the RTC was created. As a result, FIRREA included language requiring the RTC to sell real estate for no less than 95 percent of market value, which was defined as appraised value. Consequently, in the early stages of the RTC's existence, real estate auctions were prohibited for fear that they would aggravate already distressed markets and damage the financial standing of banks and thrifts that were heavily invested in real estate markets.

By the late 1980s and early 1990s, it became more acceptable to purchase all types of real estate at auctions, not just distressed properties. This led to the FDIC and the RTC initiating a number of large-scale national auctions as they saw their inventories grow with larger real estate properties. The FDIC coordinated the first nationwide auction of large real estate holdings in March 1989 and held the first of its three national satellite real estate auctions for 178 commercial properties from 23 states in December 1991. As inventory levels fell and asset sizes no longer justified nationwide initiatives, the FDIC suspended the use of national auctions after 1993 and instead relied principally on smaller, regional sales approaches.

The RTC's real estate inventory was more than \$18 billion by 1990. Congress raised concerns about the slow pace of asset sales, the carrying costs of inventory, difficulties in

managing large numbers of assets, and the continuing decline in real estate prices. FIRREA was amended and, in March 1991, the RTC responded to the mandates of FIRREA by approving a new pricing policy for all real estate sales and authorized the use of auctions to sell real estate. Through its national sales office, the RTC planned, coordinated, and executed real estate sales, including the sale of many real estate pools worth more than \$100 million.

An alternative to auctions was the sealed bid asset disposition. The FDIC had historically used the sealed bid method for owned real estate sales, believing it to be quicker and more profitable than auctions. Unlike bulk sales or auctions, sealed bid events were almost always single asset sales until the early 1990s. The RTC also made regular use of sealed bids and operated under procedures similar to those of the FDIC. Generally, sealed bid sales satisfied agency requirements for broad marketing and competitive bidding. The process also facilitated a faster sale, which was especially helpful for properties that were experiencing significant negative cash flows or holding costs.

Asset Management Contractors

During the banking crisis, the FDIC used 14 asset management contracts to liquidate assets with a book value of over \$33 billion, which was more than 45 percent of the post-resolution assets the FDIC retained for liquidation. Based on the experiences of the FDIC and the congressional goal of using private-sector resources whenever possible, the RTC started operations with the intent to fully use asset management and disposition contractors to complete its mission. The RTC issued 199 Standard Asset Management and Disposition Agreements (SAMDA) to 91 contractors, from 1991 to 1993, covering assets with a book value of \$48.5 billion.²²

The FDIC first began using contractors to manage and dispose of distressed assets in 1984 with the resolution of Continental Illinois National Bank and Trust Company. As part of the Continental OBA transaction, the FDIC acquired problem assets with an adjusted book value of \$3.5 billion. Continental established a special 250-employee unit, known as the FDIC Asset Administration (FAA) unit, within the bank to service those assets. Except for having indemnification authority, the FAA had full delegated authority to manage and dispose of problem assets. The FDIC reimbursed the FAA on a “cost-plus” basis, which meant that the FAA received the cost of its expenses plus incentive compensation based on a tiered scale of net collections.

The next large failure where asset management contractors were necessary occurred in Oklahoma City, Oklahoma, in 1986. Asset management contractors were not used again, though, until 1988 when the FDIC began receiving a torrent of failed bank assets. It began issuing contracts designed for asset pools with a book value of greater than \$1 billion called Asset Liquidation Agreements (ALA). The FDIC issued 10 contracts for

22. For additional information, see Chapter 14, Asset Management Contracting.

large banks that failed between 1988 and 1992. The average duration of an ALA contract was four years and five months. Like the Continental contract, all of these large bank contracts had a cost-plus feature where the FDIC reimbursed the contractor for the cost of all operating expenses, including all asset-related expenses, overhead, salaries, and employee benefits and, in addition, paid the contractor an incentive fee.

The process used by the FDIC regarding outside contractors evolved over time. The earlier contracts were negotiated between the FDIC and an asset management organization affiliated with the bank acquiring the deposit franchise of the failed bank. Later, ALAs evolved into competitively bid contracts between the FDIC and private sector contractors who did not have affiliations with the acquiring bank. In the first three ALA contracts, the bank that acquired the deposit franchise also owned and held title to the assets, and the FDIC basically covered the losses to the acquiring bank by paying the difference between each asset's book value and the proceeds obtained on its disposition. With the fourth and subsequent ALA contracts, the assets were owned by the FDIC. That led to a reduced funding cost as the FDIC had cheaper sources of funds than the acquirer did. As additional ALA contracts were established, the FDIC was able to change portions of the ALA structure to improve the model from the experience it gained from previous contracts. Primarily, the changes that were made to the standard ALA contract refined the way incentive fees were calculated to increase the quality of the contractor's performance.

The FDIC provided between 5 and 10 employees to oversee each ALA contract on-site at the contractor's facilities. Under delegated authority, the contractor had day-to-day control of the management of the assets, and an oversight committee composed of two senior FDIC employees and one contractor employee generally had unlimited delegated authority to jointly approve all actions related to larger asset disposition. The oversight committee approved the asset management and disposition procedures prepared by the contractor, the contractor's annual audit plan, budget, business plans, staffing levels, and salary structure, and monitored the contractor's expenses, collections, and goal achievement.

Meanwhile, the RTC had to determine how it would manage its inherited portfolio of distressed thrift assets. It designed contracts for managing and disposing of real estate and nonperforming loan portfolios that were greater than \$50 million. The RTC issued the first of its 199 SAMDAs in August 1990. The average term of a SAMDA contract was three years and three months. The contract mandated that the contractors competitively bid and subcontract 12 specified asset management and disposition activities to other firms; those expenses were reimbursed to the SAMDA contractor by the RTC. The smaller size of the SAMDA contract and the subcontracting requirements of the contract allowed the RTC to meet its goal of using more of minority- and women-owned businesses firms.²³

23. FIRREA in 1989 and RTCRRIA in 1991 mandated that the RTC promote the use of minority- and women-owned businesses (MWOB) as contractors.

The total compensation structure of the SAMDAs consisted of three components: a management fee, a disposition fee, and an incentive fee. The RTC competitively bid the earlier SAMDA contracts to private-sector firms that would submit their qualifications and bids for the management fee and disposition fee. The management fee was paid monthly and was based on the remaining value of the assets under contract. When the contractor disposed of an asset, a disposition fee was earned. Further incentive fees could be earned if the asset was disposed of within a specified time period. Disposition fees were subject to a holdback provision designed to motivate contractors from having assets with high carrying costs remaining on the contract's expiration. Because of a change in the RTC's sales policy toward the promotion of portfolio sales coordinated by RTC staff, the Standard Asset Management Amendment (SAMA) provision was introduced in January 1992 that amended most of the existing contracts by eliminating the collection of the disposition fee by the contractors.

At about the same time, in 1992, that the RTC was adding SAMAs to their contracts, the FDIC developed another type of asset management and disposition agreement, the Regional Asset Liquidation Agreement (RALA). Four RALA contracts, each of which contained asset pools of less than \$500 million in book value, were issued to private-sector contractors from November 1992 to June 1993. These four contracts covered assets totaling \$1.2 billion in book value with an average term of three years and one month. The RALA contract contained provisions for the payment of a management fee, a disposition fee, and an incentive fee and, most importantly, reimbursed the contractor only for defined asset-related reimbursable expenses, which was effective in controlling costs.

The RALA management fee was based on the estimated gross collections to be received from the assets under management. Unlike the SAMDAs where the RTC allowed contractors to bid the management fee, the RALAs had a fixed management fee rate that was applied to the asset portfolio's estimated gross collection value. The disposition fee schedule, however, could be altered as part of the bidding process; this schedule was based on projected recoveries to be achieved from the entire asset portfolio. The FDIC's estimate of the portfolio's gross collection value also was subject to adjustments from bids. The attainment of specific asset disposition goals within defined time periods served as the basis for the incentive fee. On average, contractors earned 43 percent of their revenue from management fees, 17 percent from disposition fees, and 40 percent from incentive fees. Competition from the bidding process resulted in lower costs than expected.

Table I.1-6 summarizes the financial performance of each program.

Each of the three contracting programs had its own mix of asset types, unique contractual requirements, and distinct operational environment, making the ability to draw direct comparisons among the programs impossible. Some trends are, however, worth noting as each agency revised previous agreements. With respect to compensation, although cost-plus was a feature of the earliest agreements, the agencies generally did not use that compensation method in later contracts, believing that costs could be

Table I.1-6

Summary of Contractor Financial Performance
Inception Through December 31, 1996
(\$ in Millions)

	ALAs	RALAs	SAMDAs	Totals
Number of Assets	84,610	2,455	100,344	187,409
Book Value of Assets in Program:				
Performing Loans	\$4,091	\$440	\$0	\$4,531
Nonperforming Loans	19,900	760	26,937	47,597
Owned Real Estate	4,800	0	19,031	23,831
Other Assets	3,200	10	2,509	5,719
Total	\$31,991	\$1,210	\$48,477	\$81,678
Book Value Reductions	\$30,484	\$1,156	\$46,425	\$78,065
Gross Collections	\$22,189	\$794	\$23,293 [†]	\$46,276
Expenses:				
Management Fees	0	17	400	417
Disposition/Incentive Fees	532	19	300	851
Reimbursable Expenses	2,914	15	3,739	6,668
Total Expenses	\$3,446	\$51	\$4,439	\$7,936
Net Collections	\$18,743	\$743	\$18,854 [†]	\$38,340
NPV of Net Collections*	\$16,432	\$692	\$17,369 [†]	\$34,493
Ratios (%):				
Gross Collections/Book Value Reductions	72.8	68.7	50.2	59.3
Total Fees/Gross Collections	2.4	4.5	3.0	2.7
Reimbursed Expenses/Gross Collections	13.1	1.9	16.1	14.4
Total Expenses/Gross Collections	15.5	6.4	19.1	17.1
Net Collections/Book Value Reductions	61.5	64.3	40.6 [†]	49.1
NPV of Net Collections/Book Value Reductions	53.9	59.9	37.4 [†]	44.2

* The net present value calculations (NPV) used the average one-year U. S. Treasury constant maturity rate during the term of the contracts and assumed that net collections were received evenly during the term of the contract.

[†] Collections exclude all loan payments made prior to 1993. In addition, collections for all assets withdrawn for sale by the RTC were imputed at the lesser of 90 percent of the asset's estimated recovery value (ERV) or its derived investment value (DIV).

Source: ALA and RALA data are from the FDIC Division of Resolutions and Receiverships financial performance report dated June 30, 1996. SAMDA data are from the RTC Asset Management System as of December 31, 1996.

controlled more effectively in other ways. Also, in later agreements, disposition and incentive fees were designed to generate a greater proportion of a contractor's income than in earlier contracts. In addition to compensation methods, other aspects changed as well. The manner in which the contracts were bid changed from negotiated contracts with the acquiring bank to competitive bidding among firms having asset management and disposition expertise.

In summary, neither the FDIC nor the RTC could have managed the volume of assets that came under their custodianship without the use of asset management and disposition contractors. The FDIC and the RTC did not have sufficient staff to manage the huge volume of assets in-house, nor did they have the time required to hire and train them. Through the agreements, the contractors managed and disposed of more than 187,000 assets having a book value totaling \$78 billion. Notably, some of these assets were the most complex assets within the FDIC and the RTC inventories. When a manageable level of distressed assets was reached, the contracts either expired under their terms or were terminated, and the agencies moved the remaining assets back in-house to be managed by FDIC and RTC personnel.

Affordable Housing Programs

The RTC and the FDIC affordable housing programs were considered an area in which the nation could glean some social benefit from the financial crisis. The programs' mission was to provide an opportunity for very low- to moderate-income households to realize their dream of home ownership or to improve their standard of living at affordable rent levels. During its approximately five years of operation, the RTC provided 109,141 affordable housing units, worth more than \$2 billion, to very low-, low-, and moderate-income households, as well as to nonprofit organizations and public agencies.²⁴ In total, the RTC sold 81,156 units of multi-family properties and 27,985 units of single-family properties to lower-income families or sold the properties for their benefit.

The RTC developed many strategies for marketing affordable housing. The RTC provided seller financing for 25 percent of single-family and 33 percent of multi-family properties that it sold. Retaining grass-roots technical advisors to assist the buyers and providing repair funding for the properties were two other key aspects of the program.

Because of the large inventory of assets with nominal value, the RTC also developed a policy to donate such properties to a nonprofit organization or public agency at no cost, provided that the assets would be conveyed for the public good, such as for low-income, single- and multi-family housing, homeless shelters, and day care facilities for children of low- and moderate-income families. More than 1,000 single-family and 73 multi-family assets were donated.

24. For further information, see Chapter 15, Affordable Housing Programs.

Although modeled after the RTC program, the FDIC AHP was much smaller in scope. The FDIC provided affordable housing to 2,933 low-income families. A primary difference between the FDIC and the RTC affordable housing programs was their source of funding. Because the FDIC does not use public funds for its operations (its funds come from the premiums it charges to banks for insurance), it required a separate federal appropriation for an affordable housing program. It first received funding for the AHP in fiscal year 1993. The FDIC's program subsidies were operative only insofar as congressionally appropriated funds were available. In contrast, the RTC's program operated with general funds available to the RTC and was not dependent on a specific appropriation.

During the first and second years of the FDIC AHP, the appropriated funds were not sufficient to discount all of the properties that would have been eligible for the program. The annual appropriation legislation allowed the FDIC to modify, at its sole discretion, the statutory requirements so that the available money could be put to the most efficient and beneficial use. That discretion enabled the FDIC to concentrate its efforts on single-family properties where the funding requirements were more modest. Also, discretionary language allowed the FDIC to be more creative in the way it provided discounts, which led to the FDIC's providing credits or grants on properties that could be used toward closing costs or down payments in lieu of straight discounts. The AHP placed 2,400 single-family units with low- to moderate-income families and sold 18 multi-family properties, which included 533 units.

In response to a requirement of the Completion Act, the FDIC and the RTC ratified a plan to merge the affordable housing programs in April 1994. The plan was beneficial as it allowed the FDIC and the RTC to market certain FDIC-owned multi-family properties (to which the FDIC had given a lower priority due to funding restrictions) under the RTC direct sale program.

The FDIC's public funding continued from 1993 for a three-year period on a very limited basis, but it was eliminated at the end of fiscal 1995. Because of a stipulation in FDICIA, the FDIC has to continue to maintain a non-subsidized affordable housing program.

Although the RTC and the FDIC accomplished their goal of providing affordable housing to lower-income families, taxpayer funds were used to subsidize the program. While the FDIC spent the \$15.7 million in appropriated funds to run its affordable housing program, the RTC's true costs will never be known because it did not keep an accounting of Affordable Housing Disposition Program (AHDP) costs separate from its other expenses. It is estimated that, on a conservative basis, the RTC's additional asset disposition costs due to the AHDP were in the range of \$135 million.

In summary, although the volume of assets handled within the affordable housing programs were relatively minor compared to the total assets sold by both corporations (less than one-half of one percent of total assets liquidated), the programs were viewed as significant. Their most important contribution was that they provided many lower-income families the opportunity to live in decent, affordable housing. Even though

there was a monetary cost associated with these programs, the short- and long-term benefits for the participants were significant.

Securitizations

The RTC and, to a much lesser extent, the FDIC successfully used the vehicle of securitization to dispose of a sizeable portion of their large performing mortgage loan portfolios.²⁵ In August 1990, the mortgage loan inventory of the RTC was estimated to be more than \$34 billion. After a disappointing performance in establishing a bulk sales program for such loans, the RTC explored new ways to successfully liquidate its loan portfolio. The mortgage-backed securities market was already well established by two government-sponsored entities, the Federal National Mortgage Association (Fannie Mae) and the Federal Home Loan Mortgage Corporation (Freddie Mac). These entities purchased loans with specific characteristics from mortgage originators and packaged such loans into securities. Although the RTC was able to liquidate a portion of its mortgages in Fannie Mae and Freddie Mac swaps, the majority of its mortgages did not comply with the standards set by those agencies.

Because the size of its nonconforming loan portfolio was so large, the RTC instituted its own private securitization program in December 1990.²⁶ The loans in this program had characteristics that detracted from their marketability, such as documentation inaccuracies, servicing problems, and late payments. Although the RTC securitization program initially included residential mortgage loans, it was expanded to include other types of loans that previously had not been securitized, such as commercial mortgages, multi-family properties, and consumer loans. (See table I.1-7.)

The RTC originally wanted their securitizations to have a full faith and credit guarantee of the United States government to maximize the number of investors for the offerings. With a direct government guarantee, RTC securities would have had a zero-risk weight similar to the risk weight of Government National Mortgage Association (Ginnie Mae) securities. The RTC Oversight Board did not, however, support a full faith and credit guarantee. The RTC was a temporary federal agency, and the government would retain all of the risk. The U.S. Department of the Treasury also was concerned that issuing a new security with such a guarantee would compete with contemporary Treasury issues. As a result, the RTC did not use a government guarantee to enhance the credit of RTC securities. Instead, the RTC decided to use cash reserves and other methods to provide credit support. Using these methods, it issued publicly

25. Securitization is the process by which assets with generally predictable cash flows and similar features are packaged into interest-bearing securities with marketable investment characteristics. Securitized assets have been created using diverse types of collateral, including home mortgages, commercial mortgages, mobile home loans, leases, and installment contracts on personal property.

26. For additional information, see Chapter 16, Securitizations.

Table I.1-7

RTC & FDIC Securitizations**As of June 30, 1997**

(\$ in Millions)

Type and Number of Transactions	Bond Issues			Number of Loans			Credit Reserves		
	Original	As of June 30, 1997	Percent Decrease	Original	As of June 30, 1997	Percent Decrease	Original	As of June 30, 1997	Percent Decrease
Single-Family (41)	\$24,351.50	\$7,774.20	68.1	399,946	168,044	58.0	\$3,253.60	\$2,124.90	34.7
Multi-Family (11)	4,472.20	2,158.40	51.7	8,385	3,198	61.9	1,283.10	732.50	42.9
Commercial (18)	13,931.50	5,157.10	63.0	33,870	15,850	53.2	3,596.00	2,840.20	21.0
Mobile Home (3)	615.90	90.60	85.3	39,987	16,377	59.0	103.70	69.40	33.2
Home Equity (1)	311.49	0.00	100.0	17,600	0.00	100.0	39.40	0.00	100.0
Totals (74)	\$43,682.60	\$15,180.30	65.2%	499,788	203,469	59.4%	\$8,275.80	\$5,767.00	30.3%

Source: FDIC Division of Resolutions and Receiverships.

rated mortgage-backed securities for which the senior securities were rated in the two highest rating categories by at least two national credit rating agencies.

The RTC is credited with developing the market for securities backed by “non-traditional” assets, most notably commercial mortgage loans. (As a point of reference, the securitized commercial mortgage loan market has grown from \$6 billion in 1990 to more than \$80 billion in 1997.) Commercial securitizations were an efficient way for the RTC to transfer large portfolios of real estate into the private sector by providing a consistent marketing approach to sell these assets at competitive market prices.

The FDIC securitizations, although based on the RTC’s program, were different in one major respect: the FDIC provided a limited guarantee as a mechanism for credit enhancement for which in return it would receive the excess interest after payment of the securities’ principal and interest. The FDIC completed its first securitization transaction in August 1994 for \$762 million of performing commercial real estate mortgage loans from 197 failed institutions. A second securitization followed in December 1996 for \$723 million in commercial mortgage loans from 180 failed institutions. Both issuances were considered successful.

From 1991 through December 1996, 72 RTC and 2 FDIC securitization transactions were consummated, backed by more than \$43.7 billion in book value of almost

500,000 conservatorship and receivership mortgage loans. Of the RTC's asset portfolio, more than \$42 billion, or more than 10 percent, of its total assets were resolved through securitizations. The RTC's securitization program was considered particularly successful not only because of the amount of assets that were liquidated through it, but also because of the innovative methods the RTC used, given its large portfolio of nonconforming loans, to forge new markets through which it accomplished its disposition goals. Although the RTC used securitizations more than the FDIC, both agencies found the approach to be effective when liquidating their large inventory of mortgage loans. Furthermore, outside investors have found worth in these securities, which are actively traded in secondary markets all over the world.

Equity Partnerships

One of the more innovative methods the RTC used for asset disposition was the equity partnership. In an RTC equity partnership, the RTC sold nonperforming assets acquired from failed thrifts to a joint venture between a private sector firm and the RTC. The private investor acted as general partner and controlled the management and disposition of the partnership's assets. The RTC's ongoing role was limited and generally passive, restricted to having an "equity" interest in the assets that it had sold. The RTC created equity partnerships in an effort to obtain greater present value recoveries from troubled assets by capturing the expertise and efficiencies of the private sector and reserving some upside potential from the recovery of depressed markets.²⁷

Although the concept of having the RTC hold a residual interest in sold assets was introduced in its first strategic plan in 1989, the RTC did not create an equity partnership until the fall of 1992. By that time, the RTC had tried several different approaches to dispose of nonperforming assets, most notably using private asset management contractors to manage and dispose of assets both individually and by multi-asset sealed bid sales. Each of these approaches had benefits and drawbacks. Assets disposed of through the contracting program appeared to have acceptable recoveries, but administering the program was burdensome and the pace of asset disposition slow. The RTC's multi-asset sales conveyed large volumes of nonperforming loans in a timely manner, but anecdotal evidence suggested that the purchasers were able to obtain high returns by quickly restructuring or settling the loans. The partnership structure provided a vehicle for obtaining the desired features of both programs.

The RTC created 72 partnerships with a total asset book value of about \$21.4 billion. Seven different partnership structures were developed, each designed for specific asset types and investor markets. The RTC contributed asset pools as its equity capital and arranged for financing of the partnership, providing a leveraged return to the investor. The general partner invested both equity capital and asset management services.

27. For additional information, see, Chapter 17, Partnership Programs.

Table I.1-8

General Characteristics of the Equity Partnership Types

	Program Inception	Number of Partner- ships	Bonds?/ Bond Holder	Types of Underlying Assets	Target Investor/ Legal Structure	LP/GP* Ownership Percentage
N Series	Dec. 1992	6	Yes/ Institutional investors via open market	Commercial and multi-family non- performing loans	Large investors/ Trust	51/49
MIFs	Jan. 1993	2	No, but bond equivalent/ Held by RTC	Commercial and multi-family non- performing loans, REO [†]	Large institutional investors/ Partnership	25-50/ 50-75
Land Funds	July 1993	12	No	Undeveloped and partially developed land (REO and non- performing loans)	Small investors/ Partnership	60-75/ 25-40
S Series	Sept. 1993	9	Yes/Held by a trustee for the RTC	Commercial and multi-family non- performing loans	Small investors/ Trust	51/49
JDCs	Dec. 1993	30	No	JDCs and small balance assets (SBAs)	Investors with collection experience/ Partnership	‡
SN Series	Aug. 1995	5	Yes/Held by a trustee for the RTC	Commercial non- performing loans	Large and small investors/Trust	51/49
NP Series	Aug. 1995	8	Yes/Held by a trustee for the RTC	Nonperforming land loans and land REO, unsecured loans or loans secured by non-real estate collateral (such as business loans), nonperforming commercial real estate and REO (commercial and multi-family)	Small investors/ Trust	50-70/ 30-50

* LP is limited partnership; GP is general partner.

† REO is real estate owned.

‡ The LP contributed 1 percent of the book value for JDCs and 20 percent of the book value for SBAs; the GP contributed 0.0101 percent of the book value for JDCs and 0.20 percent of the book value for SBAs.

Source: FDIC Division of Resolutions and Receiverships.

The financing terms required that cash proceeds generated from the liquidation of assets be applied first to retirement of the debt (usually bonds held by the RTC). After the debt was paid in full, the partners generally split the remaining proceeds according to the percentage of ownership each respective partner held. Table I.1-8 outlines the general characteristics of the RTC equity partnerships.

The largest of the seven types of equity partnerships set up by the RTC was the Judgements, Deficiencies, and Charge-offs (JDC) Program. The JDC Equity Partnership Program established 30 partnerships containing 137,000 assets with a book value of \$12.4 billion. The assets the RTC contributed generally were legally impaired or were unsecured and of poor quality, so typically the general partner was a firm with collection experience.

By participating in the JDC partnerships, the RTC was able to have a large volume of low quality, small balance assets processed when it realistically could not have staffed such an effort, but yet it could share in the results of having profit-oriented firms cull the assets for any substantial recoveries that might have otherwise been overlooked.

The FDIC became a limited partner in two partnerships, known as the Asset Management and Disposition Agreements or AMDA partnerships, which held assets with a book value of approximately \$3.7 billion. Unlike the equity partnerships, which the RTC created to dispose of assets, the AMDA agreements were vehicles used to restructure certain FSLIC assistance agreements. Once created, however, the AMDA partnerships operated similarly to the equity partnerships, with a general partner controlling the management and disposition of the partnership's assets and the FDIC serving as limited partner. Each was established to operate for five years and held a variety of asset types, although most were nonperforming.

Professional Liability Claims

Professional misfeasance and malfeasance were notable factors in the enormous losses from the financial institution crisis of the 1980s. The professional liability programs of the FDIC and the RTC reviewed these bank and thrift failures and sifted through thousands of potential claims relating to conduct by former directors, officers, attorneys, accountants, appraisers, brokers, and other professionals formerly affiliated with these failed banks and thrifts. This effort contributed more than \$5 billion in cash recoveries to the FDIC and the RTC receiverships.²⁸

Litigation Management

As the asset levels increased, the agencies also had to address many legal issues. The FDIC and the RTC increasingly turned to outside counsel to effectively manage the

28. For further information, see Chapter 11, Professional Liability Claims.

tremendous volume of legal matters related to the FDIC's role as receiver and the RTC's roles of conservator and receiver.²⁹ The legal work encompassed areas such as foreclosure, loan workout, bankruptcy, contract disputes, asset sales, collection of notes and guarantees, state and federal tax issues, pension funds, environmental issues relating to the institution's property, torts, and shareholder suits. The use of outside counsel peaked in 1991 when the combined FDIC and RTC direct and indirect payments to outside counsel reached \$701 million.

Asset Disposition Summary

In summary, because of the enormous amount of assets that flooded the FDIC and the RTC, the agencies had to be creative, yet responsible, in how they determined their policies regarding the handling and resolution of assets. While the FDIC strove to pass on as many assets as possible to the acquirer at resolution, the RTC focused on the disposition of assets in the conservatorship and receivership periods. Both agencies effectively used auctions and sealed bids to move as many assets as quickly as possible into the private sector. The RTC and the FDIC also improved other standard asset disposition methods and developed many innovations. For example, the agencies created new markets through the use of securitization, particularly for commercial mortgages, and equity partnerships enabled the agencies to transfer large amounts of assets into the private sector while obtaining potentially greater recoveries. All of these strategies enabled the agencies to efficiently dispose of the majority of the failed institutions' assets for which they became responsible during the crisis period.

Methods for Handling Liabilities

Simply put, a bank fails when its liabilities exceed the value of its assets. When this occurs, the FDIC as receiver needs to determine which of the creditors of the failed bank should be paid from the proceeds of the sale or settlement of its assets. Until 1993, the FDIC's first priority for paying unsecured claims against the failed national bank's estate was the administrative claims of the receiver followed by the deposit liabilities and general creditor claims; if any proceeds remained, payments were made in turn to the subordinated debtholders, the Internal Revenue Service for unpaid federal income taxes and, finally, the shareholders. The FSLIC process for distribution was similar to this although there were a few more classes of creditors identified. For failed state chartered institutions, each individual state was responsible for determining the order of payment, although usually the only main difference was that some states gave priority to all depositors' claims (after administrative costs) over the other general creditors. The National

29. For further information, see Chapter 18, The FDIC's Use of Outside Counsel.

Bank Act of 1864 established the priority of payment on unsecured creditors for national bank receiverships. The various claims priorities were unified on August 10, 1993, when the National Depositor Preference (NDP) Amendment was passed. This law standardized the asset distribution process for all receiverships regardless of charter. Claims now are paid in order of administrative expenses followed by depositors, other general creditors, subordinated debtholders, and those in the last claimant category, the shareholders.

A failed bank receivership will have many types of creditors laying claim to the assets. One type of creditor that is resolved early in the receivership is the secured depositor. Generally, these depositors are municipalities, school districts, or state agencies that by law must have their deposits secured in order for a bank to hold them. This is accomplished by the depository institution pledging sufficient securities to cover any deposit funds that would otherwise be uninsured in the event of a bank failure.

The largest liability of any failed institution is usually its insured deposits. When a financial institution fails, the FDIC, in its role as insurer, pays depositors their insured portion, then “steps into the shoes” of the depositors as claimant and files its subrogated claim against the receivership estate. Therefore, the FDIC is paid in the class that the depositors would otherwise occupy.

The FDIC is committed to providing insured depositors with their funds as quickly as possible after a bank fails. Since the start of FDIC deposit insurance on January 1, 1934, not one depositor has lost a penny of insured funds as a result of a failure. Until the early 1980s, the payment process was burdensome for the FDIC to complete. In the mid-1980s, the FDIC computerized the payment processes used to identify the insured depositors to the point where, in most instances, the insured depositors have the use of their funds the day following the bank failure. Depositors also can have their checks mailed to them, which eliminates the need to stand in line at the failed bank.

Until the early 1980s, losses to uninsured depositors were relatively small. All failed banks with deposits totaling more than \$100 million had been handled with P&A transactions that protected uninsured depositors. In the smaller institutions, the amount of uninsured funds normally was very little. As the bank failures grew in average size, so too did the number and dollar amount of the uninsured accounts. Large banks held deposit accounts from commercial businesses, other banks, and high profile accounts such as those from large churches and local governments. With the failure of the Penn Square Bank, N.A. (Penn Square), Oklahoma City, Oklahoma, in 1982, the exposure of many financial institutions to a serious loss of liquidity was brought sharply into focus.

In 1983, the insured deposit transfer resolution was developed by the FDIC to alleviate some of the problems insured depositors encountered. The IDT process transferred the insured accounts to an open institution for administration. IDTs permitted the depositors of a failed institution to make an orderly and convenient transfer to an open institution and the acquiring institution gained new customers.

To reduce the hardship on uninsured depositors, in 1984 the FDIC began making advance dividend payments soon after a bank's closing. The advance dividend percentage is based on the estimated recovery value of the failed bank's assets. Advance

dividends provide uninsured depositors with an opportunity to realize an earlier return on the uninsured portion of their deposits without eliminating the incentive for large depositors to exercise market discipline. If the FDIC's actual collections on the assets of the failed institutions exceeded the advance payments and administrative expenses of the receivership, the uninsured depositors and other creditors received additional payments on their claims. The FDIC did not pay advance dividends when the value of the failed institution's assets could not be reasonably determined at the closing.

The incentive for depositors to exercise discipline was increased with the passage of FDICIA in 1991, which required the FDIC to select the resolution method that is the least costly to the insurance fund. This places transactions with bids on uninsured deposits at a pricing disadvantage.

The category of other general or senior liabilities of a failed institution includes claims from vendors, suppliers, and contractors of the failed institution; claims arising from repudiated contracts; claims arising from employee obligations; tax claims; and claims asserting damages as a result of business decisions of the failed institution. In 1993, the National Depositor Preference Amendment lowered claimants in this category to a priority level below that of the deposit liabilities, thereby significantly reducing any potential recovery on these claims. Before NDP legislation, many banks and thrift receiverships paid general creditor claims on par with deposits.

Subordinated debtholders are allowed claims on receivership assets only after all claims with a higher priority have been satisfied. Any liability of the insured depository for a cross guarantee assessment would receive distributions after subordinated debtholders, but before distributions were made to shareholders.

Of the claimants, stockholders have the lowest priority and rarely if ever receive a dividend. Even in the case of an OBA transaction, all of its depositors and creditors were protected, but the shareholders' position was significantly diluted.³⁰ For P&A and deposit payoff transactions, the shareholders do not receive any payment unless all other creditors' claims are paid in full. From 1986 through 1994, the FDIC made distributions to stockholders in only 16 receiverships.

With their low priority status, subordinated debtholders and shareholders should provide the most discipline for financial institutions. This is especially true for individuals that are directors of the institution. In addition to their financial investment risk, they have some individual fiduciary liability if the institution fails because of some negligent acts by the board of directors.

In summary, the manner in which the FDIC handles liabilities of failed financial institutions and administers claims against their receiverships is an important part of its responsibility to lessen the economic effects of the failure of those financial institutions. The claims process has evolved into one that is predictable while meeting statutory requirements. As such, this process ensures that creditors are treated in an equitable and timely manner.

30. For further information, see Chapter 5, Open Bank Assistance.

Conclusion

The period between 1980 and 1994 was one of turbulent change for the banking industry, which saw record numbers of bank and thrift failures, the creation and dissolution of the RTC that was specifically designed to handle thrift failures, and new legislation that continually affected the way the FDIC resolved bank failures.

The FDIC's primary objective is to maintain financial stability and public confidence in the banking system. Although severely tested throughout this period, public confidence in deposit insurance never faltered. No depositor lost a penny on federally insured deposits. One of the main differences between the financial crises of the early 1930s and the 1980s was that in the latter period, the insured depositors trusted that they would not be harmed in the event of a bank failure. The FDIC and the RTC were able to gain control, liquidate, and resolve large numbers of financial institution failures without causing disruption and panic in the banking system.

The FDIC and the RTC also sought to soften the effect that the banking crisis had on the economy and to contribute to regional, as well as national, economic recovery. Their results in this area were favorable, but not without criticism. On the positive side, deposit insurance provided immediate liquidity to depositors whenever their bank failed and limited the negative effects of the failure on the local communities. In the majority of the failures, both the RTC and the FDIC had success in locating an acquiring institution to provide a continuation of banking operations. This also softened the effect of the bank failure on the community. On the negative side, however, the handling of loan customers during both the agriculture crisis and the distressed economic situation in New England was criticized.

The FDIC and the RTC met their objectives in a myriad of ways. Whenever a bank failed, the FDIC's primary focus was to ensure that the depositors received the use of their insured funds as soon as possible, which throughout the crisis was almost immediately after a bank failed. This eliminated any doubts or negative publicity about the deposit insurance system. Another method used to reduce the effects of a bank failure was the careful selection of the transaction type to be used to resolve the situation. A majority of the resolutions of both the FDIC and the RTC was completed by using a P&A transaction rather than a deposit payoff or an insured deposit transfer. The majority of those transactions protected all depositors (including those who were uninsured) against any loss. For failed thrifts, even though the FSLIC fund was insolvent, Congress took action to reassure the depositors that their insured funds would be safe.

The Evolution of the Resolution Process

Flexibility and innovation were the keys that enabled the FDIC and the RTC to meet their objectives. As the economy deteriorated and the number and size of the problem banks increased, the FDIC changed its resolution process to balance the needs of the industry with its own practical limitations. For example, when it became apparent that

there would be more deposit payoff situations, the FDIC created the insured deposit transfer transaction. That reduced the burden on insured depositors, and the need for them to line up to receive their funds was eliminated.

The FDIC also expanded its resolution options during this period to adjust to the changing times. The original P&A transaction did not transfer many assets with it. If the FDIC had not modified this process, it would have been unable to internally handle the volume of residual assets. As liquidity and workload pressures grew, the FDIC began to consider techniques and incentives to pass more of the failed banks' assets to the acquirer. A law was passed in 1987 to provide the FDIC with bridge bank authority. This provided the FDIC with the flexibility needed to handle large bank failures. To reduce the flow of assets into the FDIC, it introduced the whole bank sale transaction in 1987 and emphasized its selection from 1988 to 1991. In the end, the most dominant features of the FDIC's resolutions process were the efforts that were made, and the results achieved, in moving assets back to the private sector and the fact that all depositors generally were protected against any loss.

The FDIC created loss sharing transactions in 1991 to reduce the acquirer's concerns about the quality of failed bank assets and to keep bank assets in the banking system. The RTC increased competition for failed S&Ls by completing branch breakups to cater to the needs of their bidders.

The RTC used conservatorships to take control of a large number of institutions and to begin the process of liquidating their assets before the conservatorships were finally resolved. Because of the lack of funding for the RTC, the assets were in conservatorship an average of 13 months, a much longer period of time than were failed bank assets in bridge banks. This altered the RTC's original plan of duplicating the FDIC resolution process. Proceeds from those asset sales reduced the RTC's immediate funding problems and allowed the RTC to continue their liquidation efforts even without the availability of loss funding.

The Evolution of Asset Disposition

The ability to adjust and create new methods to adapt to the ever-changing marketplace was instrumental for both the FDIC and the RTC in accomplishing the task of disposing of assets acquired from failed financial institutions. Generally, the agencies had two basic requirements for asset disposition: (1) to dispose of the assets as soon as possible without upsetting local markets, and (2) to maximize the return to the receiverships. The factors and processes used to decide, for example, when to hold versus when to sell assets or when to litigate versus when to compromise evolved in response to the circumstances of the times.

While the primary FDIC asset disposition strategy was to sell the majority of the failed bank's asset portfolio to the acquiring bank at the time of resolution, the FDIC employed several other resourceful ways to liquidate its ever-increasing volume of assets. In the early 1980s, the FDIC normally used in-house staff to liquidate assets one at a

time. Over time, the two agencies employed more sophisticated disposition methods both in-house and through the use of their contractors. Methods such as securitizing asset sales, creating equity partnerships with private-sector firms along with mass marketing methods in bulk sales of loans, auctions, and multiple sealed bid events became the standard. The RTC was especially innovative when implementing an effective affordable housing program, which successfully employed seller financing, close working relationships with local nonprofit firms, and auctions.

The main results of the two agencies in the area of asset disposition were (1) the RTC arranged for the securitization of \$42.2 billion in mortgage loans; (2) the RTC developed equity partnerships with private-sector firms to manage the collection of \$25 billion in book value of assets; (3) the FDIC and the RTC created asset management programs with outside contractors that serviced \$80 billion in distressed asset pools; (4) the FDIC created a secondary market for nonperforming loan sales and sold in excess of 800,000 loans through sealed bid sales; (5) the FDIC piloted national real estate auctions and both the RTC and the FDIC arranged real estate events that sold hundreds of millions of dollars of property at each event; (6) the RTC developed a national Affordable Housing Program and sold more than 100,000 units; and (7) in a life span of slightly over five years, the RTC disposed of more than \$400 billion in assets; at its sunset, only \$8 billion in assets were transferred to the FDIC.

The Maintenance of Public Trust

Maintaining public trust is a key objective for any federal agency. Professional abuse, especially in the thrift industry, was suspected to be widespread, and the FDIC and the RTC needed to conduct a fair and consistent investigative process of these matters. Professional misconduct was a notable factor that exacerbated the losses from the financial institution crisis, and these parties needed to be held accountable for wrongful conduct. The professional liability programs of the FDIC and the RTC yielded cash collections of more than \$5 billion (as of December 1997) and had a positive effect on the awareness of professional standards, which directly benefits the public by promoting discipline among all professionals.

The dramatic growth in the two agencies also increased their vulnerability to inefficiency and ineffectiveness, as well as waste, fraud, abuse, and the misappropriation of assets. As the workload and staffing expanded accordingly and operations grew in complexity, traditional internal control methodologies proved insufficient. The FDIC and the RTC were faced with three areas of high vulnerability: contracting and contract management, information systems, and asset management and disposition. The internal control programs at the FDIC and the RTC were altered to adapt to the radically changing dimensions of their management requirements. In addition, mounting public concern over the financial institution crisis and new laws subjected virtually every aspect of the agencies' activities to outside scrutiny. Ultimately, the financial crisis was resolved by

the FDIC and the RTC without serious mismanagement or waste, issues that could have eroded public trust.

Other Key Objectives

Cost-Effectiveness. One objective common to both the FDIC and the RTC was to minimize costs and maximize the net present value return from the disposition of failed banks and thrifts and their assets. The 1,617 banks that failed or required OBA between 1980 and 1994 had \$302.6 billion in assets. The FDIC's cost of handling these failed banks was \$36.3 billion, or about 12 percent of the banks' assets. The 747 institutions that the RTC resolved from 1989 to 1995 had \$402.6 billion in assets. The RTC's cost of handling these assets was \$87.5 billion, or 22 percent of the assets. It is difficult to draw any firm conclusions regarding cost because of the large number of variables that affected these results. For example, the agencies had no control over such factors as the condition of the assets at the time of failure, any unrecognized losses in the failed institutions' portfolios, and prevailing economic conditions.

Equitable Treatment. Throughout this period, one objective that the FDIC had difficulty in achieving was equity to all parties throughout the resolution process. A prime example of this was the OBA transaction used to assist Continental. This type of resolution sparked a policy debate about whether certain banks were truly "too big to fail" and whether they were given special treatment not available to smaller institutions. Whether equitable or not, the FDIC felt it had fully considered a number of substantial concerns that justified the manner in which Continental was handled. The FDIC and other regulators had concerns of systemic risk that Continental's potential failure could extend beyond the bank itself. Those risks included a potential liquidity crisis for major banks with significant foreign deposits that could have caused a decrease in foreign investor confidence in U.S. financial institutions, a severe equity blow to the many unaffiliated banks with uninsured correspondent bank accounts at Continental, and a negative effect on financial markets in general. A failure of such magnitude could have caused other bank failures and tied up creditors in bankruptcy for years.

In instances where the FDIC provided assistance to keep a failing bank open or where the FDIC created a bridge bank, critics have sometimes expressed concern that the government had, in fact, "nationalized" the bank and given the assisted bank undue advantage over other banks mainly because of its low cost of funds. This concern, however, is mitigated by the short-term nature of a bridge bank. The effect of any unfair advantage for assisted banks is offset by the covenants that restrict shareholder benefits until after the FDIC's stock interest is redeemed. Stock ownership by the FDIC also worked to reduce the costs of resolution if there was any increase in the value of the stock.

The FDIC and the RTC also were concerned about equal treatment toward failed bank borrowers in the resolution process. In New England this became a topic of discussion because of the extended economic issues that led to a credit crunch in this region.

Borrowers in special asset pools were sometimes hampered in their refinancing efforts by the stigma of being a failed bank customer. The FDIC addressed this by placing such borrowers back into the acquirer's loan portfolio, subject to the FDIC's guarantee to buy back the loans that deteriorated. The creation of the loss share transaction also has addressed this problem by providing for loan customers to remain with the acquiring bank and for any losses to be shared with the FDIC.

Issues Related to Attainment of the Agencies' Objectives

The crisis has shown that there are other issues closely related to the ability of the agencies to reach their objectives. These issues are discussed in more detail below.

Use of the Private Sector. Both the FDIC and the RTC extensively employed the private sector during the crisis years. The FDIC used private-sector firms to manage more than 45 percent of its post-resolution assets during the peak period of 1988 to 1993. Because of its temporary status and as mandated by law, the RTC used private-sector resources whenever possible and used SAMDA contractors to manage hard-to-sell assets. The RTC also made good use of the secondary market to sell its securitized portfolios. In addition, the RTC established partnerships with outside parties to manage and dispose of distressed assets that either had a low present value or could not be securitized.

The FDIC modified its asset management contracts throughout the years, learning as it gathered experience. One of those lessons is that the creation of a successful contract hinges on the proper alignment of the (primarily financial) interests of the asset management firms with those of the FDIC. In addition, minimal interference from the government is important to the private sector to allow it to operate efficiently. Identifiable performance measures also are critical to motivate the contractor effectively. Finally, the contractors should be fair and equitable in all facets of their business dealings.

Competition. For the most part, both the FDIC and the RTC developed resolution and asset sales programs that provided competition to the broadest market of qualified financial institutions and asset buyers. At the beginning, because of the large volume of assets at the RTC, some of its sales were naturally restrictive because the portfolios were too large for most investors. Because of outside pressures, the RTC reduced the size of its portfolios to attract smaller investors; this change, although initially resisted, was of benefit because it increased competition and seemed to bring about better results.

The FDIC and the RTC were innovative in their sales events. The FDIC's national auctions of properties used advanced satellite technology to offer simultaneous auctions to major cities across the country. Buyers no longer needed to travel great distances to attend an event. The RTC also broke new strategic ground by selling assets through a partnership program. This program was unique in that it took product that would not bring an optimal price given the condition of either the asset or the current market and because it created a disposition vehicle that would allow the RTC (and later, the FDIC) to share in the value enhancement resulting from improved real estate markets and a better economy.

Independence. Congress has entrusted the FDIC with complete responsibility for resolving failed federally insured depository institutions and has conferred expansive powers to ensure the efficiency of the process. As receiver and as insurer, the FDIC is not subject to the direction or supervision of any other agency or department of the United States or of any individual state in the operation of the receivership. Those statutory provisions allow the FDIC to exercise its discretion in determining the most effective resolution of a failed institution's assets and liabilities. In exercising that authority, the FDIC is expected to maximize the return on the assets of the failed bank or thrift and to minimize any loss to the deposit insurance fund. The FDIC as receiver is also responsible for liquidating the failed institution's assets and using the proceeds to pay proven creditors.

Market Discipline. When large banks were in jeopardy, the FDIC had in the past protected all depositors from loss, as in the case of Continental and Bank of New England, Boston, Massachusetts. Large banks (with the exception of Penn Square) were resolved either through P&As, bridge banks, or OBA agreements where all depositors were protected.

To preserve financial stability and maintain public confidence in the deposit insurance system, however, a certain amount of market discipline is required. The savings and loan industry is a prime example of what can happen in the absence of such discipline. This situation resulted in the insolvency of the federal insurance fund for savings and loans, the subsequent dissolution of the FSLIC, and the large losses that were ultimately borne by the taxpayer.

Depositors and shareholders can provide a bank with market discipline to operate without taking excessive risks. At the time of failure, management is always removed, and the claims of the shareholders fall behind those of the depositors, the FDIC, and the bank's creditors. Because the shareholders' entire investment is almost always lost, or in the case of some OBAs at least severely diluted, they instill a certain amount of market discipline in the operations of the bank. Often, the larger shareholders are also directors of the bank; if the directors' actions are determined to be grossly negligent, they may become liable for some of the losses that they caused.

The depositors, for the most part, are minimally affected by the bank failures. Insured depositors who are fully protected by the FDIC provide no discipline to the system. In small banks, the uninsured depositors represent such a small portion of the banks' deposits that they do not influence the banks' actions. In addition, in the 1980s when the FDIC chose to complete P&A transactions for the majority (73.5 percent) of its resolutions, depositors had little reason to exercise discipline as all insured and uninsured deposits were protected in those transactions. Also, from 1980 to 1992, the FDIC completed 133 OBA transactions that again protected all depositors. The ability of banks to obtain fully insured brokered deposits lessened the effect of depositor discipline as well.

There were signs, however, that uninsured depositors exercised some discipline during this period. As problems became known, especially at some of the larger troubled institutions, those institutions had to borrow heavily from the Federal Reserve to provide liquidity caused by the withdrawal of funds by their larger depositors.

Since passage of FDICIA, there is more of an incentive for the uninsured depositors and unsecured creditors to exercise deposit discipline. The least cost provision usually causes the uninsured to share in the cost of the resolution. From 1992 to 1995, this has, on average, occurred in 82 percent of the cases. From 1986 to 1991, it took place, on average, only 17 percent of the time.

Funding and Liquidity. To ensure financial stability and public confidence in the banking system, a strong insurance fund is a necessity. The FSLIC was forced to complete transactions that had the least short-term effect on their insurance fund, which had the unfortunate effect of increasing the long-term cost of cleaning up the S&L crisis. Thrifts were viewed at the time to be too costly to resolve. The government appropriations that would have been required were not forthcoming until creation of the RTC. The lack of funding and increased congressional oversight restricted the FSLIC's ability to react quickly to many of the early, pre-FIRREA thrift crisis issues.

The FDIC also had funding and liquidity concerns during the late 1980s and early 1990s. This led, in part, to the FDIC's preference for whole bank sales to preserve liquidity. The lack of whole bank transactions since enactment of FDICIA (which contains the least cost provision) seems to show that whole bank sales were not the most cost-effective alternative. For several large bank failures in the late 1980s, the FDIC selected resolutions in which the assuming bank retained the problem assets to preserve the insurance fund's liquidity. These agreements resulted in the FDIC reimbursing the acquirer at a higher cost of funds than would have been the case if the FDIC had retained ownership of the assets. Another way the FDIC reduced its initial cash outlay was to use puts to induce the acquiring banks to take the assets at failure. Because the acquirers returned the majority of the assets to the FDIC before expiration of the put period, however, this option was significantly limited.

The lack of adequate, consistent funding also affected the way the RTC completed its mission. Because of the high cost associated with resolving the S&L problem and its effect on the U.S. deficit, the RTC often was hampered by delays in obtaining government-approved funding. The RTC had to be selective in choosing which S&L could be resolved and which had to remain in conservatorship. The conservatorships were operated for longer periods of time than would have been necessary if sufficient funds had been available. Because the thrifts' cost of funds was higher than the government's cost of funds, this additional expense had to be added to the final cost of cleaning up the S&L crisis.

Summary. Both the FDIC and the RTC made mistakes as they struggled to find a solution to the challenge of moving billions of dollars of assets properly back into the private sector. Some saw the agencies as too bureaucratic, while others complained that assets were sold too quickly and at below market prices. Nevertheless, the FDIC and the RTC accomplished their objectives. By staying flexible and creative, the FDIC and the RTC maintained the public's confidence while providing stability to the financial marketplace. Their collective experience in managing the crisis has provided the FDIC, as well as the financial industry and other regulators, with invaluable lessons on how the financial marketplace works in times of both adversity and prosperity.

After gathering the necessary information and determining the appropriate resolution structure to be offered, the FDIC begins to confidentially market the failing bank or thrift as widely as possible to encourage competition among bidders.



CHAPTER 2

Overview of the Resolution Process

Introduction

This chapter provides an overview of the specific steps undertaken by the Federal Deposit Insurance Corporation (FDIC) and the Resolution Trust Corporation (RTC) to complete a resolution of a failing or failed institution. The intent is to provide background for the reader. Chapters 3 through 7 then trace in more detail the evolution of issues associated with, and results of, various resolution alternatives employed by the FDIC and the RTC between 1980 and 1994.

Resolution Methods

The three basic resolution methods for failed and failing institutions are a deposit payoff, a purchase and assumption (P&A) agreement, and an open bank assistance (OBA) agreement. Through the years, the FDIC and RTC have used these transactions in a number of variations, which are discussed in later chapters.

In a deposit payoff, as soon as the bank or thrift is closed, the FDIC is appointed receiver, and all depositors with insured funds are paid the full amount of their insured deposits.¹ Depositors with uninsured funds and other general creditors of the failed

1. The FDIC's insurance limit is \$100,000. Any amount over that limit, including interest, is uninsured. The FDIC uses the term "insured depositor" to refer to any depositor whose total deposits are under the insurance limit. Similarly, the term "uninsured depositor" is used to refer to those depositors whose total deposits are over the insurance limit. It is important to note that customers with uninsured deposits are paid up to the insurance limit; and only that portion of their deposits over \$100,000 is uninsured. Deposit payoff is described in more detail in Chapter 3, Evolution of the FDIC's Resolution Practices.

institution are given receivership certificates entitling them to a share of the net proceeds from the sale and liquidation of the failed institution's assets.

The P&A agreement is a closed bank transaction in which a healthy institution (generally referred to as either the acquirer or the “assuming” bank or thrift) purchases some or all of the assets of a failed bank or thrift and assumes some or all of the liabilities, including all insured deposits. The acquirer usually pays a premium for the assumed deposits, decreasing the FDIC's total resolution cost. For most of the FDIC's history, P&A transactions have been the preferred resolution method.²

In an open bank assistance agreement, the FDIC provides financial assistance to an operating insured bank or thrift determined to be in danger of closing. The FDIC can make loans to, purchase the assets of, or place deposits in the troubled bank. Where possible, assisted institutions are expected to repay the assistance loans. While used in a number of situations during the 1980s, including for the resolution of several larger failing banks, that method has not been used since 1992.³

Resolution Process

Between the time it receives notification that a bank or thrift institution is about to fail and the time it develops the actual plan for closing the institution, the FDIC performs a number of specific tasks. Those tasks include processing the failing bank letter, developing an information package, performing an asset valuation, determining the appropriate resolution structure, and conducting an on-site analysis to prepare for the closing.

Failing Bank Letter

When an insured bank or thrift is about to fail, the FDIC initiates its resolution process. An institution is typically closed by its chartering authority when it becomes insolvent, is critically undercapitalized, is implicated in a discovery of a severe case of fraud, or is unable to meet deposit outflows.⁴ The chartering authority, which is the state banking agency for state chartered institutions, the Office of the Comptroller of the Currency for national banks, or the Office of Thrift Supervision for federal savings institutions, informs the FDIC when an insured institution will be closed.

2. For further information, see Chapter 3, Evolution of the FDIC's Resolution Practices.

3. For further information, see Chapter 5, Open Bank Assistance.

4. In 1991, the FDIC was given the authority to close an institution that was considered to be critically undercapitalized (having a ratio of tangible equity to total assets equal to or less than 2 percent) and that did not have an adequate plan to restore capital to the required levels. The FDIC was also given the authority to close an institution that had a substantial dissipation of assets due to a violation of law, operated in an unsafe or unsound manner, engaged in a willful violation of a cease and desist order, concealed records, or ceased to be insured.

The FDIC's formal resolution activities begin when a financial institution's chartering authority sends a "failing bank letter" advising the FDIC of the institution's imminent failure. After the FDIC receives a failing bank letter, a planning team contacts the chief executive officer of the failing bank or thrift to discuss logistics, to address senior management's involvement in the resolution activities, and to obtain loan and deposit data from the institution or its data processing servicer. After the FDIC receives the requested data, a team, usually consisting of 5 to 15 specialists, is sent to the bank or thrift to gather and analyze additional information. The team prepares an information package to give to potential bidders, assigns a value to all the assets of the institution, estimates the amount of uninsured deposits, determines the resolution structures to be offered, and plans for the closing and receivership.

The Information Package

As part of its analysis, the FDIC develops detailed data for the information package on the amounts and types of assets and liabilities that the institution holds. The information varies depending on each institution's business strategies as reflected in its asset and liability structure. For example, if a failing bank is involved primarily in residential mortgage lending, the FDIC will develop information on the basis of that bank's asset characteristics such as interest rates and loan terms, as well as the performance of the portfolio (performing versus nonperforming).

Asset Valuation

Simultaneously, the FDIC begins a review of the failing institution's assets using asset valuation models to estimate the liquidation value of the assets, which is used in calculating the cost of a deposit payoff. Because the FDIC does not have enough time to assess every asset, it uses an extensive statistical sampling procedure. Loans are divided into categories, such as real estate, commercial, and installment, and within each category the loans are identified as performing or nonperforming. For each subcategory of loans, a sample is identified and reviewed carefully to determine an estimated liquidation value. Adjustments are made to discount future cash flows and to account for liquidation expenses. The loss factor that results from that estimate is then applied to the subcategory of loans that were not reviewed.

The Resolution Structure

The FDIC uses all the previously discussed information to determine the appropriate resolution structures to offer potential bidders. In compiling the marketing strategy, the FDIC considers the asset and liability composition of the failing institution, the competitive and economic conditions of the institution's market area, any prior resolution experience with similar institutions in the same geographic area, and any other relevant

information such as potential fraud at the institution. Using that information, the FDIC determines how best to structure the sale of the bank or thrift.

The primary decisions include the following factors:

- How to market the failed institution; that is, whether to sell it whole or in parts. Portions of the bank or thrift, such as its trust business, its credit card division, or its branches, may sell best as separate transactions.
- Which types or categories of assets should be offered to purchasers.
- How to package saleable assets; for example, should the acquirer be required to purchase them, should they be offered as optional asset pools, or should they be sold with loss sharing?⁵
- At what price the assets should be sold; for example, book value, a fixed value estimated by the FDIC, or reserve pricing.

Preparation for the Closing

Finally, the FDIC conducts an on-site analysis to prepare and plan for the closing. The FDIC estimates the number and dollar amount of uninsured deposits at the institution, determines and analyzes the extent of any contingent liabilities, and investigates whether any potential fraud is present.

Marketing a Failing Institution

After gathering the necessary information and determining the appropriate resolution structure to be offered, the FDIC begins to market confidentially the failing bank or thrift as widely as possible to encourage competition among bidders. The FDIC's bank examination force compiles a list of potential acquirers consisting of financial institutions and private investors. In compiling the list, the FDIC takes into account geographic location, competitive environment, minority owned status, overall financial condition, asset size, capital level, and regulatory ratings. Before they can bid, private investors not only need to have adequate funds, but they need to be engaged in the process of obtaining a charter. They cannot purchase a failed institution unless they have obtained the necessary approvals from the chartering authority.

5. Optional asset pools and loss sharing, methods for selling assets, are discussed further in Chapter 3, Evolution of the FDIC's Resolution Practices, and Chapter 7, Loss Sharing.

The Information Meeting

The FDIC invites all approved bidders to an information meeting. After signing confidentiality agreements, the bidders receive copies of the information package, including the financial data on the institution, legal documents, and other documents describing the various resolution methods being offered. At the meeting, the FDIC discusses the details of the failing institution, the resolution methods offered, the legal documents, the due diligence process (bidders' loan review), and the bidding procedures. Chartering authority officials describe the regulatory requirements for bidding, as well as the application process for branches or new charters. Typically, the transaction terms are focused on the treatment of the deposits and assets held by the failing bank or thrift. The FDIC also advises the bidders about the types and amounts of assets that pass to an acquirer as part of each of the various transaction terms; which assets the FDIC plans to retain; terms of the asset sale, such as loss sharing arrangements and optional asset pools; and other significant conditions that are part of each proposed resolution method.

Bidder Due Diligence

Approved bidders who have signed confidentiality agreements are invited to conduct due diligence at the failing institution. Due diligence is the bidder's on-site inspection of the books and records of the institution and the bidder's assessment of the value of the assets and liabilities. The failing institution's board of directors must pass a board resolution authorizing the FDIC to conduct due diligence before bidders visit the institution. All bidders performing due diligence are provided the same information, so no bidder has an advantage.

Bid Submission

After all bidders have completed due diligence, bidders submit their proposals to the FDIC. Ideally, they will submit proposals 12 to 15 days before the closing, but they often submit them as close as 6 or 7 days before closing. All bids, including those that do not conform to the FDIC's previously identified resolution methods (referred to as non-conforming bids), are evaluated and compared with one another and with the FDIC's estimated cost of liquidation to determine the least cost resolution.

A bid has two parts: One amount, called the premium, is for the franchise value of the failed institution's deposits; the second amount is what the bidder is willing to pay for the institution's assets to be acquired. The first figure generally represents the bidder's perception of the value of the customer base; the second amount reflects the bidder's perception of the imbedded losses and the level of risk associated with the assets.⁶

6. The latter figure results in a net payment from the FDIC to the acquirer. For example, if the acquirer assumes responsibility for \$100 in deposits and views the assets with a book value of \$100 as being worth \$80, then the acquirer will expect a \$20 payment from the FDIC to make up the difference.

Least Cost Analysis

In selecting the resolution method, the FDIC has changed procedures over the years. Before 1991, the FDIC could effect any resolution transaction that was less costly than a deposit payoff. While the estimated cost of the resolution method has always been important, the FDIC at times considered other factors before making its final selection. Deposit payoffs were at times discouraged because of the effect that type of resolution method had; it reduced the availability of local banking services in smaller communities. The FDIC also looked at broad issues such as the effect certain resolution methods may have on banking stability and on discouraging shareholders and creditors of insured institutions from excessive risk-taking actions. At times, the FDIC also considered the effect the selected method had on increasing the inventory level of loans being serviced by the FDIC. In 1991, because of a change in the law, the FDIC amended its failure resolution procedures to accept the “least cost” bid.⁷

The least cost procedures require the FDIC to choose the resolution method in which the total amount of the FDIC’s expenditures and liabilities incurred (including any immediate or long-term obligation and any direct or contingent liability) has the lowest cost to the deposit insurance fund, regardless of other factors.⁸

The FDIC determines the least costly resolution transaction by evaluating all possible resolution alternatives and computing costs on a present value basis, using a realistic discount rate. The overall cost to the FDIC of a failed institution depends on a number of factors, including the following:

- The difference between book values of assets and liabilities of the bank;
- The levels of uninsured and insured liabilities;
- The premium paid by the acquirer;
- Losses on contingent claims;
- The realized value of assets placed in liquidation by the FDIC; and
- Cross guarantee provisions against affiliated institutions.⁹

7. Least cost is terminology used by the FDIC to refer to the bid alternative for a failing institution in which the total amount of the FDIC’s expenditures and obligations incurred is the least costly to the deposit insurance fund of all possible resolutions for that failed institution.

8. The only exception is if there is a finding of “systemic” problems affecting the financial marketplace. Such a finding requires a two-thirds vote of the FDIC’s and the Federal Reserve’s boards of directors and concurrence by the secretary of the Treasury after consultation with the president of the United States.

9. The Financial Institutions Reform, Recovery, and Enforcement Act (FIRREA) of 1989 included a cross guarantee provision that allows the FDIC to recover part of its resolution cost by seeking reimbursement from affiliated institutions. That provision was designed to prevent affiliated banks or thrifts from shifting assets and liabilities among themselves in anticipation of the failure of one or more of the institutions.

In most cases, the FDIC will receive at least one bid that is less costly than the estimated cost of liquidation.¹⁰ If the bid includes assumption of all deposits, including uninsured deposits, the premium paid must be at least as large as the losses that would have been incurred by customers with uninsured deposits in a payoff in order for the bid to be considered less costly.

FDIC Board Approval

The FDIC staff submits a written recommendation to the FDIC Board of Directors requesting approval of the resolution transaction. The recommendation includes a copy of the least cost analysis and information about the share of the estimated loss that should be absorbed by customers with uninsured deposits. It also addresses whether an advance dividend should be paid to customers with uninsured deposits so they can receive a portion of their claim while the FDIC proceeds with the resolution and disposition of the remaining assets.

The FDIC Board of Directors is ultimately responsible for determining the least costly transaction. The board may direct that the winning bid determination be delegated to the appropriate division director. After the board approves the transaction, the FDIC staff notifies the acquirer, all unsuccessful bidders, and the chartering agency. The FDIC then arranges for the successful acquirer to execute the appropriate legal documents before the closure. At that time, the FDIC staff meets with the acquirer to coordinate the mechanics of the closing procedures.

Closing the Institution

The final step in the resolution process occurs when the institution is closed, and the assets that the acquirer purchased and the deposits that it assumed are transferred to the acquirer. The chartering authority closes the institution and appoints the FDIC as receiver. The FDIC, as receiver, is then responsible for settling the affairs of the bank or thrift, which includes balancing the accounts of the institution immediately after closing; transferring certain assets and liabilities; and determining the exact amount of payment due the acquirer (the liabilities assumed, less the assets acquired and the premium). The settling of various accounts between the receiver and the acquirer is called “settlement.”

10. From 1980 through 1994, out of 1,617 failing or failed bank situations handled by the FDIC, 1,188 banks, or 74 percent, resulted in purchase and assumption agreements. Deposit payoffs or insured deposit transfers (IDTs) were used in 296 cases, or 18 percent of the total. Open bank assistance accounted for 133 transactions, or 8 percent of the total.

Usually by the next business day, the acquirer will reopen the bank or thrift premises, and the customers of the failed institution with insured funds automatically become customers of the acquiring bank and can gain access to their money. As receiver, the FDIC is responsible for operating the receivership, including collecting any of the failed bank's assets retained by the receiver and satisfying the claims against the receivership of the failed institution. In cases where the FDIC provides continuing assistance, such as in a loss sharing transaction, the FDIC will monitor the assistance payments during the duration of the agreement, typically over several years.

Resolution Time Line

The entire resolution process is generally carried out in 90 to 100 days, not including the settlement timeframes. It begins when the chartering authority advises the FDIC that an insured institution is in imminent danger of failing and ends when the chartering authority appoints the FDIC as receiver. Sometimes the usual resolution process cannot be fully completed before the institution fails, however, such as in cases of sudden or severe liquidity problems. In those instances, the FDIC usually does not have time to prepare a review of the assets on site,¹¹ leaving a greater likelihood the FDIC will retain the failed institution's assets while structuring a more immediate solution for the institution's deposits and other liabilities. Three primary alternatives available in the face of such time pressure are a transfer of only the insured deposits,¹² a deposit payoff, or the formation of a bridge bank. A bridge bank is a newly created national bank designed to maintain the operations of an institution until a more permanent solution can be completed.¹³

11. When there is insufficient time to perform an on-site review, the FDIC uses its research model to value all or most of the assets. The research model is based on the FDIC's historical recovery experience for six broad categories of assets belonging to a sample of prior bank failures.

12. A transfer of insured deposits (insured deposit transfer) is a variation of a deposit payoff in which another financial institution takes responsibility for paying insured depositors the amounts they are owed. See Chapter 3, Evolution of the FDIC's Resolution Practices.

13. For further information, see Chapter 6, Bridge Banks.

The FDIC's resolutions methods evolved from passing few failed bank assets with little risk to an acquiring institution to passing most failed bank assets and sharing the risk with the acquiring institutions.



CHAPTER 3

Evolution of the FDIC's Resolution Practices

Introduction

This chapter reviews the various approaches employed by the Federal Deposit Insurance Corporation (FDIC) to address the successive waves of bank insolvencies resulting from high interest rates in the late 1970s and early 1980s, energy and agriculture sector problems in the mid-1980s, and collapsing real estate markets at the end of the 1980s and early 1990s. It traces the expansion of resolution alternatives from traditional deposit payoffs and purchase and assumption (P&A) transactions to later variations of those methods.

Such a review, which could provide enough material for a book unto itself, by necessity must be limited in some ways. As a result, this chapter focuses more on the treatment of assets in bank resolution transactions than it does on the treatment of deposits and other liabilities. Also, it provides a greater focus on the many smaller failed and failing bank transactions that took place during those years than on the fewer larger bank failures. Such a focus does not mean the other topics were viewed as less important; they are covered elsewhere in this study. The treatment of depositors and general creditors is the focus of chapters 9 and 10, while larger bank failures and the policy issues they raise receive attention in Part II, Case Studies of Significant Bank Resolutions.

Resolution Strategies of the FDIC

At the beginning of the 1980s, the FDIC's procedures for resolving failed institutions were guided by provisions of the Banking Acts of 1933 and 1935 and the Federal Deposit Insurance Act of 1950. Under the Banking Act of 1933, the FDIC's sole means of paying depositors of a failed institution was through a "new bank," or Deposit

Insurance National Bank (DINB), a national bank of limited life and powers that was chartered without any capitalization. A DINB allowed for a failed bank to be liquidated in an orderly fashion, minimizing disruptions to local communities and financial services markets. The FDIC Board of Directors was empowered to issue capital stock of the DINB and offer it for sale, giving the first opportunity to purchase it to the shareholders of the failed bank. The Banking Act of 1935 authorized the FDIC to pay off depositors either directly or through an existing bank. It also gave the FDIC the authority to make loans, purchase assets, and provide guarantees to facilitate a merger or acquisition. The added flexibility provided by new resolution powers was considered essential at a time when many newly insured banks were thought to be at risk of failure.¹

The Federal Deposit Insurance Act of 1950 included an open bank assistance (OBA) provision, granting the FDIC the authority to provide assistance, through loans or the purchase of assets, to prevent the failure of an insured bank. A bank was eligible for OBA if the FDIC Board of Directors deemed the continued operation of the institution essential to the community in which it was located. Because of the essentiality requirement, the FDIC did not use OBA until 1971.² The FDIC's authority to provide open bank assistance was expanded by the Garn–St Germain Depository Institutions Act of 1982, which eliminated the essentiality test except in instances in which the cost of open assistance would exceed the estimated cost of liquidating the subject institution.³ The elimination of the essentiality test enabled the FDIC to use OBA more frequently in the 1980s.

At the beginning of the 1980s, the FDIC relied on two basic methods to resolve failing banks: the purchase and assumption transaction and the deposit payoff. When determining the appropriate method for resolving bank failures, the FDIC considered a variety of policy issues and objectives. Four primary issues were (1) to maintain public confidence and stability in the U.S. banking system, (2) to encourage market discipline to prevent excessive risk-taking, (3) to resolve failed banks in a cost-effective manner, and (4) to be equitable and consistent in employing resolution methods.⁴ Certain secondary objectives also existed, including the desire to minimize disruption to the community in which the failing bank is located and to minimize the FDIC's role in owning, financing, and managing financial institutions and assets. With passage of the Federal Deposit Insurance Corporation Improvement Act (FDICIA) in 1991, which mandated

1. Federal Deposit Insurance Corporation, *Federal Deposit Insurance Corporation: The First Fifty Years* (Washington, D.C.: FDIC, 1984), 81.

2. FDIC, *The First Fifty Years*. 94.

3. The Garn–St Germain Act was comprehensive legislation that effected major changes in federal laws governing the activities of financial institutions. Among the many provisions of the act, two were drafted specifically to enhance the FDIC's failed bank resolution capabilities. The first provision dealt with open bank assistance, discussed above; the second authorized the Net Worth Certificate Program, described later in this chapter.

4. John F. Bovenzi and Maureen E. Muldoon, "Failure-Resolution Methods and Policy Considerations," *FDIC Banking Review* 3, no. 1 (fall 1990), 1.

the use of the transaction that resulted in the least cost to the FDIC, such policy objectives became secondary in choosing among alternative resolution methods.

Clean Bank Purchase and Assumption Transactions

In purchase and assumption transactions of the early 1980s, the acquiring bank, referred to as the “assuming bank” or “acquirer,” generally assumed all the failed bank’s deposit liabilities and certain secured liabilities. The acquirer also purchased certain assets and received financial assistance from the FDIC. The P&A agreement listed the assets purchased and specified the respective rights, obligations, and duties of the assuming bank and the receiver.

At that time, for two reasons, it was common for an acquirer to bid on and purchase a failing institution without performing due diligence. First, the FDIC wanted to maintain secrecy about impending failures to avoid costly deposit runs; it was concerned that allowing due diligence teams access to a failing bank’s premises would arouse fears about an imminent closing. Second, because only “clean” assets, such as cash and cash equivalents, were passed, due diligence was not required by bidders.⁵ Bidders would determine the value of the bank on the basis of their knowledge of the local community and on deposit information provided by examiners.

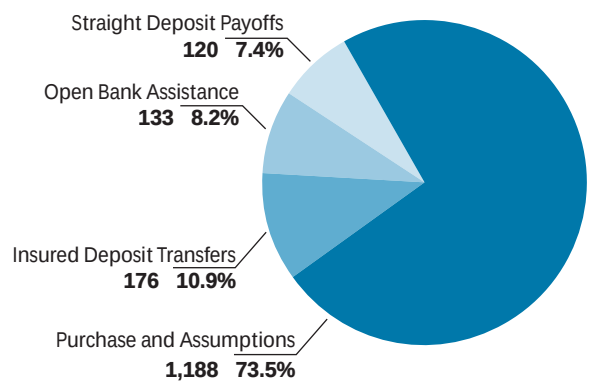
The FDIC generally did not sell loans to an acquiring institution at the time of resolution. Afterwards, though, loan officers of the acquirer often would review the borrower’s credit file and deposit relationships, pay off original notes, and draw up new loan documents to be executed by the borrower. Alternatively, to preserve the lender’s collateral position, the FDIC simply might assign notes to the acquirers. Thus, through those means, assuming banks could acquire large volumes of performing loans following resolution transactions. Nonperforming loans were not acquired by the assuming bank, even after completing the resolution transaction.

During the early 1980s, selling assets at the time of resolution, or immediately thereafter, was not a high priority for the FDIC for two reasons. First, because the frequency of bank failures was still relatively low, the FDIC was not burdened by a high volume of assets held in receivership. Second, from a supervisory viewpoint, the FDIC was not eager to place poor quality assets in the portfolios of acquiring banks. Later, as the number of failures increased and liquidity and workload pressures grew, the FDIC began to place more emphasis on selling assets as part of the initial resolution transaction. Numerous variations of P&A transactions would be developed over the course of the 1980s and early 1990s, most of which involved the treatment of a failed bank’s assets and the purchase of a failed bank’s loans from the FDIC. The P&A transaction

5. Cash equivalents included the bank securities portfolio. Banks generally purchased highly marketable, good-quality notes and bonds, usually either U.S. Government securities or issues from their local area (state, county, and municipal issues). The securities, if widely traded, were easily priced and would be sold to the acquirers on the basis of quotes from *The Wall Street Journal* or quotes obtained from several securities brokers.

Chart I.3-1

**Bank Failures by Resolution Method
1980–1994**



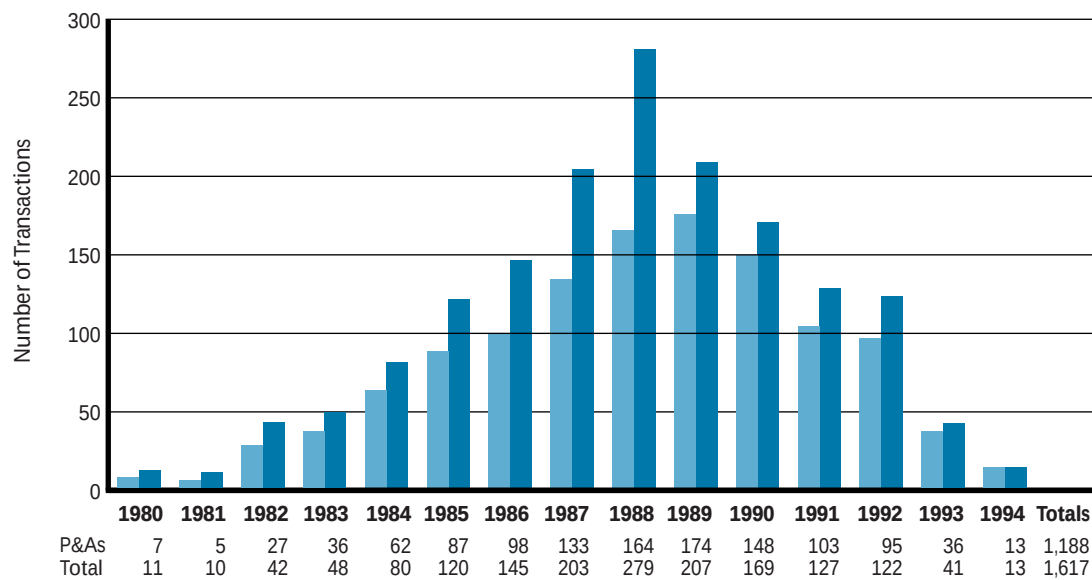
Total Bank Failures = 1,617

Sources: FDIC Division of Research and Statistics and FDIC annual reports.

remained the dominant resolution method used by the FDIC through the 1980s and early 1990s. Of the 1,617 failing and failed institutions handled by the FDIC between 1980 and 1994, 1,188, or 73.5 percent, were handled through P&A transactions. (See charts I.3-1 and I.3-2.) Similarly, of the \$302.6 billion in assets and \$233.2 billion in deposits at those 1,617 institutions, \$204 billion of the assets, or 67.4 percent of the total, and \$161.3 billion of the deposits, or 69.2 percent of the total, were in the 1,188 institutions handled through P&A transactions. (See charts I.3-3 and I.3-4.)

Chart I.3-2

**Purchase and Assumption Transactions
Compared to All Failures and Assistance Transactions
1980–1994**



Source: FDIC Division of Research and Statistics.

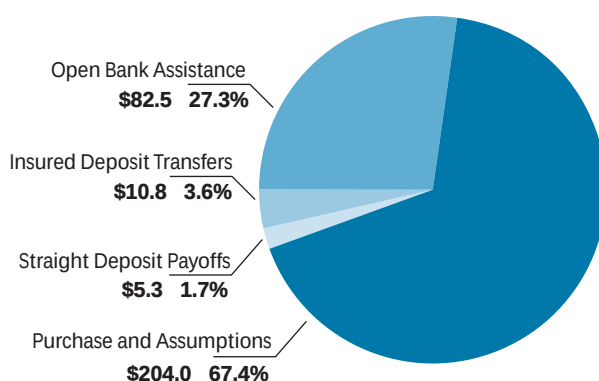
Deposit Payoffs

A deposit payoff was executed only if the FDIC did not receive a less costly bid for a P&A transaction. In a payoff, no liabilities are assumed, and no assets are purchased by another institution. The FDIC must pay, directly or through an agent, to depositors of the failed institution the amount of their insured deposits. The FDIC determines the amount in each depositor's account entitled to deposit insurance and pays that amount to the depositor. Early in the 1980s, a customer would collect a check in the amount of his deposit balance directly from an FDIC claim agent on the premises of the former bank. After that time, a customer would receive a check mailed by the FDIC within a few days after the institution's closing. In calculating the amount of each customer's check, the FDIC would include all the interest accrued under the contractual terms of the depositor's account through the date of closing.

The two main resolution methods used by the FDIC in the early 1980s, P&A transactions and deposit payoffs, differed in their effect on uninsured depositors. In a payoff, the FDIC did not cover that portion of a customer's deposits that exceeded the insured limit. The owners of uninsured claims were given receiver's certificates that entitled them to a share of collections from the receivership estate. The percentage of the claims they eventually received depended on the value of the bank's assets, the number of uninsured claims, and each claimant's relative position in the distribution of claims. In contrast, acquirers generally assumed all deposits in a P&A transaction, thereby providing 100 percent

Chart I.3-3

Failed Bank Assets by Resolution Method 1980–1994 (\$ in Billions)

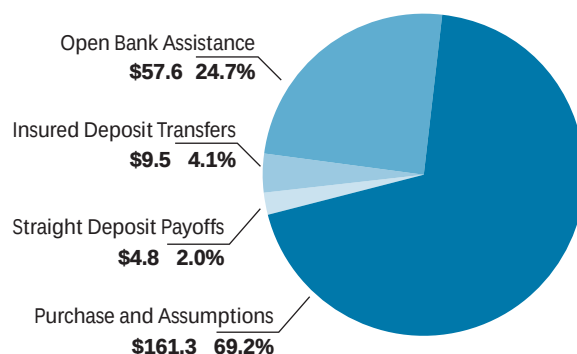


Total Failed Bank Assets = \$302.6

Sources: FDIC Division of Research and Statistics and FDIC annual reports.

Chart I.3-4

Failed Bank Deposits by Resolution Method 1980–1994 (\$ in Billions)

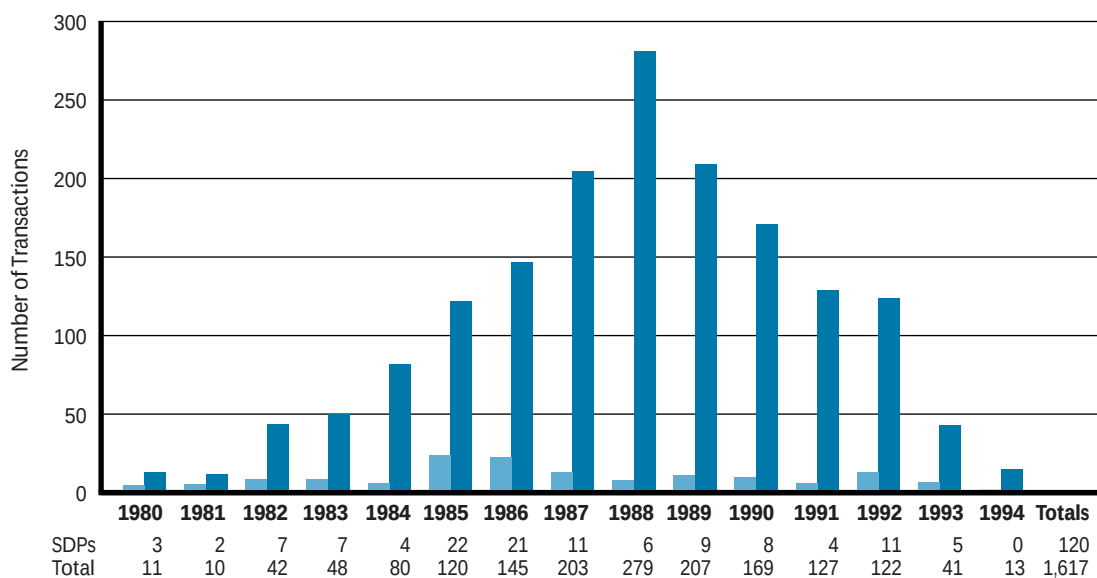


Total Failed Bank Deposits = \$233.2

Sources: FDIC Division of Research and Statistics and FDIC annual reports.

Chart I.3-5

Straight Deposit Payoffs Compared to All Failures and Assistance Transactions 1980–1994



Source: FDIC Division of Research and Statistics.

protection to all depositors. In the two decades before the 1980s, most failing banks were resolved through P&As, and uninsured depositors rarely suffered losses, particularly after 1966, when the FDIC instituted a procedure for competitive bidding to effect P&A transactions. Bidding—in contrast to negotiated deals with individual acquirers—increased the likelihood that the FDIC would receive a premium for the failed bank that would reduce the cost of a P&A transaction relative to a payoff.

Of the 1,617 failing and failed institutions handled by the FDIC between 1980 and 1994, deposit payoffs were used only 296 times, or 18.3 percent of the total. Such payoffs sometimes involved the use of an agent institution to pay depositors for the FDIC, in which case they were called insured deposit transfers (IDTs). IDTs accounted for 176 of the 296 deposit payoffs, or 59.5 percent of the total. (See charts I.3-1 and I.3-8.) Deposit payoffs generally were used for smaller institutions. While 18.3 percent of the total number of transactions were deposit payoffs, only 5.3 percent of the assets and 6.1 percent of the deposits of the banks handled by the FDIC between 1980 and 1994 were in the institutions in which the FDIC used deposit payoffs. (See charts I.3-3 and I.3-4.)

In the instances in which the FDIC used deposit payoffs, it was subjected to criticism that its resolution policies were inconsistent and inequitable. Observers pointed out that uninsured depositors in large banks were less likely to suffer losses than those in

small banks because it was easier for the FDIC to arrange P&A transactions to resolve large failures.⁶ The P&A approach minimized disruption to local communities and to financial markets generally, but it appeared to provide unfair protection for uninsured deposits in larger institutions.

Deposit Insurance National Bank

The Banking Act of 1933 authorized the FDIC to form a new bank called a Deposit Insurance National Bank to pay off the insured depositors of an insured institution. After the Banking Act of 1935 granted the FDIC authority to pay off depositors directly or through an existing bank, DINBs were rarely used. Of the five DINBs created by the FDIC after 1935, the most well-known was established in 1982 to resolve Penn Square Bank, N.A. (Penn Square), a \$516.8 million institution located in Oklahoma City, Oklahoma. Before the Penn Square resolution, every bank failure involving assets greater than \$100 million had been handled through a P&A transaction. In the case of Penn Square, which was declared insolvent by the Office of the Comptroller of the Currency (OCC) on July 5, 1982 (a federal holiday), the FDIC decided that a P&A transaction was impractical. Although Penn Square was only a \$500 million institution, it had been able to convince some of the largest banks in the country to purchase more than \$2 billion in oil and gas loans that it had originated. Most of those loans were poorly documented, and collection in full was doubtful by the time of the bank failure. Because the accuracy of loan information provided by Penn Square to the participants was suspect, the FDIC expected the loans to spawn many lawsuits from participants seeking to recover part or all of their investments. That expectation, along with other factors, made it difficult for the FDIC to estimate the losses it could incur on the bank and to evaluate P&A bids for the institution. Given the circumstances, the FDIC decided to effect a payoff of the bank by using a DINB, thus limiting its maximum potential loss to the approximately \$250 million in insured deposits.

At closing, depositors with balances in excess of the insurance limit had their insured deposits transferred to the DINB, while the excess became a claim against the receivership. Receivers' certificates totaling \$459.1 million were issued to claimants, who eventually received around 70 percent of their claims from the net sale and liquidation proceeds of the failed bank's assets. The FDIC's resolution cost was \$65 million, which represented 12.6 percent of assets at the date of resolution.⁷

6. Before 1982, the largest bank failure handled through a payoff was the \$78.9 million Sharpstown State Bank in Houston, Texas, in 1971. See Irvine H. Sprague, *Bailout* (New York: Basic Books, 1986), 117.

7. See Part II, Case Studies of Significant Bank Resolutions, Chapter 3, Penn Square Bank, N.A.

New Resolution Alternatives

The sustained period of high and volatile interest rates, coupled with an erosion of traditional funding sources through disintermediation, had a serious effect on the capital levels and earnings of FDIC insured institutions. Mutual savings banks (MSBs) were particularly affected by rising interest rates because those institutions held large portfolios of long-term, fixed-rate mortgages. MSBs were chartered in 19 states, although 95 percent of the total deposits in MSBs were in 9 states: Connecticut, Maine, Massachusetts, New Hampshire, New Jersey, New York, Pennsylvania, Rhode Island, and Washington.⁸ In 1975, there were about 450 MSBs compared to nearly 5,000 savings and loan associations and approximately 14,600 commercial banks. The average asset size of the MSBs was \$254 million compared to \$69 million for savings and loan associations and \$66 million for commercial banks.

By 1982, the MSBs were losing \$2 billion annually.⁹ In many instances, the market value of MSBs' assets fell to 25 to 30 percent below outstanding liabilities.¹⁰ The FDIC faced the possibility of incurring significant losses for a problem—high interest rates—that it thought was transitory. The FDIC's major concern was how to control the costs of resolving failing savings banks while avoiding raising the public's concern over the stability of savings banks in general.

Income Maintenance Agreements

One of the FDIC's primary strategies was to force weaker savings banks to merge into healthier banks or thrifts by guaranteeing a market rate of return on the acquired assets through an income maintenance agreement. The FDIC paid the acquirer the difference between the yield on acquired earning assets and the average cost of funds for savings banks, thereby assuming the interest rate risk. If interest rates declined to where the cost of funds was below the yield on earning assets, the acquirer was required to pay the FDIC. The FDIC entered into those agreements only if the resulting institution was viable.

Between 1981 and 1983, the FDIC used income maintenance agreements to resolve 11 of the assisted mergers of FDIC insured mutual savings banks. (See table I.3-1.) Because they were merged into operating institutions, those banks did not fail, and depositors and general creditors suffered no losses. In most cases, however, the failing bank's senior management was requested to resign, and subordinated noteholders received only a partial return of their investments. Because MSBs have no stockholders,

8. *National Fact Book of Mutual Savings Banking, 1980* (Washington, D.C.: National Association of Mutual Savings Banks), 17.

9. FDIC, *The First Fifty Years*, 99.

10. FDIC, *The First Fifty Years*, 99.

Table I.3-1

Income Maintenance Agreements

(\$ in Millions)

Date	Bank Name	Location	Assets	Acquirer	Comments
11/4/81	Greenwich Savings	New York, NY	\$2,475	Metropolitan S.B.* (Renamed CrossLand in 1984)	Failed in 1992
12/4/81	Central S.B.	New York, NY	910	Harlem S.B. (Renamed Apple Bank for Savings in 1983)	
12/18/81	Union Dime S.B.	New York, NY	1,453	Buffalo S.B. (Renamed Goldome Bank for Savings in 1984)	Failed in 1991
1/15/82	Western NY S.B.	Buffalo, NY	1,025	Buffalo S.B. (Renamed Goldome)	Failed in 1991
2/20/82	Farmers & Mechanics S.B.	Minneapolis, MN	1,002	Marquette National Bank	
3/11/82	Fidelity Mutual S.B.	Spokane, WA	703	First Interstate National Bank	
3/26/82	New York Bank for Savings	New York, NY	3,404	Buffalo S.B. (Renamed Goldome)	Failed in 1991
4/2/82	Western Savings Fund Society	Philadelphia, PA	2,126	Philadelphia Savings Fund Society (Renamed Meritor S.B.)	Failed in 1992
10/15/82	Mechanics Savings Bank	Elmira, NY	55	Syracuse Savings Bank	Failed in 1987
2/9/83	Dry Dock Savings Bank	New York, NY	2,452	Dollar S.B. (Renamed Dollar Dry Dock Savings Bank)	Failed in 1992
10/1/83	Auburn Savings Bank	Auburn, NY	133	Syracuse Savings Bank	Failed in 1987
Totals	11 Institutions		\$15,738		

* Savings Bank

Sources: FDIC annual reports, 1981 to 1993.

the FDIC did not have to concern itself with interests of existing stockholders. While the cost savings of the program are difficult to quantify, the Income Maintenance Agreement Program successfully provided the resulting merged institution with a safety net until the interest rate scenario became more favorable. Interestingly, as shown in the far right column of table I.3-1, 8 of the 11 merged institutions that were saved by income maintenance agreements in early 1980s eventually failed as a result of the real estate crisis of the late 1980s.

Net Worth Certificates

The FDIC developed another resolution strategy: the Net Worth Certificate Program (NWCP). The program's purpose was to buy time for savings banks to correct rate sensitivity imbalances and restore capital to acceptable levels. The Garn–St Germain Act of 1982 enabled any insured institutions that met statutory requirements to apply for capital assistance in the form of net worth certificates.

Under the program, institutions received promissory notes from the FDIC representing a portion of current period losses in exchange for certificates that were to be considered as part of the institution's capital for reporting and supervisory purposes. Although the Garn–St Germain Act did not prescribe a formula based on specific capital levels, the FDIC established a working formula to semi-annually purchase certificates equal to between 50 percent and 70 percent of the institution's net operating loss.

Originally, the FDIC provided assistance only to institutions with a positive level of capital. Later, it limited eligibility to institutions having a minimum capital ratio of 1.5 percent and established other requirements for participants. To be eligible, the FDIC required an institution to develop a business plan based on reasonable economic assumptions over reasonable time periods. Participating savings banks were prohibited from allowing insider trading and speculative management activity. To raise additional capital, if the need subsequently arose, the institutions also agreed to convert from mutual to stock form at the FDIC's request.

The Net Worth Certificate Program allowed solvent, well-managed institutions to survive until the results of restructured balance sheets produced profitable operations or until the banks could arrange unassisted mergers with stronger institutions. Of the 29 savings banks in the plan, 22 required no further assistance and eventually extinguished their net worth certificates. Seven savings banks required additional assistance from the FDIC; four repaid all assistance, and three merged into healthy institutions with FDIC assistance.¹¹ (See table I.3-2 for a list of the 29 institutions that were in the Net Worth Certificate Program. See charts I.3-6 and I.3-7 for the

11. Federal Deposit Insurance Corporation, Office of Research and Statistics, "Open Bank Assistance: A Study of Government Assistance to Troubled Banks from the RFC to the Present," (May 1990), 12.

number of institutions and volume of assets that were involved in the NWCP by year.)

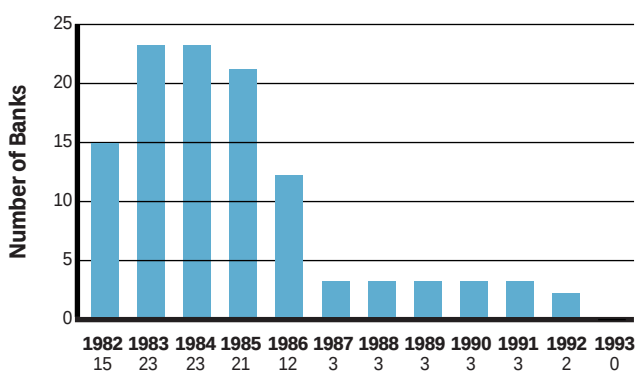
Insured Deposit Transfers

In 1983, the FDIC introduced a new type of transaction, the insured deposit transfer (IDT). In contrast to a straight deposit payoff, an IDT involves the transfer of insured deposits and secured liabilities of the failed bank to a healthy institution that agrees to act as the FDIC's agent. The agent bank makes available to the depositors of the failed bank a "transferred deposit" account, which the depositor may continue to maintain at the agent bank. Alternatively, the depositor may withdraw the balance and close the account. In an insured deposit transfer, the FDIC as receiver retains all the assets and the uninsured and unsecured liabilities of the failed institution. As part of the transaction, the FDIC makes a cash payment matching the amount of the transferred liabilities to the assuming bank. Often times, the bank acting as agent will use some of that cash to purchase some of the failed bank's assets from the FDIC. The IDT reduces the disruption caused by a deposit payoff to insured depositors and to the local community. It also reduces the FDIC's administrative costs in handling the failures because the agent bank acts as the paying agent for the FDIC and disburses insured funds to depositors.¹²

From 1983, when they were first used, through 1994, there were 176 insured deposit transfers. (See chart I.3-8.) With

Chart I.3-6

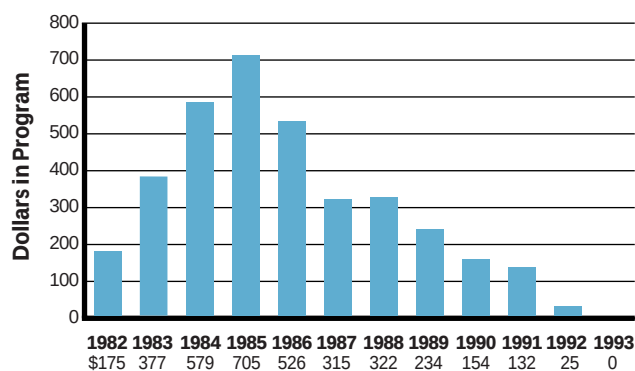
Number of Banks in Net Worth Certificate Program 1982–1993



Sources: FDIC annual reports 1982–1993.

Chart I.3-7

Dollars in Net Worth Certificate Program 1982–1993 (\$ in Millions)



Sources: FDIC annual reports 1982–1993.

12. FDIC, 1983 Annual Report, 12.

Table I.3-2

Net Worth Certificate Program

(\$ in Millions)

Bank Name	Location	Assets at Entry	Certificates (Max. Held)	Date Retired
Auburn Savings Bank*	Auburn, NY	\$125.6	\$1.6	Retained by Syracuse S.B. in 1983– Assisted Merger
Beneficial Mutual	Philadelphia, PA	1,628.7	18.9	1991
Bowery Savings Bank*	New York, NY	4,999.4	220.1	1992
Cayuga County Savings Bank	Auburn, NY	190.0	.8	1986
Colonial Mutual Savings Bank	Philadelphia, PA	70.7	.8	1984–Acquired
Dime Savings Bank of NY, FSB	New York, NY	6,393.7	72.1	1986
Dime S.B. of Williamsburgh	New York, NY	573.8	3.6	1987
Dollar Dry Dock Savings Bank†	New York, NY	4,972.8	41.3	1986
Dry Dock Savings Bank*	New York, NY			See Dollar Dry Dock S.B.‡
East River Savings Bank, FSB	New York, NY	1,777.5	26.4	1987
Eastern Savings Bank	New York, NY	786.0	13.7	1986–Merger
Elizabeth Savings Bank	Elizabeth, NJ	31.7	.3	1983–Merger
Emigrant Savings Bank	New York, NY	2,968.5	90.0	1991
Greater New York Savings Bank	New York, NY	1,816.8	23.1	1987
Home Savings Bank	White Plains, NY	427.4	5.6	1986–Assisted Merger
Inter-County Savings Bank	New Paltz, NY	123.4	1.6	1986
Lincoln Savings Bank, FSB	New York, NY	2,090.3	65.9	1987
National S.B. of the City of Albany	Albany, NY	391.2	1.1	1985

Table I.3-2**Net Worth Certificate Program**

(\$ in Millions)

Continued

Bank Name	Location	Assets at Entry	Certificates (Max. Held)	Date Retired
Niagara County Savings Bank	Niagara Falls, NY	291.9	.4	1986—Merger
Orange Savings Bank	Livingston, NJ	531.1	3.5	1984—Assisted Merger
Oregon Mutual Savings Bank	Portland, OR	260.0	1.5	1983—Assisted Merger
Rochester Community Savings Bank	Rochester, NY	1,371.3	5.0	1986
Roosevelt Savings Bank	New York, NY	858.9	5.8	1986
Sag Harbor Savings Bank	Sag Harbor, NY	203.6	1.4	1987
Savings Fund Society of Germantown	Bala Cynwyd, PA	1,373.1	17.8	1987
Seamen's Savings Bank, FSB†	New York, NY	1,825.5	31.3	1986
Skaneateles Savings Bank	Skaneateles, NY	136.1	.5	1986
Syracuse Savings Bank*	Syracuse, NY	1,180.5	See Auburn S.B.‡	1987—Assisted Merger
Williamsburgh Savings Bank	New York, NY	2,215.1	64.0	1987—Merger
Totals	29 Institutions	\$39,614.6	\$718.1	

* Failed or assisted while in Net Worth Certificate Program (NWCP).

† Failed after NWCP participation.

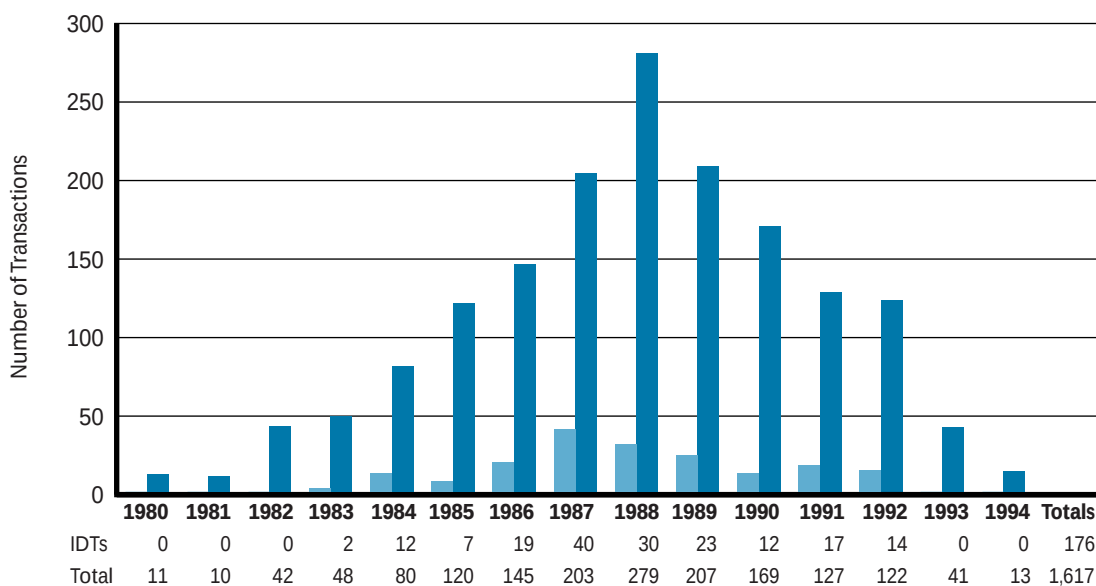
‡ Certificates issued to Dry Dock S.B. were retained when acquired by Dollar S.B. Subsequently, Dollar Dry Dock acquired additional certificates.

§ Certificates issued to Auburn S.B. were retained when acquired by Syracuse S.B. Syracuse S.B. failed in 1987.

Source: FDIC, "The Mutual Savings Bank Crises," *History of the Eighties—Lessons for the Future: An Examination of the Banking Crises of the 1980s and Early 1990s* (Washington, D.C.: Federal Deposit Insurance Corporation, 1997).

Chart I.3-8

Insured Deposit Transfers Compared to All Failures and Assistance Transactions 1980–1994



Source: FDIC Division of Research and Statistics.

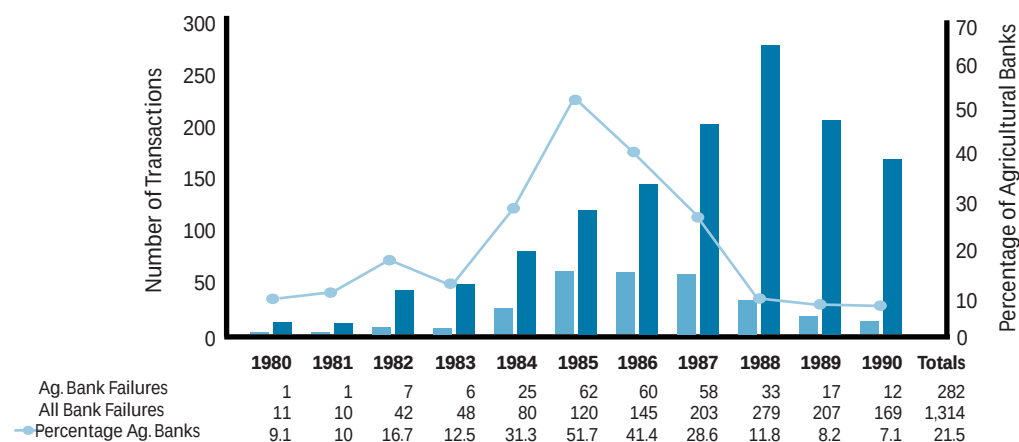
deposits totaling \$9.5 billion, the failed banks for which the FDIC used IDTs were relatively small, representing only 4 percent of the total deposits of banks that failed from 1980 to 1994. (See chart I.3-4.)

The FDIC also developed a variation of the insured deposit transfer in which uninsured depositors were issued an advance dividend based on a conservative estimate of the recovery value of the failed bank's assets.¹³ That type of transaction, known as a modified payoff, provided uninsured depositors with greater liquidity without eliminating the need for them to exercise market discipline before making deposits in an institution with higher risks.

13. An advance dividend is a payment made to uninsured depositors immediately after a bank fails; it is based on the estimated value of the receivership's assets.

Chart I.3-9

Agricultural Bank Failures versus All Bank Failures 1980–1990



Source: FDIC, Chapter 8, "Banking and Agricultural Problems of the 1980s," *History of the Eighties—Lessons for the Future: An Examination of the Banking Crises of the 1980s and Early 1990s* (Washington, D.C.: Federal Deposit Insurance Corporation, 1997).

Resolution Responses to Bank Failures from 1984 to 1986

Banks with a concentration of assets, mainly loans, in the energy and agricultural sectors began appearing on the FDIC's problem bank list in 1982 and were being resolved by 1984. Agricultural and energy banks were defined as banks having 25 percent or more of their loans in agricultural or energy loans. A total of 345 banks, most with deposits of \$30 million or less, either failed or received FDIC assistance between 1984 and 1986. Of that total, 147, or 42.6 percent, were agricultural banks.¹⁴ (See chart I.3-9.)

"Put" Options

Another approach the FDIC took in responding to the new wave of bank failures was the modification of its treatment of assets under the P&A transaction. In earlier years, the FDIC passed a limited portion of the failed bank's assets to an acquiring institution. Generally, only cash, federal funds sold, and securities were passed to the acquirer. As the number of bank failures increased, however, the FDIC began to consider methods and incentives for passing more of the failed bank's assets to the acquirer.

14. No records could be found that would indicate the number of energy banks that failed during this period.

To a certain extent acquirers were willing to take more assets, but not necessarily as many as the FDIC would have liked, given the sudden increase in the number of bank failures. To induce an acquirer to purchase additional assets, the FDIC would offer a “put” option on certain assets that were transferred. Two option programs for purchasing assets that the FDIC typically offered to acquirers in clean bank transactions were the “A Option,” which passed all assets to the acquirer and gave them either 30 or 60 days to put back those assets they did not wish to keep, and the “B Option,” which gave the acquirer 30 or 60 days to select desired assets from the receivership. The number of days offered under each option depended on the complexity of the asset portfolio. Structural problems existed, however, with both of the option programs, because an acquirer was able to “cherry pick” the assets, choosing only those with market values above book values or assets having little risk while returning all other assets. Also, acquirers tended to neglect assets during the put period before returning them to the FDIC, which adversely affected their value.

In late 1991, the FDIC discontinued the put structure as a resolution method and replaced it with the loss sharing structure and loan pool structure. During the mid-1980s, however, the put option was seen as a way to preserve the liquidity of the insurance fund by passing more assets to acquirers, thus lowering the amount of cash payments to assuming banks.

Forbearance Programs

A resolution strategy the FDIC used was forbearance, which exempted certain distressed institutions that had been operating in a safe and sound manner from capital requirements. The first formal forbearance program was the Net Worth Certificate Program, established in 1982. Under the Garn–St Germain Act, insured institutions could apply for capital assistance in the form of net worth certificates. Under the program, institutions received FDIC promissory notes representing a portion (between 50 percent and 70 percent) of current period operating losses in exchange for certificates that were considered part of regulatory capital. A total of 29 savings banks participated in the program, of which 22 required no further assistance and 7 required additional assistance. Of the 29, 26 eventually repaid all assistance and the remaining 3 merged into healthy institutions. The Net Worth Certificate Program is described in more detail earlier in this chapter.

Forbearance also was used in March 1986 when federal regulators issued a joint policy allowing the temporary Capital Forbearance Program for agricultural banks and banks with a concentration of energy credits. The program was directed at well-managed, economically sound institutions with concentrations of 25 percent or more of their loan portfolios in agricultural or energy loans. Eligible banks were required to have a capital ratio of at least 4 percent, and their weakened capital position had to be a result of external problems in the economy and not a result of mismanagement, excessive operating expenses, or excessive dividends. Ultimately, a total of 301 agricultural and energy

Table I.3-3**Results of the Capital Forbearance Programs*
Agricultural and Energy Sector Banks**

	Regulatory Joint Policy	CEBA Loan Loss Amortization
Number of Banks in Program	301	33
Assets (\$ in Billions)	\$13.0	\$0.5
Avg. Size of Bank (\$ in Millions)	\$43.2	\$15.2
Number of Banks that Survived [†]	236	29
Number of Banks that Failed	65	4

* Banks that participated in both programs are included only in the regulators' program.

† Banks that left programs as independent institutions or were merged without assistance.

Source: FDIC Division of Research and Statistics.

sector institutions with assets of approximately \$13 billion participated in the regulatory forbearance program. Overall, the capital ratio and return on assets of the banks improved by year-end 1989, a trend that mirrored improving economic conditions in the agricultural and energy markets. However, 65 of the banks in the regulatory forbearance program subsequently failed.

In 1987, Congress provided additional relief to agricultural lenders by permitting banks serving predominantly agricultural customers to defer accounting recognition of agricultural-related loan losses. The Loan Loss Amortization Program, adopted as part of the Competitive Equality Banking Act (CEBA) of 1987, allowed banks to amortize those losses over a seven-year period. Only institutions with less than \$100 million in total assets and with at least 25 percent of their total loans in qualified agricultural credits were eligible for the program. Qualified institutions were judged to be economically viable and fundamentally sound, except for needing additional capital to carry the weak agricultural credits. Congress's intent with the agricultural Loan Loss Amortization Program was to allow "fundamentally sound banks to weather (the current) storm."¹⁵ A total of 33 banks participated in the program. Of those, 27 had survived as independent institutions a year after leaving it, while 2 merged and 4 failed.

See table I.3-3 for a summary of the regulatory and legislative forbearance programs.

15. *Congressional Record*, 100th Congress, 2d sess., March 26, 1987, S.3941.

Open Bank Assistance

The failure of Penn Square in 1982 caused wide-ranging repercussions throughout the banking industry. The most serious result was the subsequent resolution of Continental Illinois National Bank and Trust Company (Continental), Chicago, Illinois, in 1984. In the years preceding its insolvency, Continental had followed a high-risk expansion strategy based on the rapid growth of its loan portfolio funded by volatile, short-term liabilities. The bank developed extensive international operations; established divisions to render specialized services to the bank's oil, utility, and finance company customers; and developed a separate real estate department to make commercial and home loans. At its peak in 1981, Continental was the largest commercial and industrial lender in the United States. As of March 31, 1984, shortly before its resolution, the bank held approximately \$40 billion in assets.

Because of the many energy loan participations Continental had purchased from Penn Square, the Oklahoma City institution's failure had a disastrous effect on Continental. The participation loans contributed significantly to the more than \$5.1 billion in nonperforming loans held by Continental as of year-end 1982. Following the shock of Penn Square, management was unable to reverse the adverse asset quality and income trends, and confidence in Continental was severely shaken. As a result, a rapid and massive electronic deposit run began in May 1984.

The FDIC decided that a payoff of Continental could cause panic in the financial and banking markets. Irvine Sprague, a former chairman of the FDIC who was a member of the FDIC's Board of Directors at that time, wrote about Continental:

Insured deposits were then estimated at about \$4 billion, barely 10 percent of the bank's funding base. At first glance, a payoff might have seemed a temptingly cheap and quick solution. The problem was there was no way to project how many other institutions would fail or how weakened the nation's entire banking system might become. Best estimates of our staff. . . were that more than two thousand correspondent banks were depositors in Continental and some number—we talked of fifty to two hundred—might be threatened or brought down. . . . The only things that seemed clear were not only that the long-term cost of allowing Continental to fail could not be calculated, but also that it might be so much as to threaten the FDIC fund itself.¹⁶

As part of the FDIC's initial response to the crisis, and in a significant departure from its approach to failed bank resolutions, the FDIC announced that all depositors, both insured and uninsured, would be protected in any subsequent resolution of Continental. The open bank assistance transaction that ultimately was used to resolve Continental sparked a policy debate about whether certain banks were truly "too big to

16. Irvine H. Sprague, *Bailout* (New York: Basic Books, 1986), 155.

fail” and whether they were deserving of special treatment not available to smaller institutions.¹⁷

While the term “open bank assistance” gained national recognition with the Continental transaction, the FDIC has been authorized to provide OBA since 1950.¹⁸ Since the Continental transaction, OBA has been transformed by the legislative process and public policy.¹⁹ Open bank assistance occurred when a distressed financial institution remained open with government financial assistance.²⁰ Generally, the FDIC required new management, ensured that the ownership interest was diluted to a nominal amount, and called for a private sector capital infusion. The FDIC also had used OBA to facilitate the acquisition of a failing bank or thrift by a healthy institution and provided financial help in the form of loans, contributions, deposits, asset purchases, or the assumption of liabilities. Generally, the majority of a failing institution's assets remained intact. Because minimizing cost to the insurance fund is the ultimate goal, the FDIC structured OBA in several ways. Major critics of OBA, however, claimed that shareholders of failing institutions benefited from government assistance, even though most of the OBA transactions required the shareholders of the failing institutions to significantly dilute their ownership interests.

The FDIC's authority to provide open bank assistance has changed over time because of legislative and policy concerns; authority was broadened in the 1980s and then restricted in the 1990s. Since passage of FDICIA, before the FDIC could provide OBA, it had to establish that the assistance was the least costly to the insurance fund of all possible methods for resolving the institution. The FDIC could deviate from the least cost requirement only to avoid systemic risk to the banking system. The appropriate federal banking agency or the FDIC also had to determine that the institution's management was competent; had complied with all applicable laws, rules, and supervisory directives and orders; and had never engaged in any insider dealings, speculative practices, or other abusive activities. Finally, the FDIC could not use insurance funds to benefit shareholders of the failing institution.

From 1980 through 1994, the FDIC provided OBA to 133 institutions out of 1,617 total failures and assistance transactions, or about 8 percent of the total. (See chart I.3-10.) Nearly 75 percent of all OBA transactions were completed in 1987 and 1988. Beginning with 1989, the FDIC moved away from providing OBA and entered into only seven OBA transactions from 1989 to 1992. There have been no OBA transactions to date since 1992.

17. See Part II, Case Studies of Significant Bank Resolutions, Chapter 4, Continental Illinois National Bank and Trust Company.

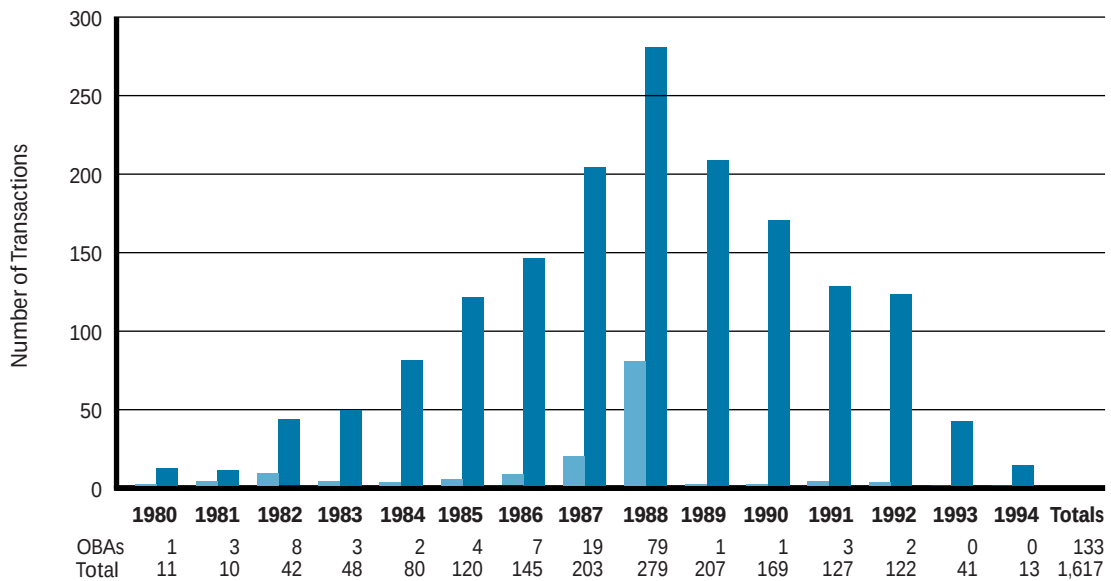
18. Federal Deposit Insurance Act of 1950, *U.S. Code*, volume 12, section 1823(c)(1).

19. See Chapter 5, Open Bank Assistance, for additional information on the FDIC's use of OBA.

20. Several types of “assistance to open banks” include forms of cash and non-cash assistance. To the FDIC, the term “open bank assistance” refers specifically to a resolution method whereby the FDIC gives financial assistance to a troubled bank or thrift to prevent its failure.

Chart I.3-10

Open Bank Assistance Transactions Compared to All Failures and Assistance Transactions 1980–1994



Source: FDIC Division of Research and Statistics.

The Banking Crisis in the Southwest

Between 1987 and 1989, a total of 689 banks either failed or required FDIC assistance. Approximately 71 percent of those failures were in Texas, Oklahoma, and Louisiana, with the majority of the failures in Texas. By 1988, 9 of the 10 largest banking entities in that state required FDIC resolution. The concentration of failures in the Southwest that occurred in the late 1980s has been attributed to several factors.²¹ The first was the volatility of oil prices, which rose sharply between 1973 and 1981, declined moderately between 1981 and 1985, and then fell 45 percent in 1986. The second factor was the explosive growth in real estate development that led to a greater than 25 percent office vacancy rate in Texas's major metropolitan areas between 1986 and 1989. The third factor was the change in composition of commercial banks' loan portfolios. Concentrations in relatively high-risk loans such as land development and commercial and industrial

21. John O'Keefe, "The Texas Banking Crisis: Causes and Consequences, 1980-1989," *FDIC Banking Review* 3, no. 3 (winter 1990), 2, 3.

Table I.3-4**Bank Failures in the Southwest
1980–1994**

Year	Total Bank Failures	Bank Failures in the Southwest*	Bank Failures in the Southwest as a Percentage of Total Bank Failures
1980	11	0	0
1981	10	0	0
1982	42	13	31
1983	48	5	10
1984	80	14	18
1985	120	29	24
1986	145	54	37
1987	203	110	54
1988	279	214	77
1989	207	167	81
1990	169	120	71
1991	127	41	32
1992	122	36	30
1993	41	10	24
1994	13	0	0
Totals	1,617	813	50

* The Southwest as defined here includes Arkansas, Louisiana, New Mexico, Oklahoma, and Texas.
Source: FDIC Division of Research and Statistics.

loans increased through the mid-1980s, exposing banks to the effects of falling land prices and diminishing cash flows of borrowers. A fourth factor was the infrequency of bank examinations in the mid-1980s. (See table I.3-4.)

The Southwest banking crisis was qualitatively different from the interest rate driven crisis of the early 1980s. In the earlier crisis, many failing banks actually had high-quality loan portfolios and took advantage of regulatory forbearance to ride out temporarily adverse economic conditions. Forbearance was not a viable option in the new crisis. The FDIC was faced with large numbers of failing banks with high levels of nonperforming real estate loans that demanded quick action. In response to that situation, the FDIC began using two new resolution methods: the bridge bank and the whole bank purchase and assumption transaction. Both methods allowed assets to

remain in private sector hands and minimized the FDIC's cash outlays required to consummate failing bank resolutions.

Bridge Banks

The Competitive Equality Banking Act of 1987 authorized the FDIC to create bridge banks to resolve failing institutions. A bridge bank is a full-service national bank chartered by the Office of the Comptroller of the Currency and controlled by the FDIC. Initially, a bridge bank was operated for two years, with a one-year extension, which later was amended by the Financial Institutions Reform, Recovery, and Enforcement Act (FIRREA) of 1989 to provide three one-year extensions. Bridge banks, which provide the FDIC time to arrange a permanent transaction, are especially useful in situations in which the failing bank is large or unusually complex. In general, the FDIC may establish a bridge bank if the board of directors determines it to be cost effective; that is, establishment of a bridge bank is in accordance with the cost test (before December 1991) or the least cost test (after December 1991). The FDIC used its bridge bank authority for the first time on October 30, 1988, when Louisiana banking authorities closed Capital Bank and Trust Company in Baton Rouge.

A bridge bank may be resolved through a purchase and assumption transaction (the most common method), a merger, or a stock sale. Of the 32 bridge banks resolved, all but 2 were short term, lasting seven months or less. The two long-term bridge banks established to resolve the First RepublicBanks and the MCorp banks technically were resolved within seven months (transactions with acquirers were consummated), but their status as bridge banks lasted beyond the resolution date because the FDIC owned stock in the bridge banks. Bridge bank status terminated when the acquirer bought the FDIC's interest and obtained a regular national bank charter. The change in status occurred after approximately thirteen months with the First RepublicBanks and two-and-one-half years with the MCorp banks.

Preference for Passing Assets

In the 1980s, the FDIC was able to select any available resolution method, as long as the method chosen was less than the estimated cost of paying off the depositors and liquidating the failed bank's assets.²² As the banking crisis became more acute in the second half of the decade, the FDIC tended to choose transactions that allowed a large proportion of a failing bank's assets to pass to the acquirer. That preference was exercised for a variety of reasons.

22. The FDIC developed its cost test in 1951 in response to congressional criticism of the FDIC's preference for facilitating deposit assumptions for failing banks over payoffs. Assumptions resulted in de facto deposit insurance of all depositors, whereas payoffs protected only insured depositors. The cost test was subsequently used to determine whether an assumption (or other transaction) would be cheaper than a payoff.

First, the FDIC became concerned that the accumulation of assets would have a disastrous effect on the insurance fund. Former Chairman L. William Seidman, noting that before this time, emphasis had not been placed on the sale of assets at resolution, wrote:

This was not a serious problem in an agency with very few failed banks, and when the FDIC insurance fund had lots of cash . . . But it could be disastrous as the number of bank failures increased . . . The strategy of holding on to assets would swallow up all our cash very quickly . . . Cash had never been a problem at the FDIC, with billions in premium income on deposit at the Treasury. But my calculations showed that on the basis of the way we were doing things, if you took the FDIC forecast of bank failures from 1985 to 1990, our cash reserve of \$16 billion would be wiped out well before the end of the decade.²³

Second, although there is no empirical evidence, it was generally believed that after an asset from a failing bank was transferred to a receivership, the asset would suffer a loss in value.²⁴ Loans have unique characteristics, and prospective purchasers need to gather information about the loans to properly evaluate them. Such “information cost” is factored into the price that the outside parties are willing to pay for the loans. That cost tends to be greater on assets from failed banks. In addition, a loss in value can occur because of the break in the bank-customer relationship. When a customer values a banking relationship, the customer is willing to work with the bank. However, when a customer merely has an obligation to pay and anticipates no continuance of a business relationship, that customer may not be as willing to pay his debt in full.

Third, as the FDIC began having to manage an extremely large portfolio of failed bank assets caused by the growing number of bank failures in the late 1980s, several logistical problems began to develop, and it therefore became more desirable to pass assets to acquirers rather than incur the added costs of acquiring, maintaining, and subsequently remarketing those assets.

Fourth, the FDIC simply considered it more appropriate for private assets to remain within the private marketplace.

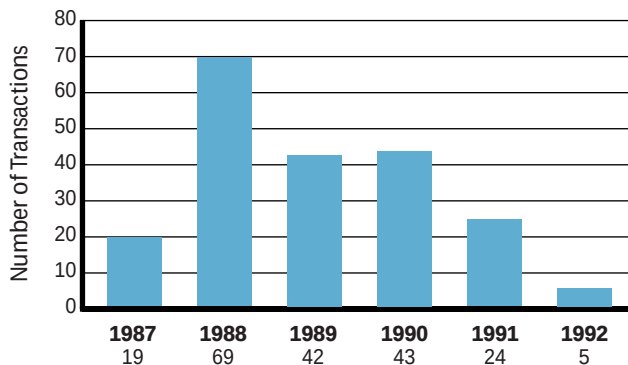
Finally, the FDIC saw the sale of higher percentages of assets at resolution as a way to minimize disruption in the communities in which failing banks were located.

Whole Bank Transactions

The whole bank purchase and assumption transaction is a variation of the P&A transaction, distinguished by the fact that virtually all the failed bank's assets are passed to the

23. L. William Seidman, *Full Faith and Credit: The Great S&L Debacle and Other Washington Sagas* (New York: Times Books, 1993), 100.

24. This loss of value is known as the “liquidation differential.” Frederick S. Carns and Lynn A. Nejezchleb, “Bank Failure Resolution: The Cost Test and the Entry and Exit of Resources in the Banking Industry,” *The FDIC Banking Review* 5 (fall/winter 1992), 1-14.

Chart I.3-11**Number of Whole Bank Transactions
1987–1992**

Source: FDIC Division of Resolutions and Receiverships.

acquirer with the institution's liabilities for a one-time cash payment. Whole bank transactions represent the most dramatic attempt by the FDIC to pass assets from failed banks quickly back into the private sector. Whole bank transactions were perceived to offer certain important advantages over other methods of transactions. Because loan customers of the failed institution continued to be serviced by an ongoing bank, the effect on the local community was minimized. In addition, whole bank transactions slowed the growth in the volume of assets held by the FDIC for liquidation. Starting in 1987, when the FDIC implemented 19 whole bank transactions, the whole bank P&A joined the clean bank P&A, the insured deposit transfer, and the straight deposit

payoff as the FDIC's standard methods for resolving failures. In 1988, 69 of the 279 failed bank resolutions were whole bank transactions. Whole bank transactions were also widely used in 1989, 1990, and 1991, when they constituted 20.3, 25.4, and 18.9 percent of all resolutions, respectively.²⁵ With the introduction of the least cost test, however, the number of successful whole bank bids declined. Because a whole bank bid constitutes a one-time payment from the FDIC, bidders tended to bid very conservatively to cover all potential losses. Conservative whole bank bids could not compete with other transactions on a least cost basis. Overall, the FDIC completed 202 whole bank transactions between 1987 and 1992, or 18.2 percent of the total number of transactions during that period. (See chart I.3-11.) The failed banks handled as whole bank transactions had \$8.2 billion in total assets.

Whole bank bids were almost always offered on an all-deposit basis, requiring any winning bidder to agree to assume both the insured and the uninsured deposits.

Other Variations of Transaction Structures

Other variations of P&A transactions existed between the clean bank P&A that passed few assets to the acquirer and the whole bank P&A that passed virtually all assets. The modified P&A required the winning bidder to purchase the cash and securities, and usually the installment loans as well as all or a portion of the mortgage loan portfolio.

25. FDIC Division of Finance.

Occasionally, multi-family loans also were included. Typically, between 25 percent and 50 percent of the failed bank's assets were purchased under a modified P&A structure. The loan purchase P&A required the winning bidder to assume a smaller portion of the loan portfolio, usually just the installment loans, in addition to the cash and securities. Typically, a loan purchase P&A transaction would pass between 10 and 25 percent of the failed bank assets. With each of those variations, deposits were treated the same during the 1980s; all of them were protected and passed to the acquirer.

Sequential Bidding

The FDIC's preference for passing assets to acquirers was made corporate policy formally on December 30, 1986.²⁶ The FDIC Board of Directors established an order of priority for six alternative transaction methods on the basis of the amount of assets passed to the acquirer.²⁷

In accordance with the transaction hierarchy established by the board, whole bank purchase and assumption bids were considered first. If any whole bank bids were received that passed the cost test, the remaining bids were not considered and the most cost-effective whole bank P&A bid was selected as the winner. If no whole bank bids were received or passed the cost test, the remaining transactions were considered in the preferential order. When evaluating P&A bids, the FDIC gave priority to those transactions through which the highest volume of assets could be sold. Thus, modified P&As took priority over loan purchase P&As, and loan purchase P&As took priority over clean bank P&As. If any P&A bids passed the cost test, the best P&A bid was selected as the winning bid. If no P&A bids were received or passed the cost test, all the acquirers originally asked to bid would be contacted again and asked to submit a whole bank deposit insurance transfer and asset purchase bid. If none of the preferential transactions were acceptable, the FDIC would make a direct payoff to the insured depositors and liquidate the assets of the failed bank.

The sequential bidding procedures employed by the FDIC accomplished what it set out to achieve: transfer assets back to the private sector and preserve the FDIC's liquidity. By determining the priority order of transactions according to the amount of assets purchased by the assuming institution, the FDIC clearly maximized its transfer of assets to the private sector, reducing its cash outlays and preserving liquidity. That action likely came at the expense of somewhat higher overall resolution costs

26. The policy was called the Robinson Resolution (named after Hoyle Robinson, Executive Secretary of the FDIC from May 7, 1979, to January 3, 1994). The resolution provided delegations to FDIC staff that allowed prioritizing the types of resolutions to be considered. The Robinson Resolution was revised and reissued in July 1992 and May 1997 to reflect the changes mandated by FDICIA.

27. The six transaction types named were, in order of preference, whole bank purchase and assumption, whole bank deposit insurance transfer and asset purchase, purchase and assumption, deposit insurance transfer and asset purchase, deposit insurance transfer, and straight deposit payoff.

than otherwise would have been the result had bidders been able to choose simultaneously from a wider range of bidding options. By 1991 the FDIC abandoned sequential bidding. Indeed, it could no longer have been used even if viewed as desirable given FDICIA and its least cost test.

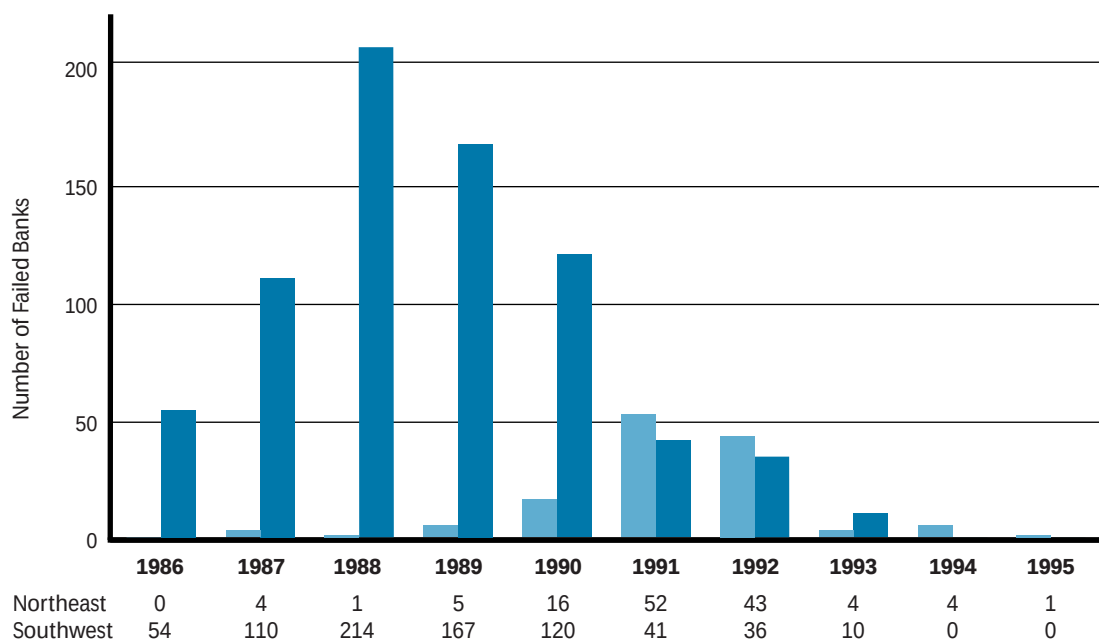
End of the Nationwide Real Estate Boom

The Tax Reform Act of 1986 removed the favorable tax treatment afforded investments in real estate. Commercial real estate markets throughout the country had been overbuilt in the boom period of the 1980s, resulting in high vacancy rates and falling property values. For those reasons, new construction came to a standstill as the U.S. entered the 1990-91 recession. Banks that had lent heavily in the real estate sector experienced a sharp decline in the credit quality of their loan portfolios. As the 1980s came to a close, the Southwest banking crisis was being eclipsed by severe problems elsewhere, particularly in the Northeast.²⁸ To illustrate, bank failures in Louisiana (an oil patch state) decreased from 21 in 1989 to 5 in 1991, while bank failures in Massachusetts rose from 1 in 1989 to 14 in 1991. Following the pattern set by the Southwest in the 1980s, the regional economy in the Northeast expanded in the 1980s, with many financial institutions growing rapidly through increased lending (particularly in commercial real estate) and/or acquisitions. The subsequent collapse in real estate prices, combined with a regional recession during the late 1980s and early 1990s, led to the failure of many banks in the Northeast.²⁹ Between January 1, 1990, and December 31, 1992, 111 FDIC insured banks with approximately \$83 billion in assets failed in the Northeast. Those failures represented approximately 27 percent of the total number of bank failures, but more significantly, 67 percent of the total assets of failed banks for those years. Losses from northeastern bank failures totaled \$9.6 billion, or 76 percent of total FDIC failure resolution costs. In 1991 alone, 52 Northeast banks with assets of \$48.5 billion (78 percent of total failed bank assets) failed, with a cost to the FDIC of \$5.5 billion (91 percent of total FDIC failure resolution costs). (See chart I.3-12 for a comparison of the number of bank failures in the Northeast and Southwest.)

The geographic distribution of bank failures was not the only aspect of the banking crisis that was changing. The volume of assets held by institutions that failed in 1991 totaled \$62.5 billion, a fourfold increase over the 1990 total of \$15.7 billion.

28. The Northeast region as defined here includes the six New England states (Connecticut, Maine, Massachusetts, New Hampshire, Rhode Island, and Vermont) plus New Jersey and New York.

29. For more information, see Chapter 10, "Banking Problems in the Northeast," *History of the Eighties—Lessons for the Future: An Examination of the Banking Crises of the 1980s and Early 1990s* (Washington, D.C.: Federal Deposit Insurance Corporation, 1997).

Chart I.3-12**Comparison of Bank Failures in the Northeast and Southwest
1986–1995**

Source: FDIC Division of Finance, *Failed Bank Cost Analysis, 1986–1995*.

Furthermore, the total assets of banks on the FDIC's problem bank list at year-end 1991 were \$609.8 billion, a sharp increase over the \$408.8 billion at the previous year end.³⁰

The heavy losses sustained by the banking industry as a result of the widespread real estate problems had a direct influence on the FDIC insurance fund. At year-end 1990, the insurance fund declined to \$4.0 billion. In 1991, for the first time in history, the insurance fund technically dropped below zero, to a negative \$7.0 billion, as the FDIC booked \$16.3 billion of reserves in anticipation of possible future bank failures. Actual cash on hand was \$9.3 billion.

Legislative Responses to the Crisis

In 1989 and 1991, Congress passed two major pieces of legislation in response to the bank crisis: the Financial Institutions Reform, Recovery, and Enforcement Act and the Federal Deposit Insurance Corporation Improvement Act.

30. FDIC, *1991 Annual Report*, 15.

The Financial Institutions Reform, Recovery, and Enforcement Act of 1989

While most provisions of the Financial Institutions Reform, Recovery, and Enforcement Act of 1989 addressed the savings and loan crisis, the law also addressed losses incurred by the FDIC insurance fund in situations in which an affiliated institution within a multi-bank holding company failed. In 1989, FIRREA added section 5(e) to the Federal Deposit Insurance Act. Section 5(e) was designed to prevent affiliated banks from shifting assets and liabilities in anticipation of failure of one or more of their number in an attempt to retain value for the owners, while depriving the FDIC of that value and increasing the FDIC's costs. The law provided for "cross guarantees" to be established among affiliated institutions: The FDIC was empowered to apportion loss among all the banks within the affiliated group in the event that one or more of the related institutions failed. The failure of the MCorp banks, Dallas, Texas, in particular, precipitated the cross guarantee statute. In the resolution of MCorp in March 1989, the holding company refused to agree to contractual cross guarantees. Only 20 of the banks could be closed; the FDIC was unable to force the five viable banks to contribute their value to the resolution. Since the addition of section 5(e) in August 1989, the FDIC, using the cross guarantee provisions, has been able to close affiliated banks that would otherwise have remained open and to sell the entire group of affiliates at the same time. That strategy was used notably in resolving the First City, N.A., Houston, Texas; Bank of New England, N.A., Boston, Massachusetts; and Southeast Bank, N.A., Miami, Florida.³¹

The Federal Deposit Insurance Corporation Improvement Act

In December 1991, President Bush signed into law the Federal Deposit Insurance Corporation Improvement Act. Observers of the financial services industry have described FDICIA as "the most important banking legislation since the Banking Act of 1933."³² While the law touched a wide range of regulatory areas, certain provisions—particularly those pertaining to prompt corrective action (PCA) on failing institutions and to least cost resolutions—had profound effects on the way the FDIC conducted failed bank resolutions.

FDICIA requires federal regulators to establish five capital levels, ranging from well-capitalized to critically undercapitalized, that serve as the basis for prompt corrective action. As an institution's capital declines, the appropriate regulator must take increasingly stringent measures. The sanctions begin with restrictions on deposit gathering for depository institutions that are not well-capitalized and culminate with the closing of institutions that have been critically undercapitalized for a prescribed period. The law is

31. See Part II, Case Studies of Significant Bank Resolutions, Chapter 5, First City Bancorporation of Texas, Inc., Chapter 8, Bank of New England Corporation, and Chapter 9, Southeast Banking Corporation.

32. George G. Kaufman and Robert E. Litan, eds., *Assessing Bank Reform: FDICIA One Year Later* (Washington, D.C.: The Brookings Institution, 1993), 19.

intended to protect the insurance system and the taxpayers by resolving troubled banks while the institutions can still absorb their own losses.

One of the aspects of PCA that most directly affects the FDIC's approach to resolutions prescribes mandatory measures for critically undercapitalized institutions (those banks with a ratio of tangible equity to total assets equal to or less than 2 percent). FDICIA requires that, not later than 90 days after an institution falls into the critically undercapitalized category, a conservator or receiver must be appointed. The FDIC may grant up to two 90-day extensions of the PCA period if it is determined that those extensions would better protect the insurance fund from long-term losses.

Under FDICIA, if the FDIC does not liquidate a failing institution (conduct a deposit payoff), then it must pick the least costly resolution transaction available. All bids must be considered together and evaluated on the basis of comparative cost; other policy considerations cannot be factored into the determination of the appropriate transaction. As discussed earlier, FDICIA compelled the FDIC to consider more transaction options than in the past to make certain that all plausible least cost structures are offered.

Responses to FDICIA: Resolution Strategies, 1992 to 1996

The passage of FDICIA in 1991 had a significant effect on the FDIC's resolution practices. In addition to eliminating the FDIC's preference for passing assets, it also eliminated the automatic assumption that all deposits were to be passed to acquirers. After FDICIA, all-deposit transfer bids were at a relative disadvantage compared to insured deposit transfer bids. FDICIA also influenced the FDIC to reduce its resolution cost by allowing the FDIC to sell asset pools to banks that were not assuming the deposits, selling a failed bank's branches to different banks, and entering into loss sharing agreements on certain asset pools.

"Insured Deposits Only" Bidding

Under the various P&A asset purchase structures offered post-FDICIA, the FDIC gave bidders the option of bidding on insured deposits only. Previously, P&A bids required that the acquirer assume all the failed institution's deposits. Because an insured deposits only bid does not have to compensate the FDIC for the additional cost of covering 100 percent of the uninsured depositor's claim, it is easier for an insured deposits only bid to pass the least cost test. Additionally, as the FDIC began offering that option on an increasingly regular basis, acquirers discovered that the effects of not covering the uninsured depositors were less detrimental than they had once thought. The results of the change on acquirer bidding behavior are immediately apparent. (See chart I.3-13 for the number of failed banks in which the uninsured depositors were both protected and unprotected from 1986 through 1995.) On average, 82 percent of all banks failing between 1992 and 1995 were resolved in a manner that did not provide full protection

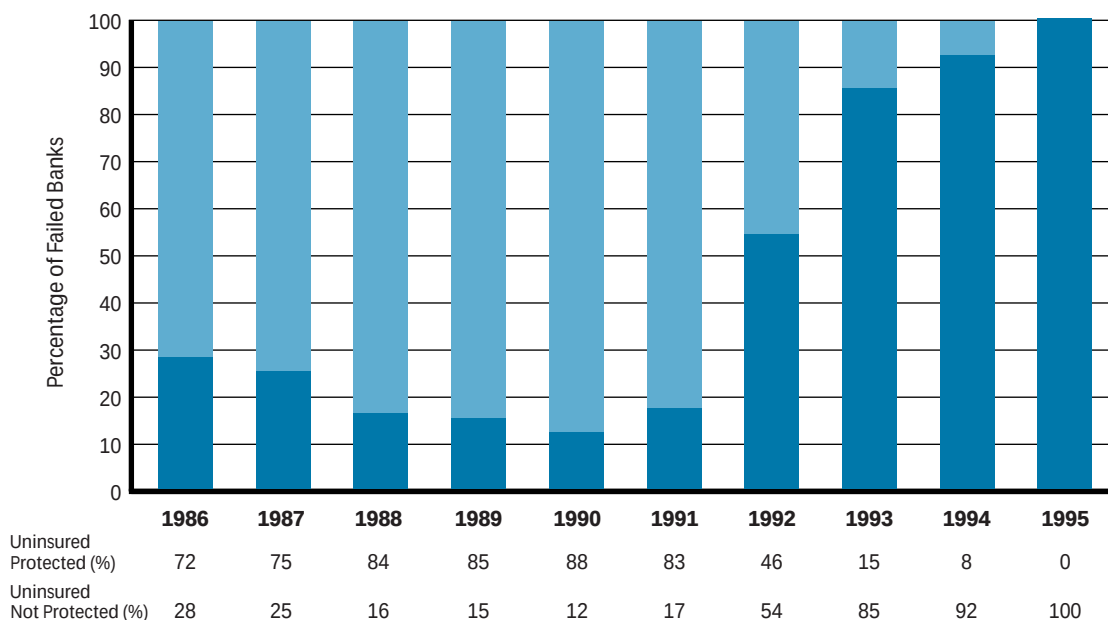
to uninsured depositors, compared with 17 percent between 1986 and 1991. Perhaps more significantly, 85 percent of all the deposits in banks that failed between 1986 and 1991 were in banks in which all deposits were protected compared to only 15 percent of the deposits in failed banks between 1992 and 1995.

Asset Pools

In addition to allowing bidders the option of choosing between an all-deposit or an insured deposit bid, the FDIC was also seeking ways to provide more flexibility for the purchase of assets. Potential acquirers often were reluctant to assume large loan portfolios that did not fit their current business strategies. As a result, FDIC officials decided that for banks with a diverse loan mix, it would be preferable to separate the loan portfolio into pools of homogeneous loans and to market those loans separately from the deposit franchise. The individual asset pools were smaller than the asset pools offered under the loan purchase or modified P&A options, and they included loans of similar collateral, term, and structure. Moreover, the FDIC structured the pools according to the preferences of acquirers within a given geographic location. It often grouped

Chart I.3-13

Uninsured Depositor Treatment 1986–1995



Source: FDIC Division of Finance, *Failed Bank Cost Analysis, 1986–1995*.

nonperforming loans, other real estate, and other loans that did not conform with one of the established pool structures into a single pool, which, depending on the overall quality of the pool, might be offered for sale. In transactions offering asset pools, the FDIC gave acquirers the option of linking their bids for the asset pools with their franchise bids. The linked bid was evaluated as one all or nothing bid. Such a strategy was intended to provide an additional level of flexibility. While certain acquirers did not wish to purchase the assets of the failed bank, for others it was in fact essential to acquire a substantial portion of the assets. In some acquisitions, banks bid on deposit franchises substantially larger than their current deposit bases. For those institutions, it was more difficult to reinvest a large cash payment received from the FDIC, and they therefore needed to acquire a large portion of the performing assets to maintain a positive net interest margin. In fact, for transactions completed between 1992 and 1994, virtually all the assets passed to acquirers were part of asset pool bids, which were made contingent on the selection of the bank as the winning franchise bidder.

Branch Breakups

Sometimes acquirers were unwilling to assume all the deposits of a multi-bank or multi-branch operation. At other times, the FDIC could obtain a better price for the franchise by selling each branch separately rather than marketing the institution in one transaction. The FDIC used this branch breakup method occasionally in the 1970s and early 1980s, usually when competition for the entire franchise was expected to be limited. Later in the 1980s it began marketing some of the institutions' branches individually when it was determined that there was an opportunity to increase the price of the franchise or sell more of the assets of the former bank through the resolution process.

Certain disadvantages exist with branch breakup transactions. Electronic data processing costs are generally higher than in whole franchise deals, and it is more difficult to complete transactions within the required timeframes. Further, branch breakups require one of the acquiring institutions to be "lead" acquirer and provide backroom operations for all the other acquirers during the transition period. Failing institutions with little franchise value or with geographically concentrated branches are considered poor candidates for branch breakup resolutions.

By offering failing institutions on both a whole franchise and branch breakup basis, the FDIC expanded the universe of potential bidders by allowing smaller institutions to participate along with larger institutions interested in only certain branches or markets. The number of successes the FDIC experienced with completing branch breakups shows that, generally, that method results in more bidders and higher premiums.

Loss Sharing Transactions

In 1991, the FDIC developed loss sharing transactions as another variation of the purchase and assumption transaction. Loss sharing was originally designed to (1) transfer as

many assets as possible to the acquiring bank, and (2) have the nonperforming assets managed and collected by the acquiring bank in a manner that aligns the interests and incentives of the acquiring bank and the FDIC. The loss sharing transaction evolved into a vehicle that allowed the FDIC to successfully resolve the unique problems associated with marketing large banks. Large banks can be more difficult to market, because they typically have sizeable commercial and commercial real estate loan portfolios. In the past, acquiring institutions had been extremely reluctant to acquire commercial assets in FDIC transactions for several reasons. First, the time allowed to perform due diligence was usually very limited. Often, the FDIC had to accommodate numerous potential acquirers who wished to perform due diligence at the target institution, and all acquirers had to complete their reviews before the bid submission date. That requirement allowed very little time for a given acquirer to perform more than a cursory review of loans in the commercial portfolio. In addition to that limitation, many acquirers did not wish to purchase large portfolios of commercial loans that they did not underwrite. In many cases, the underwriting criteria of the failed bank were extremely poor before failure, and acquirers wished to avoid the additional costs associated with completing workouts of large commercial loans that became a problem. Finally, before 1992, almost every region of the U.S. had been experiencing declining markets for commercial real estate, and even when acquiring banks were willing to acquire the commercial real estate portfolios, their bids were usually too low, because they had incorporated a large discount into their bids to compensate for the potential risk.

Loss sharing was designed to address those concerns by limiting the downside risk associated with acquiring large commercial loan portfolios, which was accomplished by—

- providing for the FDIC to cover 80 percent of any losses on commercial and commercial real estate loans purchased by the acquirer;
- reimbursing acquiring institutions 80 percent of all expenses, except for overhead and personnel expenses, incurred in relation to the disposition or collection of shared loss assets; and
- providing catastrophic loss coverage on a 95 percent basis beyond a “transition amount” if the acquirer ultimately had losses that exceeded the FDIC’s estimate of the overall loss on shared loss assets.³³

Shared loss assets consist primarily of commercial and commercial real estate loans, although some earlier agreements included additional loan categories. By limiting an acquirer’s exposure to a maximum of 20 percent, the FDIC hoped to pass most of the failed bank’s assets to an acquirer while still receiving a substantial bid premium for the deposit franchise. The loss share transaction was employed generally for failing banks

33. For further details, see Chapter 7, Loss Sharing.

Table I.3-5

FDIC Loss Share Transactions 1991–1994

(\$ in Millions)

Transaction Date	Failed Bank*	Location	Total Assets	Resolution Costs	Resolution Cost as Percentage of Total Assets
09/19/91	Southeast Bank, N.A†	Miami, FL	\$10,478	\$0	0.00
10/10/91	New Dartmouth Bank	Manchester, NH	2,268	571	25.19
10/10/91	First New Hampshire	Concord, NH	2,109	319	15.14
11/14/91	Connecticut Savings Bank	New Haven, CT	1,047	207	19.77
08/21/92	Attleboro Pawtucket S.B.	Pawtucket, RI	595	32	5.41
10/02/92	First Constitution Bank	New Haven, CT	1,580	127	8.01
10/02/92	The Howard Savings Bank	Livingston, NJ	3,258	87	2.67
12/04/92	Heritage Bank for Savings	Holyoke, MA	1,272	21	1.70
12/11/92	Eastland Savings Bank‡	Woonsocket, RI	545	17	3.30
12/11/92	Meritor Savings Bank	Philadelphia, PA	3,579	0	0.00
02/13/93	First City, Texas-Austin, N.A.	Austin, TX	347	0	0.00
02/13/93	First City, Texas-Dallas	Dallas, TX	1,325	0	0.00
02/13/93	First City, Texas-Houston, N.A.	Houston, TX	3,576	0	0.00
04/23/93	Missouri Bridge Bank, N.A.	Kansas City, MO	1,911	356	18.62
06/04/93	First National Bank of Vermont	Bradford, VT	225	34	14.97
08/12/93	CrossLand Savings, FSB	Brooklyn, NY	7,269	740	10.18
Totals/Average			\$41,384	\$2,511	6.07

* The banks listed here are the failed banks or the resulting bridge bank from a previous resolution; however, it is the acquirer that enters into the loss sharing transaction with the FDIC.

† Represents loss sharing agreements for two banks: Southeast Bank, N.A., and Southeast Bank of West Florida.

‡ Represents loss sharing agreements for two banks: Eastland Savings Bank and Eastland Bank.

Source: FDIC Division of Research and Statistics.

with commercial loan portfolios in excess of \$100 million. (See table I.3-5 for a summary of loss share agreements from 1991 to 1994.)

Resolution Costs

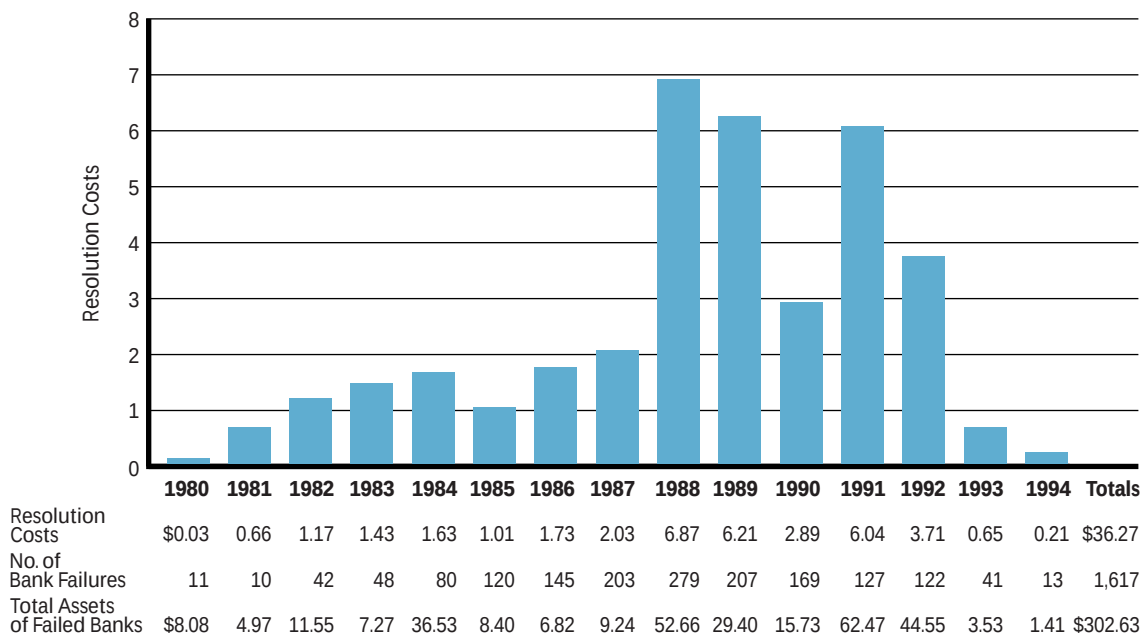
The 1,617 banks that failed (or required open bank assistance) between 1980 and 1994 had \$302.6 billion in assets. The FDIC's cost for handling the failures was \$36.3 billion, or about 12 percent of the assets in the banks that required FDIC financial assistance.

The FDIC's annual failure resolution costs steadily grew during the 1980s, along with the rise in bank failures. The years between 1987 and 1992 were exceptionally costly. The FDIC's failure resolution costs exceeded \$2 billion in each of those years. In 1988, the costs peaked at \$6.87 billion. Costs exceeded the \$6 billion mark in 1989 and 1991 as well. (See chart I.3-14.) To put the costs in perspective, FDIC insured commercial banks,

Chart 1.3-14

Resolution Costs by Year of Failure 1980–1994

(\$ in Billions)



Costs are as of December 31, 1995. The amounts are routinely adjusted with updated information from new appraisals and asset sales that ultimately affect the asset values and projected recoveries from active receiverships.

Figures include open bank assistance transactions.

Sources: FDIC Division of Research and Statistics and FDIC annual reports.

the group that pays the insurance premiums to cover those costs, earned an average of \$18.2 billion a year during 1987 to 1992. During the same period, the FDIC's bank failure costs averaged \$4.6 billion, or 25 percent of the industry's total earnings.

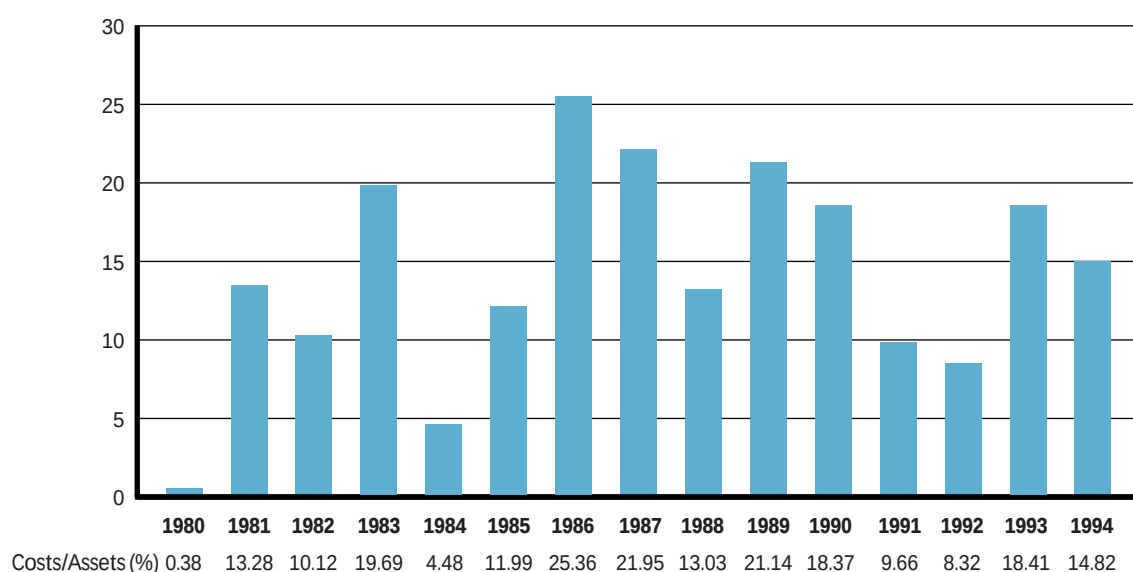
Looking at the FDIC's annual resolution costs as a percentage of failed bank assets shows no clear pattern. (See chart I.3-15.) Because of the dominance of the Continental OBA transaction in 1984, the ratio is a relatively low 4.48 percent in that year. The late 1980s show relatively high cost-to-asset ratios, exceeding 20 percent in 1986, 1987, and 1989. In those years, in spite of a large number of failures and a weak economy, few dominant, sizeable failures pulled down the averages. The 1990s, with its gradually improving economy, proved to be less costly than the 1980s.

A strong correlation exists between bank asset size and failure resolution costs as a percentage of assets. Chart I.3-16 shows that for smaller bank failures, those of banks with less than \$500 million in total assets, the overall failure resolution cost is about 20 percent of assets during 1980 to 1994. As bank asset size increases, the ratio steadily declines, reaching 6 percent for banks with more than \$5 billion in assets.

The economies of scale associated with handling larger bank failures make it difficult to discern trends over time in the FDIC's cost for handling the "typical" bank

Chart I.3-15

**Resolution Costs as a Percentage of Total Assets
1980–1994**



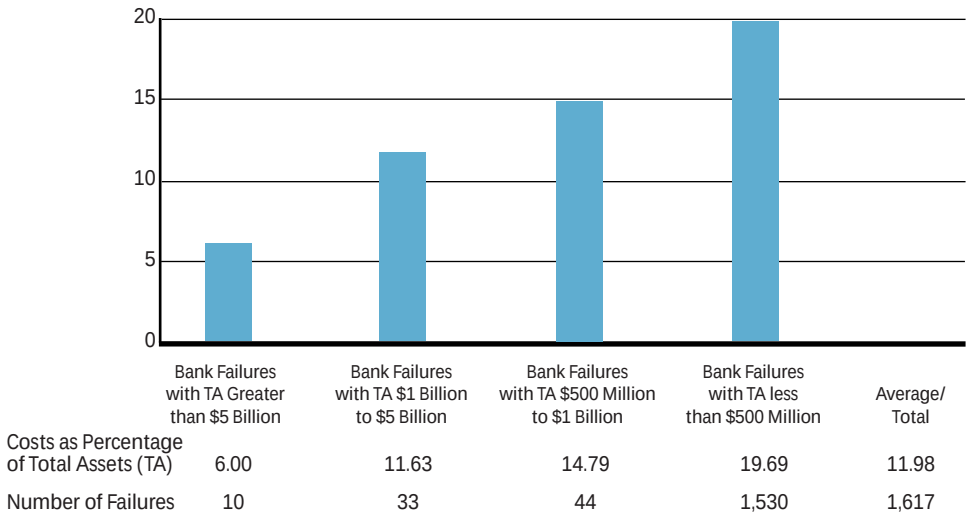
Figures include open bank assistance transactions.

Sources: FDIC Division of Research and Statistics and FDIC annual reports.

failure. One way to look at possible trends without the dominant influence of the larger bank failure is to look at the median of the FDIC’s bank resolution costs over time. (See chart I.3-17.) A look at the median FDIC resolution cost shows a dramatic jump in the 1983 to 1985 timeframe, when the economy was weakening and the steady increase in the annual number of bank failures was beginning. During 1984 and 1985, the median cost rose to over 30 percent of failed bank assets. The ratio declined for the remainder of the 1980s, but it was still above 20 percent in each of those years. During the 1990s, the ratio dropped further, into the teens.

Another way of looking at resolution costs is by transaction method. (See tables I.3-6 through I.3-9 for annual trends in the FDIC’s failure resolution costs by transaction method.) This review by transaction method reveals a relatively high cost of deposit payoffs, whether they are straight deposit payoffs or insured deposit transfers. In addition, OBA transactions were less costly than P&A transactions. It is difficult, however, to draw firm conclusions from that type of comparison. Historic bidding procedures generally did not allow for open competition among transaction methods. Open bank assistance was used for a greater percentage of larger bank resolutions, so they cannot be directly compared to the others. Because of the FDIC’s preference for P&A transactions over deposit payoffs, it is difficult to draw any conclusions there as well. The FDIC used

Chart I.3-16
Resolution Costs by Asset Size
as a Percentage of Total Assets
1980–1994



Sources: FDIC Division of Research and Statistics and FDIC annual reports.

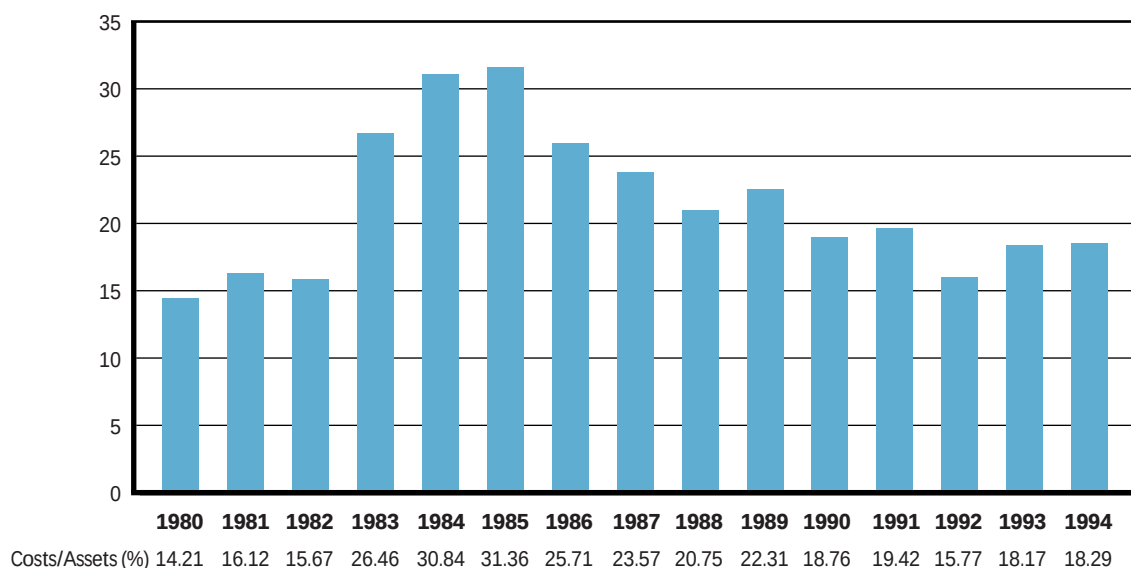
deposit payoffs in the worst situations, those where no one really wanted the failed bank franchise in a P&A transaction.

The P&A transaction, the most frequently used method, shows high costs (in excess of 20 percent of failed bank assets) from 1980 through 1987, except in 1982 when the cost-to-asset ratio was only 6.6 percent. (See table I.3-6.) The 1982 ratio, however, is an aberration caused by one large bank failure that had zero cost to the insurance fund. From 1988 through 1994, those costs were below 20 percent of assets, dropping to single digits in 1991 and 1992. During those two years, the FDIC handled several larger banks (Bank of New England, Southeast, Goldome, and CrossLand Savings Bank) at relatively low costs.

Table I.3-7 shows the relatively low costs for open bank assistance transactions. As previously stated, the lower costs are due in part to the larger average size of the banks handled by this method rather than to any inherent advantage of the method itself. This effect of the larger asset size can be seen in the Continental transaction, which, with \$33.6 billion in assets, was 40.7 percent of the total assets of all OBA transactions; yet Continental's cost-to-asset ratio was only 3.3 percent of assets. Factors other than size also are relevant. The average cost of the OBA transactions for banks with less than \$500

Chart I.3-17

**Median Bank Resolution Costs as a Percentage of Total Assets
1980–1994**



Figures include open bank assistance transactions.

Sources: FDIC Division of Research and Statistics and FDIC annual reports.

million in assets was only 7.8 percent, which is well below the cost for other types of small bank transactions. This lower cost suggests that handling those institutions relatively early helped to hold down their overall costs.

The costs associated with straight deposit payoffs (see table I.3-8) and insured deposit transfers (see table I.3-9) as a percentage of failed bank assets peaked later in the 1980s when the economy was weak and the country experienced the largest number of bank failures. Those banks often were unmarketable institutions that no one would purchase. In 1989, the average cost of the nine deposit payoffs was 44 percent of the failed banks' assets.

Table I.3-6

**Costs for Purchase and Assumption Transactions
1980–1994**

(\$ in Millions)

Year	Number of P&As	Assets at Resolution	Deposits at Resolution	Costs as of 12/31/95	Costs/Assets (%)
1980	7	\$114.4	\$195.7	\$28.4	24.83
1981	5	30.1	52.5	7.9	26.25
1982	27	1,195.6	1,026.7	79.4	6.64
1983	36	4,211.1	2,920.0	1,334.9	31.70
1984	62	1,567.8	1,400.6	431.5	27.52
1985	87	1,894.7	2,030.1	535.7	28.27
1986	98	4,791.9	4,710.9	1,213.0	25.31
1987	133	4,255.4	3,927.5	1,161.0	27.28
1988	164	37,802.8	23,967.9	4,840.9	12.81
1989	174	27,001.7	20,952.9	5,325.6	19.72
1990	148	13,241.6	11,578.9	2,148.4	16.22
1991	103	60,803.2	47,826.1	5,547.5	9.12
1992	95	42,481.7	36,565.6	3,196.8	7.53
1993	36	3,217.3	2,905.4	552.6	17.18
1994	13	1,405.1	1,233.6	208.3	14.82
Totals/ Average	1,188	\$204,014.4	\$161,294.4	\$26,611.9	13.04

Sources: FDIC Division of Research and Statistics and FDIC annual reports.

Table I.3-10 shows the FDIC's costs for the more significant types of purchase and assumption transactions. The 202 whole bank P&A transactions conducted between 1987 and 1992 cost the FDIC \$1.4 billion, or 16.7 percent of total assets. The 24 failed banks resolved through loss share transactions conducted between 1991 and 1993 cost the FDIC \$2.3 billion, or 5.5 percent of total assets. The 962 other P&A transactions accounted for \$22.9 billion in cost, a 14.9 percent cost-to-asset ratio.

It is difficult to draw any strong conclusions from the charts and graphs shown in the resolution costs section other than to point to the fact that larger banks cost less to resolve on a cost-to-asset basis than do smaller institutions. Many factors determine the overall recovery rate of each bank that fails, including the selected method of resolution,

Table I.3-7

**Costs for Open Bank Assistance Transactions
1980–1994**

(\$ in Millions)

Year	Number of OBAs	Assets at Resolution	Deposits at Resolution	Costs as of 12/31/95	Costs/Assets (%)
1980	1	\$7,953.0	\$5,300.0	\$ 0.00	0.00
1981	3	4,886.3	3,729.0	653.9	13.38
1982	8	9,770.0	8,373.3	1,018.2	10.42
1983	3	2,890.0	2,420.7	71.3	2.47
1984	2	34,147.9	17,945.0	1,111.3	3.25
1985	4	5,895.9	5,510.4	359.1	6.09
1986	7	718.8	585.6	97.4	13.55
1987	19	2,515.6	2,118.0	160.2	6.37
1988	79	13,539.0	11,501.2	1,594.5	11.78
1989	1	5.7	6.4	2.3	40.35
1990	1	15.9	15.6	2.3	14.47
1991	3	83.8	80.4	3.1	3.70
1992	2	34.9	33.5	0.6	1.72
1993	0	0	0	0	0.00
1994	0	0	0	0	0.00
Totals/ Average	133	\$82,456.8	\$57,619.1	\$5,074.2	6.15

Sources: FDIC Division of Research and Statistics and FDIC annual reports.

the bank's financial condition at the time of failure, and the economic conditions of the region. In the middle to late 1980s, when the economy was weaker and fewer banks were interested in purchasing the franchise of a failed institution, the costs of the resolutions were higher. As the economy improved in the 1990s, fewer banks failed and the costs decreased.

Conclusion

In the banking industry, the 1980s began with only a few bank failures but ended with an average of more than 200 a year. Likewise, in the early 1980s, the FDIC had little experience in handling more than an occasional small bank failure. By 1994, however,

Table I.3-8

Costs for Straight Deposit Payoffs 1980–1994

(\$ in Millions)

Year	Number of SDPs	Assets at Resolution	Deposits at Resolution	Costs as of 12/31/95	Costs/Assets (%)
1980	3	\$16.1	\$15.0	\$2.3	14.29
1981	2	54.2	48.0	1.1	2.03
1982	7	581.3	536.1	71.0	12.21
1983	7	129.7	123.1	12.0	9.25
1984	4	334.4	306.4	19.7	5.89
1985	22	279.9	247.1	78.7	28.12
1986	21	555.0	513.5	203.7	36.70
1987	11	337.7	302.2	116.3	34.44
1988	6	130.5	122.6	38.3	29.35
1989	9	580.9	499.3	257.5	44.33
1990	8	844.3	731.2	250.9	29.72
1991	4	65.9	59.4	18.4	27.92
1992	11	1,136.2	1,013.0	279	24.56
1993	5	309.5	270.7	101.9	32.92
1994	0	0	0	0	0.00
Totals/ Average	120	\$5,355.6	\$4,787.6	\$1,450.8	27.09

Sources: FDIC Division of Research and Statistics and FDIC annual reports.

the FDIC had gained considerable experience in handling failed and failing banks. In fact, from 1980 to 1994, the FDIC's successful adjustment to constantly changing circumstances in the arena of bank failures led to security for insured depositors: no insured depositor lost any money, and in every case, insured deposits were paid promptly. Such actions meant that, unlike the experience of the early 1930s, the public maintained its confidence in the banking system, and financial stability was preserved.

As the resolution process evolved, the FDIC devised new resolution methods for adjusting to the changing environment. On the asset side, the FDIC's resolutions methods evolved from passing few failed bank assets with little risk to an acquiring institution to passing most failed bank assets and sharing the risk with the acquiring institution. As special circumstances arose, such as the mutual savings bank failures in the early 1980s,

Table I.3-9

**Costs for Insured Deposit Transfers
1980–1994**

(\$ in Millions)

Year	Number of IDTs	Assets at Resolution	Deposits at Resolution	Costs as of 12/31/95	Costs/Assets (%)
1980	0	\$0	\$0	\$0	0.00
1981	0	0	0	0	0.00
1982	0	0	0	0	0.00
1983	2	43.1	43.6	13.9	32.25
1984	12	481.6	455.4	72.7	15.10
1985	7	331.9	285.8	34.0	10.24
1986	19	748.2	688.9	213.6	28.55
1987	40	2,129.2	1,810.2	590.0	27.71
1988	30	1,210.4	1,130.8	392.5	32.43
1989	23	1,814.1	1,553.7	629.4	34.69
1990	12	1,627.5	1,465.1	487.4	29.95
1991	17	1,520.6	1,256.4	467.6	30.75
1992	14	897.9	831.3	231.2	25.75
1993	0	0	0	0	0.00
1994	0	0	0	0	0.00
Totals/ Average	176	\$10,804.5	\$9,521.2	\$3,132.3	28.99

Sources: FDIC Division of Research and Statistics and FDIC annual reports.

the agricultural bank failures in the mid-1980s, and the larger commercial real estate–induced bank failures in the late 1980s and early 1990s, the FDIC handled each situation in a manner that allowed most of the institutions' assets to remain in the private sector. Overall, from 1980 to 1994, the FDIC was able to pass 76 percent of failed bank assets to the acquiring institutions. That action not only preserved liquidity for the FDIC, but also assisted significantly in the economic recovery of the local communities.

On the liability side, the FDIC devised new methods to ensure that depositors of failed banks would receive their funds quickly, thus minimizing any disruption to the financial system. The FDIC's purchase and assumption transactions gave depositors virtual immediate access to their money. In those instances in which a P&A transaction was not attainable, the FDIC developed the insured deposit transfer and paid advance dividends to expedite the return of funds to depositors. That approach resulted in minimizing the disruption to the depositors and local communities.

Given the magnitude of the problem, the FDIC's flexibility with assets and liabilities helped resolve 1,617 failed and failing banks at arguably a relatively low cost to the insurance fund. The overall resolution cost to the FDIC of \$36.3 billion was about 12 percent of the failed and failing banks' assets. When compared to the savings and loan crisis, those costs were low, not only in absolute terms but also on a per asset basis.

During this period, the FDIC also learned some important lessons that are relevant to the future: (1) Bridge banks, loss sharing, asset pools, cross guarantees, branch breakups, advance dividends, and insured deposit transfers all appear to have been useful developments; (2) open bank assistance, sequential bidding, put options, income maintenance agreements, and net worth certificate programs all served a purpose for the situations in which they were used; and (3) it became clear that, to have an adequate source of liquidity, the insurance funds need to be strong. Although minor when compared to the liquidity shortages in the savings and loan situation, the FDIC's lack of liquidity in the late 1980s and early 1990s influenced certain resolution decisions. For example, designing put options and sequential bidding helped put assets back into the private sector quickly, thereby preserving the FDIC's liquidity. In retrospect, however, those methods may not have minimized the overall cost to the insurance fund. Such unintentional consequences, while perhaps minor when put in perspective, nonetheless are of some concern.

Table I.3-10

**Costs for Different Types of
Purchase and Assumption Transactions
1980–1994**

(\$ in Millions)

Year	Whole Bank P&A Transactions				P&A Transactions with Loss Sharing				Other P&A Transactions			
	No. of Trans.	Assets at Reso-lution	FDIC's Costs	Costs/ Assets (%)	No. of Trans.	Assets at Reso-lution	FDIC's Cost	Costs/ Assets (%)	No. of Trans.	Assets at Reso-lution	FDIC's Costs	Costs/ Assets (%)
1980	0	\$0	\$0	0	0	\$0	\$0	0	7	\$114	\$28	24.56
1981	0	0	0	0	0	0	0	0	5	\$30	8	26.67
1982	0	0	0	0	0	0	0	0	27	1,196	79	6.61
1983	0	0	0	0	0	0	0	0	36	4,211	1,335	31.70
1984	0	0	0	0	0	0	0	0	62	1,568	432	27.55
1985	0	0	0	0	0	0	0	0	87	1,895	536	28.28
1986	0	0	0	0	0	0	0	0	98	4,792	1,213	25.31
1987	19	570	90	15.79	0	0	0	0	114	3,685	1,071	29.06
1988	69	2,931	551	18.80	0	0	0	0	95	34,872	4,290	12.30
1989	42	1,339	276	20.61	0	0	0	0	132	25,663	5,050	19.68
1990	43	2,314	299	12.92	0	0	0	0	105	10,928	1,850	16.93
1991	24	903	137	15.17	10	15,903	1,098	6.90	69	43,997	4,312	9.80
1992	5	102	8	7.84	13	25,256	1,188	4.70	77	17,124	2,000	11.68
1993	0	0	0	0	1	225	33	14.67	35	2,992	520	17.38
1994	0	0	0	0	0	0	0	0	13	1,405	208	14.80
Totals/ Averages	202	\$8,159	\$1,361	16.68	24	\$41,384	\$2,319	5.60	962	\$154,472	\$22,932	14.85

Sources: FDIC Division of Research and Statistics and FDIC Division of Finance.

Table I.3-11

**Bank Failures by Location
Ranked by Number of Bank Failures
1980–1994**

(\$ in Thousands)

Location	Number of Failed Banks	Total Bank Assets	FDIC's Resolution Costs	Costs/ Assets (%)	Cumulative Percentage of Failures
Texas	599	\$92,973,964	\$13,612,645	14.64	37.04
Oklahoma	122	5,504,937	1,460,113	26.52	44.59
California	87	5,445,302	1,061,335	19.49	49.97
Louisiana	70	4,401,121	1,088,554	24.73	54.30
Kansas	69	1,561,223	347,580	22.26	58.57
Colorado	59	989,252	277,217	28.02	62.21
Massachusetts	43	26,124,470	3,375,599	12.92	64.87
Missouri	41	3,075,528	535,963	17.43	67.41
Iowa	40	721,125	116,627	16.17	69.88
Florida	39	14,965,281	920,709	6.15	72.29
Minnesota	38	1,579,218	196,940	12.47	74.64
Tennessee	36	2,331,813	778,258	33.38	76.87
New York	34	49,108,444	5,115,311	10.42	78.97
Illinois	33	34,302,370	1,213,368	3.54	81.01
Nebraska	33	343,342	71,151	20.72	83.06
Connecticut	32	17,685,983	2,415,691	13.66	85.03
Wyoming	20	375,109	117,122	31.22	86.27
Oregon	17	575,551	66,382	11.53	87.32
Arizona	17	434,486	88,904	20.46	88.37
New Hampshire	16	4,908,983	1,014,347	20.66	89.36
New Jersey	14	6,658,401	470,659	7.07	90.23
New Mexico	11	714,363	183,713	25.72	90.91
Arkansas	11	191,678	42,711	22.28	91.59
Utah	11	446,839	80,564	18.03	92.27
Montana	10	209,164	40,392	19.31	92.89
Indiana	10	291,556	33,422	11.46	93.51
North Dakota	9	107,903	18,869	17.49	94.06

Table I.3-11

**Bank Failures by Location
Ranked by Number of Bank Failures
1980–1994**

(\$ in Thousands)

Continued

Location	Number of Failed Banks	Total Bank Assets	FDIC's Resolution Costs	Costs/ Assets (%)	Cumulative Percentage of Failures
Alabama	9	\$285,516	\$21,975	7.70	94.62
Alaska	8	2,862,202	615,834	21.52	95.11
South Dakota	8	659,667	16,887	2.56	95.61
Kentucky	7	120,678	21,947	18.19	96.04
Virginia	7	284,769	40,691	14.29	96.47
Puerto Rico	5	336,849	111,926	33.23	96.78
Ohio	5	140,193	4,067	2.90	97.09
District of Columbia	5	2,285,178	351,803	15.39	97.40
Pennsylvania	5	13,705,317	43,803	0.32	97.71
West Virginia	5	77,174	13,743	17.81	98.02
Washington	4	758,588	54,119	7.13	98.27
Rhode Island	3	1,140,025	48,945	4.29	98.45
Georgia	3	88,003	20,383	23.16	98.64
Michigan	3	129,832	22,994	17.71	98.82
Mississippi	3	286,729	28,160	9.82	99.01
North Carolina	2	70,760	6,863	9.70	99.13
Wisconsin	2	74,129	3,259	4.40	99.26
Maryland	2	55,771	7,777	13.94	99.38
Maine	2	2,224,770	5,614	0.25	99.51
Hawaii	2	11,798	1,762	14.93	99.63
Vermont	2	260,755	44,706	17.14	99.75
Idaho	1	61,231	17,244	28.16	99.81
Delaware	1	612,745	249	0.04	99.88
South Carolina	1	62,790	20,879	33.25	99.94
Nevada	1	8,789	0	0.00	100.00
Totals/Averages	1,617	\$302,631,664	\$36,269,776	11.98	

Sources: FDIC Division of Research and Statistics and FDIC annual reports.

Table I.3-12

**Bank Failures by Location
Ranked by Resolution Costs
1980–1994**

(\$ in Thousands)

Location	Number of Failed Banks	Total Bank Assets	FDIC's Resolution Costs	Costs/ Assets (%)	Cumulative Percentage of Total Costs
Texas	599	\$92,973,964	\$13,612,645	14.64	37.53
New York	34	49,108,444	5,115,311	10.42	51.64
Massachusetts	43	26,124,470	3,375,599	12.92	60.94
Connecticut	32	17,685,983	2,415,691	13.66	67.60
Oklahoma	122	5,504,937	1,460,113	26.52	71.63
Illinois	33	34,302,370	1,213,368	3.54	74.97
Louisiana	70	4,401,121	1,088,554	24.73	77.97
California	87	5,445,302	1,061,335	19.49	80.90
New Hampshire	16	4,908,983	1,014,347	20.66	83.70
Florida	39	14,965,281	920,709	6.15	86.24
Tennessee	36	2,331,813	778,258	33.38	88.38
Alaska	8	2,862,202	615,834	21.52	90.08
Missouri	41	3,075,528	535,963	17.43	91.56
New Jersey	14	6,658,401	470,659	7.07	92.86
District of Columbia	5	2,285,178	351,803	15.39	93.83
Kansas	69	1,561,223	347,580	22.26	94.78
Colorado	59	989,252	277,217	28.02	95.55
Minnesota	38	1,579,218	196,940	12.47	96.09
New Mexico	11	714,363	183,713	25.72	96.60
Wyoming	20	375,109	117,122	31.22	96.92
Iowa	40	721,125	116,627	16.17	97.24
Puerto Rico	5	336,849	111,926	33.23	97.55
Arizona	17	434,486	88,904	20.46	97.80
Utah	11	446,839	80,564	18.03	98.02
Nebraska	33	343,342	71,151	20.72	98.21
Oregon	17	575,551	66,382	11.53	98.40
Washington	4	758,588	54,119	7.13	98.55

Table I.3-12

**Bank Failures by Location
Ranked by Resolution Costs
1980–1994**

(\$ in Thousands)

Continued

Location	Number of Failed Banks	Total Bank Assets	FDIC's Resolution Costs	Costs/ Assets (%)	Cumulative Percentage of Total Costs
Rhode Island	3	\$1,140,025	\$48,945	4.29	98.68
Vermont	2	260,755	44,706	17.14	98.80
Pennsylvania	5	13,705,317	43,803	0.32	98.93
Arkansas	11	191,678	42,711	22.28	99.04
Virginia	7	284,769	40,691	14.29	99.15
Montana	10	209,164	40,392	19.31	99.27
Indiana	10	291,556	33,422	11.46	99.36
Mississippi	3	286,729	28,160	9.82	99.44
Michigan	3	129,832	22,994	17.71	99.50
Alabama	9	285,516	21,975	7.70	99.56
Kentucky	7	120,678	21,947	18.19	99.62
South Carolina	1	62,790	20,879	33.25	99.68
Georgia	3	88,003	20,383	23.16	99.73
North Dakota	9	107,903	18,869	17.49	99.79
Idaho	1	61,231	17,244	28.16	99.83
South Dakota	8	659,667	16,887	2.56	99.88
West Virginia	5	77,174	13,743	17.81	99.92
Maryland	2	55,771	7,777	13.94	99.94
North Carolina	2	70,760	6,863	9.70	99.96
Maine	2	2,224,770	5,614	0.25	99.97
Ohio	5	140,193	4,067	2.90	99.99
Wisconsin	2	74,129	3,259	4.40	99.99
Hawaii	2	11,798	1,762	14.93	100.00
Delaware	1	612,745	249	0.04	100.00
Nevada	1	8,789	0	0.00	100.00
Totals/Average	1,617	\$302,631,664	\$36,269,776	11.98	

Sources: FDIC Division of Research and Statistics and FDIC annual reports.

FIRREA created the RTC on August 9, 1989. The RTC headquarters were established in Washington, D.C.



The sheer volume of assets, combined with the funding issues and the changing economy, significantly affected the evolution of the RTC's resolution strategies.



CHAPTER 4

Evolution of the RTC's Resolution Practices

Introduction

On August 9, 1989, the Financial Institutions Reform, Recovery, and Enforcement Act (FIRREA) of 1989 abolished the Federal Savings and Loan Insurance Corporation (FSLIC) and the Federal Home Loan Bank Board (FHLBB) and created the Resolution Trust Corporation (RTC). The RTC's primary mission was to manage and resolve failed thrift institutions for which a conservator or receiver was appointed. Initially, Congress gave the Federal Deposit Insurance Corporation (FDIC) the authority and responsibility to act as the RTC's "exclusive manager." The FDIC managed the RTC's activities until November 27, 1991, when the Resolution Trust Corporation Refinancing, Restructuring, and Improvement Act (RTCRRIA) separated the RTC from the FDIC. Figure I.4-1 shows the impact of FIRREA.

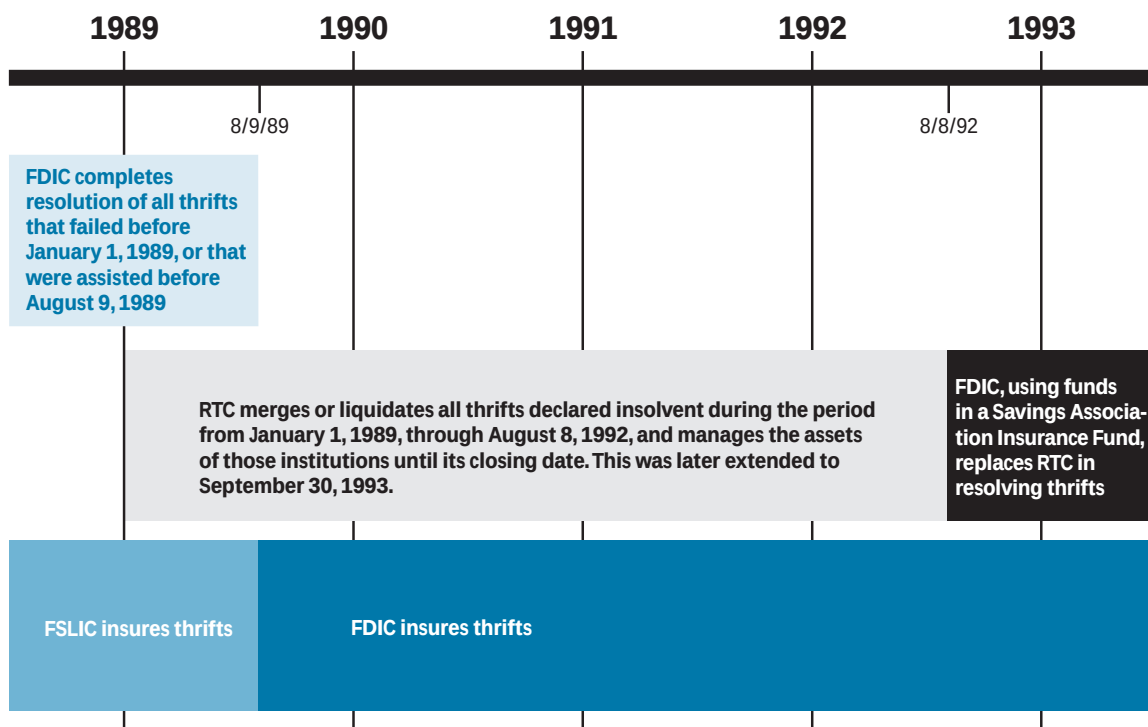
During the RTC's existence from August 9, 1989, to December 31, 1995, it was responsible for resolving 747 insolvent thrifts with assets of \$402.6 billion. (See table I.4-1.) The final cost to taxpayers for that cleanup activity is estimated to be \$87.5 billion.¹ The scope and magnitude of such a cleanup effort was unprecedented, yet essentially was completed in just six and one-half years. On December 31, 1995, the RTC was shut down, and its remaining work was transferred back to the FDIC.

This chapter focuses on an important part of the RTC's overall activity: the evolution of its resolution practices. Later chapters will discuss the RTC's asset disposition activities in greater detail.

1. Because of a number of factors, including the sale of assets in receivership and updated appraisals, this figure is adjusted periodically. The most recent estimate of RTC losses, as of December 31, 1996, is \$86.4 billion.

Figure I.4-1

Impact of FIRREA



Source: RTC, 1989 Annual Report.

Background

In early 1989, while the executive branch worked on a legislative proposal to solve the thrift crisis, the FHLBB, the FSLIC, and the FDIC developed preliminary plans for the RTC's resolution policies and practices through an interagency relationship that authorized the FDIC to manage thrift conservatorships and receiverships and to develop operating policies and guidelines. The primary focus during that developmental phase was to evaluate and assess the magnitude of the thrift problems and to develop operating strategies for marketing and selling troubled thrift institutions and disposing of their assets.

FIRREA established the RTC Oversight Board whose purpose, in conjunction with the RTC and FDIC, was to develop and establish strategies and policies for the RTC. Activities focused on six broad areas: (1) thrift resolution, (2) asset disposition, (3) affordable housing, (4) conflicts of interest and ethical standards, (5) external relations, and (6) administration. Membership of the RTC Oversight Board included the secretary of the Treasury, who served as chairman; the chairman of the Federal Reserve Board; the secretary of Housing and Urban Development; and two people from the private sector, to

Table I.4-1

Thrift Failures Resolved by the RTC
1989–1995
(\$ in Millions)

	1989	1990	1991	1992	1993	1994	1995	Totals
Number of Thrift Failures	318	213	144	59	9	2	2	747
Conservatorships	318	207	123	50	8	0	0	706
Accelerated Resolution Program	0	6*	21	9	1	2	2	41
Total Assets at Failure	\$141,749	130,247	79,034	44,885	6,105	129	426	\$402,575
Total Assets at Resolution	\$89,144	81,166	47,344	22,480	4,170	129	426	\$244,859
Total Assets Retained Post Resolution by RTC	\$61,396	53,209	35,418	15,486	3,560	71	387	\$169,527
Total Deposits at Failure†	\$112,919	98,672	64,847	33,698	4,823	124	408	\$315,491
Total Deposits at Resolution	\$85,930	69,062	40,336	21,672	3,101	124	407	\$220,632

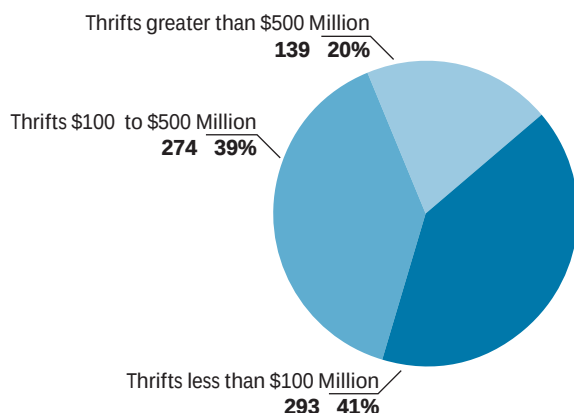
* Includes two institutions resolved with P&A transactions before conservatorship that were not in the Accelerated Resolution Program.

† Total deposits as reported in the quarter before failure.

Source: FDIC Division of Research and Statistics.

be appointed by the president of the United States.² The RTC Oversight Board also appointed a president and chief executive officer (CEO) to help manage its operations, and in October 1989, the board appointed Daniel P. Kearney as the first president and CEO. In early 1990, William Taylor from the Federal Reserve Board succeeded Kearney; Taylor would later serve as chairman of the FDIC (1991-1992).

2. Originally, the RTC Oversight Board consisted of Secretary of the Treasury Nicholas F. Brady; Chairman of the Federal Reserve Board Alan Greenspan; and Secretary of Housing and Urban Development Jack Kemp. Two independent members were named by President George H. W. Bush and confirmed by the Senate in the spring of 1990: Phillip Jackson, Jr., an adjunct professor at Birmingham Southern College in Birmingham, Alabama, and Robert Larson, president and chief executive officer of The Taubman Company, Inc., a national real estate development and property management firm in Bloomfield Hills, Michigan.

Chart I.4-1**Conservatorships by Asset Size**

Source: FDIC Division of Research and Statistics.

The RTC invited public entities and private parties, including potential acquirers of failed thrifts, representatives of community groups, and agencies in related industries such as housing, to participate in developing the RTC's overall resolution policies and plans. As a result, the case resolution mission and policy framework, when fully established, emerged as a product of governmental, private, and public entity collaboration. The RTC then took on the responsibility of implementing the mission and policy.

During the development of FIRREA and the transition of work from the FSLIC to the RTC, certain key developments and planning initiatives took place. On February 7, 1989, the FDIC entered into a man-

agement agreement with the FHLBB and FSLIC, under which the FHLBB and FSLIC authorized the FDIC to exercise management authority regarding all insolvent thrifts for which a conservator was appointed.

The FHLBB and FSLIC agreed to make their staffs available to help the FDIC perform its duties under the agreement. Because the FDIC lacked statutory authority and funding to resolve failed thrifts during the developmental phase, its primary activity between the date it entered into the management agreement and the enactment of FIRREA on August 9, 1989, was taking control of and managing 262 failed thrift institutions with \$115.3 billion in total assets. By year-end 1989, 56 thrifts had been added to the RTC's conservatorship program and 37 had been resolved, leaving a total of 281 thrifts in conservatorship.

Overview of the RTC's Use of Conservatorships

A conservatorship is established when a manager (in this case, the RTC) has been appointed to take control of a failing financial institution to preserve assets and protect depositors. Banks and thrift institutions can be placed in conservatorship; however, conservatorship was used almost exclusively by the RTC, and before that, by the FSLIC in the resolution of thrifts.³ With the passage of FIRREA in 1989, Congress granted the

3. The FDIC has used its conservatorship authority only once: to resolve CrossLand Savings Bank, FSB, Brooklyn, New York, a savings association. That action is discussed further in Chapter 6, Bridge Banks, and in Part II, Case Studies of Significant Bank Resolutions, Chapter 11, Crossland Savings Bank, FSB.

RTC the authority to act as conservator.⁴ Legislators set up a conservatorship to provide many of the same benefits to the RTC as a bridge bank did for the FDIC.

The RTC used conservatorships extensively to aid in the resolution of failing savings and loans (S&Ls). Upon its creation, the RTC immediately assumed responsibility for 262 thrift institutions already in conservatorship. From inception to June 30, 1995, the RTC managed a total of 706 institutions in the conservatorship program, with the number of conservatorships peaking at 353 in 1990. By the end of June 1995, the RTC had resolved all 706 conservatorships. (Chart I.4-1 shows the distribution of those conservatorships by asset size.)

Reasons for a Conservatorship

The conservatorship was a useful tool for resolving the thrift crisis. In early 1989, with no funds and staff available to simultaneously resolve the large number of failing thrifts, the government needed a mechanism to place the thrifts under its direct supervision while they could be marketed and sold. The RTC was expected to manage the thrifts assigned to its conservatorship program for a period no longer than necessary to complete all actions related to resolving the insolvent thrifts, such as selling or liquidating the thrifts, transferring deposits to thrift acquirers, or paying out insured deposits to depositors. Many savings and loans were in conservatorship for long periods of time, because the number of insolvent thrifts was large, staff resources were limited, and funding was periodically interrupted.

Conservatorship Process

The conservatorship process began when the Office of Thrift Supervision (OTS) closed an insolvent savings and loan and appointed the RTC as receiver.⁵ The OTS executed a pass-through receivership in which all deposits, substantially all assets, and certain nondeposit liabilities of the original institution instantly “passed through the receiver” to a newly chartered federal mutual association, subsequently known as “the conservatorship.”⁶ The OTS then appointed the RTC as conservator of the new institution, which placed the RTC in control of the institution. To achieve its goals and objectives, the RTC assigned a managing agent and one or more asset specialists, who were also RTC employees, to the institution in conservatorship. The RTC retained the majority of the former

4. Before FIRREA, the FSLIC had the authority to act as conservator for failed savings and loans. That authority originally was granted by the National Housing Act of 1934.

5. The OTS was established on August 9, 1989, by FIRREA to assume supervisory and regulatory authority over federal and state savings associations and state savings and loan holding companies.

6. Uninsured depositors were treated the same as insured depositors and were moved to the conservatorships. That practice lasted until September 1993, and from that point, uninsured deposits were left with the first receivership and not moved to the conservatorship.

institution's employees, who continued to perform the same functions they had before conservatorship; however, the day-to-day management and ultimate authority was given to the RTC-appointed managing agent. The managing agent's role was to ensure that management of the institution adhered to the RTC's policies and procedures, while the asset specialist would assist the managing agent with asset management and disposition.

The objectives of the conservatorship were to (1) establish control and oversight while promoting depositor confidence; (2) evaluate the condition of the institution and determine the most cost-effective method of resolution; and (3) operate the institution in a safe and sound manner pending resolution by minimizing operating losses, limiting growth, eliminating any speculative activities, and terminating any waste, fraud, and insider abuse. Shrinking an institution by curtailing new lending activity and selling assets was also a high priority.⁷

At the time the conservatorship was resolved, either through a sale or deposit payoff, the institution again was placed into a receivership (the second receivership). Both receiverships, the initial pass-through receivership and the second receivership, paid unsecured creditors and other claimants on a pro rata basis according to the recoveries within each receivership.

Overview of Resolution Activity

Provisions of FIRREA outlined several objectives for the RTC in its resolution and liquidation activities. Those objectives were to (1) maximize the net present value return from the sale or other disposition of the thrifts or the assets of the thrifts; (2) minimize the influence on local real estate and financial markets; (3) make efficient use of received funds to resolve the failed thrifts; (4) minimize the amount of any loss from resolutions; and (5) maximize the preservation of available, affordable residential properties for low- and moderate-income individuals.

With most of the RTC's senior personnel coming from the FDIC, the RTC initially was managed by the FDIC and followed the same statutory policies and procedures. That management approach meant that the emphasis during the resolution period generally was on purchase and assumption (P&A) transactions. Deposit payoffs usually were considered last resorts. Like the FDIC, the RTC employed a sequential bidding process that favored P&As, which generally protected all depositors against loss.

The RTC marketing process was more public than the FDIC's because the troubled status of RTC-controlled institutions was widely known. Like the FDIC, the marketing process for insolvent S&Ls began with the acquisition of a list of acceptable bidders from the FDIC's examination division.⁸ The RTC then placed advertisements in *The*

7. RTC, 1989 *Annual Report*.

8. Institutions on this list were deemed viable both before and after a potential acquisition from the RTC.

Wall Street Journal and other major publications listing by name each insolvent thrift that was for sale. The RTC's resolution staff would also check its database for investors and consultants who had previously expressed an interest in that institution or in similar types of thrifts and invite those groups to participate in the resolution without preclearance from the FDIC. Such clearance ultimately was necessary, however, before any bidder could acquire a failed S&L.

Next, the RTC valued the institution's assets. The asset valuation was one of the principal components of the RTC's cost test, which compared all the bids submitted, under each of the structures offered, to determine the least costly option.

After completing an information package that provided detailed schedules of the institution's assets and liabilities for potential bidders, the RTC held a bidders' conference. To each of the parties attending the conference the RTC distributed the information package, the bidder's instructions, the proposed resolution structures, a draft set of legal documents, the projected time line for the resolution, and the requirements from the regulatory authorities. After the meeting, potential bidders would perform their own due diligence to determine what they would submit as a sealed bid.

The RTC worked to develop a resolution process with standard procedures, legal documents, and forms to be used for all resolutions. Potential acquirers would need to become familiar with just one set of resolution procedures and documents and would not be subjected to costly time-consuming negotiations. The RTC intended that the standardized approach would maximize participation by potential acquirers of failed thrifts nationwide.

The vast majority of the RTC's resolutions were P&A transactions. Of the 747 institutions resolved by the RTC, 497 institutions (66.5 percent) were handled through P&As, 158 (21.2 percent) were insured deposit transfers (IDTs), and 92 (12.3 percent) were straight deposit payoffs. Deposit payoffs (IDTs and straight deposit payoffs) generally were used for smaller institutions. While 33.5 percent of the total number of transactions were deposit payoffs, only 17.9 percent of the deposits at resolution were handled as deposit payoffs. (See chart I.4-2.) The RTC did not use open bank assistance.

In 153 transactions, or approximately 21 percent of all resolutions, the RTC used branch breakup transactions. Of the total branch breakup transactions, 119 were P&A transactions and 34 were IDTs. (See table I.4-2 for a summary of the various resolution transactions conducted by the RTC.)

The RTC asset disposition strategy gradually became very different from the FDIC asset disposition model. The FDIC asset disposition strategy has typically emphasized the sale of the maximum amount of the failed bank's assets to the bank acquirer at resolution. The RTC, on the other hand, gradually focused its efforts on selling assets from the conservatorships or receiverships, and it often tried to sell only a limited amount of the failed thrift assets to the acquirer at the resolution. The RTC and FDIC approached asset disposition differently for the following reasons.

Table I.4-2

RTC Resolution Methods by Year of Resolution 1989–1995

Resolution Method	1989	1990	1991	1992	1993	1994	1995	Totals
Straight Deposit Payoff	4	47	33	4	1	3	0	92
Insured Deposit Transfer	26	82	14	2	0	0	0	124
Standard Purchase and Assumption	7	150	127	39	19	35	1	378
Branch Purchase and Assumption	0	22	38	24	7	26	2	119
Branch Insured Deposit Transfer	0	14	20	0	0	0	0	34
Totals	37	315	232	69	27	64	3	747

Sources: FDIC Division of Research and Statistics and RTC annual reports.

Volume of Failed Assets

As soon as the RTC was created, it faced a torrent of failed thrift assets. In 1989, it was named conservator for 318 failed thrifts having total assets of \$141.8 billion, and in 1990, was named conservator for 213 failed thrifts that had total assets of \$126.5 billion. That volume of failed assets was unprecedented. In comparison, in 1989 the FDIC had 207 failed banks having total assets of \$29.4 billion, and in 1990, it had 169 failed banks having total assets of \$15.7 billion.

Control of Failed Assets

After the RTC had been appointed conservator, it gained control of the failed thrift assets.⁹ With the average conservatorship lasting 13 months, the RTC had ample opportunity to sell the most marketable assets at this juncture. During the conservatorship period, it sold or collected \$157.7 billion in failed thrift assets. Under normal circumstances, those assets would most likely have passed to the acquirer at resolution. The RTC, however, was not faced with the same set of resolution circumstances as the FDIC.

9. During its lifetime, the RTC acquired \$402.6 billion in assets at the time of failed thrift takeover. The conservatorships obtained another \$77.5 billion in assets as a result of new loan originations, asset purchases, and other adjustments.

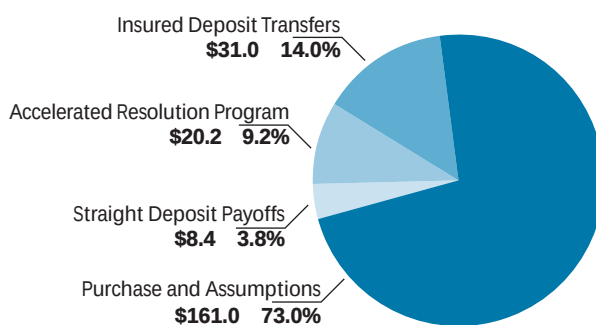
Resolution Scheduling

Because the RTC depended on Congress for resolution funding, it did not have complete control over its resolution schedule. When funding became available, the RTC would simultaneously market several dozen failed thrifts for resolution in the interest of stopping ongoing operating losses for those conservatorships as soon as practicable. The marketing periods typically would last for only a couple of months depending on the number of bidders who were interested. That situation created several bidding and logistical problems for the RTC and for the potential bidders: (1) The RTC could have a shortage of qualified acquirers given the large number of failed thrifts in certain markets; (2) potential thrift acquirers had their own limits on the number of thrifts that they could consider for a bid; (3) it could also take a successful bidder several months to fully assimilate a large RTC transaction before they were able to consider another failed thrift acquisition; and (4) a sufficient amount of time and resources was not available for potential bidders to perform a comprehensive due diligence on many of the failed thrift asset portfolios. Initially, the RTC encouraged the failed thrift acquirers to purchase as many assets as possible at resolution. Asset putback provisions were adopted to allow the acquirer to perform a more thorough due diligence after the resolution. Initially, the RTC was able to sell \$75.3 billion in failed assets to the thrift acquirer at resolution; nearly \$22 billion of these assets were later put back to the RTC.¹⁰

As the RTC's asset disposition strategies evolved, they placed far more emphasis on selling assets while they were in the conservatorship or receivership process and less emphasis on transferring assets with liabilities during the resolution process. That shift in emphasis meant that the RTC's asset disposition strategies took on relatively greater importance.¹¹

Chart I.4-2

RTC Failed Thrift Deposits by Resolution Method 1989–1995 (\$ in Billions)



Total Failed Thrift Deposits = \$220.6

Sources: FDIC Division of Research and Statistics and RTC annual reports.

10. The RTC asset sales at resolution contrast with the FDIC experience in which \$230 billion of the \$302.6 billion in failed bank assets handled by the FDIC between 1980 and 1994 were sold to the failed bank acquirer as part of the resolution.

11. The RTC's asset disposition strategies are discussed in chapters 12 through 17.

The results were different for thrift deposits. Of the \$315.5 billion in deposits handled by the RTC, \$94.9 billion (30.1 percent) were withdrawn by depositors while the institution was in conservatorship. The remaining \$220.6 billion in deposits (69.9 percent) were transferred to assuming institutions or paid off during the resolution process. (See table I.4-1.)

RTC Funding and Early Initiatives

RTC funding actually was needed for two purposes: loss funding and working capital. In fulfilling its commitment to protect insured depositors, the federal government needed to make funds available to the RTC for both purposes. Working capital was the portion of the funding that the RTC was able to recover by selling the assets of the insolvent S&Ls. The funds were paid back with interest. The portion of the funding that the RTC was unable to recover (the assets of those S&Ls that were not worth as much as the obligation to depositors) was covered by loss funds. Those funds, however, were not recoverable; they were permanent taxpayer contributions for financing the RTC.

In contrast to the FDIC, which could rely on insurance premiums paid by banks, the RTC had no internal source of funds. It relied on congressional appropriations and other indirect sources to fund its operations. Also, because appropriations to pay for insolvent S&Ls were never popular, the RTC often found itself hampered by delays in obtaining funding. It received its funding in stages, with each stage requiring separate legislation and congressional approval. The legislative involvement made long-term planning of the resolution process difficult at best.

In FIRREA, the RTC was initially provided \$50.1 billion in funds to carry out its mission of resolving troubled thrift institutions. The \$50.1 billion represented a portion of necessary “loss funds” to cover the present value cost of the embedded losses existing in insolvent and likely insolvent institutions at that time. Of the \$50.1 billion, \$18.8 billion was appropriated by Congress (on budget), with the remaining \$31.3 billion placed off budget. Of the \$31.3 billion off budget, \$30.1 billion was raised through long-term borrowings by an off budget funding entity, the Resolution Funding Corporation (REFCORP), and \$1.2 billion was provided by the Federal Home Loan Banks (FHLBs).¹² Provisions of FIRREA also established funds for the payment of interest on the bonds issued by REFCORP to come from payments from the FHLBs, the U.S. Treasury, and the RTC. In 1997, the FHLBs were paying \$300 million per year for REFCORP bond interest and the U.S. Treasury was paying the rest.

In 1989 Congress specified that the \$18.8 billion “on budget” portion of the money had to be used before the end of the current fiscal year. The immediate problem then

12. RTC, *Annual Report of the Thrift Depositor Protection Oversight Board and the Resolution Trust Corporation for the Calendar Year 1995*, (Washington, D.C.: RTC), Appendix, Table A.

became not so much whether adequate funds would be available but whether billions of dollars in funding could be used in an effective manner within an extremely short time frame. Since the RTC was created on August 9 and the fiscal year would end 52 days later, on September 30, little time was available for the new agency to get up and running and also use \$18.8 billion.

To use the money efficiently, the RTC took its less marketable institutions, the ones deemed unlikely to attract a purchaser in a P&A transaction, and conducted straight deposit payoffs and IDTs. Between August 9 and September 30, the RTC completed 24 of those resolutions, which were cash-intensive transactions, because all insured deposits were paid by the RTC. The RTC still would have to liquidate the assets, however, to partially reimburse itself for its initial cash outlay. Of the 37 resolution transactions the RTC completed in 1989, 30 were deposit payoffs.

Those initial transactions were significant because they helped to cut off some of the larger losses that were building up daily. The institutions chosen for those early deposit payoffs were among those that were paying the highest rates on their deposits. By paying off those depositors, the RTC could stop incurring those costs.

The other way the RTC used the initial \$18.8 billion was by replacing high-cost funding in its conservatorships. When certificates of deposit (CDs) paying high rates matured, the RTC would not renew them at the same high rate. It would offer rates at or somewhat below market rates. Those depositors, many of whom were there just for the high rates, would then withdraw their money. During the first two months of its existence, the RTC funded such withdrawals with part of the \$18.8 billion it needed to use by the end of September. Those early actions—the deposit payoffs of the unmarketable institutions and the elimination of high-cost deposits—helped hold down the overall cost of handling insolvent S&Ls. Furthermore, the RTC's efforts to reduce high-cost funds also helped bring down the high rates that S&Ls had to pay for deposits, thus increasing earnings for an industry that sorely needed it. For example, before August 9, 1989, the average yield on a one-year CD at an S&L was 71 basis points higher than the yield on a bank CD. By March 1990, however, that difference had been reduced to 22 basis points, which translated into an industry savings that could exceed \$1 billion per year.¹³

Few people believed the initial \$50.1 billion in funding would be adequate to handle the RTC's workload of insolvent S&Ls; rather, they viewed it as a substantial down payment to get the RTC started. That attitude became apparent in the spring of 1990 as resolution costs began to rise. FDIC Chairman L. William Seidman testified to the Congress just six months after the RTC began that the RTC would spend the original \$50.1 billion in FIRREA "loss funding" by the fall of 1990.¹⁴ As a result, the March 1991 RTC Funding Act and the November 1991 Resolution Trust Corporation

13. Remarks of FDIC Chairman L. William Seidman before the National Press Club, March 21, 1990.

14. Chairman Seidman also testified to the Congress in October 1989, two months after the RTC began, that the RTC lacked working capital, which was already becoming a constraint upon the pace of the RTC's resolution activity.

Refinancing, Restructuring, and Improvement Act (RTCRRIA) provided funds of \$30 billion and \$25 billion, respectively, to the RTC.¹⁵ The RTCRRIA legislation, however, required that the funds be used before April 1, 1992. Finally, on December 17, 1993, Congress passed the Resolution Trust Corporation Completion Act (Completion Act) of 1993, which removed the RTCRRIA April 1, 1992, deadline on “usage of funds,” and the RTC was authorized to use up to \$18.3 billion, the remaining balance of the \$25 billion initially authorized under RTCRRIA to finish its mission. The Completion Act also extended the deadline of the RTC’s appointment as conservator or receiver for S&Ls from September 30, 1993, to a date not later than July 1, 1995.

It also became clear that the RTC would require funds to meet working capital requirements. After the RTC used a portion of the initial \$18.8 billion to eliminate the high-cost deposits at the conservatorships, the issue of working capital became a subject of debate between Congress and the administration. On February 20, 1990, after months of discussion and review of difficult funding options, the oversight board authorized the RTC to borrow from the Federal Financing Bank to meet working capital needs. That agreement provided \$11 billion to the RTC during the first quarter of 1990, with additional quarterly borrowings to be authorized thereafter.

The funding process and the related delays increased the cost of resolving the troubled savings and loan associations. The pace of resolutions had to conform to the availability of funds. When funding was available, the number of resolutions increased and kept pace with the establishment of new conservatorships. Sometimes the pace of the resolution process was fast. Other times, the pace was painfully slow. The longest delay was a 21-month period from March 31, 1992, to December 17, 1993, when the RTC was without loss funding and resolution activity was severely reduced. The pace of resolutions followed the availability of funding, and resolution delays kept thrifts in conservatorship longer, which increased conservatorship operating losses. Those losses were \$5.4 billion in 1989 and decreased steadily each year. In 1992, they were \$669 million, but because of the reduced resolution activity from the lack of funding, in 1993, conservatorship operating losses increased that year to \$1.3 billion. Resolution delays and conservatorship operating losses led to increased resolution costs because of the relatively high carrying cost of maintaining assets in failed thrifts.¹⁶ Funding delays had a significant effect on how long an institution remained in conservatorship. (See table I.4-3.) Before FIRREA’s passage, when no conservatorships were resolved, thrifts averaged 454 days in the conservatorship program. After the passage of FIRREA, with the exception of 1991 and 1992, the average time until resolution for thrifts put into conservatorship was less than a year.

15. RTCRRIA also extended the RTC’s authority to accept appointments as conservator or receiver from August 8, 1992 (set in FIRREA) to September 30, 1993; redesignated the RTC Oversight Board as the Thrift Depositor Protection Oversight Board (TDPOB) and restructured its membership; abolished the RTC Board of Directors; removed the FDIC as exclusive manager of the RTC; and created the Office of Chief Executive Officer of the RTC.

16. RTC, Office of Research and Statistics, “The History of RTC Funding.” Unpublished document.

Table I.4-3

Conservatorship Institutions 1989–1995

	Conservatorships Established	Average Number of Days until Resolved	Conservatorships Resolved
Pre-FIRREA 1989 (2/7-8/8)	262	454	0
Post-FIRREA 1989 (8/9-12/31)	56	356	37
1990	207	323	309
1991	123	429	211
1992	50	596	60
1993	8	350	26
1994	0	—	62
1995	0	—	1
Totals	706	412	706

Source: RTC, 1995 Annual Report

Initially, the RTC had so many S&Ls in conservatorship, it had to set priorities in its resolution schedule. It decided to handle the most unmarketable S&Ls first. If an institution were suffering large operating losses, it was scheduled early in the resolution calendar. If an institution's losses were small, it was left in conservatorship and scheduled for later resolution.¹⁷

The case priority process was significant because it acknowledged the RTC's limitations regarding the large number of insolvent thrifts in conservatorship and the limited financial resources available. It enabled the RTC to select for resolution those institutions that presented the best opportunity for minimizing costs to the RTC or those that had a higher rate of deterioration because of operating losses, eroding core deposit bases, and loss of key personnel. The priority process also considered the amount of funding available to cover the losses and the estimated cost of resolving each institution.

17. "Strategic Plan for the Resolution Trust Corporation" (report), (Washington, D.C.: RTC Oversight Board, 1989).

Operation Clean Sweep

After the RTC's initial flurry of activity to use \$18.8 billion by the end of the third quarter of 1989, its resolution process slowed down. Lawmakers, as well as banking and thrift industry officials, who worried about assets being dumped on weakened real estate markets began demanding that the RTC market all conservatorship institutions as widely as possible and that the RTC be more flexible so that acquirers would purchase more of the assets at the time of resolution. As a result of those pressures, the RTC focused on encouraging whole thrift transactions to maximize the retention of assets in the private sector and to minimize the amount of cash needed from the RTC. Whole thrift transactions entailed passing most of the failed institution's assets to the acquirer along with its liabilities. That approach, however, had distinct disadvantages. Whole thrift resolutions required an acquirer with loan workout expertise, thereby limiting the number of interested bidders. Similarly, such transactions required extensive due diligence by potential bidders, which was lengthy and expensive. Those factors increased the degree of uncertainty that potential acquirers faced, resulting in substantial risk premiums in the final bid prices. Furthermore, many of the failed institutions had little going-concern value, and bidders showed little appetite for thrift assets, especially because, at the same time, most banks were tightening their credit standards under regulatory pressure and signs of a slower economy.

Compounding the obstacles to the RTC's resolution efforts was an increasingly hostile economic and risk-averse market. Many investors believed an oversupply of thrift and bank charters existed. To illustrate, of the 7,500 parties invited to bid on the 52 institutions resolved through the first quarter of 1990, only 263 actually performed due diligence, and only 194 actually submitted bids. Furthermore, of the 52 resolutions, only two transactions resulted in whole thrift transactions.¹⁸ Those results suggest that potential acquirers did not see great value in buying failed thrifts in their entirety, and that what limited franchise value existed was attributable almost exclusively to the deposit franchise.

Meanwhile, while the pace of resolutions was slowing, the takeover of additional institutions into conservatorships was increasing. By the end of the first quarter of 1990, the RTC had taken over 405 institutions in 40 states with more than \$200 billion in assets, leaving about 350 institutions still in conservatorship with \$180 billion in assets. Furthermore, it was becoming clear to most people familiar with the industry that the RTC's workload would continue to rise; some estimated that it would double, with the RTC having to take over another 250 to 350 institutions with up to \$200 billion in assets.

As a result, by the spring of 1990, the RTC was coming under increased criticism and pressure from Congress and others to accelerate the resolution of the conservatorship

18. Testimony of RTC Oversight Board Acting President and CEO William Taylor before the Committee on Banking, Finance and Urban Affairs, United States House of Representatives, April 2, 1990.

institutions. Critics in the industry and on Capitol Hill, who once warned the RTC not to dump assets on weak real estate markets, were now pressuring for action to quicken the pace of the resolutions.

In response, on March 21, 1990, FDIC and RTC Chairman L. William Seidman, in a speech to the National Press Club, announced that the RTC would sell or liquidate 141 conservatorship institutions by June 30, 1990. "Operation Clean Sweep" was a term that was used to describe the resolution of all 141 conservatorship institutions. That initiative was intended, in part, to demonstrate that progress was being made and to maintain credibility with potential investors and acquirers. In addition, the initiative was designed to quickly dispose of those institutions in order to spend the funds then available as quickly as possible so that the RTC could return to Congress for additional funding before the next election cycle began. Even though the S&L cleanup was less than a year old, it clearly needed more funding as an increasing number of savings and loans failed each week with no signs of a slowing pace. The S&L cleanup clearly was also becoming a politically unpopular exercise, indicating that additional funding for the RTC would be difficult to obtain.

Many industry commentators inside and outside the agency expressed skepticism about the RTC's ability to meet its ambitious goals. The RTC's plan represented a sharp acceleration from the pace of its resolutions to that date and surpassed any previous resolution pace undertaken by the FDIC. In addition to accelerating its pace, the RTC was still trying to come up to speed in its start-up phase of operation. It employed about 2,300 people, the majority of whom were new hires. Most of the staff were located in the field, in four regional offices—Atlanta, Kansas City, Dallas, and Denver—and 14 other consolidated offices.

To accomplish its aggressive goal, senior RTC management visited each of the RTC regional offices to "sell" the plan to staff. The plan stated that headquarters staff, located in Washington, D.C., would handle any resolutions with valued assets above \$500 million (major resolutions) and staff in the field offices would handle those resolutions valued under \$500 million (field resolutions).

On June 30, 1990, the RTC exceeded its goal of 141 resolutions; it completed resolution transactions for 155 failed S&Ls with total assets of \$44.4 billion and total deposits of \$38.7 billion. The total initial cash outlay by the RTC was approximately \$32 billion, and the total cost of those transactions is estimated to be \$18 billion. Of the 155 resolutions, 78 transactions with \$36.6 billion in assets were P&A transactions, 59 transactions with \$6.4 billion in assets were IDTs, and 18 transactions with \$1.4 billion in assets were straight deposit payoffs. The institutions resolved under Operation Clean Sweep were located in 31 states, with the largest concentration in Texas (34 institutions with \$6.9 billion in total assets), California (19 institutions with \$7.8 billion in total assets), Illinois (11 institutions with \$0.8 billion in total assets), Kansas (9 institutions with \$1.2 billion in total assets), Louisiana (9 institutions with \$0.6 billion in total assets), and Florida (8 institutions with \$8.0 billion in total assets). Operation Clean

Sweep included institutions of all sizes, ranging from \$6.3 million to \$6.8 billion in assets, with 18 institutions having assets above \$500 million at the time of resolution.

Operation Clean Sweep was successful in rebuilding confidence in the RTC's effort. Insured depositors received protection, and the accounts of the vast majority of depositors transferred to a healthy depository institution with little, if any, disruption in service. Substantial cost savings were achieved because the RTC had targeted conservatorships with the highest operating costs for resolution. Those institutions typically had paid above-market rates to attract and retain deposits, which also caused healthy banks and thrifts in the area to pay a market premium for their deposits. In addition, those efforts represented a significant step toward reducing the backlog of insolvent, government-controlled S&Ls that were competing against privately owned institutions. By reducing the backlog, the RTC was able to move forward with its original operating plan of completing 50 to 75 resolutions each quarter. In addition, by resolving the 155 conservatorship institutions, the RTC was able to reduce the number of insolvent institutions in conservatorship from 350 to 247, despite the addition of 52 new conservatorships during the quarter.

Operation Clean Sweep, however, also had some negative consequences. For one, the RTC's inventory of assets greatly increased; the RTC retained more than half of the assets from the 155 institutions, including a large share of the institutions' problem loans, owned real estate, and junk bonds. In addition, the effects from closing so many conservatorships so quickly contributed to accounting and back office problems that plagued the RTC for several years afterwards.

Put Options

To pass more assets to acquirers, the RTC also used the "put options" method. Because most acquirers did not want to purchase those assets, the RTC decided to require the purchaser to take most of the failing thrift assets but gave them an option that would require the RTC to repurchase most of the assets at a later date. The RTC used put options extensively during the first year of its existence, selling approximately \$40 billion of assets subject to put options. The approach for passing more assets of failed thrifts did not work, however, because too many assets were coming back; in fact, acquirers returned more than \$20 billion of those assets to the RTC.

One problem that led to the return of assets to the RTC appears to be the limited time acquirers had to evaluate the assets. After an institution closed, acquirers could purchase the assets and return them to the RTC over a 30- to 90-day period, which did not give the acquirer adequate time to review the assets. Those assets contained a wide variety of types of collateral and generally were poorly underwritten. In addition, some of the acquirers were experiencing problems with their own asset portfolios and did not want to take on any additional risk.

In the spring of 1990, in response to the time problem, the RTC extended the option period to 18 months for some assets, to give the acquirers the time necessary to

evaluate and perhaps retain the assets. That policy, however, exacerbated the existing problems with the initial policy on put options. In some cases, assets were not being properly serviced before being put back to the RTC. In other cases, acquirers “cherry picked” the assets and kept only those they could sell at a profit. In addition, the limited due diligence before bidding did not allow acquirers to include the potential profits in their bids. Ultimately, the problems led to substantial delays in the final sale and ultimate resolution of those assets.

Development of New Initiatives

As the RTC obtained a stable source of working capital, it eliminated the need to force franchise acquirers to buy assets and was able to return to the resolution strategy that it originally envisioned. Because of the large volume, variety, and quality of assets held by insolvent thrifts, the RTC needed to develop more flexible and efficient programs and asset sale initiatives. The RTC's marketing and selling approach had to attract a diverse client base, including some potential acquirers with a strong interest in assets only.

Separating Assets from Liabilities

One of the RTC's primary goals was to prepare conservatorships for resolution by shrinking the size of failed institutions. Reaching that goal involved curtailing new lending, reducing expenses, and selling assets. (Liquid assets such as securities and mortgage-backed securities were the most marketable and the easiest to sell.) Most attractive to acquirers were performing single-family mortgage portfolios. By 1990, the RTC began to use other asset sales methods, such as auctions, bulk sales, and securitizations. Because those sales methods required large numbers of assets (such as commercial and real estate loans), their closure helped speed the downsizing of conservatorships. Ultimately, the subsequent delays in the RTC's receiving funding prolonged the life of conservatorships, which forced the RTC to reassess how it should deal with conservatorship assets. The RTC decided that it should market performing mortgage portfolios immediately upon entering conservatorship to avoid decay in the value of those assets through prepayments. That decision caused the percentage of assets passing to acquirers at resolution to decrease as those marketable assets were sold. The rapid, cost-effective sale of conservatorship assets was instrumental in preparing the institution for a smooth resolution.¹⁹

Removing assets from conservatorships for sale caused the asset side of the conservatorship balance sheet to shrink, because few new loans were being made. The liability side of the balance sheet also shrank from deposit runoff. The longer an institution stayed in conservatorship, the more the deposit base deteriorated. Such deterioration

19. RTC, 1990 Annual Report.

was caused by the lower rates offered to depositors, compared to the higher rates offered before conservatorship, and the publicity from the government takeover.

The RTC's approach for resolving failed S&Ls contrasted with how the FDIC typically resolved failed banks. When the FDIC handled a resolution, it tried to sell as many assets as possible to the bank that was assuming responsibility for the failed institution's liabilities. Only after the resolution process was complete would the FDIC consider marketing assets to nondepository institutions. The RTC, however, made a conscious decision to separate many of the assets from the liabilities and to develop broader asset marketing strategies. Indeed, that step was critical to the RTC's efforts to dispose of \$402.6 billion in assets within a few years.

In June 1991, the RTC modified its resolution philosophy and eliminated requiring acquirers to purchase assets in order to buy the deposit franchise. To the extent that assets were available to sell at resolution, winning acquirers were given the option to purchase pools of similar loans at a price set by the RTC. As a result of the success of the transactions instituted by the RTC, the FDIC decided to institute a similar loan pool option in its resolution transactions.

In 1992 and 1993, when lack of funding reduced the ability of the RTC to resolve many of the conservatorships, it focused its attention on selling the assets out of the conservatorships before their resolution. By that time, the RTC had developed a national loan sale program and securitization program, which disposed of many of the assets while they were still in conservatorship.²⁰

With adequate funding, the separation of assets from liabilities and the broader marketing of assets at or near the time of resolution was a little easier for the RTC than for the FDIC, because the RTC's inventory of institutions was already in conservatorship and was being managed by the RTC. That factor made it easier to gather information about the assets to prepare for a sale. Also, unlike the FDIC, which conducted resolutions as soon as a bank closed, the RTC had already taken control of the institutions and thus had no need for secrecy.

Branch Breakups

During 1990, the number of institutions being resolved through payoffs and IDTs, together with the decreasing deposit premiums received for failed thrifts, caused the RTC some concern. In addition, commercial banks protested that they were being excluded from bidding on the best deposit franchises because of their size. Those negative resolution trends resulted in part from a decline in the financial health of large bank holding companies and their inability to make acquisitions. Without their participation, the large size of those thrifts limited the amount of competition. In response, the RTC initiated the branch breakup transaction to increase bidder participation, competition,

20. For more information, see Chapter 13, Auctions and Sealed Bids, and Chapter 16, Securitizations.

and flexibility for the resolution process. Because the branch breakup approach enabled potential acquirers to bid on individual branch offices of failed thrifts, it appealed to a much broader group of potential investors. The RTC marketed institutions through branch breakup transactions unless their accounting systems were incapable of handling multiple acquirers.

Beginning in the spring of 1990, the RTC marketed failed thrifts as either "standard" or "branch" P&A transactions. As the branch transaction evolved, it became a variation of the standard P&A transaction and included similar terms and conditions. The branches of a particular institution were offered under two structures: "core" and "limited" branch P&As. Under the core branch transaction, the acquirer assumed a specified group of deposits and obtained an exclusive option to purchase fixed assets associated with the failed thrift's headquarters and other branch offices designated part of the core branch group. The acquirer of the core branch also purchased no-risk assets associated with the core branch group of offices and received purchase options on earning assets at market prices. The core acquirer performed the administrative and operational responsibilities associated with the post-resolution phase of the transaction.

Limited branch transactions were structured for individual branches or branch clusters other than the designated main office and any branches included in the "core" agreement. Limited branch acquirers obtained the branch offices and the deposits, cash, and other loans on deposits directly attributable to the branch offices. They also received exclusive call options to purchase designated fixed assets and to assume leases and other contracts associated with the respective branch offices.

Initially, the RTC offered only deposits and a limited amount of no-risk assets through the limited branch transaction, assigning most of the earning assets to the core branch transaction. In response to changing market demands, the RTC gave limited branch bidders an opportunity to bid on earning assets similar to the core branch and standard transaction bidders. That move was a deviation from the RTC's historical resolution approach of selling earning assets only through all-deposit transactions. The RTC later enhanced the branch transaction format to permit bidders to submit multiple bids for the failed institution's branch offices and related assets.

To further increase the level of competition and to give smaller branch bidders the opportunity to more successfully compete against larger bidders, the RTC allowed such branch bidders to link their individual branch bids together or form "consortium" bids by pooling their premium dollars with other branch bidders. That process transformed branch bids into standard P&A bids through the process of submitting one bid premium for all or most of the failed institution's branch offices. The RTC facilitated the structure of consortium bids, but it entered into agreements with only one acquirer (the lead acquirer) with whom the closing and post-closing processes were conducted. The other participants in a consortium bid were not involved in direct agreements with the RTC; instead, they entered into legal agreements to purchase the failed institution's branch offices from the lead acquirer.

Consortium bid structures facilitated all branches being sold under the same deposit option and accomplished the RTC's policy objective of treating all depositors in a single institution equally from a deposit insurance perspective.

The branch breakup transaction became a successful modification to resolution procedures. Branch breakup bids were the winning bids in 153 of the 747 resolutions (20.5 percent). As time went by, the branch breakup transaction became an increasingly more significant resolution method. (See table I.4-1.) In 1994, more than 40 percent of the resolutions involved a branch breakup transaction. Furthermore, of the 52 resolutions in 1994 involving two or more branch offices, half involved branch breakup transactions. The RTC found that by offering the branch breakup transactions, competition increased, which resulted in additional savings to the RTC through increased premiums and fewer deposit payoffs. For example, in 1994, in those branch transactions in which at least one entire institution bid was also received, the RTC received an additional aggregate premium of approximately \$84 million by selecting the individual branch bids instead. Furthermore, in seven instances, the RTC did not receive any entire institution bids that could have resulted in a deposit payoff if the branch bids had not been available.

The Accelerated Resolution Program

Effective July 10, 1990, the RTC and the Office of Thrift Supervision jointly initiated the Accelerated Resolution Program (ARP) on the premise that early intervention in a troubled thrift could create significant savings for taxpayers. Placing an institution with franchise value in conservatorship had the potential of raising rather than limiting the ultimate cost of resolving the institution and selling its assets. Because the publicity surrounding the conservatorship caused a runoff of core deposits and performing loans, the RTC and OTS designed the ARP initiative to initiate the marketing and sale of troubled savings associations before they were declared insolvent by the OTS and placed into conservatorship under RTC control. The ARP usefulness was limited, however, because it could not be fully used in 1992 and 1993 when the RTC had no funding.

Initially, institutions selected for sale through the ARP process were perceived to have a high franchise value and already had attracted viable, cost-effective proposals from prospective acquirers, which indicated substantial private sector interest. Also, the troubled institutions' management had to agree to participate in the process by signing consent agreements and cooperating with the RTC and the regulators.

After gaining consent from the institution's management, the RTC conducted the resolution process in the same manner as conservatorship institutions with some minor changes. First, the RTC did not seek broad market interest through public advertisement. The overall marketing process was more selective and confidential than the RTC's typical conservatorship process. In most ways, the ARP approach resembled the FDIC's historical approach to soliciting bids for troubled banks. In addition to soliciting bidders on its National Marketing List, the RTC reached regional institutions and

investors with the help of the OTS and the thrifts' own management, who assisted with the marketing process.

Second, the asset valuation process and due diligence typically involved reviewing more of a thrift's assets because, under the ARP, substantially all of the assets were available for sale at the time of resolution. Transaction documents (purchase and assumption agreements and mortgage loan sale agreements) were modified to offer standard representations and warranties on single-family mortgage loans in lieu of the put back provisions, or put options, that the RTC offered under its conservatorship resolutions. The remaining terms in the ARP P&A contract were similar to the standard P&A contract offered by the RTC when it resolved institutions in the conservatorship program. After 1991, the language in the contract terms in the conservatorship and ARP resolution documents became identical. A major difference regarding resolution still existed between the programs; in the conservatorships, many of the assets were sold before the resolution, while in the ARPs, all the assets were available for sale at the time of resolution.

Initially, ARP transactions were structured so that residential mortgages were offered exclusively to deposit acquirers; the ARP resolution process excluded asset-only acquirers from purchasing assets. In 1991, the RTC decided to market most single-family residential mortgages simultaneously to both deposit-only and asset-only acquirers, which expanded its customer base and created more competition. The vast majority of the loans were sold to asset-only acquirers at prices substantially above the RTC's valuations. The ARP process evolved in a similar manner to the options of conservatorship resolutions, which included selecting optional asset pools, linking deposit-only with asset-only bids, and branch bidding. Of the 747 resolutions completed by the RTC, 39 institutions, or 5 percent, were sold through the ARP process.

The RTC's method for handling ARP transactions was similar to the FDIC's historical method: It avoided using a conservatorship and was generally accomplished in a short time with limited bidder solicitations.

Least Cost Transactions

Another modification to the bidding process came as a result of the language contained in the Federal Deposit Insurance Corporation Improvement Act (FDICIA) of 1991, which required the RTC to choose the least costly resolution. Initially, the RTC marketed thrifts through a sequential resolution approach under various purchase and assumption transactions. If the initial attempt was unsuccessful, the RTC reoffered the thrift to the same potential acquirers under an insured deposit transfer. If the reoffer process was unsuccessful, the failed thrift was resolved by a deposit payoff. In response to FDICIA, the RTC and the FDIC replaced the sequential approach with a bid process in which they offered acquirers the choice of buying all the deposits or only the insured deposits. That change resulted in a much higher percentage of resolutions in which only insured deposits were transferred to an acquirer.

Effect of Entrance and Exit Fees

A provision of FIRREA placed limits on the ability of insured depository institutions to change from a Bank Insurance Fund (BIF) member to a Savings Association Insurance Fund (SAIF) member or from a SAIF member to a BIF member for a period of five years. That provision was designed to stabilize membership base and insurance assessment rates. Also, by charging institutions participating in conversions both an exit and entrance fee to the appropriate insurance fund, the provision attempted to prevent dilution of the deposit insurance funds. Acquirers seeking transactions that would involve conversion from SAIF to BIF would be subject to exit fees from SAIF and entrance fees to BIF (or vice versa). Early in the RTC's history, those fees amounted to 1.5 percent of core deposits for a bank buying a failed thrift. For many thrifts the fee was more than they were worth and prevented conversion to the BIF.

However, FIRREA allowed for transactions in which a BIF institution could acquire SAIF institutions and have the acquired deposits remain insured by SAIF. In such instances, the BIF institution paid no exit and entrance fees, and the acquirer continued to pay the SAIF insurance premium. Such transactions, termed "Oakar" transactions, were designed to level the playing field for banks when competing with thrifts for thrift acquisitions and also enhance the acquisition of failing thrifts by banks.²¹ Virtually all acquisitions from the RTC by banks were handled as Oakar transactions.

Resolution Initiatives for Minorities

The RTC was committed to preserving and increasing the total number of minority owned depository institutions. To achieve those objectives, the RTC developed and administered programs for minority participation, including the Minority Resolution Program (MRP), which evolved over time as a result of legislation. (The RTC was able to develop a much more extensive minority preference program, which allowed the RTC to offer more assistance to minority purchasers, than the FDIC could develop because specific legislative provisions were governing resolution of the RTC controlled thrifts that did not apply to the FDIC.)

Initial Program

To comply with section 308 of FIRREA, the RTC initiated a plan aimed at preserving the minority ownership of failed minority thrifts. Under that section, bidders of the same ethnic identification as that of the previous owners were allowed to bid separately.

21. The term "Oakar" transaction was derived from the name of the FIRREA provision's author, Congresswoman Mary Rose Oakar.

Only if that bidding process proved unsuccessful (that is, no bids were less costly than a payoff) was the institution offered to all other potential investors.

The RTC also made available to qualified acquirers interim capital assistance (ICA) of up to two-thirds of the required capital for the acquisition. Although not a specific requirement of FIRREA, that financing approach initially was designed to act as short-term bridge financing until the acquirer could raise permanent capital. Because of the inability of many of the minority acquirers to attract permanent capital over a short time, however, the RTC lengthened the loan repayment term to at least two years and finally to five years. The ICA loans carried an interest rate equal to the RTC's cost of borrowing (approximately the six-month Treasury rate plus 12.5 basis points). Because the RTC, in its cost analysis, discounted the cash flow from the ICA note at the RTC cost of funds, the loan was considered to be cost neutral. If the discount rate had been increased to adjust for risk of default, the RTC would have realized a substantial cost for the \$56.9 million of ICA notes that they issued. Minority investors preferred the RTC financing, because the interest rate was much lower than comparable financing.

RTCRRIA Modifications

In November 1991, RTCRRIA amended section 12 of U. S. Code 1441(a) to require the RTC to reoffer failed nonminority owned institutions, or branches thereof, to minority owned institutions if it received no other acceptable offers through the conventional marketing efforts (rebidding initiative). In addition, the RTC's existing policy on minority resolutions was made a part of the law. Early in the marketing process, the RTC attempted to notify and inform all potential acquirers, including minority investors, that the RTC would consider accepting bids from minority investors if the institution, or branch thereof, was not sold through normal marketing efforts. If the RTC did not receive a bid that was less costly than a payoff without a request for interim capital assistance, it reoffered the institution, or branch thereof, to minority investors that had made their interest known to the RTC. The bids received under the special initiative were required to represent a lower cost to the RTC than that of paying off the failed thrift's insured deposits. Generally, that reoffer period lasted a few days and did not delay the closing of the failed institution. If the reoffer attempt was unsuccessful and the failed institution remained unsold, the RTC resolved the institution through a deposit payoff. Under that initiative, it also made ICA available to eligible minority owned institutions.

The RTC also offered minority bidders an option to purchase performing loans equal to 100 percent of deposits acquired at an immediate market value determined by the RTC. That option was designed to provide the acquirers with a source of earning assets. Because the loans would be sold at market value, that provision was considered "no cost"; but, it caused the RTC significant difficulty because the acquirers had lower opinions of the value of the loans than did the RTC. The program sold more than \$300 million of loans to 10 minority acquirers. In three other cases, the RTC and the acquirer

could not agree on a mutually acceptable value for the loans. Those option agreements were terminated with the RTC making cash payments totaling \$1.4 million to the acquirers.

The RTC Completion Act of 1993

In December 1993, the RTC Completion Act of 1993 amended section 21 of the Federal Home Loan Bank Act and revised the manner in which institutions were structured for sale, as well as the initial bid analysis process. The statute required that the RTC give “bidding preference” to an offer from a minority owned depository institution to acquire any failed depository institution, or any branch thereof, located in a neighborhood in which 50 percent or more of the residents were minorities, as part of the Predominantly Minority Neighborhoods (PMN) Program. Because the bidding preference was subject to the least cost test, it was limited. Minority bidders were permitted to submit a second bid if their initial bid was within 10 percent of the otherwise winning lowest bid by a nonminority bidder. The option to purchase performing loans at market value and ICA were also available to the minority acquirers.

The RTC executed the special PMN Program by simultaneously offering institutions and branch offices to all potential acquirers through normal marketing efforts and specifically identifying all PMN institutions and branch offices. As a result, the RTC offered institutions having branch offices located in PMN neighborhoods under individual branch and cluster branch transactions. Additionally, under separate provisions of the FHLB Act, section 21(A)(s), the RTC made owned banking facilities located in predominately minority neighborhoods available to minority owned financial institutions on a rent-free basis for five years. The cost of that separate provision of the law was not included in the least cost test completed for the resolution transaction.

Results of the Minority Resolution Program

The RTC’s Minority Resolution Program attracted widespread interest among minority investors, and the RTC’s National Marketing List included nearly 500 interested minority investors. Furthermore, the RTC MRP was relatively successful in preserving minority ownership of the failing minority owned thrifts. Of the 29 minority owned thrifts involving 95 branch offices, 24 institutions, or 83 percent, were sold to acquirers, thus maintaining bank services in those communities. Of those 24 sales, 15 institutions, or 63 percent, preserved the same ethnic minority ownership. Of those 15 institutions, 7 received interim capital assistance totaling \$14.3 million. In addition, under the rebidding initiative, minority investors acquired two entire previously nonminority owned thrifts, with a total of eight offices, and three branches of another nonminority owned thrift, and one acquirer obtained \$3.2 million of ICA in those transactions.

The RTC resolved 23 nonminority thrifts that had 69 branch offices located in PMNs. Minorities acquired 31 of the branch offices, or 45 percent, in those transac-

tions. The aggregate amount of ICA provided was \$39.4 million. Under the PMN Program, the RTC also made rent-free banking facilities available to 11 acquirers.

Resolution Costs

The 747 institutions that the RTC resolved between August 9, 1989, and year-end 1995 had \$402.6 billion in assets before failure. Unlike the FDIC, however, the vast majority of those institutions were not sold immediately after failure, but instead were placed into conservatorship and were later resolved after significant asset shrinkage. The 747 institutions at time of resolution had \$244.9 billion in assets. The RTC's cost for handling those failures was estimated at December 31, 1995, to be \$87.5 billion, or about 22 percent of the assets at time of failure.

The \$87.5 billion in costs was almost twice the initial \$50.1 billion FIRREA appropriation, but it was substantially less than the high end of the range that the U.S. Treasury predicted at the peak of the cycle in June 1991 of close to \$130 billion in 1989 present value costs or \$160 billion in absolute dollars.

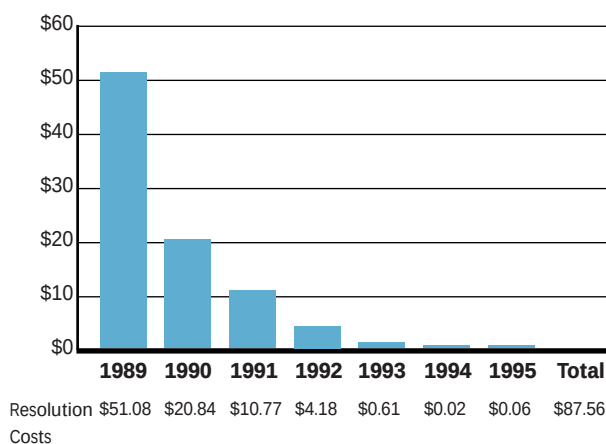
Also, the RTC's resolution costs were skewed by the fact that the majority of institutions resolved in 1990 and 1991 were institutions that had been put into conservatorship by the RTC in 1989 and 1990. A large number of those institutions had been insolvent for some time, were located in declining real estate markets (for example, the Southwest), and had little franchise value remaining. Approximately \$72 billion, or 82 percent, of the total RTC resolution costs resulted from those 531 institutions that were put into conservatorships or were resolved through the ARP during 1989 and 1990. (See chart I.4-3.) Another gauge of those institutions' poor financial condition is that 239 of those 531 institutions, or 45 percent, were resolved through straight deposit payoffs or insured depositor transfers. To put those costs in perspective, the FDIC's bank failure costs totaled only \$9.1 billion for 1989 and 1990.

Looking at the RTC's annual thrift resolution costs as a percentage of failed thrift

Chart I.4-3

RTC Resolution Costs 1989–1995

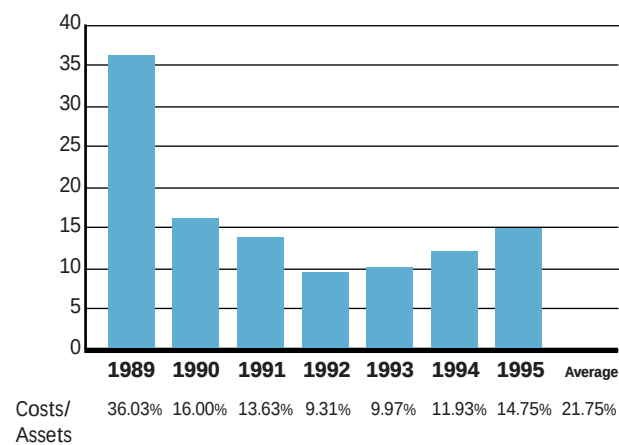
(\$ in Billions)



Costs are as of December 31, 1995. The amounts are routinely adjusted with updated information from new appraisals and asset sales that ultimately affect the asset values and projected recoveries for active receiverships.

Sources: FDIC Division of Research and Statistics and RTC annual reports.

Chart I.4-4
RTC Resolution Costs as a Percentage of Total Assets
1989–1995

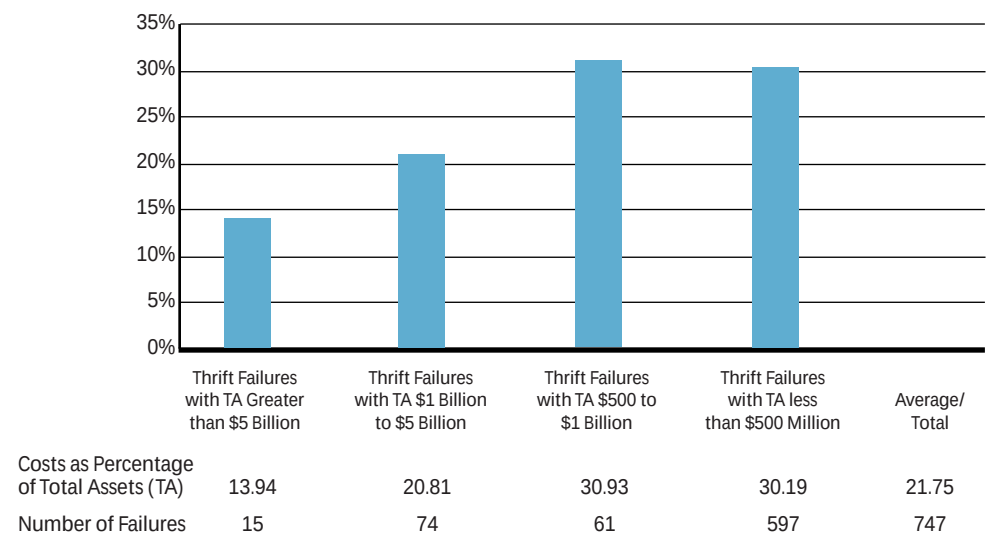


Sources: FDIC Division of Research and Statistics and RTC annual reports.

assets shows a pattern of decreasing costs until 1993 when costs begin to rise through 1995. (See chart I.4-4.) The ratio is extremely high at 36 percent for those thrifts failing in 1989. Again, the RTC expected that ratio because those institutions were the worst off financially and had little, if any, franchise value. For 1992 and 1993, as the economy gradually began to improve in most of the nation, those years show relatively low cost-to-asset ratios, between 9 and 10 percent. Cost-to-asset ratios for 1994 and 1995 increased. In those years, only four failures (two ARP transactions each year) occurred; three of those failures were in California, which was still suffering economically.

Although a correlation exists between thrift asset size and failure resolution costs as a percentage of assets,

Chart I.4-5
Resolution Costs by Asset Size as a Percentage of Total Assets
1989–1995



Sources: FDIC Division of Research and Statistics and RTC annual reports.

that correlation is less pronounced than that expressed for bank failures. (See chapter 3, Evolution of the FDIC's Resolution Practices.) While bank failure costs show a steadily declining cost ratio as bank size increased, thrift costs are almost identical for thrift failures less than \$500 million (30.2 percent) and those between \$500 million and \$1 billion (30.9 percent). The RTC resolution costs as a percentage of total assets does not drop until the total assets increase to more than \$1 billion and continues to fall, reaching 13.9 percent for thrifts with more than \$5 billion in assets. (See chart I.4-5.)

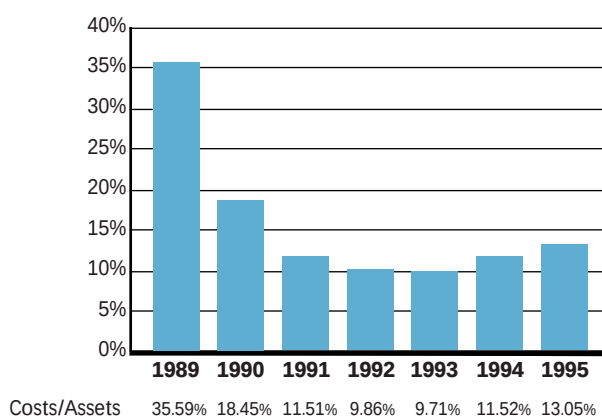
The economies of scale associated with the handling of larger thrift failures make it difficult to discern trends over time in the RTC's cost for handling the "typical" thrift failure. One way to look at possible trends without the possible dominant influence of the larger thrift failure is to look at the median of the RTC's thrift resolution costs over time. (See chart I.4-6.) However, the median RTC resolution costs are quite similar to those costs previously shown in chart I.4-4. This median cost would again seem to indicate the lower correlation between size and cost for RTC resolutions compared to the FDIC resolutions.

Another way of looking at resolution costs is by transaction type. Chart I.4-7 shows the average resolution cost as a percentage of assets by transaction type for all RTC resolutions between 1989 and 1994. As expected, the ARP and P&A transactions have the lowest average cost ratio compared to the straight deposit payoffs and insured deposit transfers. Tables I.4-4 through I.4-7 show annual trends in the RTC's failure resolution costs by transaction type. It is interesting to note that, for thrifts failing in 1989, all transaction types, including the P&As, show much higher cost ratios compared to the more recent years. The RTC resolution costs (as a percentage of assets) for thrifts failing in the other years (1990 to 1995), however, are similar to the cost ratios for bank failures occurring during those years. Interestingly, with the 1989 costs excluded, the resolution costs as percentage of assets at takeover for P&A transactions are similar to the ARP transactions.

Much of the data in this cost section is presented for informational purposes and not for drawing specific conclusions. As was the case with the FDIC cost data shown in chapter 3, it is difficult to point to any one factor to determine what had the largest effect on costs. The poor condition of the thrifts that had been left unresolved and had

Chart I.4-6

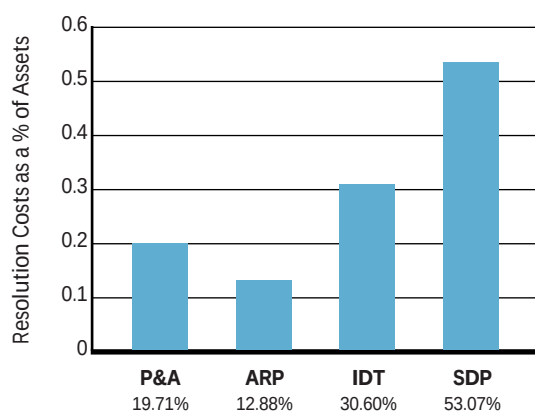
**Median RTC Resolution Costs
as a Percentage of Total Assets
1989–1995**



Sources: FDIC Division of Research and Statistics and RTC annual reports.

Chart I.4-7

**RTC's Costs for Failed Thrift Resolutions
as a Percentage of Assets by Resolution Type
1989–1994**



Average Resolution Cost = 21.76%

Sources: FDIC Division of Research and Statistics and RTC annual reports.

Table I.4-4

**RTC's Costs for Purchase and Assumption Transactions by Year of Failure
1989–1995**

(\$ in Millions)

Year	Number of P&As	Assets at Takeover	Assets at Resolution	Cost as of 12/31/95	Costs/Assets at Takeover (%)
1989	147	\$ 97,112.0	\$ 61,650.0	\$ 32,187.6	33.14
1990	141	113,800.0	71,798.9	17,503.9	15.38
1991	116	64,426.0	34,638.8	9,426.5	14.63
1992	49	35,426.0	13,035.8	2,715.8	7.67
1993	5	5,818.0	3,924.2	561.0	9.64
1994	0	0	0	0	0
1995	0	0	0	0	0
Totals/ Average	458	\$316,582.0	\$185,047.7	\$62,394.8	19.71

Sources: FDIC Division of Research and Statistics and RTC annual reports.

Table I.4-5**RTC's Costs for Straight Deposit Payoffs by Year of Failure
1989–1995**

(\$ in Millions)

Year	Number of SDPs	Assets at Takeover	Assets at Resolution	Costs as of 12/31/95	Costs/Assets at Takeover (%)
1989	51	\$ 7,553.0	\$4,880.2	\$5,003.6	66.25
1990	33	3,963.0	2,570.1	1,265.1	31.92
1991	4	232.0	170.3	46.9	20.22
1992	1	22.0	7.6	14.8	67.27
1993	3	243.0	201.7	44.6	18.35
1994	0	0	0	0	0
1995	0	0	0	0	0
Totals/ Average	92	\$12,013.0	\$7,829.9	\$6,375.0	53.07

Sources: FDIC Division of Research and Statistics and RTC annual reports.

Table I.4-6**RTC's Costs for Insured Deposit Transactions by Year of Failure
1989–1995**

(\$ in Millions)

Year	Number of IDTs	Assets at Takeover	Assets at Resolution	Costs as of 12/31/95	Costs/Assets at Takeover (%)
1989	120	\$37,084.0	\$22,613.9	\$13,885.6	37.44
1990	35	8,853.0	3,165.9	1,513.8	17.10
1991	3	6,271.0	4,430.9	574.6	9.16
1992	0	0	0	0	0
1993	0	0	0	0	0
1994	0	0	0	0	0
1995	0	0	0	0	0
Totals/ Averages	158	\$52,208.0	\$30,210.7	\$15,974.0	30.60

Sources: FDIC Division of Research and Statistics and RTC annual reports.

Table I.4-7

**RTC's Costs for Accelerated Resolution Program Transactions
by Year of Failure
1989–1995**
(*\$ in Millions*)

Year	Number of ARPs	Assets at Takeover	Assets at Resolution	Costs as of 12/31/95	Costs/Assets At Takeover (%)
1989	0	0	0	0	0
1990	4	\$3,631.5	\$3,631.5	\$554.3	15.26
1991	21	8,105.0	8,104.2	724.9	8.94
1992	9	9,436.7	9,436.7	1,449.2	15.36
1993	1	43.7	43.7	3.2	7.32
1994	2	128.9	128.9	15.4	11.95
1995	2	466.2	466.2	62.9	13.49
Totals/ Average	39	\$21,812.0	\$21,811.2	\$2,809.9	12.88

Sources: FDIC Division of Research and Statistics and RTC annual reports.

deteriorated before the involvement of the FDIC and the RTC in 1989 certainly increased the cost of those receiverships. The economic conditions, particularly the decline of real estate prices, especially for commercial real estate, profoundly affected the costs for the RTC in its disposal of the failing thrift institutions and their assets. They not only produced a wave of commercial mortgage loan foreclosures, followed by the failure of thrifts in the Southwest, New England, and California, but also added to the decline in the value of RTC sales prices and premiums received for the sale of thrift deposits. As the nation moved further into the 1990s, however, lower interest rates, improved real estate markets, and a stronger economy reduced the number of thrift failures and also reduced the resolution costs for the RTC. The stronger economy and lower interest rates resulted in higher premiums on the sale of deposit liabilities and increased the value of assets sold during that period.

Another factor influencing the ultimate resolution costs for the RTC was inadequate or delayed funding. As previously discussed in this chapter, interruption of funding occurred before passage of each of the three funding bills. The longest and most significant delay occurred for a 21-month period starting from April 1, 1992, through December 17, 1993. During that 21-month period, resolution activity was severely reduced. The delays in resolution funding tended to leave the institutions operating in conservatorship status much longer than the RTC would have preferred. Because of the large percentage of nonperforming assets, those institutions' liquidity needs were funded through deposit liabilities. If those institutions had been resolved promptly, carrying

costs would have been reduced because assets retained by the RTC were funded at RTC borrowing rates rather than at the higher insured deposit rates. In addition, allowing failed institutions to continue to operate may also have weakened competing healthy institutions; the RTC largely mitigated that potential adverse effect, however, by placing those institutions into conservatorship while awaiting final resolution.

Those losses, however, are lessened to some extent by the fact that after the RTC had access to working capital, it was able to reduce its funding costs. Furthermore, the delays in RTC funding could have been more expensive over the 21-month period were it not for the more favorable macro-economic conditions. As previously mentioned, the stronger economy reduced the number of anticipated thrift failures over that period. To the extent that some of those institutions would have been closed if funding were available, this earlier action would have increased the cost to the RTC.

Conclusion

The RTC's use of conservatorships and resolution methods was born out of a need to take quick command of a potentially disastrous situation. Upon its creation, the RTC immediately assumed responsibility for 262 thrift institutions already in conservatorship and faced the possibility of assuming responsibility for many more. Placing the failed institutions into conservatorship allowed the underfunded and understaffed RTC to manage, operate, and resolve those failed institutions while continuing to provide services to the institutions' depositors. From inception in 1989 to sunset in 1995, the RTC managed a total of 706 institutions in the conservatorship program and resolved all failed thrift institutions by the end of 1995. In every case, no insured depositor lost money and insured deposits were paid promptly.

The sheer volume of assets, combined with the funding issues and the changing economy, significantly affected the evolution of the RTC's resolution strategies. As the resolution process evolved, the RTC devised new resolution methods to adjust to its changing environment. Initially, the RTC focused on eliminating some of the institutions with the larger carrying costs by quickly paying off the depositors of its unmarketable institutions and by replacing the high-cost deposits of those remaining conservatorships that paid the most for deposits. Those initial transactions were significant because they helped to cut off some of the larger losses that were increasing daily. However, they also reduced liquidity and resulted in a majority of the assets being retained by the RTC.

As the resolution process evolved, the RTC made a conscious decision to separate the marketing of the assets from the marketing of the liabilities and to develop broader asset marketing strategies. In contrast with the FDIC's focus on selling as many assets as possible to the acquiring bank, the RTC's resolution strategies focused more on how to sell the deposit franchise. Such a shift in emphasis meant that the RTC's asset disposition strategies took on a relatively greater importance outside of the resolution process.

Regarding deposit franchises, the RTC developed new methods that enabled it to sell a large number of institutions in a short period of time. The RTC marketed widely and offered multiple bidding options. Unlike the FDIC, the RTC was able to market those institutions publicly because the identity and the problems of the institutions in conservatorship were already well known to the public. The RTC's focus on branch breakup transactions increased bidder participation, competition, and flexibility in the resolution process and ultimately led to increased premiums.

Such flexibility with assets and liabilities helped the RTC accomplish its mission one year ahead of schedule, with the RTC closing on December 31, 1995. From 1989 to 1995, the RTC resolved 747 failed thrifts (706 through conservatorship, 39 through ARP, and 2 that were neither placed into conservatorship nor resolved through ARP). Of the original \$402.6 billion in failed thrift assets, only \$7.7 billion, or 2.5 percent, were transferred to the FDIC upon the RTC's closure.

The RTC's experience, like the FDIC's, points to the importance of a strong insurance fund. As mentioned in chapter 3, to have an adequate source of liquidity, the insurance funds need to be strong. The RTC's lack of funding (and also the inadequate funding for FSLIC before that) influenced certain resolution decisions. Early attempts at whole thrift transactions and the use of put options are two examples of developments designed to put assets back into the private sector quickly, thereby preserving the RTC's liquidity. In retrospect, however, those methods may not have minimized the overall cost to the insurance fund. Also, the lack of funding kept thrifts in conservatorship longer, which increased conservatorship operating losses. The overall resolution cost estimate of the RTC's sunset of \$87.5 billion was about 22 percent of the failed thrifts' assets.

Table I.4-8**Thrift Failures by Location Ranked by Number of Thrift Failures
1989–1995**

(\$ in Thousands)

Location	Number of Failed Thrifts	Thrift Assets at Resolution	Thrift Assets at Failure	Resolution Costs	Costs / Thrift Assets at Failure (%)	Cumulative Percentage of Failures
Texas	137	\$43,328,927	\$57,575,000	\$25,908,011	45.00	18.34
California	73	45,529,855	85,696,000	11,321,265	13.21	28.11
Louisiana	52	6,274,435	9,365,000	3,926,380	41.93	35.07
Florida	49	22,939,697	35,171,000	6,627,297	18.84	41.63
Illinois	49	7,548,788	12,080,000	1,414,926	11.71	48.19
New Jersey	34	12,101,097	24,502,000	3,576,281	14.60	52.74
Kansas	23	4,976,735	16,604,000	1,905,179	11.47	55.82
Mississippi	19	1,494,275	2,609,000	687,300	26.34	58.37
Pennsylvania	19	10,654,226	18,000,000	3,128,702	17.38	60.91
Arkansas	18	2,425,428	4,568,000	2,309,681	50.56	63.32
Ohio	18	5,548,728	8,987,000	638,642	7.11	65.73
Oklahoma	18	3,454,305	5,128,000	714,758	13.94	68.14
Virginia	18	7,647,459	11,549,000	2,354,685	20.39	70.55
Colorado	17	2,660,846	4,026,000	1,925,109	47.82	72.82
Georgia	16	2,607,818	4,422,000	594,800	13.45	74.97
New York	15	10,517,031	14,778,000	3,104,777	21.01	76.97
Maryland	14	3,588,714	8,045,000	1,071,638	13.32	78.85
Missouri	14	6,293,372	7,798,000	1,499,980	19.24	80.72
Iowa	12	1,669,255	3,194,000	288,120	9.02	82.33
Alabama	11	1,779,178	3,998,000	508,891	12.73	83.80
New Mexico	11	2,431,608	4,236,000	1,964,688	46.38	85.27
Tennessee	11	1,154,458	1,813,000	335,273	18.49	86.75
Arizona	9	12,276,776	19,400,000	5,761,817	29.70	87.95
North Carolina	9	1,890,034	3,301,000	433,977	13.15	89.16
Connecticut	8	713,236	1,029,000	200,329	19.47	90.23
Nebraska	8	1,352,614	1,823,000	545,276	29.91	91.30
Massachusetts	6	5,316,082	6,457,000	1,349,711	20.90	92.10
South Carolina	6	716,092	1,436,000	155,483	10.83	92.90
Minnesota	5	2,255,491	3,706,000	961,990	25.96	93.57

Table I.4-8

Thrift Failures by Location Ranked by Number of Thrift Failures 1989–1995

(\$ in Thousands)

Continued

Location	Number of Failed Thrifts	Thrift Assets at Resolution	Thrift Assets at Failure	Resolution Costs	Costs / Thrift Assets at Failure (%)	Cumulative Percentage of Failures
Utah	5	\$2,140,015	\$2,990,000	\$565,616	18.92	94.24
Indiana	4	268,852	349,000	49,477	14.18	94.78
Michigan	4	532,336	1,295,000	88,986	6.87	95.31
West Virginia	4	142,547	248,000	20,326	8.20	95.85
Wyoming	4	224,737	309,000	43,088	13.94	96.39
Kentucky	3	458,440	484,000	49,944	10.32	96.79
North Dakota	3	589,419	1,157,000	163,165	14.10	97.19
Oregon	3	3,737,290	7,022,000	350,216	4.99	97.59
Washington	3	1,441,134	2,079,000	111,553	5.37	97.99
Wisconsin	3	300,722	453,000	91,045	20.10	98.39
Alaska	2	262,683	314,000	205,380	65.41	98.66
Maine	2	58,192	131,000	27,657	21.11	98.93
New Hampshire	2	125,384	364,000	50,073	13.76	99.20
Rhode Island	2	1,362,336	1,967,000	162,435	8.26	99.46
South Dakota	2	187,124	198,000	35,218	17.79	99.73
Nevada	1	252,373	252,000	7,323	2.91	99.87
Puerto Rico	1	1,629,356	1,667,000	317,411	19.04	100.00
Delaware	0	0	0	0	0.0	100.00
District of Columbia	0	0	0	0	0.0	100.00
Guam	0	0	0	0	0.0	100.00
Hawaii	0	0	0	0	0.0	100.00
Idaho	0	0	0	0	0.0	100.00
Montana	0	0	0	0	0.0	100.00
Vermont	0	0	0	0	0.0	100.00
Totals/Average	747	\$244,859,500	\$402,575,000	\$87,553,879	21.75	

Sources: FDIC Division of Research and Statistics, RTC annual reports, and RTC statistical abstracts.

Table I.4-9**Thrift Failures by Location Ranked by Resolution Costs
1989–1995**

(\$ in Thousands)

Location	Number of Failed Thrifts	Thrift Assets at Resolution	Thrift Assets at Failure	Resolution Costs	Costs / Thrift Assets at Failure (%)	Cumulative Percentage of Failures
Texas	137	\$43,328,927	\$57,575,000	\$25,908,011	45.00	29.59
California	73	45,529,855	85,696,000	11,321,265	13.21	42.52
Florida	49	22,939,697	35,171,000	6,627,297	18.84	50.09
Arizona	9	12,276,776	19,400,000	5,761,817	18.84	56.67
Louisiana	52	6,274,435	9,365,000	3,926,380	11.71	61.16
New Jersey	34	12,101,097	24,502,000	3,576,281	14.60	65.24
Pennsylvania	19	10,654,226	18,000,000	3,128,702	11.47	68.81
New York	15	10,517,031	14,778,000	3,104,777	26.34	72.36
Virginia	18	7,647,459	11,549,000	2,354,685	17.38	75.05
Arkansas	18	2,425,428	4,568,000	2,309,681	50.56	77.69
New Mexico	11	2,431,608	4,236,000	1,964,688	7.11	79.93
Colorado	17	2,660,846	4,026,000	1,925,109	13.94	82.13
Kansas	23	4,976,735	16,604,000	1,905,179	20.39	84.31
Missouri	14	6,293,372	7,798,000	1,499,980	47.82	86.02
Illinois	49	7,548,788	12,080,000	1,414,926	13.45	87.64
Massachusetts	6	5,316,082	6,457,000	1,349,711	21.01	89.18
Maryland	14	3,588,714	8,045,000	1,071,638	13.32	90.40
Minnesota	5	2,255,491	3,706,000	961,990	19.24	91.50
Oklahoma	18	3,454,305	5,128,000	714,758	9.02	92.32
Mississippi	19	1,494,275	2,609,000	687,300	12.73	93.10
Ohio	18	5,548,728	8,987,000	638,642	46.38	93.83
Georgia	16	2,607,818	4,422,000	594,800	18.49	94.51
Utah	5	2,140,015	2,990,000	565,616	29.70	95.16
Nebraska	8	1,352,614	1,823,000	545,276	13.15	95.78
Alabama	11	1,779,178	3,998,000	508,891	19.47	96.36
North Carolina	9	1,890,034	3,301,000	433,977	29.91	96.86
Oregon	3	3,737,290	7,022,000	350,216	20.90	97.26
Tennessee	11	1,154,458	1,813,000	335,273	10.83	97.64
Puerto Rico	1	1,629,356	1,667,000	317,411	25.96	98.00

Table I.4-9

Thrift Failures by Location Ranked by Resolution Costs 1989–1995

(\$ in Thousands)

Continued

Location	Number of Failed Thrifts	Thrift Assets at Resolution	Thrift Assets at Failure	Resolution Costs	Costs / Thrift Assets at Failure (%)	Cumulative Percentage of Failures
Iowa	12	\$1,669,255	\$3,194,000	\$288,120	18.92	98.33
Alaska	2	262,683	314,000	205,380	14.18	98.57
Connecticut	8	713,236	1,029,000	200,329	6.87	98.79
North Dakota	3	589,419	1,157,000	163,165	8.20	98.98
Rhode Island	2	1,362,336	1,967,000	162,435	13.94	99.17
South Carolina	6	716,092	1,436,000	155,483	10.32	99.34
Washington	3	1,441,134	2,079,000	111,553	14.10	99.47
Wisconsin	3	300,722	453,000	91,045	4.99	99.58
Michigan	4	532,336	1,295,000	88,986	5.37	99.68
New Hampshire	2	125,384	364,000	50,073	20.10	99.73
Kentucky	3	458,440	484,000	49,944	65.41	99.79
Indiana	4	268,852	349,000	49,477	21.11	99.85
Wyoming	4	224,737	309,000	43,088	13.76	99.90
South Dakota	2	187,124	198,000	35,218	8.26	99.94
Maine	2	58,192	131,000	27,657	17.79	99.97
West Virginia	4	142,547	248,000	20,326	2.91	99.99
Nevada	1	252,373	252,000	7,323	19.04	100.00
Delaware	0	0	0	0	0.0	100.00
District of Columbia	0	0	0	0	0.0	100.00
Guam	0	0	0	0	0.0	100.00
Hawaii	0	0	0	0	0.0	100.00
Idaho	0	0	0	0	0.0	100.00
Montana	0	0	0	0	0.0	100.00
Vermont	0	0	0	0	0.0	100.00
Totals/Average	747	\$244,859,500	\$402,575,000	\$87,553,879	21.75	

Sources: FDIC Division of Research and Statistics, RTC annual reports, and RTC statistical abstracts.

The FDIC Mutual Savings Bank Team worked hundreds of hours during 1982 handling the assisted mergers of eight failing mutual savings banks with healthy institutions. The members are (from left): William R. Watson, Roger A. Hood; Dennis A. Olson; Douglas H. Jones; Barbara I. Gersten; Robert P. Gough, Team Leader; Mary R. Warhol; Louise E. Wright; Kathy A. Johnson; William J. Via, Jr.; and William H. Roelle.



The term “open bank assistance” gained national recognition in 1984 when the FDIC provided assistance to Continental Illinois National Bank and Trust Company, Chicago, Illinois.



CHAPTER 5

Open Bank Assistance

Introduction

Open bank assistance (OBA) occurs when a distressed financial institution remains open with government financial assistance. The federal government has used various forms of OBA since the Great Depression.¹ Generally, with open bank assistance, the Federal Deposit Insurance Corporation (FDIC) required new management, ensured that the ownership interest was diluted to a nominal amount, and called for a private sector infusion of capital. The FDIC also used OBA to facilitate the acquisition of a failing bank or thrift by a healthy institution. The FDIC's overall goal in using OBA was to minimize the cost of a failing bank to the deposit insurance fund. The FDIC also provided open bank assistance for public policy reasons, such as maintaining public confidence and maintaining banking services to a community. A major criticism of open bank assistance has been that shareholders and other creditors of the failing institution benefited from the assistance provided by the government.

Chapter 3, Evolution of the FDIC's Resolution Practices, mentions several resolution strategies used by the FDIC during the 1980s to help merge weak mutual savings banks (MSBs) into healthier banks or thrifts (through income maintenance agreements) or to provide time for distressed institutions to find solutions to problems caused by external developments in the economy (through net worth certificates and capital forbearance programs). The focus of this chapter, however, is not on net worth certificate and capital forbearance programs, but on those transactions, such as assisted mergers and related income maintenance agreements, in which the FDIC provided direct financial assistance to an operating institution to prevent its failure.

1. The Reconstruction Finance Corporation (RFC), a federal government agency, began operations in 1932 by making loans to open banks, trust companies, railroad companies, and other financial institutions. It also could subscribe to the preferred stock of an institution in need of capital.

Background

To prevent an insured depository institution from closing, the FDIC provided open bank assistance in the form of loans, contributions, deposits, asset purchases, or the assumption of liabilities. In many OBA transactions, the FDIC provided a cash contribution to restore deficit capital to a positive level (referred to as “filling the hole”), with the bank’s investors providing the additional capital to capitalize the institution adequately. For larger OBA transactions, the use of an FDIC note or loan to fill the hole was a common practice. The FDIC also covered losses for a specified amount on a pool of assets over a specified period of time. Since being authorized to use open bank assistance in 1950, the FDIC has provided open bank assistance to 137 institutions with more than \$80 billion in assets. (See table I.5-1.)

The FDIC’s authority to provide open bank assistance has changed over time because of legislative and policy concerns. In general, the FDIC’s authority was broadened in the early 1980s and restricted in the early 1990s. Currently, under the Federal Deposit Insurance Corporation Improvement Act (FDICIA) of 1991, before the FDIC may provide OBA, it must determine that the assistance is the least costly option to the insurance fund of all possible methods for resolving the institution. It must also decide that the assistance is necessary to meet the FDIC’s obligation of providing insurance coverage for the insured deposits. The FDIC may deviate from the least cost requirements only to avoid “serious adverse effects on economic conditions or financial stability” or “systemic risk failure.”² The appropriate federal banking agency or the FDIC must also determine that the institution’s management has been competent and complied with all applicable laws, rules, and supervisory directives and orders, and that it has never engaged in any insider dealings, speculative practice, or other abusive activity. Finally, under the Resolution Trust Corporation Completion Act (RTCCA, or Completion Act) of 1993, which amended the Federal Deposit Insurance Act (FDI Act) of 1950, the FDIC is prohibited from using the insurance fund to benefit shareholders of a failing or failed institution. To date, there have been no OBA transactions since 1992, in part because the legislative changes made it more difficult to complete those types of transactions.

Statutory Basis and Policy Implications

Open bank assistance has been transformed by the legislative process and public policy. (See table I.5-1.) Until 1950, the FDIC had basically two alternatives for dealing with failed and failing banks: close the institution and pay off the insured depositors, or

2. Such a finding requires a two-thirds vote of the FDIC’s and the Federal Reserve’s boards of directors and concurrence by the secretary of the Treasury after consultation with the president of the United States.

arrange for the institution's acquisition. In 1950, however, the FDIC sought legislation to provide assistance to banks to prevent their failure. The FDIC sought the authority because of concern that the Federal Reserve may have been reluctant to lend to banks with temporary funding problems, particularly nonmember banks. The Federal Reserve opposed the FDIC's request for authority, considering it an infringement on its lender of last resort function. Eventually, however, Congress provided the FDIC the authority to

Table I.5-1

**Summary of
Open Bank Assistance Transactions**

Significant Legislation	Year	Number of Banks Receiving Open Bank Assistance	Total Number of Bank Failures and Assistance Transactions
Federal Deposit Insurance Act of 1950 (essentiality test)	1950-1970	0	82
	1971-1979	4	73
	1980	1	11
	1981	3	10
Garn–St Germain* (less costly than a liquidation)	1982	8	42
	1983	3	48
	1984	2	80
	1985	4	120
	1986	7	145
CEBA* (bridge bank authority)	1987	†19	203
	1988	‡79	279
FIRREA* (repeal of tax benefits)	1989	1	207
	1990	1	169
	1991	3	127
FDICIA* (least cost test)	1992	2	122
Totals	1950-1992	137	1,718

* Garn–St Germain: Garn–St Germain Depository Institutions Act of 1982; CEBA: Competitive Equality Banking Act of 1987; FIRREA: Financial Institutions Reform, Recovery, and Enforcement Act of 1989; FDICIA: Federal Deposit Insurance Corporation Improvement Act of 1991.

† Includes 11 BancTexas institutions that were part of one transaction.

‡ Includes 59 First City Bancorporation institutions that were part of one transaction.

Source: FDIC Division of Resolutions and Receiverships.

provide open bank assistance, but it imposed restrictive language related to the circumstances under which such assistance could be given.³ Basically, the FDIC could grant OBA if the institution's continued existence was determined to be "essential" to providing adequate banking services in the community.⁴ The law and legislative history of the act, however, did not provide details on how to arrive at the essentiality finding, nor did it define the community. The law merely made references to the "discretion" of the FDIC Board of Directors and the "opinion" of the board. It was clear, however, that the authority was not intended for widespread use, and the FDIC therefore rarely used open bank assistance.

It was not until 1971, when the FDIC declared Unity Bank and Trust Company (Unity), Boston, Massachusetts, to be "essential," that the FDIC first provided open bank assistance. In total, before 1980, it used OBA only four times.⁵ Although the FDIC determined that those four institutions receiving OBA were "essential," it did nothing to clarify the issue of how to define "essentiality." It did determine that Unity and one of the other institutions, both of which served inner city neighborhoods, were "essential" to at least a portion of the communities they served. The FDIC declared another bank was "essential" to provide temporary funding so a purchaser could be found. In the fourth instance the institution was declared "essential" because it was partially owned by Delaware and was the state's sole depository.

In 1980, the FDIC provided open bank assistance to First Pennsylvania Bank, N.A. (First Penn), Philadelphia, Pennsylvania.⁶ With assets of \$8 billion and deposits of \$5.3 billion, First Penn was Philadelphia's largest bank and the 23rd largest in the nation; its failure would have been the largest in U.S. history up to that time. That OBA transaction was notable because of its size and because the FDIC determined that the bank was "essential," mainly because of its size. In addition, it would have been almost impossible to arrange an acquisition because interstate mergers were not yet allowed, and only one other bank in the state was big enough to handle it; but any merger of the two would have had serious antitrust complications. Furthermore, the closing of such a large bank would have had serious repercussions, not just in the local market, but possibly nationwide as well.

3. Federal Deposit Insurance Act of 1950, *U.S. Code*, volume 12, section 1823(c)(1).

4. For a discussion of the history of the essentiality issue, see Henry Cohen, "Federal Deposit Insurance Corporation Assistance to an Insured Bank on the Grounds That the Bank is Essential in Its Community," Congressional Research Service (October 1984).

5. Before 1980, the essentiality doctrine was used for the \$11.4 million Unity Bank and Trust Company (Boston, MA, 1971); the \$1.5 billion Bank of the Commonwealth (Detroit, MI, 1972); the \$150 million American Bank and Trust Company (Orangeburg, SC, 1974); and the \$426 million Farmers Bank of the State of Delaware (Wilmington, DE, 1976).

6. The First Penn transaction is discussed in further detail later in this chapter and in Part II, Case Studies of Significant Bank Resolutions, Chapter 2, First Pennsylvania Bank, N.A.

Open bank assistance was used 14 times from 1981 to 1983 to help resolve the mutual savings bank crisis.⁷ Centered in New York City and the Northeast, those MSBs were much larger in terms of total deposits than the average commercial bank. The sheer magnitude of the problem could have resulted in enormous losses in the FDIC's insurance fund as well as in a loss in confidence in the savings bank industry. In 1981, the FDIC provided open bank assistance by arranging mergers to assist three New York City savings banks—Greenwich Savings Bank, Central Savings Bank, and Union Dime Savings Bank—with total assets of \$4.8 billion. In total, in 1981 and 1982, the FDIC used mergers to resolve 11 failing MSBs, with total assets of \$14.7 billion and total deposits of \$12.1 billion.

As a result, during that period, the FDIC pushed for additional flexibility in handling larger bank failures. In 1982, the FDIC received broader authority to provide open bank assistance with the passage of the Garn–St Germain Depository Institutions (Garn–St Germain) Act. The FDIC no longer had to satisfy the “essentiality” test to provide open bank assistance. An institution could receive OBA if the FDIC Board of Directors determined that the amount of assistance was less than the estimated cost of liquidating the institution. Only if the cost of the assistance would exceed the cost of liquidating the institution would the FDIC have to make a finding of “essentiality.” Because of the broader authority, the use of open bank assistance increased. Garn–St Germain also included provisions, despite FDIC reservations, whereby savings banks could apply for net worth certificates.⁸ Although the certificates were essentially a paper exchange of notes, they did allow many of those institutions to survive, and they significantly reduced the FDIC's use of assisted mergers. After 1982, the FDIC completed only six additional assisted mergers of MSBs.

In 1986, to provide guidance to FDIC insured banks in danger of failing, the FDIC revised its 1983 policy statement on open bank assistance concerning the general conditions and terms that a request should encompass. The policy statement was revised because the number, size, and complexity of bank failures had increased dramatically, as had requests for assistance. The revised 1986 policy statement required that—

- The FDIC's cost in providing assistance be less than if it took alternative action (which at the time was considered to be the cost of liquidation);
- The assistance proposal provide for sufficient capitalization including capital infusions from non-FDIC sources; and
- The financial effect of the assistance upon shareholders and subordinated debt holders of the bank or the bank's holding company approximate the effect on those parties had the bank failed.

7. The MSB transactions are discussed in further detail later in this chapter.

8. Net worth certificates are discussed in greater detail in Chapter 3, Evolution of the FDIC's Resolution Practices.

The statement also covered renegotiations of management contracts, avoidance of an equity position for the FDIC in a bank, the FDIC's preference not to acquire or service the assets of assisted banks, responsibility for pursuing legal claims against bonding and insurance companies, and fee arrangements.⁹

The FDIC completed the majority of OBA agreements (with 98 institutions) in 1987 and 1988.¹⁰ Those transactions represented approximately 20.3 percent of the total OBA and failure transactions during those years. The first of several reasons for the increase in OBA transactions was the FDIC's policy to communicate to bankers the deficiencies of their assistance proposals and allow them to make adjustments to conform to the policy statement. If the proposal cost less than liquidation, staff would recommend the open proposal without requesting closed bank bids. The second reason for the increase in OBA transactions was the federal income tax benefits, including the relaxed rules for tax-free reorganizations, favorable rules regarding carry forwards of net operating losses, and favorable tax treatment of assistance payments received by the failing banks from the FDIC.¹¹ In 1989, however, with passage of the Financial Institutions Reform, Recovery, and Enforcement Act (FIRREA), many potential tax benefits associated with open bank assistance were repealed.¹²

The number of OBA transactions decreased significantly after 1988. Of the 625 failed or failing banks the FDIC handled from 1989 through 1992, only 7 were resolved by OBA. The decline in open bank assistance can be attributed, in part, to the following factors:

- In 1989, the FDIC began comparing the cost of OBA proposals within a competitive bidding process. In most cases, the closed proposals were less costly to the insurance fund,¹³ or the proponents for open bank assistance failed to satisfy the criteria.
- As mentioned above, the passage of FIRREA in 1989 repealed many of the potential tax benefits associated with open bank assistance. Furthermore, the FDIC had to consider any tax benefits when evaluating bids.
- The FDIC was dissatisfied with the difficulty that occurred in negotiating and

9. FDIC News Release, "FDIC Revises Policy on Assistance to Failing Banks," PR-189-86 (December 2, 1986).

10. In 1987, 11 of the 19 assistance transactions were with BancTexas Group institutions. For 1988, 59 of the 79 assistance transactions were with First City Bancorporation of Texas, Inc., institutions.

11. Thomas D. Phelps and Sean M. Scott, "Investment Opportunities Afforded By Open Bank Assistance," *Banking Expansion Reporter* (February 6, 1989), 8-10.

12. FIRREA repealed certain provisions of the Technical and Miscellaneous Revenue Act (TAMRA) of 1988, which allowed purchasers of failing institutions to take advantage of certain tax benefits. While TAMRA was in effect, the FDIC attempted to ensure that the tax benefits effectively accrued to the insurance fund by reducing the amount of assistance provided for both open and closed transactions.

13. Closed bank transactions offer advantages over open bank transactions because, in a closed bank transaction, contingent liabilities could be eliminated, burdensome leases and contracts could be terminated, and troublesome assets could be left in the receivership. Furthermore, uninsured depositors and unsecured creditors could share in the loss.

completing the open bank assistance agreement with First City Bancorporation of Texas, Inc. (First City), Houston, Texas. Negotiations with bondholders and shareholders that began in 1987 took nine months to complete because of significant differences between the parties.¹⁴

- The Competitive Equality Banking Act (CEBA) of 1987 authorized the FDIC to establish a bridge bank, which allowed the FDIC additional time to find a permanent solution for resolving a failing bank. Furthermore, with a bridge bank, the FDIC could simply leave all bondholders' and shareholders' claims behind in a receivership, and the bondholders and shareholders would have no bargaining power. The FDIC handled the three largest bank failures in 1989 using the bridge bank structure.

The effects of the savings and loan (S&L) crisis also influenced open bank assistance. Many observers, including members of Congress, associated the term "open bank assistance" with the forbearance policies used by the Federal Home Loan Bank Board in resolving troubled S&Ls in the 1980s. Furthermore, the need for taxpayer assistance to the thrift industry created tremendous controversy and criticism.

In April 1990, the FDIC's policy was revised to reflect certain amendments to section 13(c) of the FDI Act and the addition of section 13(k)(5) as enacted in FIRREA. Section 13(k)(5) dealt with open assistance to troubled savings associations that were not in the conservatorship program of the Resolution Trust Corporation (RTC). None of the S&Ls that applied to the FDIC for open assistance were approved, however, because they failed to meet the criteria factors.

The FDIC's 1990 Statement of Policy on Assistance to Operating Insured Banks and Savings Associations retained some of the criteria from the 1986 policy statement and added several new factors.¹⁵ Some of the important new factors were as follows:

- Acceptance of proposals would be within a competitive bidding process;
- Institutions requesting assistance had to agree to unrestricted due diligence by all parties cleared by the FDIC; and
- Proposals had to quantify limits on indemnities and guarantees.

In 1992, the FDIC again revised its policy statement for open bank assistance. The revision mainly reflected changes mandated by FDICIA, which included a possibility of "early resolution" of institutions that are troubled and the requirement that

14. The First City transaction is described later in this chapter and in Part II, Case Studies of Significant Bank Resolutions, Chapter 5, First City Bancorporation of Texas, Inc.

15. FDIC, Financial Institution Letter, "Policy Statement on Assistance to Operating Insured Banks and Savings Associations," April 6, 1990, FIL 27 90.

failing institutions generally be resolved in the manner that is least costly to the deposit insurance fund. Furthermore, the policy statement indicated that the FDIC would need to make certain findings regarding ongoing management of the institution.¹⁶

With the passage of Section 11 of the RTC Completion Act, which amended Section 11(a)(4) of the FDI Act, the FDIC was prohibited from using insurance fund monies in any manner that benefited any shareholder of an institution that had failed or was in danger of failing, except in the case of a systemic risk determination. Today, given those requirements, the expectation is that open bank assistance will be used rarely, if at all.

Use of Open Bank Assistance

Of the open bank assistance transactions implemented by the FDIC from 1971 to 1992, the most notable cases are summarized below, beginning with First Penn in 1980 and ending with First City in 1988.

First Penn (1980)

On April 28, 1980, the FDIC, the Federal Reserve, and the Office of the Comptroller of the Currency jointly announced a \$500 million assistance package to ensure the viability and continued strength of First Penn, a subsidiary of First Pennsylvania Corporation of Philadelphia and the largest bank in Philadelphia.¹⁷ The assistance was in the form of \$500 million in five-year subordinated notes: the FDIC provided \$325 million, and a group of leading banks in the nation and in the Philadelphia area provided \$175 million. A \$1 billion bank line of credit through access to the Federal Reserve discount window supplemented the notes.

The assistance agreement between First Penn and the FDIC provided that the FDIC's loan would be interest free for the first year and would bear a rate for the remaining four years of 125 percent of the yield on the FDIC's investment portfolio. The assistance agreement diluted First Penn's shareholders' interest by providing the FDIC and the bank lenders with 20 million warrants for stock purchases in the bank's holding company, executable at \$3 dollars per share. On November 15, 1983, two-and-one-half years after receiving the assistance, First Penn, through a stock offering and restructuring of its debt with the bank lenders, was able to pay off the remaining loan with the FDIC early. In addition, it paid the FDIC \$13 million to repurchase 6.5

16. Section 13(c)(8) requires management of the resulting institution to be competent and to be in compliance with applicable laws.

17. For further details, see Part II, Case Studies of Significant Bank Resolutions, Chapter 2, First Pennsylvania Bank, N.A.

million of the warrants (half of the warrants that it held). On May 29, 1985, the FDIC sold its remaining 6.5 million warrants to First Penn for \$30.1 million.¹⁸ By using that open bank assistance strategy, the FDIC was able to resolve one of the largest troubled banks in the country (at that time), ultimately at no cost to the FDIC's insurance fund.

Mutual Savings Banks (1981 to 1983)

The FDIC completed 14 open bank assistance transactions between 1981 and 1983, all of which involved assisted mergers of mutual savings banks located primarily in the Northeast. The problem the FDIC faced with those savings banks was quite different from any faced earlier in its history. Asset quality was not the problem with MSBs; rather, it was the rising interest rates in the early 1980s. The FDIC's major concern was keeping the cost of resolving the failing MSBs at a reasonable level without undermining public confidence in the savings bank industry or in the FDIC.

The primary method the FDIC used was assisted mergers in which failing savings banks merged with healthier banks or thrifts. In most of the cases, to facilitate the merger, the FDIC would assume the interest rate risk by entering into an income maintenance agreement with the acquirer. The FDIC would pay the acquiring institution the difference between the yield on acquired earning assets and the average cost of funds to savings banks for some number of future years. Income maintenance agreements were used in 11 of the 14 assisted mergers during that period. In some cases, the FDIC also supplemented the assistance with an up-front cash payment, an additional dollar payment in the future, or purchased assets.

The FDIC handled the first MSB transaction through a mixture of bid and negotiation. In subsequent transactions, the FDIC defined certain bidding ground rules and then entertained bids in a variety of forms.

Because those savings banks did not fail but were merged into operating institutions, depositors and general creditors suffered no losses. In most cases, however, the failing bank's senior management was replaced and any subordinated noteholders received only a partial return of their investment.¹⁹ Generally, the FDIC negotiated with noteholders, forcing them to take a lower interest rate and/or an extended maturity. In pursuing that policy, the FDIC weighed the cost of not wiping out the noteholders (by closing the bank) against offsetting considerations, including possible lawsuits to delay the transactions, greater flexibility for the acquiring institution in continuing leases and other contractual arrangements, cooperation from state supervisors, and the possible effect on deposit outflows in other MSBs.

18. Irvine H. Sprague, *Bailout* (New York: Basic Books, 1986), 105.

19. In a few cases, senior management was not replaced and, in each case, it was determined that the current management was not considered the cause of the problem. In some cases, the management that remained had been brought on to clean up an already troubled or failing institution.

The FDIC's use of assisted mergers and income maintenance agreements was designed to provide participating MSBs time to restructure their balance sheets and remain solvent until interest rates became more favorable. Although the cost savings of the program are difficult to quantify, the program did achieve those goals.

Continental Illinois National Bank and Trust Company (1984)

The term "open bank assistance" gained national recognition in 1984 when the FDIC provided assistance to Continental Illinois National Bank and Trust Company (Continental), Chicago, Illinois. At its peak in 1981, Continental was the largest commercial and industrial lender in the United States and had purchased energy loan participations from Penn Square Bank, N.A., Oklahoma City, Oklahoma. The loans contributed significantly to the more than \$5.1 billion in nonperforming loans that Continental held, resulting in eroding confidence in the bank and, ultimately, in a rapid and massive electronic deposit run that began in 1984. On May 17, 1984, the FDIC gave its assurance to protect all depositors and other general creditors of Continental against loss. A temporary capital infusion of \$2 billion was made to stabilize liquidity concerns and to halt the run on deposits until a permanent solution could be arranged. The FDIC's options in resolving Continental were to pay off the customers with insured deposits, merge the institution with a healthier bank, or provide direct open assistance.

Because of the negative consequences for other banks and the economy, the FDIC ruled out a payoff of customers with insured deposits. It was estimated that "almost 2,300 small banks had nearly \$6 billion at risk in Continental; 66 of them had more than their capital on the line and another 113 had between 50 and 100 percent."²⁰

The FDIC also did not view merging Continental as a viable option because prospective purchasers would need a significant amount of time to evaluate the bank. In addition, a merger would require significant FDIC financial involvement to protect against the uncertainties.²¹ More significantly, perhaps, the FDIC saw little outside interest in acquiring Continental.

After ruling out the first two options, the FDIC elected to provide direct assistance to Continental. The permanent solution involved replacing senior management, purchasing \$4.5 billion in problem loans for \$3.5 billion, and injecting \$1 billion in capital. In exchange, the FDIC received 80 percent ownership in the parent company, Continental Illinois Corporation.²² As a result, the shareholders of the parent company suffered an immediate 80 percent dilution of their investments, and the shareholders

20. William M. Isaac, Chairman, Federal Deposit Insurance Corporation, "Statement on Federal Assistance to Continental Illinois Corporation and Continental National Bank Presented to Subcommittee on Financial Institutions Supervision, Regulation and Insurance of the Committee on Banking, Finance and Urban Affairs, House of Representatives," October 4, 1984, 3.

21. Isaac, 3.

22. Isaac, 4-5.

became subject to losing their remaining investment, depending on the losses suffered by the FDIC in collecting the problem loans.²³ In the end, losses on the problem loans would reduce their investment to zero. Bondholders of the parent company, however, were protected and did not lose any of their investment.

The open bank assistance agreement with Continental was controversial for several reasons. Some critics objected simply to the notion of a government agency acquiring a majority equity interest in a bank, often using the word “nationalization” to describe the assistance package. Others objected to the fact that the FDIC guaranteed all depositors and other general creditors, thus assuming their share of loss and removing the market risk. Still others objected to the bondholders of the holding company not suffering any loss and the apparent possibility that the shareholders might retain some of their investment as well. Finally, relating to all those issues and far outlasting the immediate aftermath, critics raised the issue of “too big to fail.”²⁴ That issue would create resentment by many smaller banks because of their belief that the FDIC treated larger failing banks differently from smaller ones.

Although the FDIC’s decision was controversial, the open bank assistance provided to Continental accomplished the objectives of stabilizing liquidity, preventing Continental’s failure, and restoring Continental’s capital to an adequate level. The OBA also proved to be cost-effective for the FDIC. In 1991, the FDIC sold its remaining 26 percent equity holding in Continental, thus completing the return of Continental to private ownership and producing a net gain of \$200 million on the \$1 billion of capital originally provided. Dividend income on the stock amounted to an additional \$202 million. The final resolution cost for handling Continental was about \$1.1 billion, or 3.3 percent of Continental’s assets at the time of assistance.²⁵

BancTexas Group, Inc. (1987)

Alaska Mutual Bank and United Bank of Alaska (1987 to 1988)

In 1987, the FDIC provided open bank assistance to 19 banks, 11 of which were subsidiaries of BancTexas Group, Inc. (BancTexas), a \$1.2 billion bank holding company headquartered in Dallas, Texas. The FDIC completed the OBA transaction with BancTexas on July 17, 1987. The transaction included a one-time FDIC cash contribution of \$150 million to enhance the bank’s capital, as well as an infusion of additional capital from a rights offering to shareholders and a standby pool of new private investors organized by The Hallwood Group, Inc., a New York-based merchant banking concern.

23. Isaac, 4.

24. Most of the institutions considered “too big to fail” were actually closed; however, certain troubled institutions were considered too large to be resolved by paying off only their insured depositors. A more accurate name would be “too big to pay off all depositors.”

25. For additional detail, see Part II, Case Studies of Significant Bank Resolutions, Chapter 4, Continental Illinois National Bank and Trust Company.

The one-time FDIC injection of cash resulted in a fixed cost to the insurance fund and was a relatively simple transaction. The FDIC assumed none of the bank's problem assets and obligations; instead, the new investors and managers of the new holding company agreed to carry out their own strategies for dealing with the problem assets and for maintaining the bank's capital.

It was also 1987 when the FDIC gave preliminary approval for open bank assistance to merge Alaska Mutual Bank and United Bank of Alaska, both in Anchorage, Alaska. The resulting newly formed institution had about \$1.3 billion in assets and represented the largest banking institution in Alaska. That transaction, completed in January 1988, was similar to the BancTexas transaction because it was also a fixed-cost transaction (a one-time-only FDIC cash contribution) and included new equity capital raised from a new private investor group organized again by The Hallwood Group, Inc.

In both the Texas and Alaska cases, however, the OBA proved to be insufficient to withstand the continued deterioration of the depressed regional economies. The newly formed Alaska institution remained open for about 15 months before closing in April 1989. BancTexas lasted a little more than two years before closing in January 1990. The resolution costs for those two institutions amounted to \$77.4 million and \$64.6 million, respectively.

Because of the failure of the Texas and Alaska banks, most of the later proposals for open bank assistance required the FDIC to protect an acquiring institution from losses of the failed bank's assets for a specified period.

First City Bancorporation of Texas, Inc. (1987 to 1988)

In 1987, the FDIC agreed in principle to provide open bank assistance to First City. At that time, the \$11 billion bank holding company, with 60 bank subsidiaries, was in severe financial condition. The banks were heavily dependent on energy and real estate loans, and when their condition began deteriorating with the decline of those markets, First City approached the FDIC about providing open bank assistance.

Although the FDIC's standard practice with failing banks was to protect all depositors against loss, there was little interest in protecting holding company bondholders or shareholders or the bank's management. The problem with open bank assistance was the difficulty in treating bondholders and shareholders as if the bank had failed when those creditors and investors had to approve OBA. The FDIC and other bank regulators, however, were reluctant to close the First City banks, given their regulators' view that all of Texas's major banks were facing financial difficulties because of the region's economic difficulties and, thus, were susceptible to a loss of public confidence and deposit runs.

All of these factors resulted in a nine-month effort to carry out an OBA transaction that was acceptable to bondholders and shareholders, as well as to the FDIC. Although the FDIC wanted to minimize returns to those groups, the bondholders and shareholders wanted to maximize those returns. The FDIC's leverage in the negotiations was that the banks were failing and could be closed by the primary regulators. The bondholders'

and shareholders' leverage was the knowledge that closing the bank was not the action taken with Continental.

In April 1988, the FDIC provided \$970 million in capital notes to 59 of First City's subsidiary banks.²⁶ A new private investor group, which raised \$500 million in new capital through a stock offering, assumed control of the holding company. The ownership of First City's existing shareholders was reduced to less than 2 percent of the total equity. In addition, the agreement required the transfer of approximately \$1.7 billion in non-performing and troubled assets to a separate entity created to service such assets; that transfer was funded by notes from the First City subsidiary banks. In the OBA transaction, the FDIC did not purchase any assets held by the assisted banks; it received warrants to purchase 5 percent of the common stock of First City and also purchased \$43 million of junior preferred stock convertible into 10 percent of the common stock. Finally, most holders of First City's preferred stock and publicly held, long-term debt agreed to substantial concessions as a requisite to the transaction. However, as with the BancTexas and Alaska OBAs, the assistance was insufficient. All remaining First City banks were closed in 1992 at no cost to the FDIC.

The First City case marked the beginning of the end for open bank assistance transactions. The FDIC was dissatisfied with the difficulty involved in completing a transaction. It had been asking Congress for bridge bank authority that would give it far greater leverage in such situations, and by August 1987, Congress passed legislation that gave the FDIC that authority. With a bridge bank, the FDIC could simply leave all bondholders' and debt holders' claims behind in a receivership, while transferring a failed bank's assets and other liabilities to a bridge bank controlled by the FDIC until it could be sold or liquidated. With a bridge bank, bondholders and shareholders would have no bargaining power. Incidentally, the 1992 resolution of First City involved the establishment of 20 bridge banks.

Savings and Loans

In the early 1980s, the Federal Savings and Loan Insurance Corporation (FSLIC), like the FDIC, used income maintenance agreements and net worth certificates for institutions incurring a "spread problem." In a period of rising rates, institutions were not able to increase rates earned on assets to keep pace with the rising costs of deposits and borrowed funds. In the middle and late 1980s, because of increased credit quality problems and its own lack of liquidity, the FSLIC primarily focused on assisted mergers involving the merger of an unhealthy institution with a healthier institution. To

26. Of the 60 bank subsidiaries, 59 were in Texas and 1 was in South Dakota. One Texas subsidiary, McAllen State Bank, McAllen, Texas, was closed by the Texas Banking Commission on April 19, 1988. One day later, the FDIC Board of Directors approved the open bank assistance transaction. For further detail, see Part II, Case Studies of Significant Bank Resolutions, Chapter 5, First City Bancorporation of Texas, Inc.

facilitate the merger, the FSLIC would enter into longer term assistance agreements with the acquirer. Because most of the failing S&Ls were mutual in form (no stockholders), there were no windfalls for stockholders. When stockholders owned a failing S&L, the FSLIC resolved the institution with an assisted, whole institution purchase and assumption (P&A) transaction. Claims of existing shareholders were left with the receiver of the failed institution. In only a few instances did the FSLIC provide OBA to an institution that was owned by stockholders.

From 1989 through 1995, the RTC was responsible for handling failing and failed savings and loans. During 1990, the RTC considered using open bank assistance transactions to resolve well-managed, but undercapitalized, S&Ls; but Congress opposed the idea, and the RTC never completed any OBA transactions.

Conclusion

Open bank assistance has been used infrequently by the FDIC. From 1980 through 1994, the FDIC provided OBA transactions in only 65 cases. Those cases involved 133 institutions, or only 8 percent of the 1,617 institutions that failed or received assistance during that period. The FDIC used OBA to resolve failing institutions in a variety of different circumstances. Open bank assistance was most effective when it was used selectively to resolve a specific type of problem. In the early 1980s, although the FDIC used OBA transactions to assist the weakened MSBs, OBA use reached its pinnacle in stabilizing the liquidity crisis at Continental. In the mid- to late 1980s, the FDIC used OBA more frequently to keep open several larger banking institutions that were suffering from regional economic problems. Open bank assistance in those cases, however, was less successful, and several of those assisted institutions later failed.

After the Continental transaction, many people perceived that open bank assistance was used only for larger banks. Although the FDIC has provided open bank assistance to failing banks of all sizes, it has played a more prominent role in resolving larger failing banks. Of the 65 cases in which OBA was used, 30 transactions, or 46 percent of the 65 cases, were for banks with total assets of less than \$50 million. However, the average asset size of banks handled through OBA was \$620 million, compared to an average asset size of only \$148 million for closed bank transactions. Furthermore, although OBA was used for only 8 percent of the 1,617 institutions that failed or received assistance from 1980 to 1994, it was used for more than 24 percent of the \$302.6 billion in failing or failed bank assets during that period.

In addition, OBA became synonymous with the phrase “too big to fail,” thereby heightening the controversy over whether large banks and small banks were resolved equitably. However, “too big to fail” was an inaccurate phrase. In reality, large banks did fail, shareholders lost their investments, and management was removed during that period. In practice, most large bank failures were handled by P&A transactions, in which uninsured depositors and creditors received 100 percent of their funds. P&A and

OBA transactions therefore treated uninsured depositors and creditors in a similar fashion. However, shareholders in an OBA did have a better chance of receiving some funds.

If some banks were truly too big to fail (or, more accurately, were too big for depositors to suffer any losses), the obvious corollary was that most banks were not too big to fail and that uninsured depositors could suffer losses. While recognizing the inequities of that practice, the FDIC also wanted to minimize local economic disruptions. Therefore, from the 1980s through the early 1990s, the FDIC often selected a resolution method that protected all depositors, even in smaller banks.

Another concern about OBA and the too big to fail issue was that OBA might lessen market discipline. However, in almost all OBA transactions completed by the FDIC from the 1980s through the early 1990s, the institutions were either mutual in form and had no shareholders, or the existing stockholders of the assisted institution suffered substantial losses of their investment. As part of the typical OBA transaction, the ownership position of existing shareholders was diluted to a minimal amount, typically about 5 percent. In some OBA transactions, shareholders did retain a higher percentage initially; however, the percentage was subject to decreases based on the ongoing financial condition of the bank. For example, at Continental, shareholders whose 100 percent ownership was initially diluted to 20 percent later received almost nothing because of additional losses suffered by the FDIC. For uninsured depositors and creditors, the FDIC generally believed that payoffs to ensure depositor discipline usually affected only unsophisticated depositors, whereas sophisticated depositors usually got out of failing institutions long before they failed.

The primary benefits of OBA transactions are listed below.

- OBAs were a cost-effective method for resolving failing institutions. The cost of OBA transactions (approximately 6.2 percent of the bank's assets at resolution) from the 1980s through the early 1990s was lower than that of other methods. However, because each failing bank situation was unique and because all but two of the OBA transactions were completed before the "least cost" requirement, one cannot conclude that OBA transactions were always the *most cost-effective* transactions.
- OBAs minimized disruption to the local community.
- New investors assumed some of the risk and typically brought new capital to the institution.
- Usually, OBA transactions kept a majority of the assets in the private sector.

The primary disadvantages of OBA transactions are as follows:

- Contingent liabilities remained with the troubled institution.
- Customers with uninsured deposits and general creditors were protected by

OBAs, thus potentially reducing marketplace discipline. Furthermore, although shareholders suffered substantial losses on their investments, they did receive some benefit compared to what they would have received in a closed bank transaction.

- The time necessary for a troubled institution to put together assistance proposals and to complete negotiations was sometimes outside the FDIC's parameters for resolving failing institutions.
- Weak institutions were allowed to remain open and compete with nonassisted institutions.

In 1989, the FDIC began moving away from providing open bank assistance and, from 1989 to 1992, entered into only seven OBA transactions. To date, there have been no OBA transactions since 1992. OBA transactions ceased because of problems experienced with some of the latter transactions, including problems in negotiating the transactions (for example, in the case of First City), and because of a series of legislative changes, which either restricted the use of OBAs (for example, the least cost provision) or broadened the alternatives available to the FDIC to resolve large bank failures (for example, bridge bank authority).

Table I.5-2

**Open Bank Assistance Transactions
(1980–1994)**

(\$ in Millions)

Date	Institution Name	State	Number of Failed Banks	Total Assets	Total Deposits	Costs	Costs/ Assets (%)
04/28/80	First Pennsylvania Bank, N.A.	PA	1	\$7,953.0	\$5,300.0	\$0.0	0.0
11/04/81	Greenwich Savings Bank	NY	1	2,529.9	1,881.2	465.1	18.4
12/04/81	Central Savings Bank	NY	1	918.6	675.7	127.3	13.9
12/18/81	Union Dime Savings Bank	NY	1	1,437.7	1,172.2	61.5	4.3
01/15/82	The Western New York SB	NY	1	1,022.0	890.2	30.2	3.0
02/20/82	Farmers & Mechanics SB	MN	1	980.4	789.4	52.4	5.3
03/11/82	Fidelity Mutual Savings Bank	WA	1	689.1	550.5	44.5	6.5
03/11/82	United States Bank of Newark	NJ	1	674.7	578.4	77.3	11.5
03/26/82	The New York Bank for Savings	NY	1	3,403.0	2,779.7	751.4	22.1

Table I.5-2

Open Bank Assistance Transactions (1980–1994)

(\$ in Millions)

Continued

Date	Institution Name	State	Number of Failed Banks	Total Assets	Total Deposits	Costs	Costs/ Assets (%)
04/02/82	Western Saving Fund Society	PA	1	\$2,112.8	\$1,956.8	\$29.3	1.4
09/24/82	United Mutual Savings Bank	NY	1	832.9	777.9	33.1	4.0
10/15/82	Mechanics Savings Bank	NY	1	55.3	50.6	0.0	0.0
02/09/83	Dry Dock Savings Bank	NY	1	2,500.0	2,038.0	59.4	2.4
08/05/83	Oregon Mutual Savings Bank	OR	1	260.0	251.3	11.9	4.6
10/01/83	Auburn Savings Bank	NY	1	130.0	131.4	0.0	0.0
05/17/84	Continental Illinois	IL	1	33,633.0	17,450.4	1,104.0	3.3
09/28/84	Orange Savings Bank	NJ	1	514.9	494.6	7.3	1.4
05/31/85	Bank of Oregon	OR	1	106.3	93.7	18.8	17.7
08/16/85	The Commercial Bank	AL	1	89.0	76.0	0.0	0.0
10/01/85	Bowery Savings Bank	NY	1	5,278.8	4,938.4	334.5	6.3
12/31/85	Home Savings Bank	NY	1	421.8	402.3	5.7	1.4
04/16/86	The Talmage State Bank	KS	1	9.6	8.9	1.5	15.6
08/15/86	State Bank of Westphalia	KS	1	4.3	4.1	0.0	0.0
08/30/86	Mid Valley Bank	WA	1	40.2	38.2	0.2	0.5
11/24/86	Bank of Oklahoma, N.A.	OK	1	468.2	349.9	78.8	16.8
11/26/86	Bank of Commerce	TN	1	67.3	65.6	11.3	16.8
12/29/86	Bank of Kansas City	MO	1	118.8	108.2	5.2	4.4
12/31/86	Citizens Bank & Trust Co.	LA	1	10.4	10.7	0.4	3.8
02/25/87	American National Bank	OK	1	10.3	9.1	1.1	10.7
02/26/87	Central Bank & Trust Co.	LA	1	28.3	28.0	0.0	0.0
05/13/87	Syracuse Savings Bank	NY	1	1,200.0	1,100.0	0.0	0.0
06/05/87	Security Bank of Rich Hill	MO	1	12.9	12.7	0.2	1.7
07/17/87	BancTexas	TX	11	1,192.6	900.0	150.0	12.6
07/31/87	Valley Bank of Belgrade	MT	1	18.6	16.9	3.0	16.1

Table I.5-2

Open Bank Assistance Transactions (1980–1994)

(\$ in Millions)

Continued

Date	Institution Name	State	Number of Failed Banks	Total Assets	Total Deposits	Costs	Costs/ Assets (%)
10/16/87	Commercial Bank, N.A.	OK	1	\$23.8	\$22.2	\$4.5	18.9
12/03/87	Crossroads Bank	TX	1	26.0	26.1	1.3	5.0
12/29/87	The Falun State Bank	KS	1	3.1	3.0	0.1	1.6
01/07/88	The Peoples State B&T Co.	KS	1	40.6	40.0	5.5	13.6
01/13/88	The Jefferson Guaranty Bank	LA	1	287.4	270.0	57.5	20.0
01/27/88	Citizens State Bank	MN	1	30.1	29.3	0.8	2.6
01/28/88	Alaska Mutual Bank	AK	1	822.6	676.7	170.7	20.8
01/28/88	United Bank Alaska	AK	1	462.5	419.1	170.7	36.9
02/12/88	American National Bank	OH	1	27.2	24.7	0	0.0
03/15/88	Morehead National Bank	KY	1	8.2	7.8	1.0	11.9
04/15/88	Burns State Bank	KS	1	4.1	3.6	0.6	14.6
04/20/88	First City Texas	TX	59	11,200.0	9,400.0	1,100.8	9.8
04/20/88	Bank of Santa Fe	NM	1	101.2	93.7	22.3	22.0
04/25/88	Bond County State Bank	IL	1	6.6	6.4	0.6	9.1
04/28/88	Citizens Bank of Tulsa	OK	1	8.8	8.7	1.9	21.6
05/18/88	The American State Bank	SD	1	67.3	63.5	2.6	3.9
06/14/88	Bank of Imboden	AR	1	17.8	17.2	2.2	12.4
07/14/88	Texas Bancorp Shares, Inc.	TX	1	76.5	74.2	12.1	15.8
07/15/88	Oak Forest National Bank	TX	1	8.8	8.6	1.4	15.9
08/09/88	Security State Bank	IA	1	16.8	16.3	0.2	1.2
09/16/88	Guaranty National Bank	TX	1	22.0	23.0	4.2	19.0
11/16/88	Alliance Bank, N.A.	OK	1	9.6	12.0	4.1	42.7
12/21/88	Baton Rouge B&T Co.	LA	1	114.9	115.3	18.0	15.7
12/30/88	Tracy Collins B&T Co.	UT	1	206.0	191.0	17.4	8.5
01/31/89	Metropolitan National Bank	TX	1	5.7	6.4	2.3	40.7

Table I.5-2

Open Bank Assistance Transactions (1980–1994)

(\$ in Millions)

Continued

Date	Institution Name	State	Number of Failed Banks	Total Assets	Total Deposits	Costs	Costs/ Assets (%)
09/12/90	The Pawnee National Bank	OK	1	\$15.9	\$15.6	\$2.4	15.1
09/16/91	First Bank and Trust	IL	1	29.7	28.8	0.6	2.1
10/02/91	The Gunnison B&T Co.	CO	1	22.3	21.4	1.5	6.6
12/04/91	The Douglass Bank	KS	1	31.9	30.2	1.0	3.1
10/16/92	Freedom Bank	TX	1	21.7	20.9	0.4	1.7
12/10/92	Citizens State Bank	TX	1	13.2	12.6	0.2	1.5
Totals/Average		65	133	\$82,457.0	\$57,619.3	\$5,074.3	6.2

Source: FDIC Division of Research and Statistics.

When banks face a poor regional economy and a sudden or severe liquidity crisis, the bridge bank structure allows time to evaluate the bank's condition and address outstanding problems before the marketing and sale of the bank.



CHAPTER 6

Bridge Banks

Introduction

On August 10, 1987, Congress signed into law the Competitive Equality Banking Act (CEBA) of 1987, which authorized the Federal Deposit Insurance Corporation (FDIC) to establish bridge banks. A bridge bank is a temporary national bank chartered by the Office of the Comptroller of the Currency (OCC) and organized by the FDIC to take over and maintain banking services for the customers of a failed bank. It is designed to “bridge” the gap between the failure of a bank and the time when the FDIC can implement a satisfactory acquisition by a third party. An important part of the FDIC’s bank resolution process for large or complex failing bank situations, a bridge bank provides the time the FDIC needs to take control of a failed bank’s business, stabilize the situation, effectively market the bank’s franchise, and determine an appropriate resolution. See chart I.6-1, which shows the FDIC’s use of bridge banks.

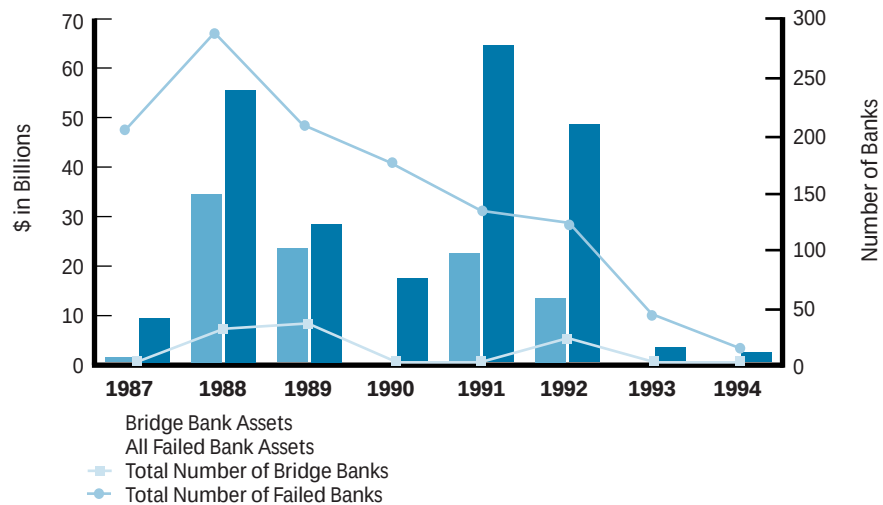
Background

Between 1987 and 1994, the FDIC used its bridge bank powers only 10 times; however, most of those instances involved multiple related bank failures. The 10 situations in which the FDIC used its bridge bank authority resulted in the creation of 32 bridge banks into which the FDIC placed 114 individual banks.¹ Those banks had total assets

1. Throughout this chapter, a distinction is made among (1) individual banks, (2) bridge banks, and (3) bridge bank situations. Number (1) refers to the number of individual failed banks that were put into bridge banks; (2) refers to the number of bridge banks that were created to handle the individual banks; and (3) groups all individual banks within a holding company into one “situation” that was handled by the FDIC with its bridge bank authority. For example, First RepublicBanks’ 41 individual banks were placed into two bridge banks. Table I.6-1 shows the results of those distinctions.

Chart I.6-1

Number and Total Assets of FDIC's Bridge Banks by Year 1987–1994



Source: FDIC Division of Research and Statistics.

of about \$90 billion. Between 1987 and 1994, bridge banks made up only a small portion (10 percent) of the total bank failures, but they represented a substantial portion (45 percent) of the total assets of failed banks. See table I.6-1 for details of the 10 bridge bank situations.

Bridge banks are designed to aid in the resolution of complicated, large failing banks. Seven of the 10 instances in which the FDIC used its bridge bank authority involved assets of more than \$1 billion. (See chart I.6-2.) The largest bridge bank situation was for First RepublicBanks (Texas), with \$33.4 billion in assets at resolution.

The location of the bridge banks reflects the economic problems of the late 1980s and early 1990s. All but 3 of the 32 bridge banks were located in the Southwest or Northeast. In the Southwest, 23 bridge banks were in Texas and 1 was in Louisiana. In the Northeast, two bridge banks were in Connecticut and one each was in Massachusetts, Maine, and Vermont. The remaining three bridge banks were in Delaware, Florida, and Missouri.

When the FDIC establishes bridge banks, it intends that the banks will be interim, rather than permanent, solutions for failing banks. Each bridge bank that the FDIC created has lasted less than seven months, with the exception of two early bridge banks, the First RepublicBanks (Texas) and the MCorp banks. In those two instances, acquirers were selected early in the bridge bank process, but because the FDIC took an equity position as part of the banks' resolutions, the bridge bank periods were extended. First

Table I.6-1

The FDIC's Use of Bridge Bank Authority 1987–1994

(\$ in Thousands)

Bridge Bank Situations	Failure Date	Bridge Banks	Number of Failed Banks	Total Assets	Total Deposits
1	10/31/87	1 - Capital Bank & Trust Co.	1	\$386,302	\$303,986
2	07/29/88	2 - First RepublicBanks (Texas)	40	32,835,279	19,528,204
	08/02/88	3 - First RepublicBank (Delaware)	1	*582,350	*164,867
3	03/28/89	4 - MCorp	20	15,748,537	10,578,138
4	07/20/89	5 - Texas American Bancshares	24	*4,733,686	*4,150,130
5	12/15/89	6 - First American Bank & Trust	1	1,669,743	1,718,569
6	01/06/91	7 - Bank of New England, N.A.	1	*14,036,401	*7,737,298
	01/06/91	8 - Connecticut Bank & Trust Co., N.A.	1	*6,976,142	*6,047,915
	01/06/91	9 - Maine National Bank	1	*998,323	*779,566
7	10/30/92	10 - First City, Texas-Alice	1	127,990	119,187
	10/30/92	11 - First City, Texas-Aransas Pass	1	54,406	47,806
	10/30/92	12 - First City, Texas-Austin, N.A.	1	346,981	318,608
	10/30/92	13 - First City, Texas-Beaumont, N.A.	1	531,489	489,891
	10/30/92	14 - First City, Texas-Bryan, N.A.	1	340,398	315,788
	10/30/92	15 - First City, Texas-Corpus Christi	1	474,108	405,792
	10/30/92	16 - First City, Texas-Dallas	1	1,324,843	1,224,135
	10/30/92	17 - First City, Texas-El Paso, N.A.	1	397,859	367,305
	10/30/92	18 - First City, Texas-Graham, N.A.	1	94,446	85,667
	10/30/92	19 - First City, Texas-Houston, N.A.	1	3,575,886	2,240,292
	10/30/92	20 - First City, Texas-Kountze	1	50,706	46,481
	10/30/92	21 - First City, Texas-Lake Jackson	1	102,875	95,416
	10/30/92	22 - First City, Texas-Lufkin, N.A.	1	156,766	146,314
	10/30/92	23 - First City, Texas-Madisonville, N.A.	1	119,821	111,783
	10/30/92	24 - First City, Texas-Midland, N.A.	1	312,987	289,021
	10/30/92	25 - First City, Texas-Orange, N.A.	1	128,799	119,544
	10/30/92	26 - First City, Texas-San Angelo, N.A.	1	138,948	127,802

Table I.6-1

The FDIC's Use of Bridge Bank Authority 1987–1994

(\$ in Thousands)

Continued

Bridge Bank Situations	Failure Date	Bridge Banks	Number of Failed Banks	Total Assets	Total Deposits
	10/30/92	27 - First City, Texas-San Antonio, N.A.	1	\$262,538	\$244,960
	10/30/92	28 - First City, Texas-Sour Lake	1	54,145	49,701
	10/30/92	29 - First City, Texas-Tyler, N.A.	1	254,063	225,916
8	11/13/92	30 - Missouri Bridge Bank, N.A.	2	2,829,368	2,715,939
9	01/29/93	31 - The First National Bank of Vermont	1	224,689	247,662
10	07/07/94	32 - Meriden Trust & Safe Deposit Co.	1	6,565	0
10	Totals	32	114	\$89,877,439	\$61,043,683

Data for Total Assets and Total Deposits are as of resolution.

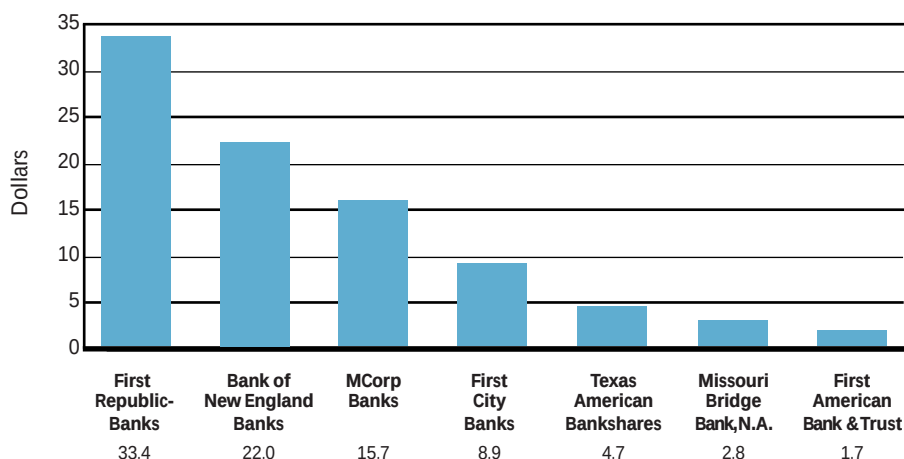
Data marked with an asterisk (*) are from the quarter before resolution.

Source: FDIC Division of Research and Statistics.

Chart I.6-2

Bridge Bank Situations in which Assets Were Greater than \$1 Billion 1987–1994

(\$ in Billions)



Source: FDIC Division of Research and Statistics.

RepublicBanks (Texas) lasted for a little more than a year, from July 29, 1988, to August 9, 1989, and MCorp operated from March 28, 1989, until October 28, 1991, for a total of 31 months. Although the bridge banks were in existence for a long period of time, they were under the control of the acquiring banks, which had contributed part of the banks' capital.

Reasons for a Bridge Bank

When a large bank with a complex structure, such as a multi-bank holding company, is in danger of failing, creating a bridge bank allows the FDIC to take control of the bank and stabilize it. It also enables the FDIC to gain sufficient flexibility for marketing the bank. After the bank is under the FDIC's control, the additional time allows for a thorough assessment of the bank's condition and a complete evaluation of alternate forms of resolution. Additional time also allows for due diligence by all interested parties. All of those functions can be performed without inhibiting the day-to-day operations of the bridge bank for its depositors.

Public disclosure of serious financial problems at a large bank can cause sudden liquidity problems that could result in the closing of the banks if they are not stabilized quickly. After a bridge bank is established, the FDIC can lend directly to the bridge bank and provide assurance to insured depositors that their money is safe. The alternative to creating a bridge bank may be to use a straight deposit payoff or, at best, an insured deposit transfer. Usually, in situations such as liquidity failures, far less advance preparation has taken place (compared to a situation in which asset quality problems have built up over time), so creating a bridge bank gives the FDIC and potential bidders an opportunity to review the bank in a more stable environment. In the case of multiple bank failures within a holding company, such as First RepublicBanks (Texas), bridge banks can facilitate the handling of multiple failures in a short time.

Bridge Bank Operations

The FDIC's bridge bank authority permits the creation of a national bank, and the FDIC has broad powers to operate, manage, and resolve that bank. Initially, the FDIC establishes bridge banks for two years maximum, with the possibility of up to three one-year extensions. A bridge bank operates in a conservative manner, while serving the banking needs of the community. It accepts deposits and makes low-risk loans to regular customers. Its management goal is to preserve the franchise value and lessen any disruption to the local community. For the early bridge banks, such as First RepublicBanks (Texas) and MCorp, the FDIC had an acquirer before the bridge bank was organized or shortly thereafter. The FDIC entered into a management agreement with the acquirer, who made almost all decisions concerning bank operations. The acquiring bank

managed the bridge bank under that contract until the acquisition was finalized. For the later bridge banks, the FDIC would select a chief executive officer (CEO) from the private sector or FDIC senior staff to conduct day-to-day operations. It would then appoint a board of directors, composed of senior FDIC personnel and the CEO, for the bridge bank. The bridge bank board, along with the CEO and management, is responsible for developing a strategic plan to meet the goals recommended and for addressing any operational issues confronting the bank. The bridge bank board is also responsible for reviewing and approving the bank's business plan and for assuming other management and oversight duties. The FDIC board retains authority to effect a final resolution of the bank and approve the sale of bank assets.

Lending

In the early bridge bank transactions, little lending took place until the acquiring bank took control. In the later transactions, in which the FDIC would be in control for a longer time, however, the bridge bank would attempt to maintain a presence in the local community to prevent a significant outflow of commercial and retail loan customers. Specifically, the bridge bank would be expected to make limited loans to the local community and to honor the previous institution's commitments that would not create additional losses, including funding the completion of unfinished projects.

Assets

The bridge bank staff completes an inventory to identify, evaluate, and work out troubled assets. It develops realistic market values for assets and assigns appropriate loss reserves. The bridge bank may sell assets if such an action is suitable. For a period of up to 90 days after the bridge bank begins operations, assets that could benefit from the powers of the receivership or assets that would be difficult to sell to a franchise acquirer can be transferred by the bridge bank management to the receivership. The assets transferred from the bridge bank to the receivership would be those with the most problems and the least potential for improvement, including nonperforming loans, owned real estate, subsidiaries, assets in litigation, and fraud-related assets.

The bridge bank management attempts to maintain the quality of the assets that remain in the bank and, to the extent possible, work out or reduce nonperforming assets. Under the latter scenario, the bank focuses on a workout program that offers a greater chance for recovery than alternatives such as foreclosure and litigation. Another cost-effective option is a compromise settlement. The CEO, in consultation with the bridge bank's board of directors, makes the final decision on the most appropriate type of asset workout.

Liabilities

Before the failing bank is closed, the FDIC must decide whether to pass all deposits or only insured deposits to the bridge bank. Before the passage of the Federal Deposit Insurance Corporation Improvement Act (FDICIA) of 1991, all the deposits were passed to a bridge bank. Since FDICIA, the FDIC has passed only insured deposits to a bridge bank when there is an expected loss to the receivership; uninsured depositors share in any loss with the FDIC. Those depositors are entitled to their proportionate share in the liquidation of the receivership. Usually, most unsecured nondeposit creditors are also left with the receivership. Secured creditors are passed to the bridge bank, along with their collateral.

Like any other bank that has assumed deposits from the FDIC, the bridge bank must notify depositors that their accounts have been transferred to the bridge bank. In turn, depositors must contact the bank within 18 months to claim their deposits. Unclaimed deposits are subject to state escheat laws and are turned over to the respective state if they are not claimed. Bridge bank management also decides whether to maintain or change the interest rates paid on deposits by the failing bank. The FDIC requires that rates remain the same for the first 14 days and that the bank provide depositors 7 days' notice of a rate change. Customers can withdraw their funds without penalty until they enter into new contracts with the bridge bank.

Liquidity

The FDIC reviews the failing bank's liquidity during the bridge bank preparation phase. It monitors liquidity levels to determine if the bridge bank can meet its own funding needs or if it needs access to the FDIC's revolving credit facility. The bridge bank also attempts to reestablish lines of credit and correspondent banking relationships that were maintained by the failing institution.

The FDIC's Experience with Bridge Banks

Passage of CEBA in 1987 authorized the FDIC to create bridge banks to resolve failing institutions. According to CEBA, the FDIC may establish a bridge bank if the board of directors determines that such an action is cost-effective; that is, that the action is in accordance with the cost test (before December 1991) or the least cost test (after December 1991).

The FDIC used its bridge bank authority for the first time on October 30, 1987, when the Louisiana banking commissioner closed Capital Bank & Trust Company, Baton Rouge, Louisiana, and placed the failed bank into a bridge bank. On May 23, 1988, Grenada Sunburst System Corporation, Grenada, Mississippi, acquired the bridge bank. The FDIC determined that using the new bridge bank authority was the most

cost-effective way to preserve existing banking services and give sufficient time to arrange a permanent transaction.²

Some of the early bridge banks—First RepublicBanks (Texas), MCorp, and Texas American Bancshares—involved many banks within a holding company.³ First RepublicBanks (Texas) combined 40 failed banks into one bridge bank; MCorp combined 20 failed banks into one bridge bank; and Texas American Bancshares combined 24 failed banks into one bridge bank.

First RepublicBanks (Texas), MCorp, and Texas American Bancshares were large multi-bank holding companies whose banks failed during 1988 and 1989. During that period, the FDIC's policy was to sell large institutions in total rather than by part or by branch, so the holding company's failed banks were combined into one bridge bank.⁴ In each case, all deposits, including uninsured deposits, were transferred to the bridge bank. At the time those banks were bridged, the test for establishing a bridge bank was whether the cost of organizing and operating the bridge bank was less than the cost for liquidating the failed bank. Acquirers were either selected before going into the bridge bank, as with First RepublicBanks (Texas) and Texas American Bancshares, or shortly thereafter, as with MCorp. The FDIC sold each bridge bank to one acquirer. In those cases, the acquiring institution operated the bridge bank under a management agreement, while negotiating the final terms of the transaction.

Bank of New England (1991) and the Use of Cross Guarantee Authority

On August 9, 1989, Congress signed into law the Financial Institutions Reform, Recovery, and Enforcement Act (FIRREA). The law focused primarily on the thrift crisis, but also included significant provisions for bank failures. The cross guarantee provision of FIRREA allowed the FDIC to recover part of its costs of liquidating or aiding a troubled insured institution by assessing those costs against the solvent insured institutions in the same holding company.

The first time the FDIC used the cross guarantee in connection with a bridge bank was with the Bank of New England (BNE), Boston, Massachusetts, failure on January 6, 1991. BNE, Connecticut Bank & Trust Company, N.A. (CBT), Hartford, Connecticut, and Maine National Bank (MNB), Portland, Maine, were all subsidiaries of the Bank of New England Corporation. BNE was considered the flagship bank and was significantly larger than the other two banks. BNE's failure was attributed to rapid growth, particularly in commercial real estate lending, which was adversely affected by deterioration of the local economy. Following an announcement of major increases in

2. FDIC, 1987 Annual Report.

3. See Part II, Case Studies of Significant Bank Resolutions, Chapter 6, First RepublicBank Corporation, and Chapter 7, MCorp.

4. First RepublicBanks Corporation also had a credit card subsidiary located in another state (Delaware), which was placed in its own bridge bank and was sold in a separate transaction.

loan loss reserves and an erosion of deposit funding, BNE experienced severe liquidity problems and subsequent failure. Because BNE experienced heavy deposit withdrawals, the FDIC used the essentiality provision of Section 13(c) of the Federal Deposit Insurance (FDI) Act to help stabilize the situation and explicitly guaranteed all deposits, including uninsured deposits, in all three banks.⁵ CBT failed at the same time as BNE because of losses on federal funds sold to BNE. Using the cross guarantee provision, MNB was assessed with the FDIC losses for BNE and CBT, causing MNB's failure.

The FDIC placed each of the three institutions into a separate bridge bank, transferring all deposits and most assets. The FDIC marketed the bridge banks individually and as a total package. On April 22, 1991, the FDIC Board of Directors awarded the three bridge banks to Fleet/Norstar Financial Group (Fleet). Fleet managed the banks on an interim basis until the sale closed on July 14, 1991.⁶

First City Bancorporation of Texas, Inc. (1992) and Least Cost Resolution

On December 19, 1991, Congress signed FDICIA into law, an act that had far-reaching effects on the FDIC. The law's provision for least cost resolutions had a major effect on bridge banks. Before FDICIA, the FDIC could select any resolution method as long as it was less costly than a payoff of insured deposits and a liquidation of the assets. FDICIA, however, requires the FDIC to choose the least cost alternative in resolving failing institutions. The least cost provision can be waived only in a systemic risk situation in which the least cost resolution of a failed institution would have a serious effect on economic conditions or financial stability.⁷ Before establishing a bridge bank, the FDIC prepares a cost analysis comparing the estimated operation and resolution costs of the bridge bank to the cost of liquidation. The FDIC can establish a bridge bank only if it is the least costly resolution method.

Following the open bank assistance (OBA) transaction between the FDIC and the First City Bancorporation of Texas, Inc. (First City), in 1988, First City continued to be affected by the poor quality of its loan portfolio and experienced additional losses on real estate.⁸ In October 1992, the two largest First City banks in Houston and Dallas were found insolvent and closed. The remaining 18 First City banks were closed after

5. A bank was deemed essential when, in the opinion of the FDIC Board of Directors, the continued operation of the bank was essential to providing adequate banking service in the community. Ultimately, the provision would come under scrutiny by Congress because large banks were being treated differently than small banks.

6. FDIC, *1991 Annual Report*.

7. The provision was the result of a reaction to the perceived FDIC policy of "too big to fail," and as a result, in all future bridge banks only insured deposits will be placed in the bridge bank, except in cases of systemic risk or cross guarantee in which there is no loss in the bank. Any case of systemic risk must be approved by the secretary of the Treasury in consultation with the president of the United States.

8. See Chapter 5, Open Bank Assistance, for a discussion of the 1988 open bank assistance transaction for First City and Part II, Case Studies of Significant Bank Resolutions, Chapter 5, First City Bancorporation of Texas, Inc.

the FDIC exercised its cross guarantee authority to assess the other subsidiaries for anticipated losses from the Houston and Dallas banks.

Each of the 20 banks was placed in an individual bridge bank. By separating the banks, an individual sale of each bank was possible. Unlike previous multi-bank bridge banks, such as First RepublicBanks (Texas), in which the bridge bank was made up of 40 individual banks and was purchased by one acquirer, the First City bridge banks could have had one acquirer or different acquirers. By selling each bank separately, the FDIC opened the door for smaller institutions to join the resolution process and generally increased interest from banks of all sizes. Previously, the FDIC had sold only one large institution, American Savings Bank, New York, New York, by breaking the branch network into parts or clusters and selling them to several acquirers.

To comply with the least cost requirement, the FDIC analyzed each of First City's banks to determine if a loss was anticipated. In the four banks in which the FDIC projected a loss—those in Houston, Dallas, San Antonio, and Austin—uninsured deposits were not passed to the bridge banks but stayed with the receiverships. The remaining 16 better-capitalized banks passed all deposits to the bridge banks. In February 1993, the FDIC sold the First City bridge banks to 13 acquirers in transactions that were projected to result in no loss to the Bank Insurance Fund (BIF). It sold 3 of the 20 bridge banks with loss share arrangements, which were five-year assistance agreements that provided protection on certain assets sold in the resolution. Loss share arrangements, which after 1991 became standard resolution tools for larger banks with more than \$500 million in assets, followed the FDIC's preference for keeping bank assets in the private sector.⁹

Initially, at the time of failure in October 1992, the uninsured depositors of the Houston, Dallas, San Antonio, and Austin banks received an advance dividend of 80 percent of their claims on the receivership. In January 1993, when it became apparent that losses at Dallas, San Antonio, and Austin were likely to be less than projected, the FDIC made an additional 10 percent advance dividend to the uninsured depositors of those three banks (thus increasing their cumulative advance dividend to 90 percent). The receivership eventually was able to pay uninsured depositors, other creditors, and bondholders 100 percent of their claims. It was even able to return some funds to the failed bank's stockholders.

Smaller Bridge Banks (1993 to 1994)

In January 1993, the FDIC placed The First National Bank of Vermont (FNB), Bradford, Vermont, in a bridge bank. Although FNB was smaller than most bridge banks, with \$225 million in assets, the FDIC placed it in a bridge bank because Vermont statutes did not include emergency provisions for an interstate acquisition of a failing

9. See Chapter 7, Loss Sharing, for more detail.

institution, thus severely limiting the number of potential bidders. Moreover, the FDIC could not use section 13 of the FDI Act, which allowed the FDIC to market institutions on an interstate basis before interstate branching was allowed, because section 13 is applicable only to banks with more than \$500 million in assets. Section 13, however, can be used in the case of a bridge bank. In addition, FNB was created by a merger of three banks in July 1992, but the operations of the banks had not been merged when FNB failed, making resolution activities such as data gathering and due diligence difficult. A bridge bank structure gave the FDIC the time necessary to prepare the institution for sale. It also gave the FDIC an opportunity to offer the bank to both in-state and out-of-state bidders. On June 4, 1993, New FNB was sold to Merchants Bank, Burlington, Vermont.

Another small institution, The Meriden Trust & Safe Deposit Company (Meriden), Meriden, Connecticut, was an FDIC insured institution based on its charter as a depository institution and on its past deposit activities, although it no longer made loans or accepted deposits from the public. Meriden, with assets of \$6.6 million, primarily operated a trust department. Meriden became critically undercapitalized and failed when it was assessed on October 16, 1992, for cross guarantee liability by the FDIC in connection with Meriden's failed affiliate, Central Bank (Central), Meriden, Connecticut. Both Meriden and Central were owned by Cenvest, Inc., Meriden, Connecticut. In court, Cenvest, Inc., challenged the FDIC's assessment of Meriden with Central's losses, partly on the basis that Meriden was not an insured depository institution. Because of the protracted litigation between the FDIC and Meriden, it was uncertain when the FDIC would be able to appoint itself receiver. On June 30, 1994, the U.S. District Court in Connecticut ruled in favor of the FDIC, and for the first time, the FDIC closed an institution and appointed itself receiver of Meriden on July 7, 1994 (in contrast to being appointed receiver by the chartering authority). The FDIC was not able to plan and schedule a resolution to occur simultaneously with the self-appointment, so the FDIC used a bridge bank to provide staff with the necessary time to market the institution to maximize the FDIC's recovery on the cross guarantee claim. On October 18, 1994, New Meriden was acquired by Peoples Savings Bank of New Britain, New Britain, Connecticut.

The FNB and Meriden cases illustrate the versatility of the FDIC's bridge bank authority. A bridge bank is not just a valuable tool for the resolution of large failing banks, but it is also useful for resolving smaller failing institutions with complex issues that are not easily solved within the 90-day prompt corrective action (PCA) period.¹⁰

10. Prompt corrective action is a provision of FDICIA that affects the timing of bank failures. Prompt corrective action requires that an institution must be closed by its primary regulator if it is "critically undercapitalized" for a prolonged period. A bank that is critically undercapitalized is defined as having tangible capital that is equal to or less than 2 percent of total assets. Under previous law, an institution typically was closed only after its capital had been exhausted.

Resolution Cost of Bridge Banks

The FDIC applies the least cost test twice in cases in which it uses bridge banks: first, before a failed bank (or failed banks) goes into the bridge bank and, second, at final resolution of the bridge bank. The FDIC compares the estimated cost of a bridge bank and its subsequent resolution to the estimated cost of the two alternatives: an immediate sale without the bridge bank structure or a payoff of deposits. The FDIC determines the estimated cost using several factors such as the cost of operating a bridge bank, the market value and relative attractiveness of the bridge bank's assets, and the premium expected from the eventual sale of the franchise. The FDIC also factors in the significant negative effect a substantial shrinkage of the deposit base could have on the amount of premium ultimately received and on the viability of the bridge bank as a cost-effective resolution mechanism for the failed bank.

The FDIC also must consider another factor: treatment of the uninsured deposits. In the earlier bridge banks, the FDIC transferred both insured and uninsured deposits to the bridge bank. In later bridge banks, the FDIC made a determination on the basis of treatment of the uninsured deposits in keeping with the least cost resolution requirement. If the FDIC's initial cost analysis, made when a bank is placed in a bridge structure, indicates a loss is going to occur in the bridge bank, the FDIC will transfer only insured deposits to the bridge bank. It leaves uninsured deposits with the receivership created when the bridge bank is established. Uninsured deposits and unsecured creditors that are left with the receivership become claimants of the receivership and share in any losses.

At the sale of each bridge bank, all deposits in the bank, including uninsured deposits accepted during the bridge period, will pass to the acquirer. The FDIC determined that the cost savings of leaving the new uninsured depositors behind in a receivership would be outweighed by the impairment of the usefulness of bridge banks as a resolution method in the future. The bridge bank, however, does not attempt to increase deposits and, in fact, attempts to limit any new uninsured deposits.

Before forming a bridge bank, the FDIC completes a timetable and strategy for resolution, which varies, depending on whether the bridge bank will be held short term or long term. Of the 32 bridge banks resolved, all but 2 were short term, lasting seven months, or less. The two long-term bridge banks, First RepublicBanks and MCorp, were resolved within seven months but, as a part of the transaction, the FDIC maintained a stock ownership position in each of the new entities. The FDIC expects that future bridge banks will continue to be short term because the ultimate purpose is to resolve failing banks as quickly, efficiently, and cost-effectively as possible. Table I.6-2 shows the FDIC's resolution costs for each situation in which the FDIC used its bridge bank authority.

It is difficult to make resolution cost comparisons among failed banks because each failing bank is unique. The problems that led one bank into failure may not be the same ones that lead another bank into failure. Also, banks vary in their asset mix and a bank

with certain assets may be more marketable than others; the assets may benefit the sale of the failing bank franchise and the sale of assets remaining in the receivership after the bank is sold. In addition, a bank's regional location may affect the ease with which the bank franchise and the assets are sold. If the bank's region is in a severe downturn, marketing the bank might be more difficult. Indeed, it was the unique characteristics that a failing bank (particularly a large failing bank) can have that led to the creation of the bridge bank as a resolution tool.

Table I.6-2

Bridge Bank Resolutions**1987–1994**

(\$ in Thousands)

Bridge Bank Situations	Total Assets (as of failure)	FDIC Resolution Cost (as of December 31, 1996)*	Costs as a Percentage of Assets	Time Elapsed Until Resolution (days)
Capital Bank & Trust Co.	\$386,302	\$55,594	14.4	206
First RepublicBanks	33,417,629	3,856,826	11.5	†273
MCorp	15,748,537	2,839,514	18.0	†308
Texas American Bancshares	4,733,686	1,076,760	22.7	147
First American Bank & Trust	1,669,743	388,573	23.3	129
Bank of New England Banks	22,010,866	889,379	4.0	189
First City Banks	8,850,054	0	0.0	121
Missouri Bridge Bank, N.A.	2,829,368	355,765	12.6	161
The First National Bank of Vermont	224,689	33,638	15.0	126
Meriden Trust & Safe Deposit Co.	6,565	0	0.0	123
Totals/Average	\$89,877,439	\$9,486,049	10.6	NA

* For bridge banks with open receiverships, the cost of resolution is the estimated total cost of resolution as of December 31, 1995.

† Acquirers for the bridge banks were chosen within seven months of their inception; the time elapsed represents the time needed to finalize the transaction. As part of the resolution, the FDIC took an equity position in the bridge banks. The First RepublicBanks' bridge bank was terminated after 376 days and the MCorp bridge bank was terminated after 944 days, when the acquirers purchased the FDIC's stock in each.

NA: Not applicable.

Source: FDIC Division of Research and Statistics.

Bridge Bank Issues

Several issues regarding the future use of a bridge bank and the effect on uninsured depositors' and shareholders' interests include future effects from passage of FDICIA, nationalization, depositor discipline, and loss to stockholders.

Future Effects from the Passage of FDICIA

Two key provisions of FDICIA could make the use of bridge banks more likely in the future.

1. The prompt corrective action provision limits regulatory discretion and requires that institutions be closed by their chartering authority within 90 days of their becoming critically undercapitalized (capital is less than or equal to 2 percent). Before FDICIA, an institution typically was not closed until it was book insolvent. In the case of publicly traded institutions, PCA directives become public information and could lead to deposit withdrawals and liquidity crises for the failing bank.
2. FDICIA also restricts the authority of a Federal Reserve Bank (Federal Reserve) to make advances to institutions that are undercapitalized or critically undercapitalized. By limiting a failing institution's ability to borrow from the Federal Reserve banks, FDICIA makes it more likely that failing banks could face liquidity shortages in the future.

Whether increased liquidity pressures could result in the potential for more bridge bank transactions will depend on the size, complexity, and other characteristics of the specific failing institution. Since passage of FDICIA in 1991, numerous banks have failed because of liquidity crises; however, most have been relatively small, and none have required the use of a bridge bank.

Nationalization

When the FDIC creates a bridge bank from a failing bank and maintains control of the bank until it is sold or resolved, the bridge bank is in effect a nationalized bank. Critics have expressed concern that the government is running a bank and competing against other nongovernment owned banks. That concern can be mitigated by the short-term nature of the bridge bank as they are meant to be sold as quickly as possible.

Depositor Discipline

Until 1992, the FDIC protected all depositors, insured and uninsured, in bridge banks. Beginning with the First City transaction, the FDIC, as required by statute, focused on

obtaining the least costly resolution. The FDIC now leaves uninsured deposits with the receivership when a bridge bank is created and a loss is associated with the failed bank. The new policy moves responsibility for uninsured deposits from the FDIC to the depositors themselves and imposes market discipline on the public.

Loss to Stockholders

Before the passage of CEBA, which first enabled the FDIC to establish bridge banks, the FDIC resolved most large failing banks through open bank assistance. OBAs allowed holding company shareholders and creditors to retain an interest in the bank, though their interest was significantly diluted from their previous position. In a bridge bank, the FDIC transfers liabilities and some assets of the failing bank to the new bridge bank, while the shareholders' and creditors' interests remain with the receivership. The 1988 First RepublicBanks (Texas) transaction was the first large failing bank resolution that eliminated holding company interests in the new bank. That treatment of the holding company interests raised concern within the financial sector that it would be more difficult for holding companies to raise capital and would force them to pay a higher rate of return to lure investors. If anything, such treatment likely has instilled greater market discipline into the system by placing more of the burden on shareholders and creditors of the holding company to scrutinize large banks and carefully consider their investments.

FDIC Alternative to Use of Bridge Banks

When the FDIC is dealing with insured financial institutions that are not banks (savings banks and thrifts), it does not have the authority to use a bridge bank; in these situations, the FDIC can create a conservatorship. The FDIC has used its conservatorship authority only once, in January 1992, with CrossLand Savings Bank, FSB (CrossLand), Brooklyn, New York.¹¹ Although the Office of Thrift Supervision (OTS) was CrossLand's primary regulator, the bank was insured by the BIF. The FDIC did not use a bridge bank for CrossLand because it had a thrift charter. When CrossLand was closed by the OTS, the FDIC was appointed receiver. The FDIC created a new federal mutual savings bank, which was chartered by the OTS and for which the FDIC was appointed conservator. The new savings association, CrossLand Federal Savings Bank (New CrossLand), acquired substantially all the assets and assumed all deposits and certain other liabilities of the original CrossLand.

In many ways the CrossLand resolution was unique. It was the first time the FDIC exercised its conservatorship authority. Also, the FDIC determined that the least cost resolution would be for the FDIC to operate New CrossLand as an ongoing bank with

11. See Part II, Case Studies of Significant Bank Resolutions, Chapter 11, CrossLand Savings Bank, FSB.

the goal of improving its franchise value, rather than liquidating it. The FDIC carried out its objective by shrinking New CrossLand to its core franchise, cleaning up its balance sheet (working out bad assets as appropriate), and reducing noninterest expenses. By the time New CrossLand was ready to be returned to the private sector almost 19 months later, it had reduced total assets by more than \$2 billion, closed or sold 45 non-core branches, sold 2 major operating subsidiaries, and reduced the number of employees by 1,200.

Using a method unlike the resolution practice it typically used, the FDIC converted New CrossLand to stock ownership and sold it through a private placement of stock and debt to a group of 40 institutional investors for \$332 million. The FDIC also received warrants providing the FDIC the right to purchase one million shares, or 7 percent, of the common stock of New CrossLand. Finally, to effect the sale, the FDIC entered into a loss sharing assistance agreement with New CrossLand providing loss coverage on the commercial and real estate assets.

As of December 31, 1995, the cost to the FDIC for resolving CrossLand was \$739.9 million, a relatively favorable 10.2 percent of CrossLand's assets at time of failure. That cost is considerably less than the estimated \$1.2 billion cost of liquidation, which was the least costly alternative available in January 1992. Previous marketing attempts by the FDIC had resulted in no acceptable offers for CrossLand that were less than the cost of liquidation. In February 1996, New CrossLand was acquired by Republic New York Corporation (Republic), New York, New York, and the FDIC was able to exchange its warrants for a price equal to the difference between the exercise price and Republic's offer price, resulting in additional cost savings of \$10 million to the FDIC.

Conclusion

The bridge bank vehicle has proved to be a valuable tool for the FDIC and has been used to resolve some of the largest and most complex failures in recent history. Bridge banks were created 32 times in 10 failing bank situations between 1987 and 1994. When banks face a poor regional economy and a sudden or severe liquidity crisis, the bridge bank structure allows time to evaluate the bank's condition and to address outstanding problems before the marketing and sale of the bank. Bridge banks have been used effectively in the past and likely will continue to be useful in the future.

Table I.6-3**Individual Failed Banks that Were Placed into Bridge Banks**

(\$ in Thousands)

Bridge Date	Failed Institution	Location	Total Assets
Oct. 87	Capital Bank & Trust Co.	Baton Rouge, LA	\$386,302
July 88	First RepublicBank-Austin, N.A.	Austin, TX	1,734,407
July 88	First RepublicBank-A&M	College Station, TX	92,090
July 88	First RepublicBank-Abilene, N.A.	Abilene, TX	214,305
July 88	First RepublicBank-Brownwood, N.A.	Brownwood, TX	124,218
July 88	First RepublicBank-Cleburne, N.A.	Cleburne, TX	114,816
July 88	First RepublicBank-Clifton	Clifton, TX	77,693
July 88	First RepublicBank-Conroe, N.A.	Conroe, TX	206,393
July 88	First RepublicBank-Corsicana, N.A.	Corsicana, TX	198,593
July 88	First RepublicBank-Dallas, N.A.	Dallas, TX	18,162,609
July 88	First RepublicBank-Denison, N.A.	Denison, TX	141,514
July 88	First RepublicBank-El Paso, N.A.	El Paso, TX	212,114
July 88	First RepublicBank-Ennis, N.A.	Ennis, TX	96,137
July 88	First RepublicBank-Forney	Forney, TX	50,994
July 88	First RepublicBank-Fort Worth, N.A.	Ft Worth, TX	1,905,148
July 88	First RepublicBank-Galveston, N.A.	Galveston, TX	261,089
July 88	First RepublicBank-Greenville, N.A.	Greenville, TX	82,781
July 88	First RepublicBank-Harlingen, N.A.	Harlingen, TX	208,383
July 88	First RepublicBank-Henderson, N.A.	Henderson, TX	120,083
July 88	First RepublicBank-Hillsboro	Hillsboro, TX	63,530
July 88	First RepublicBank-Houston, N.A.	Houston, TX	2,886,126
July 88	First RepublicBank-Jefferson Co.	Beaumont, TX	221,573
July 88	First RepublicBank-Lubbock, N.A.	Lubbock, TX	496,207
July 88	First RepublicBank-Lufkin	Lufkin, TX	218,720
July 88	First RepublicBank-Malakoff	Malakoff, TX	47,978
July 88	First RepublicBank-Midland, N.A.	Midland, TX	616,165
July 88	First RepublicBank-Mineral Wells, N.A.	Mineral Wells, TX	167,841
July 88	First RepublicBank-Mt. Pleasant, N.A.	Mt. Pleasant, TX	142,692

Table I.6-3

Individual Failed Banks that Were Placed into Bridge Banks
Continued

Bridge Date	Failed Institution	Location	Total Assets
July 88	First RepublicBank-Odessa, N.A.	Odessa, TX	167,958
July 88	First RepublicBank -Paris	Paris, TX	77,906
July 88	First RepublicBank-Plano, N.A.	Plano, TX	183,784
July 88	First RepublicBank-Richmond, N.A.	Richmond, TX	94,945
July 88	First RepublicBank-San Antonio, N.A.	San Antonio, TX	743,428
July 88	First RepublicBank-Stephenville, N.A.	Stephenville, TX	119,699
July 88	First RepublicBank-Temple, N.A.	Temple, TX	163,400
July 88	First RepublicBank-Tyler, N.A.	Tyler, TX	600,406
July 88	First RepublicBank-Victoria	Victoria, TX	173,057
July 88	First RepublicBank-Waco, N.A.	Waco, TX	703,104
July 88	First RepublicBank-Wichita Falls, N.A.	Wichita Falls, TX	287,558
July 88	First RepublicBank-Williamson	Austin, TX	41,681
July 88	National Bank of Ft. Sam Houston	San Antonio, TX	614,155
Aug. 88	First RepublicBank-Delaware	Newark, DE	582,350
Mar. 89	MBank Abilene, N.A.	Abilene, TX	189,363
Mar. 89	MBank Alamo, N.A.	San Antonio, TX	687,646
Mar. 89	MBank Austin, N.A.	Austin, TX	591,009
Mar. 89	MBank Brenham, N.A.	Brenham, TX	143,838
Mar. 89	MBank Corsicana, N.A.	Corsicana, TX	190,909
Mar. 89	MBank Dallas, N.A.	Dallas, TX	6,973,816
Mar. 89	MBank Denton County, N.A.	Lewisville, TX	230,149
Mar. 89	MBank Fort Worth, N.A.	Fort Worth, TX	766,273
Mar. 89	MBank Greenville, N.A.	Greenville, TX	166,244
Mar. 89	MBank Houston, N.A.	Houston, TX	3,098,989
Mar. 89	MBank Jefferson County, N.A.	Port Arthur, TX	325,646
Mar. 89	MBank Longview, N.A.	Longview, TX	261,253
Mar. 89	MBank Marshall, N.A.	Marshall, TX	217,748

Table I.6-3

Individual Failed Banks that Were Placed into Bridge Banks
Continued

Bridge Date	Failed Institution	Location	Total Assets
Mar. 89	MBank Midcities, N.A.	Arlington, TX	\$369,280
Mar. 89	MBank Odessa, N.A.	Odessa, TX	322,582
Mar. 89	MBank Orange, N.A.	Orange, TX	158,888
Mar. 89	MBank Round Rock, N.A.	Round Rock, TX	159,912
Mar. 89	MBank Sherman, N.A.	Sherman, TX	274,782
Mar. 89	MBank The Woodlands, N.A.	The Woodlands, TX	165,063
Mar. 89	MBank Wichita Falls, N.A.	Wichita Falls, TX	455,147
July 89	Texas American Bank-Amarillo, N.A.	Amarillo, TX	222,179
July 89	Texas American Bank-Austin, N.A.	Austin, TX	144,372
July 89	Texas American Bank-Breckenridge, N.A.	Breckenridge, TX	85,676
July 89	Texas American Bank-Dallas, N.A.	Dallas, TX	227,312
July 89	Texas American Bank-Denison, N.A.	Denison, TX	139,323
July 89	Texas American Bank-Duncanville, N.A.	Duncanville, TX	218,539
July 89	Texas American Bank-Farmers Branch, N.A.	Farmers Branch, TX	49,381
July 89	Texas American Bank-Fort Worth, N.A.	Fort Worth, TX	1,974,591
July 89	Texas American Bank-Forum, N.A.	Arlington, TX	66,618
July 89	Texas American Bank-Frederickson, N.A.	Fredericksburg, TX	145,123
July 89	Texas American Bank-Galleria, N.A.	Houston, TX	300,022
July 89	Texas American Bank-Greater Southwest	Grand Prairie, TX	40,997
July 89	Texas American Bank-LBJ, N.A.	Dallas, TX	67,192
July 89	Texas American Bank-Levelland	Levelland, TX	198,523
July 89	Texas American Bank-Longview, N.A.	Longview, TX	92,880
July 89	Texas American Bank-McKinney, N.A.	McKinney, TX	168,389
July 89	Texas American Bank-Midland, N.A.	Midland, TX	145,952
July 89	Texas American Bank-Plano, N.A.	Plano, TX	35,503
July 89	Texas American Bank-Prestonwood, N.A.	Dallas, TX	227,312
July 89	Texas American Bank-Richardson, N.A.	Richardson, TX	43,059

Table I.6-3

Individual Failed Banks that Were Placed into Bridge Banks
Continued

Bridge Date	Failed Institution	Location	Total Assets
July 89	Texas American Bank-Southwest, N.A.	Stafford, TX	\$36,015
July 89	Texas American Bank-Temple, N.A.	Temple, TX	68,011
July 89	Texas American Bank-Tyler, N.A.	Tyler, TX	148,321
July 89	Texas American Bank-Wichita Falls, N.A.	Wichita Falls, TX	66,699
Dec. 89	First American Bank and Trust	North Palm Beach, FL	1,669,743
Jan. 91	Bank of New England, N.A.	Boston, MA	14,036,401
Jan. 91	Maine National Bank	Portland, ME	998,323
Jan. 91	Connecticut Bank & Trust Co., N.A.	Hartford, CT	6,976,142
Oct. 92	First City, Texas-Alice	Alice, TX	127,990
Oct. 92	First City, Texas-Aransas Pass	Aransas Pass, TX	54,406
Oct. 92	First City, Texas-Austin, N.A.	Austin, TX	346,981
Oct. 92	First City, Texas-Beaumont, N.A.	Beaumont, TX	531,489
Oct. 92	First City, Texas-Bryan	Bryan, TX	340,398
Oct. 92	First City, Texas-Corpus Christi	Corpus Christi, TX	474,108
Oct. 92	First City, Texas-Dallas	Dallas, TX	1,324,843
Oct. 92	First City, Texas-El Paso, N.A.	El Paso, TX	397,859
Oct. 92	First City, Texas-Graham, N.A.	Graham, TX	94,446
Oct. 92	First City, Texas-Houston, N.A.	Houston, TX	3,575,886
Oct. 92	First City, Texas-Kountze	Kountze, TX	50,706
Oct. 92	First City, Texas-Lake Jackson	Lake Jackson, TX	102,875
Oct. 92	First City, Texas-Lufkin, N.A.	Lufkin, TX	156,766
Oct. 92	First City, Texas-Madisonville, N.A.	Madisonville, TX	119,821
Oct. 92	First City, Texas-Midland, N.A.	Midland, TX	312,987
Oct. 92	First City, Texas-Orange, N.A.	Orange, TX	128,799
Oct. 92	First City, Texas-San Angelo, N.A.	San Angelo, TX	138,948
Oct. 92	First City, Texas-San Antonio, N.A.	San Antonio, TX	262,538

Table I.6-3**Individual Failed Banks that Were Placed into Bridge Banks**
Continued

Bridge Date	Failed Institution	Location	Total Assets
Oct. 92	First City, Texas-Sour Lake	Sour Lake, TX	\$54,145
Oct. 92	First City, Texas-Tyler, N.A.	Tyler, TX	254,063
Nov. 92	Metro North State Bank	Kansas City, MO	685,045
Nov. 92	The Merchants Bank	Kansas City, MO	2,161,323
Jan. 93	The First National Bank of Vermont	Bradford, VT	224,689
Nov. 94	The Meriden Trust and Safe Deposit Co.	Meriden, CT	6,565

Source: FDIC Division of Research and Statistics.

The original goals of loss sharing were to (1) sell as many assets as possible to the acquiring bank and (2) have the nonperforming assets managed and collected by the acquiring bank in a manner that aligned the interests and incentives of the acquiring bank and the FDIC.



CHAPTER 7

Loss Sharing

Introduction

Loss sharing is a feature that the Federal Deposit Insurance Corporation (FDIC) first introduced into selected purchase and assumption (P&A) transactions in 1991. The original goals of loss sharing were to (1) sell as many assets as possible to the acquiring bank and (2) have the nonperforming assets managed and collected by the acquiring bank in a manner that aligned the interests and incentives of the acquiring bank and the FDIC. Under loss sharing, the FDIC agrees to absorb a significant portion of the loss—typically 80 percent—on a specified pool of assets while offering even greater loss protection in the event of financial catastrophe, and the acquiring bank is liable for the remaining portion of the loss.

Loss sharing can provide benefits to all parties involved when compared to the conventional P&A structure, particularly where nonperforming assets are involved. For example, by keeping loss share assets in the banking (as opposed to the liquidation) environment, the FDIC may benefit by better preserving the value of the assets. Failed bank asset portfolios with loss sharing are more attractive to acquirers because the FDIC is absorbing a significant portion of the loss. Another benefit of loss sharing is that the asset management and disposition incentives of the acquirer and the FDIC become more rationally aligned as both parties are sharing in the loss. This common interest reduces the need for direct FDIC asset disposition oversight and helps provide a more streamlined disposition process for the loss share assets.

The FDIC has entered into 16 loss sharing agreements that were created to resolve 24 banks that failed between 1991 and 1993. Many of the failed banks were fairly large. While fewer than 10 percent of banks that failed during that period were resolved using loss sharing, those transactions accounted for 40 percent of the total failed bank assets.

Loss sharing has evolved into a vehicle that allows the FDIC to better manage some of the unique problems associated with the marketing of large banks. In the early 1990s,

large banks were difficult to market because of their sizable commercial loan and commercial real estate portfolios. The FDIC already had a record amount of assets in liquidation, and the explosive growth of commercial assets in liquidation had become a critical concern. Acquiring institutions had been extremely reluctant to acquire the assets in FDIC transactions.

One reason for that reluctance was that the time allotted to perform due diligence was limited, while the associated costs were high. The FDIC accommodated a number of potential acquirers who wished to perform due diligence at the failing bank, and all potential acquirers were required to complete their reviews before the bid submission date. That constraint often allowed little time for any given acquirer to have more than a cursory review of a complex commercial loan and real estate portfolio. A thorough due diligence of a large failed bank could also be rather expensive for a potential acquirer, with no assurance that it would be the winning bidder.

In addition, many acquirers were reluctant to purchase large portfolios of commercial loans. In many cases, the underwriting criteria of the failed bank were poor and may have been a primary reason for the bank's failure. Many potential acquirers wished to avoid the additional costs associated with managing and working out those problem assets.

Finally, because almost every region of the United States had experienced declining markets for commercial real estate in the late 1980s and early 1990s, there was considerable uncertainty regarding collateral values and future economic conditions. Even when acquiring banks were willing to purchase the commercial real estate loan portfolios, they typically would incorporate a large discount into their bid to compensate for the risk of further market declines.

Loss sharing was designed to address those concerns by limiting the risk associated with acquiring large commercial loan and real estate portfolios and to reduce FDIC costs and insurance fund outlays by having greater volumes of those banking assets owned and managed by the banking sector.¹ The FDIC accomplished its objective of selling those types of assets to the acquirer by absorbing a significant portion of any credit losses on commercial and commercial real estate loans, typically 80 percent for a certain period of time—ranging from three to five years—during which time the FDIC as receiver reimbursed the acquiring bank for 80 percent of net charge-offs (charge-offs minus recoveries) plus reimbursable expenses. During the shared recovery period, the acquiring bank paid the receiver 80 percent of any recoveries (less any recovery expenses) on loss share assets previously experiencing a loss. The shared recovery period ran concurrently with the loss share period and lasted another one to three years beyond the expiration of the loss sharing period.

Acquiring institutions would assume the remaining 20 percent of loss. By having the acquirer absorb a limited amount of the credit loss, the FDIC hoped to pass most of

1. Several of the earlier loss share agreements covered loan categories in addition to large commercial loans and real estate portfolios.

the failed bank's commercial and commercial real estate loans to the acquirer while still receiving a substantial bid premium for the bank's deposit franchise. Also, by having the acquirer absorb a portion of the loss, the FDIC was attempting to induce rational credit management behavior. Eventually, loss sharing was structured to include a "transition amount" so that if losses exceeded the projected amount, the FDIC and the acquirer would share the losses on a 95/5 basis, respectively. The transition amount was defined as the FDIC's estimate of the loss on the loss share assets acquired by the acquirer. The transition amount was used by the FDIC to address the acquirer's concerns about catastrophic losses resulting from limited due diligence time and uncertain collateral values stemming from deteriorating markets.

The FDIC also expected to reduce resolution costs by keeping assets in the banking sector rather than placing them into a liquidation mode. The prevailing view was that certain failed bank assets would lose additional value if placed into a receivership or liquidation mode because of the break in the customer-bank relationship. (The loss in value from placing an asset in receivership was referred to as the liquidation differential.)

An additional benefit of loss sharing is that the structure softens the effect of the bank failure on the local market by keeping more of the failed bank's borrowers in a banking environment. The acquiring bank can more easily work with the borrowers to restructure problem credits or to advance additional funding where prudent. This "anticredit crunch" benefit avoids the exacerbation of declining collateral values that could be precipitated by having a significant amount of local failed bank assets falling into a liquidation mode.

Background

The FDIC entered the early 1990s with record levels of assets in liquidation and dwindling insurance reserves. The number of problem banks hovered near 1,100, and the amount of assets held by problem banks had increased from \$236 billion in 1989 to a record \$609 billion in 1991. A relatively large number of small banks failed during that period only to be replaced on the problem bank list by a nearly offsetting number of larger banks (See table I.7-1 and chart I.7-1.)

Many of the new problem banks were exceptionally large and were concentrated in deteriorating markets in the Southwest and Northeast. Additionally, the portfolio of problem loans that the FDIC was servicing had escalated to record levels, while insurance funds were at an all-time low and provided no liquidity. (See chart I.7-2.) The FDIC needed to develop a feature for resolution transactions that allowed the FDIC to keep more assets in the banking sector and to better align the interests of the FDIC and the acquiring bank. That alignment of interests would serve to rationalize the asset management incentives of the acquiring bank and also minimize the need for active FDIC asset oversight. If successful, that feature would accomplish the following:

Table I.7-1

Number and Average Size of Failed Banks and Problem Banks 1988–1991

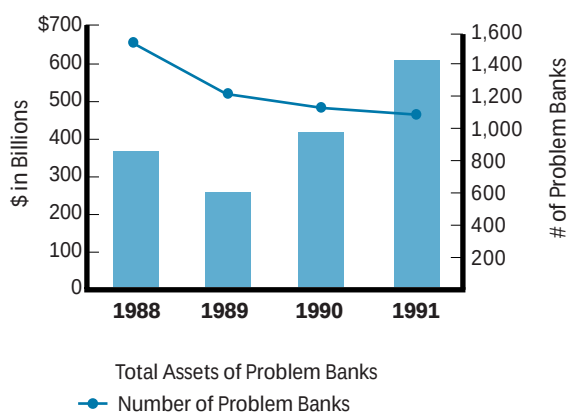
(\$ in Millions)

Year	Number of Bank Failures	Average Total Assets of Failed Banks	Number of Problem Banks	Average Total Assets of Problem Banks
1988	279	\$189	1,406	\$251
1989	207	142	1,109	213
1990	169	93	1,046	391
1991	127	492	1,090	559

Sources: FDIC Division of Research and Statistics and FDIC annual reports.

Chart I.7-1

Number and Total Assets of Problem Banks 1988–1991



Source: FDIC annual reports, 1988–1991.

- Reduce resolution costs;
- Conserve FDIC cash reserves; and
- Limit the explosive growth of assets in FDIC liquidation, thus minimizing the need for the FDIC to hire additional staff.

On September 19, 1991, the FDIC used the loss share method for the first time with the resolution of Southeast Bank, Miami, Florida, which had nearly \$10.5 billion in total assets. Southeast Bank was located in a less economically troubled region of the country (compared to the Texas or the New England markets) and had attracted the interest of several relatively strong prospective

acquirers. As such, the FDIC believed that the situation represented an opportunity to experiment with a new form of resolution—an assistance agreement with loss sharing.

The FDIC worked virtually around the clock with prospective bidders to collectively develop a transaction structure with which all parties were comfortable. In that transaction, the acquiring bank would assume all assets, including classified and nonperforming assets (excluding owned real estate and in-substance foreclosure assets).² All loans acquired were designated as shared loss assets eligible for coverage

under the loss sharing provisions of the purchase and assumption agreement.

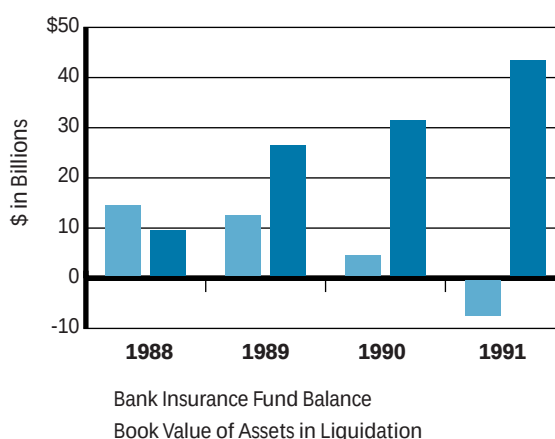
The winning bidder in that transaction was First Union National Bank of Florida. That acquiring bank was required to hold and manage the covered failed bank assets, with the FDIC agreeing to reimburse the acquirer for a major portion—in that case, 85 percent—of the loss on those assets for a set period of time. The 15 percent level of loss exposure was chosen to be high enough to have the acquirer responsibly manage the shared loss assets—to manage those assets as if its own money was on the line—but low enough to dampen the effect of any significant error in the initial loss estimate.³

That loss share agreement required the FDIC to agree to two major accommodations in its attempt to have loss sharing supplant the old large bank resolution structure (in which the FDIC alone shouldered the responsibility and risk for the failed bank assets). The first accommodation involved the FDIC's agreeing to take a note—the nonaccrual asset note—bearing a nominal rate of interest as a funding mechanism for the nonaccrual assets. The second accommodation involved the FDIC's offer to purchase perpetual preferred stock to offset the additional burden on the acquiring bank's capital that would be imposed on the acquirer as a result of its ownership of the classified assets. That stock purchase was designed with features that encouraged the acquirer to redeem the stock in the near term and enhance the marketability of the stock should it not be redeemed when expected.

In October 1991, loss sharing played a supporting role in the resolution of seven failed New Hampshire banks.⁴ In that situation, the FDIC placed the majority of the failed bank assets with an outside contractor. It passed the smaller balance, one-to-four-

Chart I.7-2

Comparison of the Bank Insurance Fund and the FDIC's Total Assets in Liquidation 1988–1991



Source: FDIC annual reports, 1988–1991.

2. Before that transaction, many large bank resolutions had used a separate asset pool structure in which classified (problem) assets were segregated into a separate asset pool to be serviced by the acquiring bank. The FDIC retained all risks of ownership of the separate asset pool, including risks associated with loss in asset values, funding costs, and expenses. Direct FDIC oversight of the management and operating expenses of the separate asset pool was necessary because the FDIC was bearing all of the ownership risk.

3. For example, the original estimate of loss on covered assets in the Southeast Bank transaction was \$869 million. As such, the acquirer's 15 percent risk exposure would amount to \$130 million. Under loss sharing, if actual losses were substantially underestimated (say, by 50 percent), the acquirer would have an additional loss exposure of only \$65 million, an amount that would be painful, but by no means fatal, to the acquirer of the failed bank.

4. See Part II, Case Studies of Significant Bank Resolutions, Chapter 10, The New Hampshire Plan.

family residential and consumer loans to the acquirers of the two failed banks using a loss share structure in which the FDIC would absorb 90 percent of the loss for a period of three years and receive 90 percent of the recovery on those assets for a period of four years.

The FDIC completed its next major loss sharing agreement in November 1991 with the resolution of Connecticut Savings Bank, New Haven, Connecticut. Much of New England was in recession at the time, including the New Haven area. Centerbank, Waterbury, Connecticut, acquired Connecticut Savings Bank under a loss sharing arrangement in which the FDIC absorbed 85 percent of the loss on commercial assets and 80 percent of the loss on consumer assets for a period of two years. The FDIC would receive 60 percent of the recovery on commercial assets and 40 percent of the recovery on consumer assets covered by that agreement for a period of three years.⁵ (See table I.7-2 for an illustration of the variety of terms for the early loss share transactions.)

In mid-1992, the FDIC conducted a series of meetings to develop a standard loss share structure. The meetings focused on the following:

- Determining which asset types were most suitable for loss share coverage;
- Developing a “stop-loss” mechanism to limit the acquirer’s exposure to unanticipated losses on the shared loss assets;⁶ and
- Developing a more “standardized” structure for future loss share transactions to increase the comfort level with the loss share structure for potential acquirers, thereby enabling them to be more efficient in performing due diligence and pricing risk. A standardization of terms would also allow the FDIC greater efficiency in marketing problem institutions and would minimize the need for additional monitoring resources.

As a result of the meetings, the following was determined:

- The commercial and industrial loans and the commercial real estate loan portfolios (performing and nonperforming) would sell with a loss sharing provision because those assets typically involved high dollar balances and a greater variability in risk.
- The one-to-four-family mortgage and consumer loan portfolios (performing and nonperforming) generally would not be sold with loss share coverage because the

5. The FDIC would share any recovery on a loss share asset under a predetermined formula. Typically, the shared recovery coverage ratio would be identical to the shared loss coverage ratio for a specified pool of assets. In several of the earlier transactions, however, the FDIC agreed to provide the acquirer with a larger share of any recoveries as an incentive to better manage and collect on assets that had been charged off. Examples of the enriched level of recovery sharing on the credit card portfolio at Southeast Bank, as well as the commercial and, most notably, consumer loan portfolios at Connecticut Savings Bank, are detailed in table I.7-2.

6. Acquirers wanted to limit their risk exposure to unforeseen and catastrophic losses on loss share assets arising from their limited due diligence time and the uncertain value of collateral located in deteriorating markets.

Table I.7-2

Summary of Loss Share Transactions 1991

(\$ in Millions)

Failed Bank	Southeast of West Florida South- east Bank	Dartmouth Numerica S.B.* New Hampshire S.B.	Amoskeag BankEast Nashua Trust Bank Meridian	Connecticut S.B.
Acquirer	First Union National Bank of Florida	New Dartmouth Shawmut	First NH Bank	Centerbank
Acquisition Date	Sept. 19, 1991	Oct. 10, 1991	Oct. 10, 1991	Nov. 14, 1991
Total Assets At Resolution	\$10,478	\$2,269	\$2,109	\$1,047
Beginning Amount of Loss Share Assets	\$7,941	\$876	\$622	\$555
Term: For Shared Losses	5 years	3 years	3 years	2 years
For Shared Recoveries	7 years	4 years	4 years	3 years
Shared Loss Coverage	All loans except credit cards 85%/15%	1-4 residential (less than \$191,250)	1-4 residential (less than \$191,250)	Commercial 85%/15%†
	Credit cards Yr. 1 - 85%/15% Yr. 2 - 80%/20% Yr. 3 - 75%/25% Yr. 4 - 70%/30% Yr. 5 - 65%/35%	Consumer (less than \$100,000)	Consumer (less than \$100,000)	Consumer 80%/20%
		All categories 90%/10% Quarterly threshold	All categories 90%/10% Quarterly threshold	
Shared Recovery Coverage	All loans except credit cards Percentage same as loss share	Percentage same as loss share	Percentage same as loss share	Commercial 60%/40%†
	Credit cards 65%/35%			Consumer 40%/60%
Transition Amount	Not applicable	Not applicable	Not applicable	Not applicable

* S.B. : Savings Bank

† By P&A agreement definition, includes any nonconsumer (multi-family and 1-4 residential) loans.

Sources: FDIC Division of Resolutions and Receiverships reports.

risks for those types of assets were considered low and were more easily ascertainable.

- A nonaccrual asset note would be offered to the acquirer to help fund the nonaccrual commercial assets. That type of note was offered in some of the earlier transactions and paid a nominal rate of interest. (The possibility of adverse tax consequences soon ended the attractiveness of that option.)
- The FDIC would share in recoveries on the same basis that it shared in losses.
- The stop loss mechanism could best be implemented via use of the “transition amount,” which represents the FDIC’s best estimate of the loss on shared loss assets. It is set so that if asset losses exceed it, the FDIC’s loss coverage is then increased to 95 percent, and the acquiring bank’s exposure is reduced to 5 percent of the loss over the transition amount. The transition amount successfully addressed acquirers’ concerns of unanticipated loss exposure because of limited due diligence time and uncertain economic factors in the future.

The General Structure of Loss Sharing

The following sections review the terms and conditions of the most recent loss sharing P&A agreements, which were the product of the FDIC’s standardization effort described above. In addition, they include more detailed information regarding the treatment of shared loss assets, the shared loss and shared recovery mechanisms, transition amounts, reimbursement procedures for shared losses and recoveries, and the administration of the shared loss agreement.

Shared Loss Assets

Shared loss assets generally consist of commercial and commercial real estate loans. Consumer loans, home equity loans, and residential mortgage loans usually are not covered in shared loss assets because those loans are of better quality. The relatively small balances of those loans, coupled with their large number of transactions, also make monitoring costs very expensive.

Shared loss assets initially are recorded at the failed bank’s book value and, thereafter, the value of a shared loss asset may be increased by additional advances, capitalized expenditures, and accrued interest (subject to certain limitations); the value may decrease by the amount of principal payments received and charge-offs recorded. Capitalized expenditures are permitted only on owned real estate, and such expenditures must be capitalized in accordance with generally accepted accounting principles. (Environmental expenditures are excluded from loss share coverage.) Advances cannot exceed certain specified percentage limitations (generally 10 percent of the book value as of the

commencement date) and are not allowed on any loan on which the acquiring bank has recorded a charge-off.

Shared loss loans may be amended, modified, renewed, or extended, and substitute letters of credit may be issued in lieu of original letters of credit. The amount of principal remaining to be advanced on a line of credit, however, may not be increased beyond the original amount of the commitment. Paydowns on revolving lines of credit may be readvanced up to the original amount of the commitment. Terms may not be extended beyond the end of the final quarter through which the receiver has agreed to reimburse losses under the agreement.

Shared loss coverage ceases upon the sale of an asset or upon the making of advances or amendments that do not comply with the restrictions described above. Shared loss coverage also ceases if the acquiring bank exercises collection preference regarding a loan held in its own portfolio that is made to or attributable to the same obligor as a shared loss loan.

Shared Loss Arrangement

During the shared loss period, usually the FDIC as receiver reimburses the acquiring bank for 80 percent of net charge-offs (charge-offs minus recoveries) of shared loss assets plus reimbursable expenses. The acquiring bank generally pays the receiver 80 percent of recoveries less recovery expenses on covered assets previously experiencing loss.⁷

Losses are defined as charge-offs or write-downs of the value of shared loss assets recorded in accordance with examination criteria. Losses on the sale of real estate are included, but losses on the sale of shared loss loans are generally excluded.⁸

Recoveries are defined as collections of (1) charge-offs of shared loss assets and reimbursable expenses, (2) charge-offs recorded by the failed bank (including charge-offs of consumer and residential loans recorded by the failed bank, whether or not such loan categories are designated as shared loss assets under the agreement), and (3) gains on the sale or disposition of real estate.

Reimbursable expenses are defined as out-of-pocket expenses paid during the shared loss period to third parties (excludes payments to affiliates) to effect recoveries and to manage, operate, and maintain owned real estate, less income received on other real estate (amount may be negative). Expenses that are not covered include (1) income taxes; (2) salaries and related benefits of employees; (3) occupancy, furniture, equipment, and data

7. The term of the shared loss period varies from two to five years. The term of the shared recovery period runs concurrently with the shared loss period with an additional one to three years. The loss sharing and recovery sharing percentages may also vary by transaction and by asset category.

8. While losses on the sale of loans are generally excluded to limit the receiver's exposure to interest rate risk, in cases where circumstances indicate that allowing the acquiring bank to sell loans may be in the receiver's best interest, coverage may be extended to include losses on the sale of loans; however, limitations regarding the dollar amount of loans that may be sold and the amount of resulting losses that may be eligible for reimbursement are established.

processing expenses; (4) fees for accounting and other independent professional consultants (other than legal fees and consultants retained for environmental assessment purposes); (5) overhead or general and administrative expenses; and (6) expenses not incurred in good faith or any extravagant expenses.

Transition Amounts

The transition amount is determined by using an estimate of the loss expected on the assets subject to coverage. Net losses in excess of the transition amount are reimbursed at 95 percent instead of 80 percent; however, the payment of the additional 15 percent reimbursement is deferred until the end of the agreement.

Certificates and Payments

Acquiring banks are required to file certificates within 30 days of the end of each calendar quarter during the shared loss period and recovery period. Dollar amounts for the following items must be reported on the certificate: (1) charge-offs, (2) recoveries, (3) net charge-offs, and (4) reimbursable expenses. If the shared loss amount is positive, the receiver will reimburse 80 percent of the amount within 15 days of receipt of the certificate. If the shared loss amount is negative, the acquiring bank must remit 80 percent of the amount with the certificate.

During the recovery period, the amount of recoveries and recovery expenses must be reported on the certificate. The recovery amount is equal to recoveries less recovery expenses. The acquiring bank must remit 80 percent of the recovery amount with the certificate.

Administration of the Shared Loss Agreement

The acquiring bank is required to manage, administer, and collect shared loss assets consistent with usual and prudent business and banking practices and in a manner consistent with internal practices, procedures, and written policies. It must use its best efforts to maximize collections and use its best business judgment in effecting charge-offs. It must maintain separate accounting records for shared loss assets. The acquiring bank is prohibited from contracting with third parties to provide services if the assuming bank normally provides the service regarding its own assets that are not subject to loss sharing.

Within 90 days after each calendar year end, the acquiring bank must furnish the FDIC a report signed by its independent public accountants containing specified statements relative to the accuracy of any computations made regarding shared loss assets. It must also perform a semi-annual internal audit of shared loss compliance and provide the FDIC copies of the internal audit reports and access to internal audit work papers.

Additionally, the FDIC may perform an audit, of such scope and duration as it may determine to be appropriate, to ascertain the bank's compliance with the assistance agreement.

The FDIC provides formal procedures to resolve any disputes that may arise in connection with the loss sharing arrangement. The parties are required to make a good faith effort to resolve a dispute within a 45-day period. Any disputes that cannot be resolved within that period are submitted for arbitration. Arbitration issues regarding charge-offs are resolved by the acquiring bank's chartering authority. Other disputes are resolved by determination of a review board. Determinations by the chartering authority or review board are conclusive and binding. See tables I.7-3 and I.7-4 for a summary of loss share transactions for 1992 and 1993.

Negative Aspects of Loss Sharing

One of the negative aspects of the loss sharing structure is that it requires the FDIC and the acquirer to take on additional administrative duties and costs in managing the loss sharing assets throughout the life of the agreement. For some acquirers, the added administrative duties and costs may be unacceptable, and they may lose interest in bidding. Generally, the FDIC has considered loss sharing only if the pool of loss sharing assets is of a significant volume, greater than \$100 million. Furthermore, many healthier, smaller banks may not have the appropriate experience in working out problem credits. As a result, they may either lose interest in bidding or, if they acquire the assets, they may not have the ability to manage them in the best interests of all involved.

Analysis and Conclusion

The FDIC used loss sharing a total of 16 times to resolve 24 banks that failed between September 1991 and January 1993. Those 24 failed banks had total assets of \$41.4 billion, of which approximately \$18.5 billion were covered by loss sharing. Loss share transactions were extremely successful in keeping failed bank assets in the banking sector and out of the liquidation mode. Table I.7-5 illustrates that success by comparing the amount of assets passed to acquirers through the 24 loss share transactions to the amount of assets passed in the 175 banks that failed during 1991 and 1992 and were resolved using conventional P&A transactions. The loss share transactions accounted for \$41.4 billion in failed bank assets and were able to pass to the acquirers \$18.5 billion (45 percent) under loss sharing and another \$17.8 billion (43 percent) without loss sharing. As a result, \$36.3 billion (88 percent) of failed bank assets were passed to acquirers and only \$5.1 billion (12 percent) of those failed bank assets were retained by FDIC for liquidation. The 175 P&A transactions during 1991 and 1992 that did not involve loss sharing accounted for \$62.1 billion in failed bank assets and were able to pass

Table I.7-3

Summary of Loss Share Transactions 1992

(\$ in Millions)

Failed Bank	Attleboro Pawtucket S.B.*	First Constitu-tion	Howard S.B.	Heritage Bank for Savings	Eastland S.B.	Eastland Bank	Meritor S.B.
Acquirer	New Bedford Institute for Savings	First Federal	First Fidelity	Fleet of MA	Fleet of RI	Fleet of RI	Mellon Bank
Acquisition Date	Aug. 21, 1992	Oct. 2, 1992	Oct. 2, 1992	Dec. 4, 1992	Dec. 11, 1992	Dec. 11, 1992	Dec. 11, 1992
Total Assets at Resolution	\$595	\$1,580	\$3,258	\$1,272	\$473	\$72	\$3,579
Beginning Amount of Loss Share Assets	\$338	\$241	\$865	\$347	\$294	\$8	\$755
Term: For Shared Losses	3 years	5 years	5 years	5 years	3 years	3 years	5 years
For Shared Recoveries	5 years	7 years	7 years	7 years	5 years	5 years	7 years
Shared Loss Coverage	1-4 residential Commercial†	Commercial	Commercial	Commercial	Commercial	Commercial	Commercial
	ORE‡	ORE	ORE	ORE	ORE	ORE	ORE
	Recoveries plus expenses	Recoveries plus expenses	Recoveries plus expenses	Recoveries plus expenses	Recoveries plus expenses	Recoveries plus expenses	Recoveries plus expenses
	All categories 80%/20%; greater than transition amount: 95%/5%	All categories 80%/20%; greater than transition amount: 95%/5%	All categories 80%/20%; greater than transition amount: 95%/5%	All categories 80%/20%; greater than transition amount: 95%/5%	All categories 80%/20%; greater than transition amount: 95%/5%	All categories 80%/20%; greater than transition amount: 95%/5%	All categories 80%/20%; greater than transition amount: 95%/5%
Shared Recovery Coverage	Percentage same as loss share	Percentage same as loss share	Percentage same as loss share	Percentage same as loss share	Percentage same as loss share	Percentage same as loss share	Percentage same as loss share
Transition Amount	\$49.3	\$49.2	\$130	\$53	\$38	\$2	\$60

* S.B.: Savings Bank

† Commercial includes multi-family loans.

‡ ORE: Owned real estate.

Sources: FDIC Division of Resolutions and Receiverships reports.

just \$24.3 billion (39 percent) of failed bank assets to the acquirer. As a result, \$37.8 billion (61 percent) of those failed bank assets were retained for liquidation by the FDIC.

Even though 122 banks, with total assets of \$44.6 billion, failed in 1992, the FDIC, by using loss sharing, was able to halt the skyrocketing growth of assets in liquidation at \$43.3 billion at year-end 1992. The FDIC was able to manage the situation by using loss sharing to keep assets out of the liquidation area, as well as by implementing improved asset disposition measures for assets that were in the liquidation phase. (See table I.7-6.)

The loss sharing transactions were less expensive than the P&A transactions without loss sharing. The 24 failed loss share banks had total assets of \$41.4 billion and were resolved by the FDIC at a cost of \$2.5 billion, or 6.1 percent of assets at the time of resolution. The 175 banks resolved by P&A without loss sharing had \$62.1 billion in failed bank assets and were resolved by the FDIC at a cost of \$6.5 billion, or 10.4 percent of assets at the time of resolution.

Loss share transactions were less expensive than conventional P&A transactions for large banks (total assets over \$500 million), as well as for small banks (total assets under \$500 million). The FDIC resolved 16 large banks with loss sharing and another 16 large banks using conventional P&A transactions. The large loss share banks had total assets of \$39.2 billion and cost the FDIC \$2.1 billion (5.38 percent of assets) to resolve. The large failed banks on which loss share was not used had total assets of \$47.1 billion and were resolved at a cost of \$4.1 billion (8.66 percent of assets). The FDIC resolved 8 smaller banks with loss sharing and 159 with conventional P&A transactions. The smaller loss share transactions had \$2.2 billion in total assets and were resolved at a cost to the FDIC of \$200 million (9.55 percent of assets). The 159 conventional P&A transactions had total assets of \$15 billion and cost the FDIC \$2.4 billion (15.82 percent of assets) to resolve. (See table I.7-7 for a summary of the cost of resolution on P&A transactions in 1991 and 1992.)

The FDIC's projected payments on the loss share assets are less than its original estimate of \$1.4 billion. As of December 1997, the FDIC expected to make loss share payments of more than \$1 billion, or just 74.3 percent of the amount originally forecast.

By December 1997, the loss sharing period for 21 of the 24 failed banks covered by loss sharing agreements had either been completed or terminated. Less than \$310 million of shared loss assets remained, representing less than 2 percent of the beginning book value for loss share assets. The estimated loss and recovery share payments on those remaining assets were included in the above cost calculations.

The loss share transaction has been successful for the FDIC in the past and, should the need arise, is likely to be used in the future.

Table I.7-4

Summary of Loss Share Transactions 1993*

(\$ in Millions)

Failed Bank:	First City-Dallas First City-Houston	First City-Austin	Missouri Bridge Bank (Merchants Bank) (Metro North State Bank)	New First National Bank of Vermont	CrossLand Fed
Acquirer	Texas Commerce	Frost National Bank	Boatmen's First Nat'l Bank of Kansas City	The Merchants Bank	CrossLand Fed
Acquisition Date	Feb. 13, 1993	Feb. 13, 1993	April 23, 1993	June 4, 1993	Aug. 13, 1993
Total Assets at Resolution	\$4,901	\$347	\$2,846	\$225	\$7,234
Beginning Amount of Loss Share Assets	\$1,694	\$58	\$953	\$160	\$2,820
Term: For Shared Losses	5 years	5 years	5 years	3 years	5 years
For Shared Recoveries	7 years	7 years	7 years	5 years	8 years
Shared Loss Coverage	Commercial† ORE‡ Recoveries plus expenses All categories 80%/20%; greater than transition amount: 95%/5%	Commercial ORE Recoveries plus expenses All categories 80%/20%; greater than transition amount: 95%/5%	Commercial ORE Recoveries plus expenses All categories 80%/20%; greater than transition amount: 95%/5%	1-4 residential Agriculture Commercial ORE Recoveries plus expenses All categories 80%/20%; greater than transition amount: 95%/5%	Commercial ORE Recoveries plus expenses All categories 80%/20%; after net charge-offs exceed \$179
Shared Recovery Coverage	Percentage same as loss share	Percentage same as loss share	Percentage same as loss share	Percentage same as loss share	Percentage same as loss share
Transition Amount	\$81.2	\$5.3	\$92	\$41	Not applicable

* All of the banks in this table (excluding New First National Bank of Vermont) were resolutions involving bridge banks that were created when each constituent bank failed in 1992. New First National Bank of Vermont was created in January 1993 following the failure of First National Bank of Vermont. CrossLand Savings was a savings association that failed in January 1992 and was operated in conservatorship as CrossLand FSB. All of the P&A transactions with loss sharing occurred in 1993.

† Commercial includes multi-family loans.

‡ ORE: Owned real estate.

Sources: FDIC Division of Resolutions and Receiverships reports.

Table I.7-5

**Analysis of P&A Transactions
With and Without Loss Sharing
1991 and 1992**

(\$ in Billions)

	P&A with Loss Sharing*		P&A without Loss Sharing	
Number of Failed Banks	24		175	
	Total Assets	Percentage	Total Assets	Percentage
Passed with Loss Sharing	\$18.5	45	\$0	0
Passed without Loss Sharing	17.8	43	24.3	39
Total Assets Passed	36.3	88	24.3	39
Assets Retained by the FDIC	5.1	12	37.8	61
Total Failed Bank Assets	\$41.4	100	\$62.1	100

* Includes the January 1993 resolution of First National Bank of Vermont with assets totaling \$225 million.

Sources: FDIC Division of Research and Statistics and FDIC annual reports.

Table I.7-6

Book Value of Assets in FDIC Liquidation at Year End

(\$ in Billions)

Year	Asset Balance
1990	\$30.9
1991	43.3
1992	43.3
1993	28.0

Sources: FDIC Division of Research and Statistics and FDIC annual reports.

Table I.7-7

**FDIC's Cost of Resolution as a Percentage of Assets
of P&A Transactions for Failing Banks
1991–1992**

Failed Banks with Total Assets over \$500 million		
	Average Cost of Resolution (%)	Median Cost of Resolution (%)
With Loss Sharing	5.38	7.77
Without Loss Sharing	8.66	12.21
Failed Banks with Total Assets under \$500 million		
	Average Cost of Resolution (%)	Median Cost of Resolution (%)
With Loss Sharing	9.55	6.06
Without Loss Sharing	15.82	17.10

Sources: FDIC Division of Research and Statistics and FDIC annual reports.

Table I.7-8

**FDIC Loss Share Transactions
1991–1994**
(\$ in Millions)

Transaction Date	Failed Bank*	Location	Total Assets	Resolution Costs	Resolution Cost as Percentage of Total Assets
09/19/91	Southeast Bank, N.A†	Miami, FL	\$10,478	\$0	0.00
10/10/91	New Dartmouth Bank	Manchester, NH	2,268	571	25.19
10/10/91	First New Hampshire	Concord, NH	2,109	319	15.14
11/14/91	Connecticut Savings Bank	New Haven, CT	1,047	207	19.77
08/21/92	Attleboro Pawtucket S.B.	Pawtucket, RI	595	32	5.41
10/02/92	First Constitution Bank	New Haven, CT	1,580	127	8.01
10/02/92	The Howard Savings Bank	Livingston, NJ	3,258	87	2.67

Table I.7-8

FDIC Loss Share Transactions**1991–1994**

(\$ in Millions)

Continued

Transaction Date	Failed Bank*	Location	Total Assets	Resolution Costs	Resolution Cost as Percentage of Total Assets
12/04/92	Heritage Bank for Savings	Holyoke, MA	\$1,272	\$21	1.70
12/11/92	Eastland Savings Bank†	Woonsocket, RI	545	17	3.30
12/11/92	Meritor Savings Bank	Philadelphia, PA	3,579	0	0.00
02/13/93	First City, Texas-Austin, N.A.	Austin, TX	347	0	0.00
02/13/93	First City, Texas-Dallas	Dallas, TX	1,325	0	0.00
02/13/93	First City, Texas-Houston, N.A.	Houston, TX	3,576	0	0.00
04/23/93	Missouri Bridge Bank, N.A.	Kansas City, MO	1,911	356	18.62
06/04/93	First National Bank of Vermont	Bradford, VT	225	34	14.97
08/12/93	CrossLand Savings, FSB	Brooklyn, NY	7,269	740	10.18
Totals/Average			\$41,384	\$2,511	6.07

* The banks listed here are the failed banks or the resulting bridge bank from a previous resolution, however, it is the acquirer that enters into the loss sharing transaction with the FDIC.

† Represents loss sharing agreements for two banks: Southeast Bank, N.A., and Southeast Bank of West Florida.

‡ Represents loss sharing agreements for two banks: Eastland Savings Bank and Eastland Bank.

Source: FDIC Division of Research and Statistics.



CHAPTER 8

The FDIC's Role as Receiver

Introduction

The Federal Deposit Insurance Corporation (FDIC) has three main responsibilities: (1) to act as an insurer, (2) to act as a supervisor, and (3) to act as a receiver.¹ The roles of insurer and receiver require that the FDIC play an active role in resolving failing and failed FDIC insured institutions. To maintain confidence in the banking system and to maintain stability of the financial system, the federal statutory framework governing the resolution of failed depository institutions was designed to promote the efficient, expeditious, and orderly liquidation of failed banks and thrift institutions. The interactions between the FDIC as insurer and the FDIC as receiver are important in ensuring that those objectives are achieved.

As a rule, the FDIC's role as receiver is independent of its corporate roles as supervisor and insurer.² The FDIC's corporate role as insurer is important in the receivership process. That role helps ensure the stability of the financial system by guaranteeing the timely funding of deposit insurance and consequent faith in the banking system in times of stress. The FDIC's role as receiver is also important. When a depository institution fails, the FDIC has statutory responsibility to the creditors of the receivership to recover for them, as quickly as it can, the maximum amount possible on their claims. Just as importantly, the FDIC's insurance fund becomes a major creditor, paying insured depositors the full amount of their claims. When acting as receiver, the FDIC, through

1. The FDIC is the primary federal banking regulator of all state nonmember banks. In that regard, the FDIC performs safety and soundness examinations, visitations, and investigations.

2. The courts have long recognized the FDIC's legal ability to operate in different capacities, with its different capacities conducting arms' length transactions with each other.

acts of Congress, uses broad statutory authority and protections that enable it to fulfill its mission.

Why the FDIC Acts as Receiver

To understand why Congress gave the FDIC receivership powers, it is necessary to go back to the FDIC's beginnings and look at the structure of the banking industry and the economic conditions at that time. The FDIC was created in 1933 to halt a banking crisis. Nine thousand banks—a third of the banking system in the United States—failed in the four years before the FDIC was established. The failure of one bank would set off a chain reaction, bringing about other failures. Sound banks frequently failed when large numbers of depositors panicked and demanded to withdraw their deposits, leading to “runs” on the bank. The behavior of depositors was not irrational. They had learned from hard experience that if they kept their money in banks, it might not be available when they needed it, and they might lose it all, or a large portion of it.

Before the creation of the FDIC, national bank liquidations were supervised by the Office of the Comptroller of the Currency (OCC), who had authority to appoint the receiver and had a permanent staff of bank liquidation specialists.³ Liquidations of state chartered banks varied considerably from state to state, but most were handled under the state code provisions for general business insolvencies. By 1933, most state banking authorities had at least some control over state bank liquidations. The increased incidence of national bank failures from 1921 through 1932, however, created a shortage of experienced receivers. Furthermore, there was some concern in Congress that receiverships, both national and state, had been doled out as political plums, with the recipients attempting to make as much commission as possible and to keep the work going as long as possible.

In general practice, between 1865 and 1933, depositors of national and state banks were treated in the same way as other creditors; they received funds from the liquidation of the bank's assets *after* those assets were liquidated. On average, it took about six years at the federal level to liquidate a failed bank's assets, pay the depositors, and close the bank's books—although in at least one case, it took 21 years. Even when depositors ultimately received their funds, the amount was significantly less than what they had put into the bank. From 1921 through 1930, more than 1,200 banks failed and were liquidated. From those liquidations, depositors at banks chartered by the states received, on average, 62 percent of their deposits. Depositors at banks chartered by the federal government received an average of 58 percent of their deposits. Given the long delays and the significant risk in getting their deposits, anxious depositors understandably

3. Authority to appoint a receiver for a national bank originated in the National Bank Act of 1864; authority to appoint a conservator for a national bank subsequently originated in the Bank Conservation Act of 1933.

withdrew their savings when there was any hint of problems. With the wave of bank failures that began in 1929, it became widely recognized by the federal government that the lack of funding that resulted from the process for resolving bank failures was contributing significantly to the economic depression in the United States.⁴

To deal with the economic crisis, the federal government focused on returning the financial system to stability by restoring and maintaining the confidence of depositors in the banking system. When it created the FDIC, Congress addressed that problem by (1) allowing for the FDIC to provide deposit insurance, initially up to \$2,500, but now up to \$100,000; (2) giving the FDIC special powers to resolve failed banks; and (3) requiring the appointment of the FDIC as receiver for all national banks. Congress believed that the appointment of the FDIC as receiver would simplify procedures, eliminate duplication of records, and vest responsibility for liquidation in the largest creditor whose interest is to obtain the maximum possible recovery. For state chartered banks, Congress preferred that the FDIC be receiver, but did allow each state to appoint a receiver according to state law. By 1934, 30 states had provisions by which the FDIC could be appointed receiver but, in practice, most often they did not do so. It would be the rare exception today if the FDIC were not appointed receiver, however, and most states now require that the FDIC be appointed receiver.

How the FDIC Becomes Receiver

An institution's chartering authority typically closes a bank when it becomes critically undercapitalized or unable to meet deposit outflows. The Prompt Corrective Action (PCA) provisions of the Federal Deposit Insurance Corporation Improvement Act of 1991 require that an institution be closed by its primary regulator or the FDIC within a prescribed period of time after the regulator determines that the institution is critically undercapitalized (a situation that was defined as tangible equity capital of 2 percent or less) and does not have an adequate plan to restore the capital to the required levels.⁵

Following certain procedural requirements, the FDIC may be appointed as receiver for any insured depository institution if any of the following conditions exist:

- The institution's assets are less than its deposit and administrative obligations (insolvency);
- The institution's assets or earnings have been substantially dissipated because of a violation of a statute or regulation, or because of any unsafe or unsound practice;
- The institution is operating in an unsafe or unsound condition;

4. C.D. Bremer, *American Bank Failures* (New York: Columbia University Press, 1935), chapters IV and V.

5. The prescribed timing is 90 days; however, if warranted, the time can be extended by the primary regulator with concurrence of the FDIC.

- The institution has willfully violated a final cease and desist order;
- The institution's books, papers, records, or assets have been concealed, or the institution has refused to submit its books, papers, records, or affairs for inspection by an appropriate regulatory authority;
- The institution is unable to pay its obligations or meet its depositors' demands in the normal course of business;
- The institution has incurred or is likely to incur losses that will deplete all or substantially all of its capital, with no reasonable prospect for the institution to become adequately capitalized without federal assistance;
- The institution has violated any law or regulation, or has engaged in an unsafe or unsound practice, that is likely to (a) cause insolvency or substantial dissipation of assets or earnings, (b) weaken the institution's condition, or (c) seriously prejudice the interests of depositors or the deposit insurance fund;
- The institution, by resolution of its board of directors or shareholders, consents to the appointment;
- The institution ceases to be an insured institution;
- The institution is undercapitalized and (a) has no reasonable prospect of becoming adequately capitalized, (b) fails to become adequately capitalized when required to do so, (c) fails to submit an acceptable capital restoration plan to the appropriate regulatory authority, or (d) materially fails to implement a capital restoration plan submitted and accepted;
- The institution is critically undercapitalized or otherwise has substantially insufficient capital; or
- The institution has been found guilty of money laundering under federal law.

A depository institution's charter determines which state or federal regulatory agency will appoint a conservator or a receiver for a failing institution. For federal savings associations and national banks, the Office of Thrift Supervision (OTS) and the Office of the Comptroller of the Currency, respectively, are the chartering authorities responsible for determining when appointment of a receiver is necessary.⁶ The FDIC must be appointed as receiver for insured federal savings associations and national banks. For state chartered savings and loan associations or banks, the FDIC may accept appointment as receiver by the appropriate state regulatory authority, but it is not

6. The same authority would appoint the FDIC as conservator for the institution if the imposition of a conservatorship were determined to be the appropriate strategy for dealing with a failing institution. However, the FDIC has never been appointed conservator by the OCC or state regulatory authority and may decline the appointment if tendered; the FDIC was appointed conservator once by the OTS.

required to do so. Today, state regulatory authorities virtually always request the appointment of the FDIC when a receiver is appointed. In the case of state chartered banks that are members of the Federal Reserve System, the Federal Reserve Board also may appoint the FDIC as receiver. In certain limited instances, the FDIC may appoint itself as receiver for insured depository institutions. Congress provided the FDIC that additional authority in 1991 out of concern that the FDIC depended on the judgment of individual state chartering authorities or that of other federal chartering authorities and that it needed an independent basis to protect the insurance fund in a timely manner. Since receiving that power from Congress in 1991, however, the FDIC has closed an institution and appointed itself as receiver only once, in the 1994 failure of The Meriden Trust & Safe Deposit Company, Meriden, Connecticut.

General Overview of the FDIC's Role as Receiver

Congress has entrusted the FDIC with complete responsibility for resolving failed federally insured depository institutions and has conferred expansive powers to ensure the efficiency of the process. The FDIC as receiver is not subject to the direction or supervision of any other agency or department of the United States, or of any state, in the operation of the receivership. Those congressional provisions allow the receiver to operate without interference from executive agencies and to exercise its discretion in determining the most effective resolution of the institution's assets and liabilities. In exercising that authority, the FDIC is expected to maximize the return on the assets of the failed bank or thrift and to minimize any loss to the deposit insurance fund.

As receiver, the FDIC succeeds to the rights, powers, and privileges of the institution and its stockholders, officers, and directors. It may collect all obligations and money due to the institution, preserve and liquidate its assets and property, and perform any other function of the institution consistent with its appointment.

The FDIC as receiver is also responsible for liquidating the failed institution's assets and using the proceeds to pay proven creditors. Typically, creditor claims are paid through periodic dividend distributions from the receiver to the extent that liquidation proceeds are available after expenses and obligations. To promote the rapid return of liquidity to creditors, including depositors and the banking system, the FDIC is able to declare "advance" or "accelerated" dividends based on an estimate of recoveries on the assets retained in receivership.⁷

As receiver, the FDIC also has the power to merge a failed institution with another insured depository institution and to transfer its assets and liabilities without the consent or approval of any other agency, court, or party with contractual rights. Furthermore, the

7. For further information on the payment of dividends, see Chapter 10, Treatment of Uninsured Depositors and Other Creditors.

FDIC may form a new institution, known as a bridge bank, to take over the assets and liabilities of the failed institution, or it may sell or pledge the assets of the failed institution to the FDIC in its corporate capacity.⁸

In many respects, the powers of a receiver and a conservator are similar. Many of the statutory powers of a receiver, however, are expressly conferred upon a conservator, while certain powers are limited to the receiver. The guiding principle is to grant to the FDIC acting in either capacity those powers and obligations most consistent with performance of its statutory role. A conservatorship is designed to operate the institution for a period of time in order to return the institution to a sound and solvent operation.⁹ While in conservatorship, the institution remains subject to the supervision of the appropriate state or federal banking agency. The conservator's goal is to preserve the "going concern" value of the institution. For example, a conservator, like a receiver, is empowered to dishonor or repudiate contracts such as leases, but it may decline to do so if the contracts would benefit the open institution's business.

FDIC's Closing Function

When a bank or thrift is closed by its chartering authority and the FDIC is appointed receiver, the first task is to take custody of the failed institution's premises and all of its records, loans, and other assets. After taking possession of the premises, the FDIC posts notices to explain the action to the public. It changes locks and combinations as soon as possible. Then, it notifies correspondent banks and other appropriate parties of the closing.

The FDIC closing staff, working in conjunction with employees of the failed institution, bring all accounts forward to the closing date and post all applicable entries to the general ledger, making sure that everything is in balance. The FDIC then creates two complete sets of inventory books containing an explanation of the disposition of the failed institution's assets and liabilities, one set for the assuming institution (if there is one) and one for the receivership.

The FDIC's Receivership Functions

A receiver steps into the shoes of an insolvent party with the goal of liquidating the entity. Federal law grants the FDIC additional special powers. Through those powers,

8. While the FDIC in either its corporate or receivership capacity can establish a bridge bank, to date all bridge banks have been established by the FDIC in its corporate capacity.

9. Resolution Trust Corporation (RTC) conservatorships differed in their purpose. Instead of operating institutions with the objective of returning them to a sound position, the RTC downsized and stabilized the operations of the failed institutions until a more permanent solution could be found.

the FDIC can minimize the receivership estate's exposure to loss, thereby increasing the amount available for reimbursement to the FDIC and other creditors. Many reasons for the special powers include the provision of common standards and uniform expectations of creditors, shareholders, and the public.

The FDIC's role and responsibilities when serving as receiver are defined by specific statutory provisions contained in the Federal Deposit Insurance Act (FDI Act) of 1950. Those additional powers enable the FDIC to maintain confidence in the national banking system by expediting the liquidation process for banks and thrifts and preserving a strong deposit insurance fund by maximizing the cost-effectiveness of the receivership process. The FDIC as receiver is not subject to court supervision, but its decisions are subject to limited judicial review. The most significant of the additional powers fall into five broad categories: determining claims, repudiating contracts, placing litigation on hold, avoiding fraudulent conveyances, and using special defenses.

Determining Claims

The receiver has the power to determine whether to allow or disallow claims. Section 11(d) of the FDI Act sets forth the mechanisms and deadlines for claims against commercial banks and thrift institutions in receivership.

Two basic types of unsecured claims are in a receivership: uninsured deposit claims and general creditor claims. Uninsured deposit claims are those that may be filed by depositors who had deposits over the federally insured limit. Uninsured deposit claims (as well as insured deposit claims) are second only to administrative claims in the priority of creditors.

General creditor claims comprise all other unsecured claims against the receiver for the failed institution. Those include claims from vendors, suppliers, and contractors of the failed institution; claims arising from leases; claims arising from employee obligations; and claims asserting damages from business decisions of the failed institution or receiver.

Promptly after its appointment as receiver, the FDIC publishes a notice to the failed institution's creditors, generally in a local newspaper, that they must present their claims by a specified date (the bar date). All claimants, including those who may have been suing the failed institution, must then file proof of their claims with the receiver by the bar date. Failure to submit a claim by the bar date results in a final disallowance of the claim. After a claim has been filed, the receiver has 180 days from the date of filing the claim to determine if the claim should be allowed or disallowed.

The payment of any claim (other than claims of secured creditors) depends on the availability of assets in the receivership estate from which to pay the claim and on whether the claim is provable to the satisfaction of the receiver. The receiver is authorized, in its discretion and to the extent funds are available, to pay such claims. The receiver also has the authority, in its sole discretion, to pay dividends on any proven claim at any time. Even if no funds are currently available for distribution, the receiver

will provide the proven claimant with a receivership certificate evidencing entitlement to a pro rata share in the receivership estate.

Since August 10, 1993, the priority for paying allowed claims against a failed depository institution has been determined by federal law. On that date President Clinton signed the Omnibus Budget Reconciliation Act of 1993, which amended section 11(d)(11) of the FDI Act to establish a national priority scheme for the distribution of assets from failed insured depository institutions. That amendment, known as the National Depositor Preference Amendment, provided payment priority to depositors, including the FDIC as subrogee, over general unsecured creditors. The statute applies to all receiverships established on or after its enactment. For receiverships established before that date, distribution of the assets is still determined according to the law of the chartering jurisdiction, either state or federal.

Under the National Depositor Preference Amendment, after payment of secured claims, claims are paid in the following order of priority:¹⁰

1. Administrative expenses of the receiver;
2. Deposit liability claims (the FDIC claim takes the position of all insured deposits);¹¹
3. Other general or senior liabilities of the institution;
4. Subordinated obligations; and
5. Shareholder claims.

Inasmuch as most liabilities of a failed institution are deposit liabilities, the practical effect of depositor preference in most situations is to eliminate any recovery for unsecured general creditors.¹²

Repudiating Contracts

To wind up the institution's affairs efficiently, a receiver may repudiate contracts of the depository institution that it deems burdensome. Financial institutions often enter into contractual or lease arrangements that at the time of bank or thrift receivership are burdensome in terms of duration or cost, or in terms of need to the receiver. The power to disaffirm or repudiate a contract simply permits the receiver to terminate the contract, thereby ending any future obligations imposed by the contract. The receiver must decide to repudiate a contract within a "reasonable period" or lose its right to do

10. Secured creditors have their claims paid to the extent of the collateral; if they are undersecured, they then have a claim as a general creditor for the excess over the collateral.

11. Because of the manner in which the FDI Act defines a "deposit," foreign deposits do not obtain the benefit of this priority and are paid with the other general or senior liabilities of the institution.

12. For further information on the payment and priority of claims, see Chapter 10, Treatment of Uninsured Depositors and Other Creditors.

so.¹³ In addition, the receiver may be liable for some damages resulting from the repudiation of a contract; however, those damages are limited to actual, direct compensatory damages determined as of the date of the receiver's appointment.¹⁴

Placing Litigation on Hold

Following its appointment as receiver, the receiver is responsible for litigation pending against the failed bank or thrift. However, because the receiver needs time to assess and evaluate the facts of each case to decide whether and how to proceed, the law permits the receiver to put litigation on hold, or to "stay" it. That power also extends to litigation filed after the institution's failure. The receiver must request the stay for it to become effective. The courts, however, cannot decline to issue the stay once the receiver has filed its request.¹⁵

When litigation resumes after a stay is lifted, the receiver is generally entitled to have the controversy resolved in either state or federal court. Typically, when the litigation is before a state court, the FDIC has the added flexibility to either keep it in state court or to "remove" it to federal court.

A special statute of limitations exists for actions brought by a receiver. Under the statute, the receiver has up to six years to file a contract claim and up to three years to begin a tort suit.¹⁶

Avoiding Fraudulent Conveyances

A receiver has the power to avoid certain fraudulent conveyances. Under federal banking law, a receiver may avoid a security interest in a property, even if perfected, in which the security interest is taken in contemplation of the institution's insolvency or with the intent to hinder, delay, or defraud the institution or its creditors. The receiver may avoid any transfers made by obligors within five years of the appointment of the receiver. Those rights are superior to any rights of a trustee or any other party.

13. In giving those powers to the FDIC and the RTC, Congress specifically elected not to impose a particular time limitation within which the receiver might properly repudiate. Thus, whether the receiver has repudiated within a reasonable time depends on the circumstances of the case.

14. A different standard of damages applies in the case of qualified financial contracts.

15. A receiver may obtain a stay for 90 days; a conservator is allowed 45 days.

16. Tort actions are lawsuits that seek compensation for a civil wrong (as opposed to a crime) committed by someone against another person. They include lawsuits for personal injury or property damage due to negligence, as well as suits for libel, false arrest, and other disputes.

Using Special Defenses

Over the years, both common law and federal statutes have provided certain special defenses—such as “improperly documented agreements are not binding on the receiver” and “courts may not enjoin the receiver”—to the FDIC in its role as receiver to allow for the efficient resolution of the failed institution’s affairs.

Improperly documented agreements are not binding on the receiver. Like bank regulators, the receiver must be able to rely on the books and records of the failed financial institution to evaluate its assets and liabilities accurately. For the receiver, the ability to rely on the failed institution’s records in resolving the institution’s affairs is critical in completing cost-effective resolution transactions, such as the sale of assets to third parties, and in effectively collecting debts due to the failed bank or thrift.

As a result, both common law (*D’Oench Duhme*) and the FDI Act, *U.S. Code*, volume 12, sections 1823(e) and 1821(d)(9)(A), recognize that, unless an agreement is properly documented in the institution’s records, it cannot be enforced against the receiver either to make a claim or to defend against a claim by the receiver. Therefore, an argument by an obligor on a promissory note that an undocumented, unrecorded side agreement changes or releases the duty to repay the loan generally will be barred. The FDIC has issued a policy statement on the use of *D’Oench Duhme* and similar statutes.¹⁷

Courts may not enjoin the receiver. Congress has provided the FDIC as receiver with additional protection by prohibiting courts from issuing injunctions or similar equitable relief to restrain the receiver from completing its resolution and liquidation activities. For example, the FDI Act bars an injunction to prevent foreclosures or asset sales. Similarly, courts are prohibited from issuing any order to attach or execute upon any assets in the possession of the receiver. Those statutory provisions, however, do not bar the recovery of monetary damages.

Settlement with the Assuming Institution

The FDIC and the assuming institution handle most of their post-closing activities through the “settlement” process. The settlement date may be from 180 days to 360 days after the bank or thrift closing, depending on the failed institution’s size. Adjustments made between the institution’s closing date and the settlement date reflect (1) the exercise of options by the acquirer, (2) any repurchase of assets needed by the receiver or “put back” of assets to the receiver by the assuming institution, and (3) the valuation of assets sold to the acquirer at market prices.

17. See *Federal Register* 5984 (February 10, 1997).

Management and Accounting for Receiverships

Each receivership is operated as a separate entity. During the peak years of 1990 to 1992, the FDIC actively managed nearly 1,000 receiverships and terminated on average 110 receiverships each year. In addition, at its peak in 1992, the Resolution Trust Corporation (RTC) actively managed about 650 receiverships. Both the FDIC and the RTC had to develop and maintain separate accounting for each of those receiverships. As a result, the agencies developed allocation methods to distribute income and expenses among the various receiverships.

Professional Liability Claims

The FDIC conducts an investigation into each failed institution to determine if negligence, misrepresentation, or wrongdoing was committed. Any funds recovered from those investigations are returned to the receivership.¹⁸

Terminating a Receivership

Receivership termination represents the final process of winding up the affairs of the failed institution. All significant issues must be resolved before termination. The duration of a receivership varies depending on individual circumstances, such as type of closing; volume and quality of assets retained by the receivership; and the existence of defensive litigation, environmentally impaired assets, employee benefit plans, and professional liability claims.

Conclusion

The FDIC as receiver helps ensure the stability of the financial system in times of stress by providing for the timely resolution of failed institutions. This stability helps promote public confidence in the system and restores liquidity to the economy by quickly returning assets of the failed banks to the private sector. In addition, cost-effective receivership management helps ensure strong insurance funds.

The FDIC's roles of insurer and receiver have allowed it to make payments to insured depositors almost immediately after their institution fails and to make subsequent payments to uninsured depositors in a timely manner. This action has minimized the disruption to depositors, mitigated the adverse economic effects of financial

18. For further information, see Chapter 11, Professional Liability Claims.

institution failures, and promoted public confidence in the banking system during a time of severe stress in the banking industry. No insured depositor has ever lost any funds in an FDIC insured institution.

On July 5, 1934, Mrs. Lydia Lobsiger received the first federal deposit insurance disbursement, following the failure of the Fond Du Lac State Bank, East Peoria, Illinois.



Although the insurance coverage amount is simple to understand, the process for determining the insurance coverage is complex and time consuming. The FDIC has to identify and define ownership rights and capacities according to statutes.



CHAPTER 9

The Closing Process and the Payment of Insured Depositors

Introduction

When the Federal Deposit Insurance Corporation (FDIC) was created in 1933, the financial impact of a bank failure on a bank's depositors was a major concern. Before federal deposit insurance, depositors typically would recover 50 percent to 60 percent of their money from a failed bank's receivership. Furthermore, depositors often were not able to obtain those funds for several years, because disbursements were made only when a failed bank's assets were liquidated. Consequently, public confidence in the banking system wavered, and depositor runs became more frequent, thus triggering more bank closings. Federal deposit insurance was designed to provide greater protection to depositors, thereby enhancing public confidence and leading to greater financial stability.

The first real tests of whether federal deposit insurance could provide sufficient protection to depositors and maintain public confidence during a banking crisis occurred during the 1980s and early 1990s. This chapter discusses how the FDIC and the Resolution Trust Corporation (RTC) met the challenge and provided timely payments to insured depositors. The discussion in this chapter begins with a summary of the overall level of closing activity and a description of how the FDIC conducts the closing process. The chapter examines how the process for making payments to insured depositors gradually became more sophisticated, allowing the FDIC and the RTC to cope with the increasing demands that were placed on them during the crisis period.

Summary of Closing Activities of Banks and Savings & Loans

Before 1983, the FDIC had two alternatives for the resolution of a failed bank: the purchase and assumption (P&A) transaction or the direct payment of FDIC deposit insur-

ance to the depositors of the failed bank (deposit payoff).¹ The P&A transaction allowed a healthy financial institution to acquire all of the failed bank's deposits. Because all of the deposits were acquired, it was not necessary to determine which accounts were above the limits of FDIC deposit insurance. From the perspective of the depositor, the P&A transaction would appear to be little different than a bank merger.

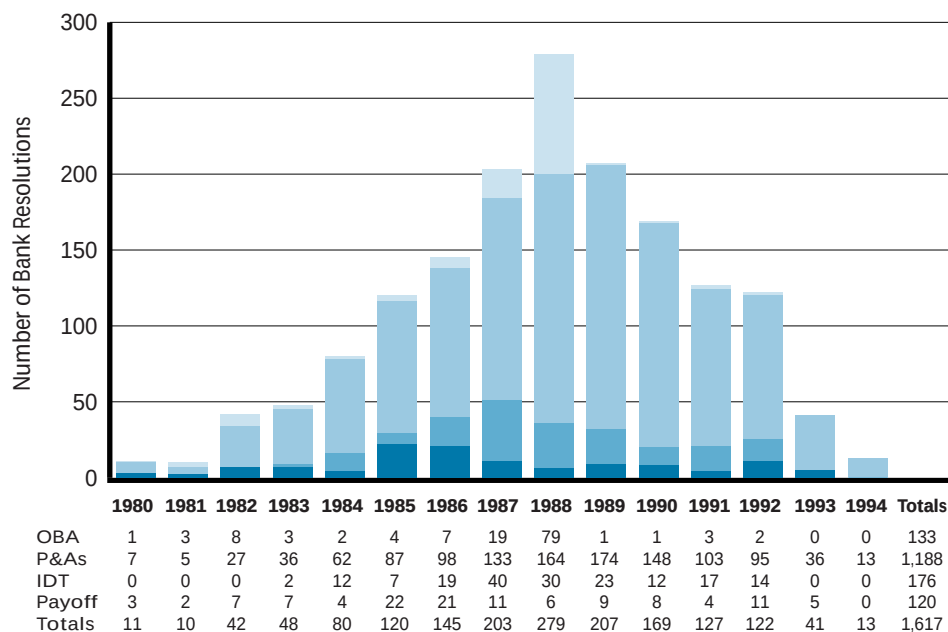
If the FDIC was unable to find an acquirer for the failed bank's deposits, then the only other option was to conduct a deposit payoff. In such a case, a determination of the amount of FDIC deposit insurance coverage was required for each depositor. A deposit payoff is a major event for both the FDIC and the depositors of the failed bank. The FDIC assesses the amount in each deposit account at the time of the bank closing, determines whether the accounts are within the deposit insurance limits, and pays the depositor with a check for the insured amount. The FDIC would begin the deposit payment process on the first business day after the bank closing, and anxious depositors would come to the bank on that day and stand in line to receive their checks. Depositors having more than the insured amount (currently \$100,000) in deposits would meet with FDIC representatives to determine whether the funds exceeding the insured limit qualified for separate deposit insurance coverage.

A deposit payoff can be disruptive to the local community. Because the depositors would be paid the insured balances in their accounts at the time of the bank failure, any outstanding checks drawn on the accounts would not be paid. The depositors then would have to quickly establish checking accounts in another local bank and make arrangements with their landlords, grocers, and other creditors to cover the unpaid checks.

In 1983, to help alleviate those problems, the FDIC developed a new resolution alternative: the insured deposit transfer (IDT). Using this method, all of the insured deposits are transferred to a healthy financial institution and are available immediately. Outstanding checks are honored, and accounts continue to earn interest at their original rates. Immediately before the failed bank closed, the FDIC would contact healthy local financial institutions to request their participation in competitive bidding to acquire the insured portion of the deposit base. The IDT provides additional benefits because the acquiring institution gains new customers, and the FDIC obtains resolution cost savings from the competitive bidding proceeds. Since 1983 the FDIC has used the IDT transaction 176 times (see chart I.9-1) and has conducted 120 deposit payoffs.

The FDIC has found acquirers for approximately 93 percent of the failed bank deposits (via IDTs and P&As, or by providing open bank assistance), thereby avoiding the inconvenience and disruption caused by a deposit payoff. From 1989 to 1995, the RTC conducted 158 IDTs and 92 deposit payoffs (see chart I.9-2) and found a buyer

1. The FDIC also used open bank assistance (OBA), in which an insured bank *in danger of failing* received assistance in the form of a direct loan, an assisted merger, or a purchase of assets.

Chart I.9-1**Distribution of FDIC Transaction Types
1980–1994**

Source: FDIC annual reports, 1980–1994.

for approximately 88 percent of the failed savings and loan deposit accounts through IDTs or P&A transactions.

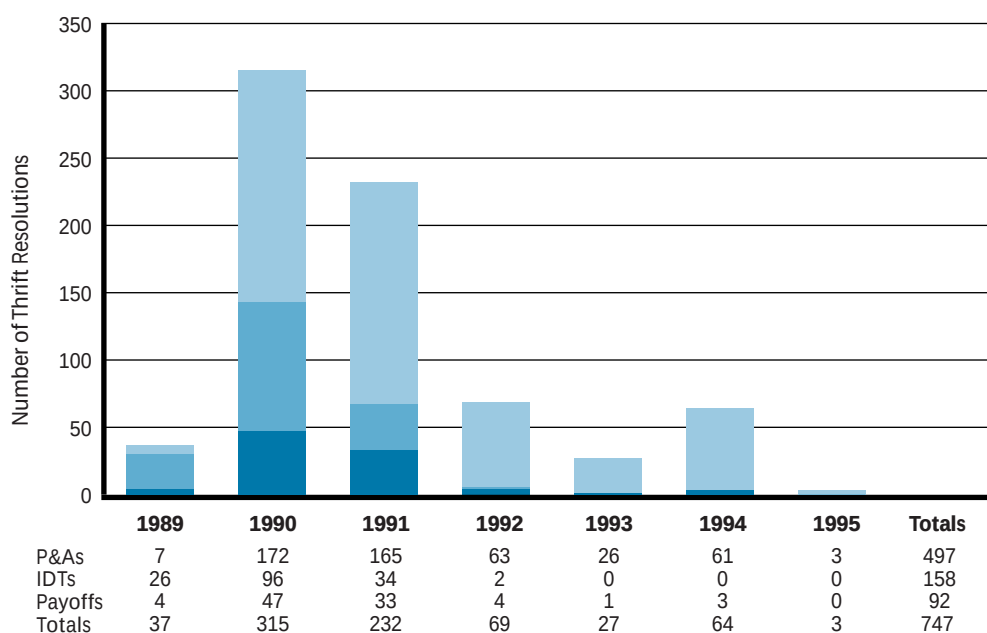
In 1984, FDIC resolution activity began to escalate rapidly. The FDIC resolved a record number of 80 banks that year, eclipsing the previous high of 77 in 1937. Chart I.9-1 shows that the number of FDIC bank resolutions increased each year thereafter, with 279 resolutions in 1988. FDIC bank resolution activity remained high until 1993, when the number of resolutions fell to 41. The RTC, which was created in 1989, resolved 315 failed thrifts in 1990 and 232 failed thrifts in 1991. After 1991, the RTC was able to resolve failed thrifts only as Congress made funding available. As a result, several failed thrifts operated under conservatorship for several months or years while awaiting their final resolution.

Summary of the Closing Process

To prepare for the closing of a failing institution, FDIC employees review the financial and operational information gathered on the institution to determine how many

Chart I.9-2

Distribution of RTC Transaction Types 1989–1995*



* The transactions detailed here are as of time of resolution, not as of time of RTC takeover.

Source: RTC annual reports, 1989–1995.

personnel are needed for the closing. The FDIC appoints a closing manager to oversee the process and to plan, manage, and coordinate all activities related to the closing. The primary factors used in determining the number of persons needed for the closing team are (1) the asset and deposit size of the institution, (2) the number of its branches or locations, and (3) the type of resolution.

Before the actual closing date, the closing team members learn as much as they can about the failing institution. The amount of time available to prepare for the actual closing varies. When the failing institution is attempting to recapitalize, the chartering authority may give it ample opportunity to identify and obtain additional sources of capital. In other cases, widespread fraud or money laundering may be discovered, and the chartering authority will close the institution with little advance notice. To avoid a run on the institution's deposit base, confidentiality of the closing activity is essential.

The closing team is composed of various subteams that ensure that the resolution is conducted in an orderly and expedient manner. The primary subteams are listed below:

Asset Team. This team inventories assets consisting of commercial, real estate, and installment loans; owned real estate (ORE); cash; furniture, fixtures, and equipment;

and other assets such as bank-owned vehicles or repossessed automobiles. Team members review the transaction agreement to determine which assets the assuming institution is buying. The team prepares inventory listings, and the assuming institution signs receipts acknowledging what it has purchased.

Deposit Team. This team determines which deposits are insured. When there is a deposit payoff or a transaction in which only insured deposits will pass to the purchasing institution, the size of this team increases significantly.

The deposit team members, known as claim agents, must be knowledgeable about the rules and regulations governing deposit insurance. They generally must work long hours to determine which deposits are insured and which are not. After the team accomplishes this task, the team prepares a list of accounts identifying which deposits are fully insured and will pass on to the purchasing institution, and which deposits may not be fully insured and have holds placed on them. If the FDIC has been unable to find an institution to assume the failed bank's deposit base, the deposit team is responsible for preparing payoff checks to pay the depositors. The deposit team also helps the asset team to identify account holders who have delinquent loans as well as deposits or to identify a possibility for an offset in cases for which a deposit is being held as collateral for a loan.² In all types of resolution transactions, the deposit team identifies and notifies the general creditors of the failed institution, a process that is similar to that conducted for a regular bankruptcy.

Accounting Team. This group reconciles the institution's general ledger accounts and closes out the failed institution's books. This task can be arduous if the institution is large and has a complex accounting system, or if the institution has accounts that are out of balance and have not been reconciled on a regular basis. This process is similar to completing a year-end audit.

The accounting team reconciles each general ledger account and compiles a final balance sheet on the failed institution. From this balance sheet, the team will compile a new balance sheet (referred to as a pro forma statement) for the assuming institution. The pro forma statement shows the assets and liabilities the acquirer will have assumed. The team prepares another pro forma statement for the FDIC that reflects the assets and liabilities remaining with the receivership. Using these statements, the accounting team determines the amount of cash that must be wired to the assuming institution. The initial wire transfer occurs on the next business day.

Settlement Team. This team works with the acquirer to make adjustments over a 120- to 180-day period for income and expense items not previously accounted for in the initial wire transfer payment. The settlement team also monitors the transaction agreement to ensure that both the assuming institution and the FDIC comply with all

2. Depositors are allowed to apply the uninsured portion of their deposit accounts to their outstanding loan balances. The FDIC requires those depositors to provide it with an explicit request concerning the offset. In cases of delinquent loans, the FDIC may have the right to offset the accounts, regardless of whether they are insured or uninsured, without an explicit request from the depositor.

terms and conditions of the agreement. The settlement process allows for the transfer of funds to and from the assuming institution(s) to pay for assets sold to the assuming institution under the agreements and to reimburse expenses incurred on behalf of the FDIC. Examples of assets that would be sold are loan pools, securities, the failed institution's building(s), and the furniture, fixtures, and equipment in the building(s). Examples of expenses that would be incurred are costs associated with paying the failed institution's employees for working over the weekend and certain data processing fees.

Information Support Team. This team communicates and coordinates with the data processing center, whether that center is on site or off site. The team works with the various subteams to ensure that all of the work for the day has been processed and forwarded to the processing center, and that the necessary reports are generated and distributed. The information support team also supplies, supports, and maintains the data processing equipment and software needed by the closing team.

All of the teams focus on the main objective of the closing process: to control, inventory, and balance the books of the failed institution. The teams complete the critical tasks that are vital to the success of that process.

Deposit Insurance Coverage

The FDIC's insurance limit is the maximum insurance coverage available under applicable insurance regulations. The FDIC set the original limit at \$2,500 in 1933 and increased it to \$5,000, effective June 30, 1934. That limit remained in effect until 1950, when it was increased to \$10,000 as part of the Federal Deposit Insurance Act. The limit was increased to \$15,000 in 1966, to \$20,000 in 1969, and to \$40,000 in 1974. In 1974, the insurance limit for time and savings accounts held by state and political subdivisions was increased to \$100,000. The FDIC extended that same limit to individual retirement accounts (IRAs) and Keogh accounts in 1978. The most recent increase occurred in 1980, when the FDIC raised the maximum insurance coverage to \$100,000 for all types of accounts.

Although the insurance coverage amount is simple to understand, the process for determining the insurance coverage is complex and time-consuming. The FDIC has to identify and define ownership rights and capacities according to statutes. Deposit accounts usually fall into the following categories: single accounts, joint accounts, revocable trusts, irrevocable trusts, corporate and other business accounts, accounts held by depository institutions in fiduciary capacities, employee benefit plan accounts, IRA and Keogh accounts, and public unit accounts.

In applying the \$100,000 deposit insurance limitation, the FDIC examines the statutory rights and capacities of the accounts. The federal statute has always required the FDIC to aggregate all deposit balances held in the same right and capacity before applying the insurance limit. Accounts held in different rights and capacities are each insured up to the \$100,000 limit. The FDIC reviews deposit information to make preliminary

determinations on the number of depositors that may exceed the statutory insurance limit of \$100,000. After the deposit team has located and grouped accounts that are related by name, address, or social security number, the team begins to separate depositor accounts that obviously are fully insured (for example, depositor accounts that are, in aggregate, under the \$100,000 insurance limit) from the depositor accounts that need additional analysis and documentation to qualify for full insurance coverage.

The FDIC has devoted considerable time and effort in trying to inform the public about federal deposit insurance coverage. Most of that effort has focused on what is an insured deposit, and what deposit insurance protection means to a depositor if an institution should fail. Although the rules can be complex, the basic purpose of deposit insurance is clear.

Evolution of the Closing and the Payment Process for Insured Depositors

In the early 1980s, the closing process and payment of insured depositors in a deposit payoff was time-consuming, labor intensive, and methodical. The FDIC had a small, but dedicated field staff of professional claim agents and bank liquidators, supported by senior Washington Headquarter experts, who came together as a team to handle insured bank failures throughout the country. The FDIC's personnel were required to be available on 24-hour notice to travel from their existing failed bank receivership sites to any geographic location of the United States or its Commonwealth states. Because of the limited use of automation and modern communication technologies, the majority of the closed bank work was done manually. If necessary, there were many occasions where FDIC closing personnel worked around the clock to help prepare the new assuming bank for reopening and processing of deposit payoff checks. Starting in November 1982, in response to the rapidly accelerating number of failing banks, the FDIC expanded its liquidation presence by organizing its operations into regions and establishing regional sites in New York City, Atlanta, Chicago, Dallas, Kansas City, and San Francisco. Those offices were staffed to oversee all liquidation activity occurring within their geographical territories.

Early Deposit Payment Process

The following steps reflect the time-consuming and labor-intensive process involved in preparing checks for the payoff of depositors in the early 1980s:

1. All financial transactions conducted before the closing that had not yet been posted to the institution's records and customers' accounts had to be sent to the institution's data processing servicer or to the in-house bookkeeping area for processing and recording. That process was completed immediately after the closing of the institution so that the FDIC would have a current balance sheet for the

institution as of its closing date. In the early 1980s, most bank data processing systems were not compatible with the FDIC's requirements because they were set up for ongoing bank operations and were incapable of producing financial reports at other than month-end increments. That processing inadequacy created some delays in producing final balance sheets.

2. The servicer or in-house processor was instructed to produce deposit statements showing principal and interest as of the closing date. In some cases, the FDIC was required to use the financial institution's manually maintained account ledger cards to produce accurate deposit statements. The servicer also provided a general ledger, a subsidiary ledger, and loan trial balance reports. If the FDIC was unable to obtain that information from the servicer over the closing weekend, the entire process was delayed until accurate information for paying depositors became available.
3. Deposit statements had to be sorted by hand into alphabetical batches based on the account title and name. This step was required to identify all deposits in a certain name or capacity. Each batch was then totaled, and the total of all of the batches was balanced back to the general ledger. Depending on the number of deposit accounts, the number of different types of accounts offered to depositors (such as checking, savings, money market, and certificates of deposit [CDs]), and the method of recordkeeping of the failed institution, this sorting and balancing step could take as long as one or two days.
4. The FDIC had to determine insurance coverage for each depositor. That was the most crucial and time-consuming step in the entire closing process. To determine insurance coverage, the FDIC had to review all the deposit account records, apply the proper FDIC insurance regulations to each account, and prepare a combined account statement for depositors with multiple accounts. After that step was completed, there would be only one account statement for each depositor. The account statements were then balanced to the general ledger to ensure that they were accurate.
5. The FDIC created a list of all depositors and the amount of deposit insurance due to each depositor. That list, known as the deposit liability register, was created from the information on the combined statement and ledger cards and was then balanced back to the general ledger to ensure accuracy. Because the deposit liability register was a typed list with five carbon copies, every mistake a typist made had to be corrected by hand on each copy. Because the majority of deposit payoffs in the 1970s and early 1980s occurred in small towns where the options for locating typists were limited, it often was difficult to find enough typists to get the deposit liability register prepared on time. Sometimes the FDIC contacted local high schools to request that students enrolled in typing classes assist the payoff team. Even when a closing was located in a large metropolitan area

where typists were more readily available, the enormity of the typing task still created a problem. For example, when Sharpstown State Bank, Houston, Texas closed in 1971, more than 100 typists were needed to prepare the deposit liability register for that bank's 27,300 deposit accounts.

6. The deposit insurance checks had to be typed, separated, alphabetized, and balanced back to the general ledger.
7. Finally, a list had to be prepared and deposit insurance checks had to be held because of uninsured funds, past-due loans, or overdrafts. Those checks would then have to be segregated from the other deposit insurance checks.

Before reopening the bank and paying the insured depositors, the FDIC also had to meet with the security team or local police to discuss safety concerns and prepare a press release for the local newspapers and radio and television stations announcing when the payoff would begin. The FDIC also set up offices or private areas for its staff to meet with depositors who may have had uninsured deposit amounts.

Penn Square Bank, N.A.

Under the Banking Act of 1933, the only vehicle used for paying depositors was the Deposit Insurance National Bank (DINB), a new national bank chartered without any capitalization and with limited life powers.³ Two years later, the Banking Act of 1935 gave the FDIC authority to pay off depositors directly or through an existing bank, rather than through a DINB. The FDIC has used the DINB authority only five times since 1935; the last occasion was for the closing of Penn Square Bank, N.A. (Penn Square), Oklahoma City, Oklahoma.

Penn Square, a one-office bank with a separate drive-up facility located in a shopping mall, was the most unusual, most notable, and by far the most difficult closing the FDIC had handled up to that time. The Office of the Comptroller of the Currency (OCC) declared the bank insolvent on Monday, July 5, 1982, which was a federal holiday. The failure quickly attracted nationwide attention because it was the largest deposit payoff in history, and more than half of the bank's \$470.4 million in deposits exceeded the \$100,000 insurance limit. That was not a typical bank failure, for which the total of uninsured deposits was less than 5 percent of the total of all of the bank's deposits.

The FDIC established the Deposit Insurance National Bank of Oklahoma City. All insured deposits in the closed bank were transferred to the DINB, while all assets were passed to the FDIC as the receiver. Penn Square had made an inordinate number of high-risk, energy-related loans. Although the bank had less than \$500 million in depos-

3. The Banking Act of 1933 authorized the FDIC to establish a Deposit Insurance National Bank to assume the insured deposits of a failed bank. A DINB had a limited life of two years and continued to insure deposits still in the bank. Depositors were given up to two years to move their deposit accounts to other institutions.

its, it originated more than \$2.1 billion in loans, which it sold to some of the largest financial institutions in the country. Furthermore, a large number of credit unions and savings and loans, as well as some banks, had CDs with Penn Square. Many of those financial institutions were at risk of insolvency because they were limited to receiving only the insured portion of their deposits after Penn Square failed. Consequently, those institutions lost millions of dollars as a result of their dealings with Penn Square.

Planning for this closure was difficult because the FDIC was facing a number of unusual challenges at the time. The OCC was completing an examination of Penn Square but was unable to provide the FDIC with information before the actual closing took place. FDIC personnel were not experienced in dealing with such a large and complex institution and, therefore, had difficulties in determining which accounts were uninsured. The decision to immediately reopen the institution as a DINB before closing out the failed institution's books further compounded the situation.

Moreover, the FDIC did not have a regional structure set up to provide resources when it was notified of the impending failure of Penn Square. Instead, the FDIC had staff at individual failed bank sites and a corporate headquarters, where the employees of the asset management division were located. When the word was given to prepare for the closing, FDIC staff members who normally handled bank failures were sent to Oklahoma City from individual bank sites all over the country and from Washington, D.C. The FDIC supplemented that staff with a large number of its bank examiners.

The process for paying the depositors of Penn Square presented a multitude of problems for the FDIC because the bank's deposit and loan records were neither accurate nor complete, making it difficult for the FDIC to readily make insurance determinations. The FDIC had little more than 72 hours (Saturday, Sunday, and Monday) to review 24,538 deposit accounts, totaling \$470.4 million, for preliminary insurance determinations. The closing team worked around the clock over that weekend to determine deposit insurance coverage and prepare for the opening of the DINB. Even with that extraordinary effort, FDIC personnel could not fully prepare to deal with the sheer number of depositors or to fully discuss what would happen to a depositor with uninsured deposits.

On Tuesday, July 6, the Associated Press released an article that described the scene at the reopening as follows: "Hundreds of depositors seeking their money crowded the former Penn Square Bank. The bank reopened at 9:00 am and according to FDIC Chairman, William Isaac, would remain open 24 hours a day if need be. By noon, nearly 100 people stood outside the bank's doors in 90 degree heat. A continuous line of cars went through the drive-in lanes." The majority of the FDIC staff members had not previously worked as claim agents; therefore, it was taking an average of three to four hours for a single customer with uninsured funds to get through the process the first day. Even though the FDIC had assured depositors with accounts of less than \$100,000 that they were fully insured and that they could continue to write checks on their new accounts at the newly chartered DINB, the depositors were nervous and came to the

bank to get their money. It took approximately a week before depositors' claims began to be processed in a reasonable time frame.

The claim agents were further challenged by the fact that Penn Square operated in two locations. It was therefore possible for a depositor to collect insured funds twice, because it was impossible for the claim agents to contact staff members at the other location so they could manually cross off the customers they had met with and paid. The same customer could have gone to the other location later that same day and received another check. (Technology was not yet advanced enough to offer the FDIC the convenience of automating the payoff process.)

Another problem, although short-lived, was that some of the local financial institutions would not accept the DINB insurance checks or wanted to put holds on them. That situation caused a near-panic, as customers who thought they were being paid returned to the bank complaining that they could neither cash nor deposit their checks. By Wednesday that situation was resolved when the local institutions agreed to accept the DINB insurance checks.

In addition, Penn Square's \$2.1 billion in loan participations complicated the offset process. Initially, the FDIC determined that when a deposit was offset against a loan, the participant's share of the offset would be paid in cash. Subsequently, the FDIC determined that that was a noncash transaction and that the participant's share should be paid with a receiver's certificate. The FDIC provided the information to the participants and requested the return of funds previously sent to them. However, some of the larger financial institutions sued the FDIC over the offset issue. Ultimately, the courts upheld the receiver's position, and the participants were issued a receiver's certificate.⁴

Penn Square did serve to remind the FDIC and Oklahoma City that there was no such thing as a "painless" bank failure. Today the closure of an institution is far less inconvenient to former bank customers than it was in the early 1980s. The lessons learned from Penn Square were invaluable to the FDIC. Penn Square, as is true for other institutions that have failed, required the FDIC to evaluate and modify its closing process.

Automation of the Deposit Payoff Process

After the Penn Square failure, the FDIC began to automate the deposit payoff process. In 1982 the FDIC began to use portable computers to store the bank's depositor database and drive the printers. Switching from manual systems to computer database systems allowed the FDIC more flexibility in creating lists of deposit accounts, enhanced

4. Loan participants usually receive their pro rata share of any payments made by a debtor that augments the receivership estate. The same holds true if the receiver forecloses on and liquidates the underlying collateral. However, loan participants may suffer a loss greater than they would otherwise incur if the debtors or receivers exercise their right of offset. Because the offset does not "augment the receivership estate," there are no proceeds to be passed on to the loan participants. The loan participants are therefore left with general unsecured claims against the receivership estate for the amounts they have lost as a result of the offset. The general unsecured claims are likely to be worth far less than the 100 cents on the dollar that direct proceeds or cash is worth.

its record-keeping abilities, and increased its efficiency in handling bank failures. Automation, even at this early stage, also increased accuracy while decreasing the amount of time needed to prepare for a deposit payoff.

Although the automated system did not alter the basic steps necessary to identify depositors, determine insured and uninsured amounts, produce lists of deposits, and create checks, it did save considerable time in executing all of those steps. When preparing the automated checks that were paid to insured depositors, the FDIC used the following steps:

1. Working from the financial institution's general ledger or other available records, the closing team members would enter account titles and balances, along with social security numbers (when available) into a spreadsheet program.
2. They then verified, balanced, and converted the spreadsheet into a database file, which allowed them to sort several file types (savings accounts, checking accounts, and certificates of deposit) into one file in any order they desired.
3. The team reviewed the accounts of each depositor to determine if they exceeded the \$100,000 limit. If they did exceed the limit, the database file would flag the account(s).
4. They printed checks (up to the amount of \$100,000) from the database file for each depositor.
5. Finally, team members kept a record of all payments made to depositors in the same database file to ensure the accuracy of accounting for check distribution.

The automated process saved a considerable amount of time. FDIC staff still had to manually enter the initial data and balance to the institution's general ledger, but the additional personnel that had been necessary to manually type and correct each of the five multicolored forms were no longer required.

The FDIC first tested the new system at Western National Bank, a relatively small bank in Santa Ana, California, that failed on August 27, 1982. The bank had 1,949 deposit accounts totaling \$11 million. The automated deposit grouping was run parallel to the manual tally of accounts just in case the new system did not work. The FDIC first relied exclusively on the new automated system in a deposit payoff for the Hohenwald National Bank, Hohenwald, Tennessee, which closed on September 3, 1982. The institution had 4,468 deposit accounts totaling \$26.9 million.

Accomplishments Through the Use of Automation and Planning

As computer technology advanced (computer systems became more portable, the disk storage capacity increased, the database handling capabilities increased, and the price of the equipment and software fell), the FDIC automated its deposit and closing processes

in an increasingly rapid manner. The technology expedited the manner in which the liquidators could handle institutions with larger depositor bases.

In addition, with increased computerization, the FDIC no longer had to deal with the problem of not being able to coordinate the payment of insured deposits in multiple locations (branches) without duplication. It began developing computer network systems that shared software, communicated routinely through modem connections, and could accept and convert data downloads from other automated systems.

In 1983, as the FDIC began an effort to improve the automated deposit payoff process, it identified the need for a software program to track depositor information in case another large financial institution failure resulted in a deposit payoff. The software was structured to capture an institution's deposit account rights and capacities, social security numbers, account numbers, balances, and types of deposit as of the date of closing. The software had the ability to "add in" discovered deposits and withdrawals, compute the interest accrued through the date of closing, and sort the data in a variety of ways. More important, it was able to segregate potential uninsured deposits from the general database. The FDIC used this software just before the closing, and the work was updated daily until the bank failed and the resolution was completed.

Implementation of the Automated Grouping System and Automated Payout System

In 1987, the FDIC developed the Automated Payout System (APS), which greatly enhanced the deposit payoff process. When preparing for a payoff, the APS saved significant amounts of time and money by allowing for a direct download of the failed institution's records into the FDIC's database. The automation of this step resulted in huge savings in the amount of time required to input the information and produce depositor listings from which insurance determinations were made. The APS also printed the payoff checks, the liability register, and the uninsured depositor report. The liability register produced with APS is a tracking system that identified who should be paid, the amount to be paid, the type of account, and any holds that the FDIC may have placed; it saved the claim agents significant time in reconciling or researching the checks and funds disbursed.

The APS not only saved the FDIC valuable time in preparing for a payoff and having the checks readily available for the depositors, but also increased the FDIC's accuracy by automating the transfer of deposit account information and allowing time for more thorough deposit insurance determinations. The FDIC used the APS successfully for the first time at North Central National Bank, Austin, Texas, which closed on April 23, 1987.

Two years later, the FDIC developed the Automated Grouping System (AGS) and combined it with the APS. The AGS/APS could download an institution's deposit information directly into the FDIC's database, which could then be aggregated on the basis of specified identifying fields (including the depositor's name, social security number, and address) to determine the appropriate amount of deposit insurance coverage. Before

the automation of that process, FDIC personnel (anywhere from 5 to 20 or more people) would have to manually alphabetize (or group) the deposit accounts by the same name, rights, and capacities of the accounts, and combine similar accounts to determine insurance coverage. Issues would arise about whether a depositor's name had been duplicated; for example, when a Mary J. Jones and a Mary Jo Jones were listed as depositors. The claim agent was then required to research the institution's deposit information to determine whether Mary J. Jones and Mary Jo Jones were one and the same. With the implementation of AGS/APS, the FDIC was able to eliminate that time-consuming and labor-intensive step.

Automating the deposit payoff process also allowed the FDIC to focus its attention on customer service rather than on the "backroom" operations of the payoff. The FDIC was then able to handle the payment of depositors in a more expeditious manner. It first used AGS/APS successfully at Fulshear State Bank, Fulshear, Texas, which closed on June 8, 1989.

AGS/APS has continued to become more sophisticated. A major enhancement was the development of the "pass with a hold" feature, which allowed the FDIC to transfer money to the assuming institution for funds that the FDIC suspected would be insured after additional documentation proving ownership of the accounts was provided. The assuming institution was allowed to pay the insured portion to the depositor and to hold the potentially uninsured portion until an insurance determination could be made. An example of this feature might have occurred when the failed institution did not keep a copy of the trust agreement for an account held in trust for a family member. Before the pass with a hold enhancement, the potentially uninsured funds remained with the FDIC, and the FDIC then had to initiate a second funding after the additional documentation was received. With the new enhancement, funds were available to the assuming institution so they could be immediately released to the customer.

Another enhancement was the development of FDIC internal management reports that the FDIC used to analyze the deposit base before a closure. The FDIC uses those reports to identify the deposit composition and ascertain how the institution should be marketed. An additional improvement was made in how loans and potential offsets were analyzed and the overall impact of those loans and offsets on the deposit base. The benefit of that enhancement was demonstrated in 1989, when the FDIC completed several deposit analyses two years before the Bank of New England was put into receivership. Those analyses provided the FDIC with a clearer picture of the deposit base composition for the Bank of New England and of how different deposit classes would be affected by the various types of transactions being proposed.

Implementation of U.S. Mail Payoff

In 1988, the FDIC developed the U.S. mail payoff process. The purpose of the process was to get deposit insurance checks into the hands of insured depositors as quickly as possible, thereby eliminating the need for depositors to stand in line at the failed institu-

tion to wait for their checks. The mail payoff process, which made it possible for depositors' checks to be delivered straight to their mailing addresses, has been used consistently for depositor payoffs since 1990.

Advance Planning for a Closing

When a bank closure was impending, FDIC planners would review all the financial and operational information available to prepare for the closing. The FDIC, the OCC, or the state bank examination staff that was monitoring the failing bank would then forward the information to FDIC liquidation personnel. Beginning in 1988, members of the FDIC liquidation staff would join the bank examiners on site to directly obtain the necessary preclosing information. By 1989, members of the FDIC, or the newly created RTC, closing teams would visit the failing institution to download deposit data.

Because most failed savings and loans were in an RTC-controlled conservatorship and their employees were under the management of RTC personnel, the RTC closing team was also able to use the institutions' employees and data processing systems to prepare for the closing. The RTC developed a national manual that divided the closing into three stages: preclosing, closing, and postclosing. The work completed during the preclosing stage was critical when the RTC faced a multi-billion-dollar institution with multiple branch locations and the possibility of multiple acquirers and differing transaction types. Because the FDIC did not use conservatorships, its personnel had to complete their planning off site and without the assistance of the failing institutions' employees. The following three cases demonstrate the benefits of the emphasis on advance planning for impending resolutions.

Southwest FSA, Dallas, Texas

In July 1991, the RTC closed and liquidated the Southwest FSA (Southwest), Dallas, Texas, a large institution with approximately \$2.2 billion in deposits and 67 branches located throughout Texas. Before resolving Southwest, the RTC had prepared for the possibility of multiple acquirers, and because the institution had multiple computer systems, the RTC had to complete various software changes to enable the institution to be broken out by branch and sold to those multiple acquirers. The RTC sold the insured deposits from 45 of the branches to one of two acquirers, and the remaining 22 branches were resolved through a deposit payoff.

For the uninsured depositors at all 67 branches, the RTC had engaged an accounting firm to assist in the closing and claims process. If the RTC had not been able to complete the preclosing computer programming and prepare for multiple acquirers, its closing team would have experienced operational problems in segregating the appropriate branch customers among the two acquirers and the RTC as the receiver.

Columbia Savings and Loan Association, Beverly Hills, California

In September 1991, the RTC closed and liquidated the Columbia Savings and Loan Association (Columbia), Beverly Hills, California. That resolution involved the largest deposit payoff of brokered deposits, \$2.8 billion, in the history of both the RTC and the FDIC. In addition to the \$2.8 billion in brokered deposits at Columbia, the institution had approximately \$2.3 billion in retail deposits. The retail deposits were transferred to an assuming institution in an insured deposit transfer, and the brokered CDs were paid off. The large number of depositors (365,000) and the unique deposit composition required extensive preresolution planning.

To address the brokered deposit situation, the RTC initiated a meeting with executives of the Depository Trust Company (DTC), the Securities Industry Association (SIA), and major deposit brokers in New York City. The DTC held the brokered deposits on behalf of the brokers and their clients, while the SIA and the brokers sold their clients an interest in one of the CDs issued by Columbia. Frequently, the CD was held in the DTC's nominee name. Columbia did not have any documentation to determine who the actual holders of the CDs were, so the RTC thought that it would be wise to meet with this group to explain the closing and claims process. The meeting was held in accordance with an earlier agreement between the FSLIC and the SIA that was adopted by the RTC. The agreement detailed procedures for processing brokered accounts.

The RTC, in addition to meeting with the above-mentioned parties and writing special computer programming, established additional telephone lines to handle thousands of calls related to the closing. The brokers were encouraged to provide their documentation on computer tapes, thus expediting the grouping process and providing timelier determinations for all depositors. Within nine business days of the resolution, approximately \$2.3 billion (82.1 percent) of the \$2.8 billion in total insured brokered funds at Columbia had been paid.

The Columbia transaction was successful as a result of the preclosure planning and the meeting, which provided the RTC with an opportunity to learn about the daily operations of the DTC that were related to ongoing trading of the certificates. That experience proved to be of further assistance to the RTC and the FDIC when they developed software and procedures for processing and tracking brokered accounts of that magnitude.

Guardian Bank, Los Angeles, California

In January 1995, the FDIC closed the Guardian Bank (Guardian), Los Angeles, California, whose closing is of special interest because of its unique deposit base. The failure of that institution could have created significant problems for the real estate industry in Southern California, even though the bank had only 5,419 deposit accounts totaling \$211 million. Approximately 67 percent of Guardian's deposits were from title and escrow companies for pending real estate transactions. The deposit base could there-

fore change dramatically each month, with swings of as much as \$300 million. The transitory nature of those funds made planning for the closing more difficult. Most of the title and escrow company deposit accounts had multiple owners, ranging from 20 to 1,000. If the escrow funds were not available to complete real estate sales, the impact on the local economy could have been serious. When Guardian was closed, 1,608, or 30 percent, of the deposit accounts held funds that were potentially uninsured, in comparison to the average bank, in which 5 percent or below of the deposit accounts could have been uninsured.

The main problem facing FDIC staff was the identification of the owners of the escrow account funds and the insurability of each owner. If the deposit accounts of the institution properly reflected the title company's or escrow company's interest in the deposits as a fiduciary or other custodial capacity, and the title or escrow company had adequate records to support the different escrow account principals, separate insurance coverage could be provided on the basis of the owners' rights and capacities. If the deposit account records did not reflect the fiduciary relationship of the title or escrow companies, the funds would be insured solely as the funds of the title or escrow company, and then aggregated with all other funds owned in the same capacity. Accordingly, the title or escrow company would only be provided with \$100,000 in deposit insurance coverage. However, even if separate insurance were to be provided to the individual principals of the deposit accounts, each escrow principal could be provided with only \$100,000 in deposit insurance coverage. It was therefore necessary to aggregate the actual names of the account owners with the other depositors of Guardian. That required running a new grouping or aggregation report every day after the information was received from the title or escrow companies.

Because of the size and complexity of the accounts involved in the projected Guardian failure, the FDIC had to do extensive preclosing work. The FDIC used post-closing procedures, developed specifically for that closing, to provide comprehensive information to the depositors and to clarify what was needed from the title or escrow companies to prove ownership for deposit insurance purposes. A town meeting was held on the Monday after the closing to explain the insurance rules and to provide each title and escrow company with a computer disk and instructions on how to report the ownership and deposit information needed to prove eligibility for insurance coverage. The State of California Department of Corporations, in cooperation with the FDIC, did extensive work to ensure that the title and escrow companies were given sufficient notification so that as many as possible could be at the meeting. The FDIC developed the program for title and escrow deposit accounts reporting specifically for Guardian on the basis of a similar type of program created for the Columbia closing handled by the RTC in 1991. The program was extremely successful, with accuracy and prompt turnaround time being just two of the many benefits.

Guardian also had a large number of employee benefit plan accounts (approximately 550) for labor unions in Southern California. The closing was the first major test of the pass-through insurance rules governed by the recently enacted Federal Deposit

Insurance Corporation Improvement Act of 1991.⁵ The FDIC, on the basis of the new rules for the acceptance of brokered deposits and notification to employee benefit plan depositors, was required to determine the dates on which those accounts were opened in order to determine whether the deposits were eligible for pass-through insurance.

Guardian's closing required major preplanning concerning handling of the unique depositor base, the coordination of nationwide staffing for specialized areas, the promotion of a greater commonality of procedures, and the ability to work together on a national level to serve a specific office and community. All of those challenges were accomplished with minimal economic disruption to the depositors and communities served by the failed institution.

Conclusion

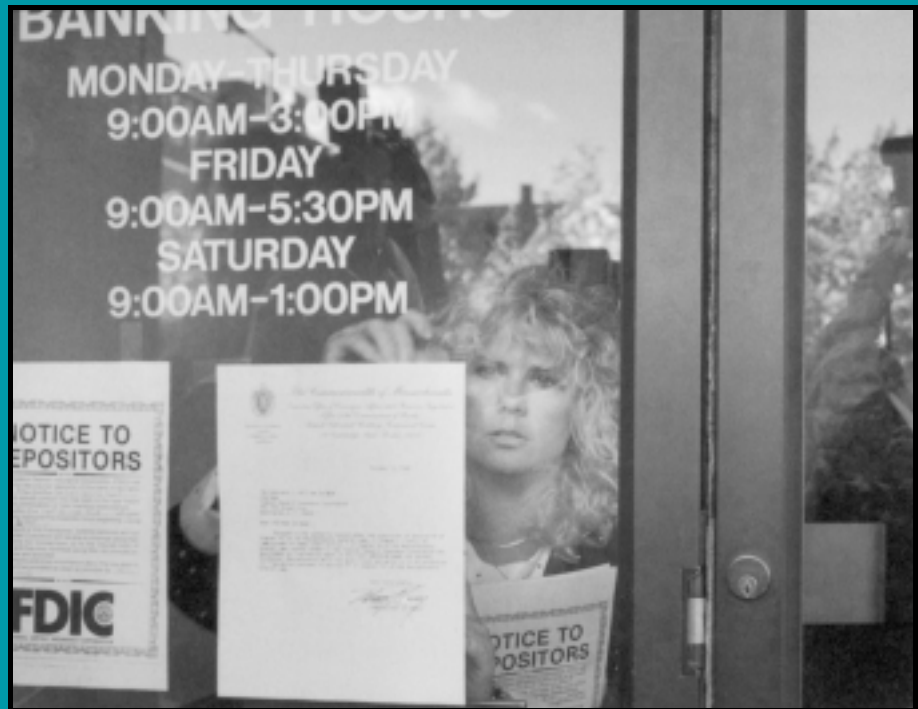
The FDIC and the RTC have continually developed their ability to efficiently and effectively pay deposit insurance proceeds through innovations in automation, training, and procedures. The increased number and sizes of failing financial institutions, coupled with the failure of several state-sponsored deposit insurance funds, made the mid-1980s and early 1990s especially challenging. Nevertheless, the public maintained its confidence in the federal deposit insurance system and in the ability of the FDIC and the RTC to handle the failures.

After development of the insured deposit transfer in 1983, the FDIC had a 93 percent success rate in finding acquirers for the failed bank deposit accounts. The development of the automated grouping system and the ability to service multiple acquirers made it possible for the RTC to resolve many large thrift failures.

Innovations in the deposit payoff process were also made. The supplementation of the automated payoff system with the automated grouping system greatly speeded up the FDIC's capability to accurately produce deposit insurance settlement checks. The implementation of the U.S. mail payoff process got those checks delivered quickly to the depositors' homes, making the scene of depositors waiting in long lines to get their money a thing of the past.

5. Section 330.12 of the FDIC's regulations provides that "pass-through" coverage of \$100,000 applies to each participant's noncontingent interest in an employee benefit plan account. The availability of this coverage depends on the capital level of the institution and compliance with the applicable recordkeeping requirements. The capital level of the institution determines whether the institution is eligible to accept brokered deposits and the employee benefit plan deposits.

Michelle Slusher of the FDIC's liquidation office in Knoxville, Tennessee, posts signs informing depositors about the closing of First American Bank for Savings, Boston, Massachusetts on October 19, 1990.



Payments are made to creditors with valid claims through the dividend process. If no funds are available for immediate distribution, the claimant receives a receivership certificate showing entitlement to a share in the receivership estate.



CHAPTER 10

Treatment of Uninsured Depositors and Other Receivership Creditors

Introduction

A failed bank or thrift receivership has a statutory obligation to identify creditors and distribute proceeds of the liquidation of assets to these creditors commensurate with applicable statutes and regulations. Typical receivership creditors include uninsured depositors, general trade creditors, subordinated debtholders, and shareholders. This chapter discusses the evolution of the claims process from 1980 to 1994 into a uniform system now codified in federal law.

The chapter details the history of the order in which the creditors of the various types of receiverships are paid after the receivership's assets have been liquidated, and describes the actual process used to make distributions, known as liquidating dividends, to uninsured depositors and other creditors with allowable claims. The discussion then focuses on the history of the treatment of each of the different classes of creditors.

The Administrative Claims Process

The administrative claims process varied among the Federal Deposit Insurance Corporation (FDIC), the Federal Savings and Loan Insurance Corporation (FSLIC), and the Resolution Trust Corporation (RTC) and even changed for the FDIC with the passage of the Federal Financial Institutions Reform, Recovery, and Enforcement Act (FIRREA).

FDIC Receiverships (Before FIRREA)

Before FIRREA was enacted in 1989, the National Bank Act (NBA) of 1864 required all creditors with claims against national bank receiverships to file their claims against the receivership. Unlike FIRREA, the NBA addressed claims issues very generally. The NBA stated that the receiver should publish notice to claimants in a newspaper for three consecutive months after the receiver had been appointed. It also allowed an unlimited amount of time up until termination of the receivership for a claim to be filed and determined. The statute further mandated that the proceeds from the sale of assets should be distributed on a pro rata basis to the creditors. It is important to note that even though the NBA stated that creditors should file claims against the receivership estate, the courts allowed lawsuits to be filed without requiring that claimants first go through the claims process.

State chartered bank receiverships adhered to claims processes outlined in state liquidation statutes, for which a specific provision existed in most state codes. The actual steps in the process varied somewhat from state to state, but in general, most states provided for notifying creditors, filing claims, and allowing or disallowing the claims submitted.

Federal Savings and Loan Insurance Corporation Receiverships (Before FIRREA)

From 1984 to 1989, the Federal Savings and Loan Insurance Corporation contended that courts lacked subject matter jurisdiction over claims filed against FSLIC receiverships before claims had been presented to the FSLIC. That policy was based on a decision by the Fifth Circuit Court in *North Mississippi Savings and Loan v. Hudspeth*, 756 F.2d 1096 (1985), involving a compensation dispute between an association and its former president. As a result of the decision, the FSLIC developed internal procedures for processing claims.

In October 1988, the Federal Home Loan Bank Board (FHLBB) had attempted to correct the deficiencies in the claims procedures by promulgating regulations establishing detailed procedures for determining claims filed with the FSLIC as receiver. Several years earlier, the FSLIC had adopted detailed procedures for deposit insurance reconsiderations (*Code of Federal Regulations (C.F.R.)*, volume 12, section 564.1[d]). The FDIC, however, had no regulation for reconsiderations and did not adopt the FSLIC regulation in 1989. Instead, the FDIC and the RTC heard requests for deposit insurance reconsiderations based on internal policies and practices.

In March 1989, the U.S. Supreme Court overruled *Hudspeth* in *Coit Independence Joint Venture v. FSLIC*, 489 U.S. 561 (1989). The court found the claims procedure deficient because no clear constraints existed for the time it took the FSLIC to make a determination on claims filed against a receivership. *Coit* also determined that the FSLIC procedures improperly gave the FSLIC and the FHLBB authority to make final decisions without allowing the claimant an opportunity for a de novo judicial review.

FDIC and RTC Receiverships (After FIRREA)

FIRREA established new procedures for presenting and resolving claims filed by creditors against failed financial institutions. These claims provisions more closely resembled the FDIC's pre-FIRREA procedures and were intended to cure the constitutional problems the Supreme Court had with the FSLIC procedures. FIRREA established a receivership claims process applicable to all federal and state chartered banks and thrifts, thus standardizing the treatment of all receivership claims filed against either an FDIC or RTC receivership. The process required that the—

- Receiver post notice in a newspaper of general circulation for three consecutive months and mail notices to creditors on the books and records;
- Creditors file a claim within the time frame provided in the notice (approximately 90 days from the date of the published notice);
- Receiver make a determination on the claim within 180 days of the date of the filing unless both parties agreed to an extension; and
- Creditors file suit in a U.S. District Court within 60 days of the date of a denial or within 60 days to 180 days after the claim had been filed if no determination had been made.

Both the FDIC and the RTC developed procedures to implement the statute. Over time, however, and because of the ambiguous nature of some of its provisions, questions such as 'Who must file a claim?' and 'Does the state court or federal court have jurisdiction over lawsuits filed as the result of disallowed claims?' arose concerning FIRREA's claims procedures.

History of the Claims Priorities and the Payment Process

Before the National Depositor Preference (NDP) Amendment (described later in this chapter) was enacted, the National Bank Act had established the priority of payment of unsecured claims for national bank receiverships. Although the NBA did not explicitly state the claims priorities, the FDIC interpreted the payment order to be as follows:

1. Administrative expenses of the receiver;
2. Deposit liabilities and general creditor claims;
3. Subordinated debt claims;
4. Federal income taxes; and
5. Stockholder claims.

Individual state laws specified the distribution priorities for receiverships of state chartered banks and may have incorporated the concept of depositor preference, depending on the laws of the given state.

The FSLIC claims priorities regulation (12 C.F.R. 569c.11), promulgated in 1988, was adopted by the FDIC in 1989. The FDIC and the RTC used the regulation for failed thrift receiverships until 1993. Under the regulation, unsecured claims against the receiver had the following order of priority:

1. Administrative expenses of the receiver;
2. Administrative expenses for the failed association, provided that such expenses were incurred within 30 days before the appointment of the receiver, and that such expenses were limited to reasonable expenses incurred for services actually provided by accountants, attorneys, appraisers, examiners, or management companies or to reasonable expenses incurred by employees;
3. Claims for wages and salaries earned before the appointment of the receiver by an employee of the savings association whom the receiver determined was in the best interest to retain for a reasonable period of time;
4. If authorized by the receiver, claims for wages and salaries earned before the appointment of the receiver, up to \$3,000 by an employee not retained by the receiver;
5. Claims for governmental units for unpaid taxes other than federal income taxes;
6. Claims for withdrawable accounts, including those of the FDIC as subrogee, and all other claims that had accrued and become unconditionally fixed on or before the date of default, unless the association was chartered and operated in a state where state law provided priority to depositors over other creditors. In that case, the depositors had priority over other creditors in both a state chartered or federal chartered association;
7. Claims other than those that had accrued and become unconditionally fixed on or before the date of default, including claims for interest after the date of default on claims under paragraph (6);
8. Claims of the United States for unpaid federal income taxes;
9. Claims that had been subordinated in whole or in part to general creditor claims; and
10. Claims by holders of nonwithdrawable accounts, including stock.

National Depositor Preference

The National Depositor Preference Amendment (Public Law No. 103-66 Section 3001 [a]), enacted on August 10, 1993, standardized the asset distribution plan for all receiverships, regardless of the institution's charter, and gave priority payment to depositors, including the FDIC as "subrogee" for insured deposits. Because, so far, most liabilities of failed institutions have been deposit liabilities, the effect of depositor preference in practice has been to eliminate any recovery for unsecured general creditors. Under the NDP Amendment and related statutes, claims are paid in the following order of priority:

1. Administrative expenses of the receiver;
2. Deposits (the FDIC claim takes the position of the insured deposits);¹
3. Other general or senior liabilities of the institution;
4. Subordinated obligations;² and
5. Shareholder claims.

The Dividend Process

Payments are made to creditors with valid claims through the dividend process. The payment of any claim depends on two factors: (1) a favorable final determination by the receiver on the merits of the claim, and (2) the availability of assets in the receivership estate with which to pay the claim. The receiver is authorized, at its discretion and to the extent that funds are available, to pay valid claims at any time. If no funds are available for immediate distribution, the claimant receives a receivership certificate showing entitlement to a share in the receivership estate.

To reduce the hardship on uninsured depositors, in 1984 the FDIC began making "advance dividend" payments soon after a bank's closing. The advance dividend percentage is based on the estimated recovery value of the failed bank's assets. The FDIC did not pay advance dividends when the value of the failed institution's assets could not be reasonably determined at the time of closing.

Advance dividends provided uninsured depositors with an opportunity to realize an earlier return on the uninsured portion of their deposits without eliminating the incentive for large depositors to exercise market discipline.

1. Because of the manner in which the Federal Deposit Insurance Act of 1950 defines a "deposit," foreign deposits are not accorded the benefit of this priority and are therefore paid with the other general or senior liabilities of the institution.

2. Any liability of the insured depository for a cross guarantee assessment would receive distributions after subordinated debtholders but before distributions were made to shareholders. See Chapter 3, Evolution of the FDIC's Resolution Practices.

If the FDIC's actual collections on the assets of the failed institutions exceeded the advance payments and administrative expenses of the receivership, the uninsured depositors and other creditors received additional payments on their claims. If the total of actual collections was less than the advance payments and administrative expenses of the receivership, the FDIC insurance fund absorbed the shortfall.

Between 1984 and 1987, the FDIC authorized advance dividends for 29 of the 118 cases involving insured deposit only resolutions. During the next four years, no advance dividends were approved. From 1992 through 1994, 176 banks were resolved, for which 103 involved insured deposit only transactions. In 69 of those cases, advance dividends totaling \$274.9 million were paid at resolution, and 9 cases indicate a possible overpayment totaling \$324,000, or one-tenth of 1 percent of total advance dividends paid. Of the nine cases, six were located in California, with five in the Los Angeles area, where real estate values continued to decline after the failures and assets were liquidated at a much slower pace than originally had been contemplated.

Advance dividends typically were funded by a loan from the FDIC corporate account to the receiver, which used the cash to pay the advance dividends to the third-party claimants. As the receiver liquidated assets, cash proceeds were used to reduce the loan balance.

Treatment of Like Classes of Creditors

As the deposit insurer, the FDIC is obligated to satisfy deposit liabilities of a failed institution up to the deposit insurance limit. The FDIC in its corporate capacity then "steps into the shoes" of the depositor as a claimant and files its subrogated claim against the receivership estate. The FDIC, like other creditors in the same class, then is paid a pro rata share of its claim based on the liquidation value of the receivership assets.

In 1978, in *First Empire Bank v. Federal Deposit Insurance Corporation*, 572 F.2d 1361 (9th Cir. 1978), the Ninth Circuit Court of Appeals (Ninth Circuit Court) ruled that the FDIC could not arrange a transaction that passed all of a national bank's assets and satisfied some of its liabilities in full while failing to satisfy other liabilities, regardless of class, without violating the NBA's ratable distribution requirement. The decision had a significant effect on the FDIC for several years thereafter.

Transaction Types: 1980 to 1988

In the early 1980s, the FDIC used two transaction methodologies to resolve failed banks: the purchase and assumption (P&A) transaction and the deposit payoff. In P&A transactions, all deposits (insured and uninsured) and most other liabilities transferred to an acquiring institution. If all liabilities that were at the same priority level as the deposit liabilities transferred, the FDIC was, in effect, in compliance with the *First Empire* decision because all creditors had been treated equally. When some liabilities were left behind in the receivership that were on par with the deposit liabilities, the

First Empire Decision

In 1973, the United States National Bank of San Diego (USNB), San Diego, California, closed, and its assets and liabilities were assumed by Crocker National Bank (Crocker). As of the closing date, USNB had 335,000 depositors with \$932 million in deposits. That was the largest financial institution failure since the inception of the FDIC and the first occasion on which the FDIC modified its standard purchase and assumption (P&A) agreement. In the standard P&A, the liability for outstanding standby letters of credit (LOCs) transferred to the acquiring institution and continued to be honored.

The FDIC determined that certain standby LOCs might have been fraudulently issued to guarantee the debts of companies controlled by the former president of USNB and his associates. Potential participants in the P&A, including Crocker, believed that assumption of liability on the LOCs presented an unacceptable risk; therefore, the LOCs remained with the receiver. The holders of the suspected fraudulent LOCs were not paid, but were provided with a receiver's certificate that would allow them to share in any eventual distribution of funds as USNB's assets were liquidated. In contrast, the LOCs that were not suspected of fraud were transferred to Crocker and paid in full when presented.

Two holders of the allegedly fraudulent LOCs, First Empire Bank and Société Generale, sued the FDIC, maintaining that USNB's obligations to them should have been treated in the same manner as the LOCs assumed by Crocker. A California federal district court held that the FDIC, in determining not to pay the suspect letters of credit, had properly exercised the discretion granted to it under federal banking law. That decision was appealed to the Ninth Circuit Court and was reversed in favor of the holders of the LOCs. In October 1978, the Supreme Court declined the FDIC's request to review the Ninth Circuit Court's opinion. Accordingly, the FDIC had to pay the holders of the LOCs that were not assumed by Crocker. The *First Empire* case affected subsequent P&As and placed more significance on the classes of liabilities transferred.

FDIC made the creditors whole out of the receivership estate (that is, creditors were paid from the receivership or were given receivership certificates, rather than being paid from the assuming institution). Once again, all like creditors were treated the same. For payoff transactions, the FDIC paid the insured portion of the depositor's account, and all other creditors (such as uninsured depositors and trade creditors) received a receivership certificate and a distribution that was pro rata with other creditors in their class. Again, in this type of transaction, all creditors of like classes were treated the same.

Between 1980 and 1982, 39 institutions were closed and resolved using a P&A transaction, 12 institutions were closed and resolved using a deposit payoff, and 12 institutions received open bank assistance.

The *First Empire* decision had significant implications for the resolution of Penn Square Bank, N.A. (Penn Square), Oklahoma City, Oklahoma. Until 1982, all failed banks with deposits totaling more than \$100 million were handled with P&A transactions, which protected uninsured depositors. In July 1982, Penn Square, with assets of \$517 million, was closed and uninsured depositors were not paid in full.³ The FDIC decided not to give full protection to uninsured depositors primarily because of the potential contingent liabilities associated with more than \$2 billion in participation loans. Because of suspected inaccuracies in the loan documentation, the FDIC anticipated multiple lawsuits, which made it difficult to value the bank's assets and to determine accurately the volume of creditors' claims. The FDIC also would have to make whole all creditors if uninsured depositors were given complete protection through a P&A transaction. With \$2 billion of possible claims, a P&A transaction could not be viewed as less costly than a deposit payoff.

In December 1983, the FDIC introduced new procedures for bank closings intended to minimize the disruption of bank services generated by deposit payoffs yet expose uninsured depositors to some degree of risk in the event of a failure. The new "modified payoff" procedures provided for advance dividends (partial payments to uninsured depositors and other creditors) on the basis of an estimate of the proceeds from the liquidation of the assets. In many of the closings handled under the new procedures, an acquirer would be found who was willing to accept the insured deposit liabilities. That type of transaction became known as an insured deposit transfer. The uninsured depositors and unsecured creditors remained with the receivership and received pro rata payments based on the liquidation value of the receivership's assets, an arrangement in which all creditors were treated the same. The insured deposit transfer limited the disruption normally caused by a deposit payoff, while promoting some market discipline for larger depositors.

From 1983 to 1985, the FDIC resolved 248 institutions, the majority of which (185) were P&A transactions. Deposit payoffs were used in 33 cases, and the newly created insured deposit transfer accounted for another 21 closings. Open bank assistance was provided in nine transactions.

Efforts to have uninsured depositors share in the losses of failed banks came to a halt with the resolution of the Continental Illinois National Bank and Trust Company (Continental), Chicago, Illinois. Continental had purchased participation loans from Penn Square that contributed significantly to the more than \$5 billion in nonperforming loans held by Continental. In May 1984, a massive deposit run and the inability to find an acquirer led the FDIC to arrange for open bank assistance (OBA). Concerns about the effect this action would have on other financial institutions and the magnitude of the potential losses to uninsured depositors prompted the FDIC to issue a press release assuring full deposit protection. The FDIC's departure from policy and the

3. See Part II, Case Studies of Significant Bank Resolutions, Chapter 3, Penn Square Bank, N.A.

extraordinary amount of assistance it extended to Continental implied that the FDIC might have set a limit on the size of banks for which uninsured depositors were not protected in full, and questions were raised over whether certain banks were “too big to fail.”⁴

From 1986 to 1988, the FDIC resolved 395 failed institutions using P&A transactions. OBAs reached a high at 105 transactions, with 89 institutions resolved using insured deposit transfers. An additional 38 failed banks were resolved using deposit pay-off transactions in which depositors received the insured portion of their accounts and uninsured depositors and other creditors received a portion of their outstanding claims.

Post-FIRREA: 1989 to 1994

FIRREA clarified existing law so that the FDIC's maximum liability to any receivership claimant was limited to the amount the claimant would have received if the institution's assets had been liquidated. In other words, the unassumed creditors were entitled to receive only what they would have received in a hypothetical liquidation, even though assumed creditors received payment in full. The statute also made it clear that the FDIC, at its sole discretion and in the interest of minimizing its losses, could use its own resources to make additional payments to any creditor or class of creditors without being obligated to make the same payment to any other creditor or class of creditors.

After the Federal Deposit Insurance Corporation Improvement Act (FDICIA) of 1991 was signed, the FDIC was required to select the least costly resolution method available. The requirement had a significant effect on the FDIC's and RTC's resolution practices. Previously, the FDIC had structured most of its transactions to transfer both insured and uninsured deposits along with a significant amount of failed bank assets. Under FDICIA, however, when transferring the uninsured deposits was not the least cost solution, the FDIC began entering into P&A transactions that included only the insured deposits.

Of the 1,423 closings from 1989 to 1994, 1,063 were resolved with P&A transactions. The insured deposit transfer method was used in another 224 closings, payoffs accounted for an additional 129 closings, and OBA was provided in 7 transactions.

Unclaimed Deposit Accounts

Before the Unclaimed Deposits Amendment Act (UDAA), which amended the Federal Deposit Insurance Act (FDI Act), was enacted on June 28, 1993, depositors had been required to make a claim within 18 months of the appointment of the receiver or lose their deposit insurance coverage and have their claim be treated as a receivership claim.

4. See Part II, Case Studies of Significant Bank Resolutions, Chapter 4, Continental Illinois National Bank and Trust Company.

The UDAA, which applies to all receiverships established after its enactment, allows the FDIC to make insurance payments available to depositors for 18 months, after which time all remaining unclaimed funds are offered to the appropriate state. The state can attempt to locate the depositors for 10 years before the funds revert to the FDIC in its corporate capacity.

Classes of Creditors (Post-National Depositor Preference Amendment)

The National Depositor Preference Amendment set forth the priority that claims against the receivership would be paid. This section describes those priorities.

Administrative Expenses of the Receiver

Administrative expenses, the category given first priority of payment, include post-appointment obligations incurred by a receiver as part of the liquidation of an institution. It may also include certain expenses incurred before the appointment of the receiver but determined necessary to facilitate the smooth and orderly transfer of banking operations to a purchasing institution or to obtain an orderly accounting and disposition of the assets of the institution. The expenses may include, but are not limited to, payments for the institution's last payroll, guard services, data processing services, utilities, and expenses for leased facilities. Administrative expenses usually do not include expenses such as severance claims, "golden parachute" claims, and claims arising from contract repudiations. An interim final regulation (12 C.F.R. 360.4), promulgated in August 1993, limits the inclusion of expenses within the scope of "administrative expenses" to those that the receiver determines are "necessary and appropriate" for the orderly liquidation or other resolution of the institution.

Deposit Liability Claims

The category given second priority applies to any deposit liability of the institution, including both the insured depositors and the uninsured depositors. Insured deposit claims are claims by depositors for insured amounts of their accounts at the time of the appointment of the receiver. Because the FDIC in its corporate capacity satisfies its deposit insurance obligations and in doing so assumes the rights of the depositors to make a claim against the institution, the FDIC is almost always the largest creditor of the receivership.

Uninsured deposit claims are claims filed by depositors whose accounts exceeded the federally insured limit. These claims are paid on par with the FDIC corporate claim for the insured depositors.

Depositors with uninsured funds can be classified into one of two broad categories: (1) depositors unfamiliar with the deposit insurance rules and the financial condition of

the institutions in which they deposit money, and (2) depositors who are fully aware of the deposit insurance rules and the financial condition of the institutions with whom they do business, but are willing to assume a certain level of risk to obtain higher interest rates on deposits.

Because certain aspects of the deposit insurance regulations were more complicated than others, there was confusion among certain types of depositors, namely joint and testamentary account holders. Deposit accounts associated with charity organizations also caused confusion but usually did not account for a large percentage of the uninsured.

The receiverships established in the early 1980s were unique because they had a higher proportion of uninsured funds in relation to the total number and dollar amount

Bank of Credit and Commerce International and Independence Bank

In 1992, the FDIC was affected by the highly publicized Bank of Credit and Commerce International (BCCI) scandal and the eventual closing of the bank by the Bank of England. The closing affected the treatment of Independence Bank, Encino, California, for which a receiver had been appointed on January 30, 1992. Allegations that the former managers and operators of BCCI fraudulently acquired direct or indirect ownership of Independence Bank, along with First American Bankshares, Inc. (First American), Washington, D.C., led to that closing.

Because of those alleged ties, the FDIC was concerned that a direct payoff of Independence Bank could cause a deposit panic and a run on the multi-billion-dollar First American. However, the FDIC was unable to locate an acquirer willing to assume Independence Bank's 14 branches.

Depository institutions were contacted to see if they would simply help the FDIC pay off the depositors. Finally, the FDIC secured the assistance of First Interstate Bank, Los Angeles, California. Because First Interstate was only paying the deposits on behalf of the FDIC and not assuming them, the arrangement required new legal documents that were finalized at 2:00 a.m. on January 31, 1992. The payoff of more than 33,000 accounts was to begin in 14 hours, at 4:00 p.m., that same day.

As part of an overall settlement of the BCCI matters in the United States, the Justice Department assured all U.S. government entities that were owed money by BCCI that they would be reimbursed for losses incurred as the result of the failure of BCCI. That assurance was crucial to the FDIC's decision to make all depositors whole through the payment of deposit insurance.

Depositors were paid from First Interstate branches located close to Independence Bank branches to avoid media attention that might incite panic at First American. As of year-end 1997, the depositors at Independence Bank had been paid \$522 million, of which \$21 million were uninsured deposits. First American remained stable and was subsequently sold to First Union Corporation, Charlotte, North Carolina, in 1993.

of accounts. Most of those deposits were either “jumbo” (\$100,000) certificates of deposit or brokered deposits including brokers “chasing” the higher interest rates. In the mid-1980s, institutions began offering \$98,000 certificates of deposit to prevent the accumulation of uninsured interest. After 1986, that type of uninsured interest was rarely seen.

Measuring the runoff of deposits before the appointment of a receiver may reveal the level of consumer awareness over time. The FDIC used two methods to determine uninsured deposit runoff. First, assuming that uninsured deposit runoff was to some extent correlated with total deposit runoff, total deposit balances as of the quarter before intervention were compared to total deposits as of the closing date for receiverships not yet terminated as of August 1997. From 1986 to 1994, 214 Bank Insurance Fund (BIF) institutions that had depositors with uninsured funds were closed. Deposit runoff ranged from 6.25 percent in 1989 to 17.83 percent in 1994. Higher percentages of runoff were experienced from 1986 to 1987 and again from 1993 to 1994 than between 1987 and 1993. It appears that while the number of failures was rising, depositors became more confident in the insurance system.

The RTC’s insured deposit transactions indicated a much more significant level of runoff of total deposits than did the FDIC’s, primarily because of the conservatorship program, which encouraged downsizing. During the height of RTC activity, total deposits decreased dramatically from the quarter before intervention (when a conservator was appointed) to the date of the final resolution, which could take place several months later. In 1990, the decline was 36 percent and by 1993, it had grown to 52 percent. Before the RTC was created, deposit runoff had ranged from 2 percent to 8.5 percent, a level that was much more in line with the industry average.

Among the many issues resulting from the RTC conservatorship program were those related to dealing effectively with potentially uninsured depositors who were likely to be affected by the subsequent final resolution. Although the RTC was under no legal obligation to provide notice to those depositors, the common presumption of government care prompted the RTC’s initial policy (in July 1990) to encourage the active reduction of uninsured funds during conservatorship. However, that policy was reversed in December 1990 when the reduction efforts were criticized as increasing the cost of resolution by facilitating a runoff of uninsured deposits.

A more difficult analysis was made of the reduction in actual uninsured deposits over a period of time. A study conducted by the FDIC in February 1996 compared uninsured deposit estimates prepared before a closing to the actual uninsured deposit balances as of the closing date. The estimates were completed for cost test purposes and were cursory in nature. The study suggests that preclosing estimates of uninsured deposits were approximately two to four times higher than the actual uninsured deposits from 1992 to 1994. Table I.10-1 compares the estimated uninsured deposits and the actual uninsured deposits.

The results of that study may indicate substantial depositor discipline. It is difficult to draw any firm conclusions, however, because the preliminary determination is based

Table I.10-1

**Estimates of Uninsured Deposits
Compared to Actual Uninsured Deposits**

Year	Estimated Uninsured Deposits/ Total Deposits (%)	Actual Uninsured Deposits/ Total Deposits (%)	Actual Uninsured Deposits/Estimated Uninsured (%)
1992	3.00	1.41	47.0
1993	6.82	2.71	39.8
1994	6.75	1.74	25.8

Source: FDIC, Division of Resolutions and Receiverships.

on an estimate of the uninsured deposit amount rather than on a thorough insurance determination process that is conducted at the time of closing.

Other General or Senior Liabilities of the Institution

The category given third priority typically comprises all other claims against the receiver, including claims from vendors, suppliers, and contractors of the failed institution; claims arising from repudiated contracts; claims arising from employee obligations; tax claims; and claims asserting damages as a result of business decisions of the failed institution.

The NDP Amendment of 1993 lowered claimants in this category to a priority level below that of the deposit liabilities, thereby significantly reducing any potential recovery on these claims. However, before the NDP legislation, many banks and thrift receiverships paid general creditor claims on par with deposits.

Vendors and Suppliers. A trade creditor is any person, company, or corporation that provides goods or services to an institution before its failure. Examples of vendor claims include claims concerning advertising, appraisals, check printing, courier services, employment agencies, insurance, janitorial services, property management fees, office supplies, and utilities. Because the FDIC bridge banks and the RTC conservatorships were ongoing entities, discretion was used in determining claims against an initial receivership. In some instances, and in accordance with applicable P&A agreements, certain bills for goods and services (such as utilities, lease payments, data processing, and final payroll) were deemed essential to the ongoing operations of the receivership and therefore were paid as administrative expenses of the receiver or by the FDIC, at its discretion. Claims for less than \$500 also were paid in full because of administrative ease and because the cost to process such claims would exceed that amount.

Repudiated Contracts. The FDI Act, as amended by FIRREA, gives the conservator or the receiver the power, at the conservator's or the receiver's discretion, to repudiate most

contracts determined to be “burdensome,” providing that the contract is not essential and the repudiation promotes the “orderly administration of the institution’s affairs.” The conservator or receiver must decide whether to exercise its power to repudiate within a “reasonable period” after appointment. A reasonable period for the conservator or the receiver to exercise its authority under the statute has been subject to interpretation by the courts. The liability of the conservator or receiver for a repudiated contract is limited to actual direct compensatory damages that are determined as of the date of appointment. The damages do not include punitive or exemplary damages, damages for lost profits, opportunity costs, or damages for pain and suffering.

Service Contracts. If a party entered into a contract with a failed institution and the FDIC repudiated the contract after the receiver was appointed, claims for services rendered before the appointment would be considered as allowable claims. If the party performed services after the FDIC’s appointment and the FDIC accepted those services before the repudiation, the party would be paid under the administrative expense category for the services performed.

Leases. A receiver or conservator also has the authority to repudiate any burdensome lease, whether the receiver or conservator is the lessor or the lessee. If the institution were the lessee, the lessor would be entitled to a general creditor claim against the receivership for the payment of contractual rents accruing before the notice of repudiation.

Letters of Credit. In a bank closing, the FDIC typically encounters two types of letters of credit. The first is a commercial LOC that is used by a buyer of goods to ensure payment to the seller upon delivery. Those LOCs are backed by funds placed in an account by the buyer. At the time a receiver is appointed, the account, along with the LOC, usually transfers to an acquiring institution. In the case of a payoff transaction, the seller may delay delivery of the goods until the buyer obtains a substitute LOC. Money on deposit would be insured up to the deposit insurance limit.

The second type is the standby LOC, which is backed by a contingent promissory note from the bank customer to the bank, rather than being backed by actual funds on deposit, and serves as a guarantee mechanism. The issuing bank agrees to pay a third party (“the beneficiary”) if the bank’s customer does not honor its contract with or make payment to a third party, and the bank’s advances are charged against the customer’s promissory note. The FDIC historically has taken the position that a claim based on a standby letter of credit is provable against the receiver only if the contingency triggering payment under the LOC (generally, default by the bank customer) occurred before the appointment of the receiver. In such a case, the claim would be treated as a general creditor claim against the receivership or, in the case of a collateralized letter of credit, as a secured claim.

Employee Benefits. Employee benefit plans may be divided into two categories: qualified plans (under title 26 of the Internal Revenue Code) and nonqualified plans (these usually are unfunded contractual promises to provide certain retirement benefits). Examples of qualified plans include 401(k) plans, defined benefit plans, and profit-sharing plans. If a failed institution has sponsored a qualified plan, the receiver, upon

appointment, becomes responsible for the plan.⁵ Plan assets do not become part of the receivership estate except in rare instances for defined benefit plans for which a reversion of funds is created at the plan termination. In this instance, all plan obligations would have been satisfied before the reversion. The receiver's objective is to distribute vested benefits to plan participants and to terminate the plan in accordance with the Internal Revenue Service (IRS) and the Pension Benefit Guaranty Corporation (PBGC) requirements, if applicable.

Occasionally, a receivership has a defined benefit plan that is underfunded (the plan's assets are insufficient to pay the full benefits owed to the participants). In this situation, two options are considered. One option is a funding contribution from receivership assets that is sufficient to eliminate the deficiency in the plan. The second option is to transfer the underfunded plan to the PBGC. The decision to choose between the two options is based on the Employee Retirement Income Security Act (ERISA) of 1974 (as amended) rules concerning contributions from members of the control group to underfunded plans.

Under ERISA rules, solvent subsidiaries could be required to contribute to the plan to eliminate the underfunding. If such a situation existed, the receivership would fund the plan if sufficient assets existed. If no subsidiaries existed, the subsidiaries had minimal assets, or the subsidiaries were insolvent, the plan would be submitted to the PBGC for future administration and payment of benefits. The PBGC would then file a claim against the receivership for the liability assumed and would be entitled to dividends.

Individuals who have participated in employee stock ownership plans (ESOPs) and thus hold shares of stock in the institution probably will not recover anything from the financial institution's estate because of the low priority of shareholders' claims. When the ESOP assets consist of holding company stock, the ESOP may have some value beyond the holdings of the failed financial institution.

If a plan is nonqualified (and generally unfunded), a provable claim is satisfied on a pro rata basis in accordance with applicable claims priorities. Certain types of employee-related claims arise out of employment contracts, which may also be governed by additional regulations.

Claims for unpaid wages and salaries are usually paid as an administrative expense of the receiver. All other claims arising out of unfunded plans (such as severance and deferred compensation plans) are determined to be either allowable or disallowable, depending on whether the claim was fixed as of the date of appointment of the receiver or was contingent at that time. Fixed claims are allowable and are classified as a general creditor claim, but claims that are not fixed are disallowed.⁶ As a general rule, if any rights to benefits are fixed before appointment of the receiver, the rights "survive" and the claim is

5. See *U.S. Code*, volume 29, section 1001(16).

6. Under the *Code of Federal Regulations*, volume 12, section 360.3, the governing priorities regulation for most savings associations that failed before August 10, 1993, contingent claims may be paid under priority (a)(7).

Great American Bank, FSA, and Home Federal Bank, FA

Both the RTC and FDIC occasionally had to administer an underfunded defined benefit plan. For example, the Great American Bank, FSA, San Diego, California, and the Home Federal Bank, FA, San Diego, California, receiverships were both underfunded by more than \$10 million each. The employees of those institutions were very concerned about the underfunding. After an analysis of the applicable ERISA and PBGC regulations and the determination that the value of solvent subsidiaries exceeded the underfunding, the RTC determined that the receiver was obligated to infuse sufficient money to allow the plan to become fully funded so that participants would receive their full benefit.

allowable. If they have not been fixed, the rights are terminated. For severance plans, a claim is allowable upon the occurrence of a triggering event (such as termination without cause or retirement). Exceptions to this general rule have been made when the government participated in the hiring or retention of the employee. Finally, before allowing a claim for employee benefits under an employment contract, the receiver should consider whether the contract represented an “unsafe or unsound practice.”

Federal, State, and Local Taxes. Claims of governmental units for unpaid taxes at the federal, state, and local level may be allowable claims against a receivership. According to section 15(b) of the FDI Act, *U.S. Code*, volume 12, section 1825(b), if there are no specific state or federal exemptions, receivers usually are not immune from the following:

- Ad valorem real property taxes;
- Federal employment taxes, including the payment and remittance of the employee's portion as well as that of the employer (receiver);
- Federal excise taxes; and
- Federal income taxes. A December 1992 interagency agreement between the IRS and the RTC, affirmed by the FDIC for RTC receiverships for which the FDIC is acting as successor receiver, provides that for RTC receiverships, upon certification that “Treasury funds” would be needed to satisfy depositor claims, the IRS will assess, but not collect, income tax, interest, and penalties from those receiverships. The FDIC, however, asserts that section 7507 of the Internal Revenue Code prohibits the IRS from assessing or collecting federal income or excise taxes from most receiverships.

Furthermore, under the IRS regulations issued pursuant to section 597 of the Internal Revenue Code, all federal financial assistance (FFA) usually is allowed to be included as ordinary income to the receiver at the time the FFA was received or accrued. The collection of the tax is deferred, however, until those receivership assets, the losses of which

will offset the income, are sold. The IRS therefore attempts to recapture any tax benefits obtained by the failed bank or affiliate for pre-receivership years. In any event, the regulation under section 597 states that the IRS will not collect taxes on FFA if the burden is to be borne by the FDIC.

All valid claims for pre-resolution state taxes, and for taxes from which the receivership is not immune, are paid under the appropriate priority system or as secured claims. A conservatorship usually has no tax immunities.

Receivers typically are immune from the following:

- Personal property taxes.
- Transfer, recording, and documentary stamp taxes, which are taxes imposed on the privilege of transferring real property, recording deeds, and the like.
- Intangible property taxes, which are taxes on copyrights, patents, stock, money, and so forth.
- State income, franchise, and privilege taxes. Several states have asserted that FFA should be treated as income to the failed bank. The FDIC, however, has been successful in arguing that because the assistance is provided to the receivership, it therefore is not taxable.
- Sales, use, gross receipts, occupation, and license taxes, if those taxes are imposed by state law on the receiver. Unless state or local law provides a special exemption, contractors are not exempt from sales or use taxes for property they purchase on behalf of receivers.
- State employment taxes on employers; however, the FDIC has never asserted any immunity on behalf of receivers from withholding and remitting state income taxes.
- Other state taxes, including utility and excise taxes.
- Penalties.

Subordinated Obligations

Subordinated obligations represent the fourth priority of claims. Subordinated debt-holders are allowed claims on receivership assets only after all claims with a higher priority have been satisfied. As of October 1997, of the 1,107 open receiverships, 27 had subordinated debt claims filed against them for a total of \$906.3 million. Four of the 27 receiverships had paid dividends on those claims for a total of \$180.7 million.

Of special interest is a practice that occurred from the mid- to the late 1980s in both commercial banks and thrifts in which junk bonds were sold in retail branches, sometimes to the elderly who thought they were buying insured certificates of deposit. Approximately 23,000 of Lincoln Savings and Loan, Irvine, California, investors bought

more than \$200 million in uninsured bonds issued in 1987 and 1988 by American Continental Corporation (ACC), Lincoln's parent company. The depositors charged that they intended to buy insured certificates of deposit, but were steered instead to a special desk at Lincoln's 26 retail offices where the ACC bonds were sold. After the appointment of a receiver, the RTC settled with the ACC bondholders for a lump sum payment of \$21 million.

Shareholder Claims

The fifth priority of claims is shareholder claims. From 1986 to 1994, the FDIC made distributions to stockholders of 16 receiverships for a total of approximately \$40 million, with the largest payment (\$22.8 million) occurring in 1989 to shareholders of Franklin National Bank, New York, New York. Approximately \$13 million were distributed to shareholders of Birmingham-Bloomfield Bank, Birmingham, Michigan, which was terminated in 1993. Frequently the failure of a bank can lead to the inevitable bankruptcy of the holding company. It is important to note that as the institution's shareholder, only the holding company, not the creditor of a holding company, has a claim against the assets of the failed institution.

Conclusion

The FDIC's administrative claims process is an important part of its responsibility to mitigate the economic effects of financial institution failures. From 1980 to 1994, when the number of failed institutions rose, the FDIC increasingly emphasized the equitable treatment of all creditors. The FDIC's concern about market discipline, response to legislative initiatives requiring the least costly transaction possible, and changes in payment priority methodology affected how claims were determined and ultimately paid.

Thus, the FDIC's mechanism for providing payment to uninsured depositors and other receivership creditors evolved into one that is predictable while meeting statutory requirements. This process ensures that creditors are treated in an equitable and timely manner.

The professional liability program contributed more than \$5 billion in cash recoveries to the receivership efforts.



CHAPTER 11

Professional Liability Claims

Introduction and Overview

Professional misconduct was a significant factor in the failures of financial institutions during the 1980s. The Professional Liability (PL) Program at the Federal Deposit Insurance Corporation (FDIC) and the Resolution Trust Corporation (RTC) played an important role in recovering losses from those failures. This chapter describes the development of professional liability operations at the FDIC and the RTC and provides an overview of the legal standards and major areas of collection during the period of professional liability activity after the Financial Institutions Reform, Recovery, and Enforcement Act (FIRREA) of 1989 was enacted.¹

When an insured depository institution fails, the FDIC as receiver—like the RTC and the Federal Savings and Loan Insurance Corporation (FSLIC) before the RTC—acquires a group of legal rights, titles, and privileges that are generally known as professional liability claims. These receivership assets are claims under civil law for losses caused by the wrongful conduct of directors, officers, lawyers, accountants, brokers, appraisers, and others who have provided professional services to a failed institution. To collect on these claims, the receiver often must sue the professionals for losses resulting from their breaches of duty to the failed institution. This specialized group of receivership claims also includes contract rights inherited from the institution under any available director and officer liability insurance policy, and under the fidelity bond insurance policy that institutions purchase to cover losses resulting from dishonest or fraudulent acts by their employees.

1. The Financial Institutions Reform, Recovery, and Enforcement Act of 1989 abolished the Federal Home Loan Bank Board and the Federal Savings and Loan Insurance Corporation and gave the FDIC initial responsibility for the Resolution Trust Corporation and permanent responsibility for operating the new Savings Association Insurance Fund. The FDIC managed the RTC's activities until November 27, 1991, when the Resolution Trust Corporation Refinancing, Restructuring and Improvement Act (RTCRRIA) separated the RTC from the FDIC. The RTC existed from August 9, 1989, to December 31, 1995.

The main objectives of the FDIC's PL Program are first to investigate all potential claims inherited from each receivership, and then to recover losses based on meritorious claims in a cost-effective manner. Although more than \$5 billion have been collected on professional liability claims, that amount is only a partial recovery of much larger losses to the deposit insurance fund (or, in the RTC's case, to the taxpayer) resulting from professional misfeasance and malfeasance. Professional liability claims are complex and contentious and often require many years and substantial investments in investigation and litigation before any actual recovery is realized.

Professional liability activities are closely related to important matters of corporate governance and public confidence. The FDIC's PL Program helps to strengthen the perception as well as the reality that directors, officers, and other professionals at financial institutions are held accountable for wrongful conduct. To this end, the complex collection process for PL claims is conducted in as consistent and fair a manner as possible. Potential claims are investigated carefully after every bank and savings and loan failure and are subjected to multi-layered review by the FDIC's attorneys and investigators before a final decision is rendered on whether and how to proceed. A lawsuit on any particular claim is filed only after attempts at resolution through settlement are made. At the FDIC, the final decision about whether to file suit typically rests with the board of directors. At the RTC, the decision to file suit typically was delegated to senior managers in the Legal Division and the Office of Investigations, and only the largest claims went to the chief executive officer (CEO).

No claim is pursued by the FDIC unless it meets both requirements of a two-part test. First, the claim must be sound on its merits, and the receiver must be more than likely to succeed in any litigation necessary to collect on the claim. Second, it must be probable that any necessary litigation will be cost-effective, considering liability insurance coverage and personal assets held by the defendants.

A number of meritorious civil cases have not been pursued because insufficient reliable sources of recovery were available to justify the cost. Wrongdoers, however, can still be held accountable. The FDIC, the RTC, and the FSLIC have referred various civil matters to the supervisory and enforcement arm of the appropriate regulatory agency. The agencies also have made thousands of criminal referrals and provided ongoing support to the Justice Department on matters involving suspected criminal activity. Since 1980, the courts have ordered more than a billion dollars in restitution against several thousand criminals formerly affiliated with failed institutions, including numerous directors, officers, and other professionals. Of the total criminal restitutions ordered, however, less than 10 percent have been paid to the FDIC.

The Professional Liability Program involved an enormous range of complex law and fact issues that were negotiated and litigated on a case-by-case basis in jurisdictions all over the country (and in some foreign countries). The program recovered a substantial amount of money and should have a beneficial effect on professional conduct at both present and future financial institutions.

Professional Misconduct as a Significant Factor in Financial Institution Failures During the 1980s

The Professional Liability Program is an important part of the effort to recover losses from insured depository institution failures. That became clear at the beginning of the emerging crisis in the early 1980s, when concerns about financial institution fraud began to surface.² Before FIRREA's enactment and throughout the years of its implementation, regulators, independent commissions, and legislative bodies have concluded that professional wrongdoing played a significant role in the depository institution crisis of the 1980s and 1990s. For example, an early systematic study by the Office of the Comptroller of the Currency (OCC) found that of the 171 national banks closed by the OCC between 1979 and 1987, more than 90 percent suffered from significant mismanagement, 35 percent suffered from insider abuse, and 11 percent were victims of fraud.³ In October 1988, the U.S. House of Representatives Government Operations Committee stated that misconduct by insiders and affiliated borrowers had contributed to the insolvency of at least one-third of failed commercial banks and more than 60 percent of all failed thrifts, resulting in tremendous costs to the federal deposit insurance funds.⁴ In addition, a 1992 report to Congress by the General Accounting Office (GAO) concluded that "a key component of these failures was wrongdoing, including negligence and fraud, on the part of directors, officers, and other professionals associated with the institutions."⁵

In July 1993, a national commission, created to study the causes of the financial institution crisis of the 1980s, reported to the president and Congress on its new research, public hearings, interviews, and review of existing work in that area.⁶ The national commission concluded that there had been "unprecedented fraud and abuse" by persons connected with failed institutions, although that was not the sole cause of the crisis, and that "fraud and misconduct were important elements in the savings and loan (S&L) debacle."^{7,8} The national commission found a "continuum of abusive practices"

2. House Committee on Government Operations, *Federal Response to Criminal Misconduct and Insider Abuse in the Nation's Financial Institutions*, H.R. Rep. No. 1137, 98th Cong., 2d Sess., 1984.

3. Office of the Comptroller of the Currency, *Bank Failure: An Evaluation of the Factors Contributing to the Failure of National Banks*, June 1988, 21. See also *Report on Director and Officer Liability Insurance and Depository Institution Bond Pursuant to Section 220(b)(3) of the FIRREA*, September 13, 1991, 26 ("Regardless of whether precisely the same result would be found in a survey of current bank and thrift failures, the OCC study—and the FDIC's experience—make[s] it clear that mismanagement is very common in failed depository institutions.")

4. H.R. Rep. No. 982, 101st Cong., 2d Sess., 1990, 5.

5. "Bank and Thrift Failures: FDIC and RTC Could Do More to Pursue Professional Liability Claims," Testimony of the U.S. General Accounting Office before the Senate Committee on Banking, Housing, and Urban Affairs, June 2, 1992 (hereafter called the *1992 GAO Report*), Summary Statement & 17.

6. National Commission on Financial Institution Reform, Recovery, and Enforcement, *Origins and Causes of the S&L Debacle: A Blueprint for Reform*, July 27, 1993 (submitted pursuant to Section 2556 of FIRREA).

7. National Commission, *Origins and Causes*, ix & 3.

8. National Commission, *Origins and Causes*, 70.

ranging from aggressive search for regulatory loopholes to outright fraud by failed institution managers, attorneys, accountants, appraisers, and others.⁹ Noting that “estimates of the actual dollar losses due to fraud and misconduct differ widely,” the national commission concluded “that taxpayer losses due to fraud were large, probably amounting to 10 to 15 percent of total net losses.”¹⁰

Thus, investigation and pursuit of PL claims were primary concerns after the enactment of FIRREA and during the subsequent receivership activities at the RTC and the FDIC.

Development of Professional Liability Operations

Before the late 1970s, neither the FDIC nor the FSLIC had receivership staff devoted to PL matters. However, expertise at both agencies quickly developed thereafter in response to notable failures such as the Penn Square Bank, N.A. (Penn Square), Oklahoma City, Oklahoma, liquidation in 1982 and the Continental Illinois National Bank and Trust Company (Continental), Chicago, Illinois, assistance transaction in 1984. Initially, in addition to the attorneys assigned to PL matters in each of those cases, and as part of the institution’s overall resolution process, teams of liquidation and examination personnel were detailed for extended periods at the location of the failed financial institution. Outside contractors, such as litigation counsel, were retained as necessary.

In 1986, as the frequency and size of failures increased, the FDIC transferred responsibility for investigating claims from Washington, D.C., headquarters to employees at the consolidated field offices then forming throughout the country. A separate unit was established in Texas, for example, to handle the large bank investigations in the Southwest. Dedicated to PL matters, those in-house personnel worked with FDIC lawyers in Washington to investigate and evaluate the claims. Investigation staff included, at various times and locations, expertise as diverse as certified public accountants, attorneys, commercial lending officers, real estate appraisers, former bank examiners, and even geologists and petroleum engineers. To meet the shifting geographic focus of receivership activity, FDIC staff and offices were relocated from the Southwest and West Coast in the early 1980s to the Northeast later in the decade.

The FDIC developed consistent procedures for managing the claims and any necessary litigation. The investigation of losses incurred by the failed institution begins at its closing, when investigation specialists enter the institution with the first group of closing personnel and conduct interviews with institution managers and other key personnel. Meanwhile, other team members retrieve important documents, searching office by office for relevant records such as loan files and minutes of board meetings. After all records have been collected, inventories are completed. For larger institutions hundreds,

9. National Commission, *Origins and Causes*, 8 & 14.

10. National Commission, *Origins and Causes*, 69-71.

or even thousands of boxes of documents might be retrieved. Keeping accurate inventories and documenting the custody of the records are especially important if litigation becomes necessary. After all documents have been retrieved and initial interviews completed, documents are removed from the failed institution to an FDIC field office. Over time these procedures have become increasingly automated and sophisticated.

The principal role of the FDIC investigator is to establish the factual basis for legal claims, and to identify losses for which the FDIC can pursue recovery in a cost-effective manner. Working with in-house attorneys and outside litigation counsel, the investigation staff compiles, analyzes, and maintains evidence and documentation to support claims. It also reviews all functions of the bank. Audits are analyzed for evidence of audit failure, operational losses are reviewed, and potential claims against professionals are identified.

Before FIRREA, the FSLIC was developing PL operations in response to thrift failures. The FSLIC relied to a much greater degree on the use of outside contractors when closing thrift institutions. It engaged private law firms at the outset of a receivership to investigate and develop PL claims. Supervised by FSLIC attorneys at the Washington office, the outside firm would be responsible for resolving all types of assets, including PL claims, from the particular receivership. The FSLIC did not develop a significant in-house capacity for investigating PL claims.

Professional Liability Operations After FIRREA

As manager of the FSLIC Resolution Fund after FIRREA, the FDIC assumed directly from the former FSLIC the responsibility for resolving claims arising from thrifts that failed before 1989. When the FSLIC PL claims transferred to the FDIC, a small group of in-house attorneys at the FDIC was suddenly managing a large caseload of claims arising from hundreds of failed thrifts as well as banks.¹¹ A Professional Liability Section (PLS) within FDIC's newly reorganized Legal Division was formed to handle all FDIC and RTC PL matters arising nationwide. Although all of RTC's PL matters involved only failed thrift institutions, most of which had been closed by the Office of Thrift Supervision (OTS), many non-RTC PL claims also arose from thrifts, most of which had been FSLIC institutions.

In late 1989, the FDIC established in Dallas its first office of professional liability attorneys outside its Washington, D.C., headquarters. The addition of those attorneys brought PLS staffing to 60 lawyers. During 1990, additional RTC teams of investigators

11. Even before FIRREA's enactment in August 1989, the FDIC had become responsible for thrifts placed in conservatorship or receivership beginning in February 1989. By the time of FIRREA's enactment, the FDIC-managed thrifts totaled 253. When that caseload was combined with an existing caseload of approximately 500 failed banks, some of the 22 FDIC professional liability attorneys each had responsibility for 50 bank and thrift failures. See 1992 GAO Report, 8.

were established in 4 regional and 14 field offices. By the end of 1990, a national network of offices employed almost 400 investigators and staff in the RTC Office of Investigations. The FDIC assigned separate teams of PLS lawyers to oversee all investigations and litigation arising from nearly 500 RTC receiverships. In early 1991, the RTC established a separate PLS section within the independent Legal Division. The section was staffed initially by transferring attorneys from the FDIC PLS, most of whom had already been dedicated to RTC matters. Thereafter, the separate staffs at the RTC and the FDIC grew significantly through new hires; by April 1992, a total of 175 in-house lawyers at the RTC and the FDIC were assigned to PL work.

Shortly after its separation from the FDIC, when the RTC decided to decentralize its PL operations, staff in the RTC field offices began to report to their respective regional counsels and directors, rather than through the Washington, D.C., headquarters. Most lawsuits and settlement recommendations by regional staff were approved under delegated authority in their respective regions. The FDIC, in contrast, retained its reporting lines through Washington, D.C., and all suits and settlements arising nationwide were approved by the same senior management. In 1993, Congress reversed the RTC's decentralization of PL operations, mandating that an RTC assistant general counsel direct the investigation, evaluation, and prosecution of all PL claims.¹²

During its lifetime, the RTC investigated potential claims arising from more than 740 failed thrifts. The RTC brought a PL lawsuit or achieved settlement before filing suit in matters from 444 institutions, which constituted nearly 60 percent of the total institutions it handled.¹³ The RTC pursued claims against directors and officers for a third of the total number of institutions that it handled. The 559 civil professional liability actions that the RTC filed, inherited, or defended fall into a wide variety of categories, including 274 suits related to director and officer liability, 126 attorney malpractice suits, 46 fidelity bond matters, and 43 accounting malpractice matters. Some of the 274 director and officer claims brought by the RTC, however, involved insurance coverage actions out of the same institution for which a separate suit was filed.

From 1980 through 1995, the FDIC investigated all PL claims after each of the more than 1,600 depository institution failures for which it had direct responsibility for resolution. The FDIC brought claims specifically against directors and officers in less than one-fourth of the bank failures occurring between 1985 and 1992. As manager of the FSLIC Resolution Fund, the FDIC handled approximately 300 thrift institutions from 1990 to 1996, and from 1990 to 1995, the FDIC managed 361 PL cases initiated during this period. Thus, the FDIC filed, inherited, or defended more than 800 professional liability lawsuits. The figure for total non-RTC professional liability lawsuits

12. That mandate was part of a number of RTC management reforms directed by Congress under the RTC Completion Act of 1993, Pub. L. No. 103-104, codified at *U.S. Code*, volume 12, section 1441a (w)(10).

13. *Final Report of the Resolution Trust Corporation Professional Liability Section and Office of Investigations*, April 1996 (submitted to Congress by FDIC pursuant to the RTC Completion Act of 1993) (hereafter called the *Final RTC PLS Report*), 5.

includes all thrift claims inherited by the FDIC from the FSLIC after the enactment of FIRREA, as well as professional liability suits from commercial bank failures that occurred during the early 1980s.

The RTC PL function transferred to the FDIC upon the RTC's statutory "sunset" on December 31, 1995. As of January 1, 1996, the FDIC inherited an additional 193 RTC thrift institutions with open investigations, uncollected settlements, or litigation and 196 RTC professional liability lawsuits pending at RTC's sunset. The RTC's PL collections had peaked the previous year (1994) at \$512 million. The FDIC's PL collections had peaked earlier, with cash recoveries of \$610 million during 1992. Within a year after the RTC's consolidation back into the FDIC, professional liability staffing and workload had wound down to levels comparable to the period before FIRREA, although recoveries from continuing PL operations remained substantial.

Significant Issues and Events in Professional Liability Claims Litigation

The FDIC and the RTC investigated thousands of potential PL claims arising from the financial institution failures of the 1980s. Most of those claims were closed following investigation, either because it was already clear that they lacked strong factual and legal support on the merits, or because adequate resources from which the claim could be collected cost-effectively appeared not to be available. Of the claims that were pursued, most eventually were resolved through settlements. To reach settlement, however, the FDIC and the RTC usually had to file a lawsuit and engage in some litigation.

The duration and cost of PL litigation increased during the years after enactment of FIRREA. The FDIC and the RTC achieved a number of large, comprehensive "global" resolutions, particularly in the accounting and securities industries, but only after substantial and costly litigation. Meanwhile, success in obtaining cash recoveries from meritorious director and officer claims diminished during the years after FIRREA's enactment. Fewer claims were covered by accessible liability insurance, while the most culpable individuals at failed institutions usually had few accessible personal assets from which collections could be made. As cases proceeded through litigation, developing legal doctrines began to limit the personal liability of former depository institution professionals (especially directors).

Because of the complex and often litigious nature of PL claims, it takes a long time to settle and collect any proceeds. The "tail" on investigating and litigating professional liability claims can often run more than a decade from the time of the actual misconduct until ultimate resolution and collection by the receiver. Indeed, even in late 1997, the FDIC still had numerous pending lawsuits to recover on PL claims arising from depository institution failures during the 1980s.

The changes in the law governing liability insurance, the evolving standards of liability for director and officer claims, typical defenses raised, and the specialized areas of accounting, legal malpractice, and securities brokerage are described in the following sections.

Insurance Coverage for Director and Officer Liability Claims

Director and officer insurance contracts purchased by institutions before failure were a principal source of recovery for losses resulting from misconduct of culpable directors and officers before their institutions failed. Depository institutions purchase director and officer insurance to protect their directors and officers against liability posed by negligence, gross negligence, and breach of fiduciary duty claims. Although the insurance generally excludes coverage for losses resulting from dishonesty, fraud, and other such intentional misconduct, such losses potentially are covered by the fidelity bond insurance that all insured institutions are required to purchase pursuant to laws and regulations. Director and officer liability insurance typically covers only claims made with the carrier during the policy period, whereas fidelity bonds cover losses discovered during the period the insurance is in force. Both types of insurance contain notice provisions and various other requirements that can pose obstacles to recovery by the insured institution or its receiver.

Liability insurance and fidelity bonds had been the main recovery source for directors' and officers' misfeasance and malfeasance. Beginning in the early 1980s, however, insurers began to add new exclusionary endorsements to insurance policies sold to financial institutions. One such provision, the "regulatory exclusion," purported to preclude any government agency from recovering losses under the policy, even if the losses from wrongful acts by management would have been paid to other claimants, such as shareholders in a derivative action concerning an open institution.¹⁴

Until 1990, the agencies usually defeated regulatory exclusions by arguing that they were vague, unenforceable, and contrary to public policy. After FIRREA's enactment, however, court decisions have largely upheld regulatory exclusions. In fact, six U.S. Circuit Courts of Appeals cases eventually upheld regulatory exclusions as sufficiently clear clauses negotiated as part of a contract between two parties.¹⁵ In reaching their determinations, the courts relied in part on their finding that Congress had expressed no public policy, in FIRREA or elsewhere, against enforcing regulatory exclusion clauses.

When enacting FIRREA, Congress categorically determined not to address the regulatory exclusion issue directly and, instead, allowed the courts to continue addressing

14. Insurance carriers included other exclusions to bar recoveries by the government, such as an exclusion for classified loans and a variety of coverage termination provisions. Insurance carriers also routinely contested the adequacy of notice when the FDIC and the RTC sought to recover as receivers for the insured depository institution. The primary subject of coverage disputes between the agencies and the insurance carriers, however, was the regulatory exclusion.

15. The Sixth Circuit Court, in *FDIC v. Aetna Casualty & Co.*, 903 F.2d 1073 (6th Cir. 1990), was the first Circuit Court of Appeals to address the issue after FIRREA's enactment. Two trial courts after FIRREA, however, found in favor of coverage in particular circumstances. The Colorado Supreme Court, in *FDIC v. American Casualty Co.*, 843 P.2d 1285 (Colo.1992), held that the regulatory exclusion violated state public policy as evidenced by Colorado's banking code. A federal district court in Florida held that the regulatory exclusion did not apply to a derivative action filed by a shareholder before the failure of the bank in which the FDIC was later substituted as a party plaintiff in *ACC v. Frogel*, Case No. 91-0786 (S.D. Fla. 1993).

those contract clauses on a case-by-case basis under existing law.¹⁶ Congress also directed the FDIC, Justice Department, and Treasury Department to issue a joint study of provisions that prevented government agencies from recovering under insurance policies purchased by financial institutions such as the regulatory exclusion. The study ultimately recommended amending FIRREA to assert a federal policy against enforcement of regulatory exclusions and similar clauses.¹⁷ However, because Congress took no action on this recommendation, some courts found that there was no longer any public policy against enforcing these clauses.

That change in the law greatly hindered the agencies' efforts to recover losses caused by culpable officers and directors. Recovering losses from the personal assets of such individuals is typically more difficult and less cost-effective than obtaining indemnification from carriers under a failed institution's insurance policies. Moreover, liability insurance indemnifies losses caused by wrongful conduct of any and all former bank professionals, whose liability for loss typically was "joint and several." Resolution of claims with insurance carriers thus does not require allocation of portions of fault to each individual director and officer. As regulatory exclusions vitiated liability insurance coverage, however, collection efforts shifted to focus more on the particular liability of culpable individuals with accessible personal assets. Those persons usually were outside directors, rather than former loan officers. Not surprisingly, the specific standard of care applied to former directors increasingly became the focus of professional liability litigation.

Standard of Liability for Director and Officer Claims

Long before the 1980s crisis, the legal obligations of directors and officers had been established in common law (judicial) decisions and in federal and state statutes. Directors and officers of a financial institution owe duties to their institution, its shareholders, and its creditors, as do directors and officers of corporations in general. The most important of those legal obligations are the duties of care and of loyalty. As the U.S. Supreme Court stated more than a century ago, the duty of care requires directors and officers, when conducting an institution's affairs, to use the degree of care that ordinarily prudent and diligent persons would exercise under similar circumstances.¹⁸ The duty of loyalty requires directors and officers to administer the institution's affairs and to protect the interests of depositors and shareholders with personal honesty and integrity, and

16. U.S. Code, volume 12, section 1821(e)(12). See also H.R. Rep. No. 54(I), 101st Cong., 1st Sess. 416-17 (1989), reprinted in 1989 U.S. Code Cong. & Admin. News 86, 212-13.

17. "Report on Directors and Officers' Liability Insurance and Depository Institution Bonds Pursuant to Section 220(b)(3) of the Financial Institutions Reform, Recovery, and Enforcement Act of 1989" (September 13, 1991), reprinted in *Regulatory Exclusions Pertaining to Financial Institution D&O Professional Liability Insurance Policies*. Before the House Committee on Banking, Finance, and Urban Affairs, 103rd Cong., 1st Sess. 158 (1993).

18. *Briggs v. Spaulding*, 141 U.S. 132, 152 (1891).

prohibits them from advancing their own personal interests or those of others over the interests of the institution.¹⁹

Directors are responsible for selecting and supervising competent officers; establishing business strategies and policies; monitoring the progress of business operations; and monitoring adherence to policies and procedures required by statutes, regulations, and principles of safety and soundness. Directors must make business decisions based on fully informed and meaningful deliberation. Directors need timely, ample information from officers to discharge board responsibilities and must require officers to respond promptly to supervisory criticism. Open and honest communication among directors, officers, and regulators is therefore vital.

Corporate directors and officers are potentially liable for damages resulting from the breach of their duties. Such liability can flow from breaches of duty that are unintended but negligent, as well as from misconduct that is either intentional or so reckless or wanton as to imply deliberate intent. Before the 1980s, most state laws imposed the so-called “simple” or “ordinary” negligence standard of liability of corporate directors and officers in general.²⁰

During the 1980s and early 1990s, however, several states relaxed the simple negligence standards for director and officer liability, instead requiring that liability be based only on culpable conduct that was grossly negligent or worse. Those states, and many others that did not amend their general standard of care, also acted to protect directors and officers with some form of insulating statute.²¹ State insulating statutes typically stipulate that a corporation, by amending its bylaws or articles of incorporation, may limit the civil liability of its directors so that their liability for negligent breach of the duty of care is eliminated completely.²² Typically, state insulating statutes usually do not apply to officers, however, and do not limit liability for breach of the duty of loyalty.

When enacting FIRREA in 1989, Congress was concerned about state efforts to insulate directors and officers of federally insured depository institutions from liability for losses inflicted on the public. Congress therefore preempted state statutes so that they did not insulate directors and officers from liability for culpable conduct that is

19. *Pepper v. Litton*, 308 U.S. 295, 306-07 (1939).

20. In at least two states, the liability standard is even stricter for managing financial institutions. The standard imposes on those directors and officers a duty of care higher than the simple negligence standard applicable to directors and officers of *nonfinancial* institutions. The standard is stricter because of the fiduciary relationship of institutions that are responsible for handling other people's money.

21. To date, 46 states have adopted a form of insulating statute. Some of the statutes apply specifically to financial institutions, and others apply to corporations in general.

22. Beginning in 1987, for example, corporations in Arkansas could specify that directors are not liable for civil damages except for breach of the duty of loyalty, acts or omissions not in good faith, intentional misconduct, knowing violations of law, or acts giving rise to liability to entities other than the corporation and its stockholders. *Arkansas Code*, Section 4-27-202B(3), made applicable to banks by Section 4-26-103(b) and to thrifts by Section 23-37-105.

grossly negligent or worse. In a new section 11(k) added to the Federal Deposit Insurance Act, Congress provided the following:

(k) Liability of directors and officers

A director or officer of an insured depository institution may be held personally liable for monetary damages in any civil action by, on behalf of, or at the request or direction of the Corporation [FDIC], which action is prosecuted wholly or partially for the benefit of the Corporation—

- (1) acting as conservator or receiver of such institution,
- (2) acting based upon a suit, claim, or cause of action purchased from, assigned by, or otherwise conveyed by such receiver or conservator, or
- (3) acting based upon a suit, claim, or cause of action purchased from, assigned by, or otherwise conveyed in whole or in part by an insured depository institution or its affiliate in connection with assistance provided under section 1823 of this title,

for gross negligence, including any similar conduct or conduct that demonstrates a greater disregard of a duty of care (than gross negligence) including intentional tortious conduct, as such terms are defined and determined under applicable State law. Nothing in this paragraph shall impair or affect any right of the Corporation under other applicable law.

The federal courts soon agreed that, for claims filed by the FDIC and the RTC on behalf of state chartered institutions, section 11(k) preempted only state insulating statutes, not other state laws like standards of care.²³ However, the courts disagreed over whether section 11(k) preempted federal common law and whether, for *federally* chartered institutions, it also preempted state simple negligence standards of care. The U.S. Supreme Court resolved this basic issue when it held that state law, not federal common law, provides the liability standard for directors and officers, and that section 11(k) provided a gross negligence floor for the FDIC claims in states with insulating statutes.²⁴ In other words, a state statute allowing directors to insulate themselves from all liability for breaches of their duty of care does not bar FDIC claims based on gross negligence. The ruling is consistent with the FDIC's long-standing internal policy of pursuing only "outside" director claims for which the facts show that the culpable conduct rises to the level of gross negligence or worse.²⁵

Although most state law definitions of gross negligence are consistent, some definitions vary. A few states have attempted to redefine gross negligence as willful or intentional

23. See, for example, *FDIC v. Canfield*, 967 F.2d 443 (10th Cir. 1992) (*en banc*), cert. denied, 506 U.S. 993 (1992).

24. *Atherton v. FDIC*, 117 S. Ct. 666 (1997).

misconduct, at least for FDIC professional liability cases. Not enough cases have been litigated under these statutes to clearly indicate what effect they actually will have. Directors and officers are generally protected from liability, however, if they have acted in good faith and with due care, and if they have made fully informed business decisions within the scope of their authority and without personal interest or self-dealing.

During the 1980s and early 1990s, the OCC, the OTS, and the FDIC developed several guides for directors: *The Director's Book*, first published by the OCC in 1987 and revised in March 1997; the *Director Information Guidelines*, published by the OTS in 1989; the FDIC General Counsel's statement titled "New FDIC Guidelines Issued to Clarify the Responsibilities of Bank Directors and Officers," dated December 17, 1992, and the *FDIC Pocket Guide For Directors*, reprinted November 1997. The FDIC guidelines clarify FDIC policies concerning professional liability suits. They describe the duties and responsibilities expected of depository institution directors and officers, discuss the differences in the way the FDIC analyzes claims against inside directors as opposed to those against outside directors, describe factors considered in filing suits, and note procedures used by the FDIC in authorizing civil lawsuits.

Defenses to Liability

After the FDIC has demonstrated that the defendants acted wrongfully under the applicable legal standard, it must then show that the conduct caused a reasonably certain measure of damages. Defendants to professional liability claims invariably raise a number of defenses, which fall into such predictable categories as the following:²⁶

- The defendant's obligation for any losses was discharged in bankruptcy;
- Other people bear a portion of the responsibility (the "comparative fault" defense);
- The regulators are at fault and should have stopped the defendant (the "contributory fault" defense);

25. An "inside" director is a person such as a member of a shareholder control group or an officer responsible for running some part of the daily operations of the institution. Insiders have more knowledge of the institution's operations, and they are responsible for ensuring that the institution complies with laws and regulations and for implementing the policies and business objectives promulgated by the board of directors. Because outside directors are neither officers nor control group members, they do not know as much about the institution's daily operations as do insiders.

26. The simplest defense is a general denial of liability. That defense is also the most powerful because if the FDIC is persuaded that it has mistaken the facts, it will voluntarily dismiss its claims. For example, the FDIC dropped some claims after the sunset of the RTC after it determined that the claims were not meritorious or no longer cost-effective. That situation rarely occurs, however, because each claim is extensively investigated before the FDIC decides to pursue it.

- The FDIC cannot sue the defendant because the officers of the failed institution knew what the defendant was doing (the “imputation” defense);
- It is too late to sue (the “statute of limitations” defense); or
- The FDIC’s conduct after failure made things worse rather than better (the “failure to mitigate” or “mitigation” defense).

Before a judge or jury can decide whether any of these defenses are applicable, a preliminary question has to be decided: What law governs? More specifically: Is the right to assert a particular defense determined by state law or by federal law? That issue was extensively litigated for several years following FIRREA’s enactment. After decisions made by many federal district courts and several federal courts of appeals, the issue eventually rose to the U.S. Supreme Court. In 1994, that court held that state, not federal, law governs the issue of whether a defendant can assert an “imputation” defense against the FDIC.²⁷

O’Melveny & Myers v. FDIC settled the question of “what law governs” the assertion of the “imputation” defense. It left undecided, however, the question of “what law governs” the assertion of other defenses to professional liability claims. Later, the Supreme Court also addressed the governing law issue in the standard of care context in *Atherton v. FDIC* when it held that state law sets the standard of conduct as long as the state standard (such as simple negligence) is at least as strict as the federal statute.^{28,29}

One defense frequently raised is the expiration of the “statute of limitations.” When wrongdoers have dominated the board of a failed institution, the FDIC has argued that the statute of limitations did not expire because of the doctrine of “adverse domination.” According to this doctrine, the clock stops running for the statute of limitations on a lawsuit against corporate wrongdoers as long as those same people control the board of directors. The theory behind the doctrine is that the wrongdoers would not have sued themselves, and that no one else could sue them until they were out of power. Not every state accepts this theory, and the states that do accept it impose different conditions on the right to invoke it. So far, three federal courts of appeals (*RTC v. Artley*, *FDIC v. Cocke*, and *FDIC v. Dawson*) have agreed that state, rather than federal, law governs concerning the operation of any “adverse domination” doctrine.³⁰ Those decisions have in practice established rules that are usually very difficult to meet, unless one can show intentional—as opposed to grossly negligent—misconduct. However,

27. *O’Melveny & Myers v. FDIC*, 114 S.Ct. 2048 (1994).

28. *Atherton v. FDIC*, 117 S.Ct. 666 (1996).

29. See *U.S. Code*, volume 12, section 1821(k). This federal statute sets a “gross negligence” floor, which applies as a substitute for state law standards that are less stringent.

30. *RTC v. Artley*, 28 F.3d 1099 (11th Cir. 1994); *FDIC v. Cocke*, 7 F.3d 396 (4th Cir. 1993), cert. denied, 115 S.Ct. 53 (1994); and *FDIC v. Dawson*, 4 F.3d 1303 (5th Cir. 1993), cert. denied, 112 S.Ct. 2673 (1994).

because the Supreme Court has declined to review those decisions, they remain the governing laws in the states within their circuits.³¹

Defendants in professional liability suits also have argued that the FDIC, while acting as receiver for a failed financial institution, did not take all the reasonable measures it could have to seek out or take advantage of business opportunities to minimize the losses on the transactions for which damages are claimed. The argument is typically raised as the affirmative failure to mitigate defense, and sometimes also as part of the comparative and contributory fault defenses. To date, three federal courts of appeals (*FDIC v. Bierman*, *FDIC v. Mijalis*, and *FDIC v. Oldenburg*) have held, as a matter of federal common law, that such defenses are not available to defendants in professional liability cases, regardless of what a state's law may provide.³² Those courts found that Supreme Court decisions and other long-standing federal precedents establish the need to protect from "second-guessing" in litigation the discretionary conduct undertaken by federal officials in the course of liquidating failed financial institutions and implementing FIRREA's complex statutory scheme of policy mandates. Most courts considering such defenses after *O'Melveny* and *Atherton* have found that this federal rule precluding such defenses continues to be appropriate because of the potential for significant conflict between a federal interest and state law, if a state law were allowed to permit courts or juries to second-guess the discretionary judgments made by federal officials in the course of liquidating the assets of federally insured depository institutions.

Recoveries From Accountants

From the 1980s through the early 1990s, federal regulations required all thrifts to hire independent outside accountants to audit the institutions annually, to verify the institutions' annual financial statements, and to review management's internal control mechanisms. Many banks also contracted for outside audits. Accountants agreed to conduct their audits in accordance with generally accepted accounting principles (GAAP). Those principles include standards for planning and executing the audit, including guidelines for testing evidence supporting entries or disclosures. GAAP is a complex body of accounting literature and decisions that is frequently subject to more than one interpretation.

31. Of the various state law defenses asserted by defendants, the statute of limitations arguments were the most detrimental to FDIC efforts to collect on professional liability claims. As a result, otherwise meritorious claims, for many hundreds of million dollars in losses, were eliminated outright. The FDIC therefore proposed to Congress that it amend FIRREA to make it clear that lawsuits could be brought unless the state limitations statute had expired five or more years before the failure of the financial institution. The amendment would have eliminated the "adverse domination" issue in most cases. Ultimately, Congress amended the FDIC's proposal and enacted a five-year rule that applied only to cases of fraud and intentional misconduct and not to cases of gross negligence. Thus, except for situations involving fraud and intentional misconduct, state law continues to govern, in at least three circuits, when and how the doctrine of "adverse domination" will be applied to stop the running of the clock for bringing suits.

32. *FDIC v. Bierman*, 2 F.3d 1424 (7th Cir. 1993); *FDIC v. Mijalis*, 15 F.3d 1314 (5th Cir. 1994); and *FDIC v. Oldenburg*, 38 F.3d 1119 (10th Cir. 1994).

In most cases, auditors issue “unqualified” opinions that an institution’s financial statements are presented fairly in all material respects. The auditor may qualify the opinion, however, noting any observed deviations from GAAP. In some instances, an institution’s finances may be so shaky that the accountant issues a “going concern” letter questioning whether the institution will survive. When an accounting firm does not give an institution an unqualified opinion, the institution sometimes tries to replace it with another firm.

For most banks and thrifts, the most important issue in the audit report is the loan loss review. Banks and thrifts are required to write down the value of loans that are substantially and permanently impaired. However, write-downs may decrease stock prices, may threaten jobs, and even more seriously, may cause an institution’s capital to fall below the minimum percentage of total institution assets that is required under federal regulation. Institutions with less than the minimum required capital are subject to more stringent supervision and restrictions and possibly to receivership. Regulators frequently require such institutions to either raise more capital or close. The amount of an institution’s capital also determines the extent to which an institution can make further loans to generate income.

The audit of internal controls is a review of management’s procedures for detecting problems, such as faulty underwriting, fraud, and noncompliance with regulations. Regulations require, in addition to the annual audit opinion, that the independent accountant issue an annual management letter identifying internal control problems. This letter must be submitted to the regulators, and management is required to respond to criticisms in the management letter.

The basic elements of an accounting malpractice claim are as follows:

- A clear and unambiguous breach of the duty to perform a competent audit in compliance with GAAP. Examples of such breaches include failing to perform an adequate sample of delinquent loans, failing to require a write-off of loans that have been “permanently impaired,” allowing securities that are readily marketable to be reported at book value rather than their lower market value, or failing to include an important internal control deficiency in the management report.
- Materiality, which occurs when the mistake on the financial statement is large enough to be significant in the overall context of the institution.
- Causation and damages, which occurs when the error causes a loss to the institution.

To establish causation the FDIC must show what management or the regulators would have done had they known the truth about an institution’s financial condition. In some cases, causation is relatively straightforward. For instance, if the board knew that the institution, which reported income in a fiscal year, actually had a loss, it could not lawfully have paid a dividend. However, proof of causation is usually difficult. The

FDIC and the RTC typically claim as damages the losses on loans made after an accountant should have issued an opinion that an institution was in dire financial straits.

During the 1980s and early 1990s, accounting malpractice lawsuits proved to be immensely complex and expensive, and accounting firms mounted formidable defenses. Considerable uncertainty existed about how juries would view the huge, technical cases that featured opposing experts opining on the complexities of GAAP accounting. In the early 1980s, the FDIC lost an expensive accounting malpractice lawsuit involving the failure of Continental. Later, the FDIC spent more than \$35 million in outside counsel costs alone when it pursued claims against Ernst & Young and that firm's audit of the Butcher banks in Tennessee. After nine months of trial in 1991, but before any verdict, Ernst & Young settled the case as part of a comprehensive global resolution of all potential liability arising from banks and thrifts that had failed previously. Other global settlements were made by several other national accounting firms during the next few years.

From the 1980s to the early 1990s, the "Big Six" accounting firms had audited more than a thousand failed institutions. As a result, the FDIC and the RTC, as well as the OTS, had potential claims against the accounting firms involving numerous institutions. In some cases, the total damages that were identified dwarfed the assets of the entire accounting firm and its insurance coverage. In discussing the claims and potential settlement, some of the firms expressed an interest in settling all claims with the FDIC, the RTC, and the OTS, rather than addressing one claim at a time.

The agencies had already demonstrated a commitment to fully litigate such claims in the Butcher banks case, as well as other high-profile institutions like Lincoln Savings and Loan (Lincoln), Irvine, California, and Centrust Federal Savings Bank (Centrust), Miami, Florida. It became apparent that the cost of litigating those claims would probably consume most of the accounting firms' insurance assets, as well as hundreds of millions of dollars in agency costs. Consequently, the FDIC, the RTC, and the OTS formed an interagency task force to negotiate across-the-board settlements.

Spurred by its exposure in the expensive Butcher banks litigation, in September 1992 Ernst & Young became the first accounting firm to enter into a global resolution, including a settlement payment of \$400 million. By the end of 1993, KPMG Peat Marwick settled for \$186.5 million, and Deloitte & Touche settled for \$312 million. In 1995, Arthur Anderson settled for more than \$100 million. In addition, those firms agreed to establish an extensive training program for accountants who would be auditing federally insured depository institutions. Two other Big Six firms settled individual cases with the FDIC. All told, \$1.15 billion on accounting claims were recovered by the FDIC and RTC, with about \$1 billion of that total being recovered through the four global settlements discussed above. As a result, very few claims actually went to trial, and many potential claims were resolved without incurring further costs of collection.

Attorney Malpractice Claims

Banking is a law-intensive business. Lending, in particular, may entail a myriad of transactions, usually involving complex collateral arrangements. Insured institutions, in addition to being subject to general principles of corporate governance, are subject to special rules and regulations designed to keep them safe and sound and to protect depositors. An insured institution can be regulated by more than one governmental agency, at both the state and the federal levels.

Attorneys play an important role in advising banks about how to do business in compliance with these complex rules. Sometimes, the scope of the attorneys' employment is limited to closing a particular loan transaction. In other institutions, outside attorneys play a central role at the institution; for example, by serving as the general counsel or as a member of the board. Lawyers who serve central roles in corporate governance may be held to a higher standard than a layperson.³³

Not surprisingly, among the thousands of potential claims investigated the FDIC and the RTC found that some attorneys had made serious mistakes that damaged their client institutions. The FDIC and the RTC filed a total of 205 attorney malpractice suits arising from less than 10 percent of all failed institutions. From those cases and some prelitigation settlements, the agencies recovered more than \$500 million, averaging about \$2.5 million for each suit filed. Most of the cases were settled at an early stage in the litigation. The primary source of recovery in most of the cases was attorney malpractice insurance policies.

As is true for other professional liability claims, attorney malpractice cases require a breach by the individual or the firm of a duty to a client institution, as well as damages caused by the breach. The claims ran the gamut, from simple failure to record a lien to allegations that attorneys played a central role in aiding and abetting a criminal CEO in deceiving shareholders and regulators. Many attorney malpractice claims involved the attorney's failure to advise the client institution about violations of regulations and statutes, usually concerning imprudent loans. For example, attorneys have failed to alert a bank's board that a loan to a nominee borrower was really a loan to an insider designed to skirt credit concentration restrictions such as the "loans-to-one-borrower" regulation.

A controversial issue in those cases is what standard of knowledge the lawyer must have of the insider's conduct to be liable: actual knowledge, intentional ignorance, or "constructive" knowledge (what the attorney should have known under the circumstances). A related issue is the extent to which a lawyer has a duty to investigate suspicious representations of bank officers. If a lawyer learns of an illegal transaction, the lawyer has a duty to go to the board of directors, if necessary, to advise them of the violation or to withdraw from the representation.

33. See *Escott v. BarChris Construction Corp.*, 283 F. Supp. 643 (S.D.N.Y. 1968).

The largest attorney malpractice recoveries involved powerful insiders at the client institution, who had little respect for the rules and pressured outside professionals to overlook violations and even to help conceal matters from the institution's directors or regulators. When the lawyers succumbed to these pressures, they were treating the CEO rather than the institution as the client. The lawyers forgot that their job was to serve the interests of the entire institution, not those of the CEO or controlling shareholder. Some particularly egregious cases included allegations that the attorney aided and abetted the CEO in breaches of fiduciary duty, such as the PL suits involving Lincoln's CEO Charles Keating and Centrust's CEO David Paul.

The largest attorney malpractice recoveries arose from the RTC receiverships of Lincoln and Centrust, two institutions dominated by strong CEOs who eventually were convicted of bank fraud. The RTC recovered a total of \$120 million from seven different firms serving as regulatory counsel for Lincoln and another \$48 million from settlements with two firms representing Centrust.

Securities Broker Claims: Drexel Burnham Lambert, Inc., and Michael Milken

The FDIC has recovered more than \$1.1 billion on securities claims against Drexel Burnham Lambert, Inc. (Drexel), and Michael Milken, the head of Drexel's "junk bond" unit. Beginning in the early 1980s, Michael Milken targeted thrift institutions as a large, federally insured pool of capital that could be used to finance his junk bond efforts. Through Drexel, Milken engineered a campaign to exert improper influence on investment decisions at thrifts, including illegal bribes and misrepresentations concerning the value, liquidity, and risk associated with the junk bonds. Drexel also performed underwriting services for several huge thrifts, such as Centrust and Columbia Savings and Loan Association, Beverly Hills, California, through which substantial proceeds from various Drexel activities were invested. In fact, the acquisition of Lincoln by Charles Keating was facilitated by proceeds derived from a Drexel underwriting.

In early 1990, the RTC and the FDIC established a joint task force to oversee a nationwide investigation into the losses suffered by failed thrifts caused by improper activities related to Drexel and junk bonds. Within the year, the joint task force identified failed financial institutions that had traded in junk bonds underwritten by Drexel, reconstructed numerous, complex trading histories, quantified losses resulting from the trading, and amassed the oral testimony and documentary evidence necessary to evaluate and prosecute possible claims. The agencies filed multiple claims and lawsuits against Drexel, Milken, and their partnerships. The claims included those filed in the Drexel bankruptcy proceedings on behalf of 45 failed financial institutions for losses exceeding \$11 billion and those for treble damages under the federal Racketeer Influenced and Corrupt Organization (RICO) statute. The FDIC and RTC were by far the largest claimant among the thousands of claims filed in federal bankruptcy court and took the lead in litigating all civil claims for securities fraud against Drexel.

In January 1991, the agencies filed a class action suit against Milken and numerous other former Drexel managers on behalf of 53 failed thrifts. The lawsuit involved more than 1,600 different issues of junk bonds and several hundred Milken partnerships that were used to implement unlawful securities schemes. The monumental litigation required production of more than 20 million pages of documents from numerous FDIC and RTC sites nationwide. In March 1992, slightly more than a year after all claims were filed, the parties negotiated global agreements to resolve all pending litigation between the claimants, including the FDIC, the RTC, and private-sector class action litigants, and all named defendants, including Drexel, Milken, and more than 500 former Drexel and Milken partnerships and employees. The Drexel and Milken claims were resolved through highly complex structured settlements entailing periodic cash payments over time, particularly as the large bankruptcy of the Drexel brokerage house itself was resolved. A comprehensive resolution of the Drexel bankruptcy litigation was established through an amended plan of reorganization that was finally approved in March 1992. The plan set aside a percentage of Drexel's bankruptcy estate to satisfy the claims of securities litigants, pooled claims related to securities fraud against Drexel, and established a pro rata distribution plan for securities claimants. In resolving all pending civil claims against him, defendant Milken agreed to pay \$950 million in cash, plus future distributions from liquidation of his other assets. The Drexel bankruptcy plan called for periodic cash distributions to all claimants totaling at least \$1.3 billion as sums were derived from the unwinding of Drexel's bankrupt operations. Under those settlement arrangements, approximately 40 percent of the total payments would be paid to the RTC and the FDIC, as opposed to the numerous other settling claimants.

As of December 1996, more than \$1.1 billion had been collected by the FDIC since the courts approved the Drexel and Milken settlements in 1992. Of the total amounts collected, approximately \$515 million are attributed to the settlement with Milken and related parties, and approximately \$606 million are attributed to the resolution of the Drexel bankruptcy proceeding. Most of the settlement payments (93.5 percent) to the agencies were paid to the RTC, thus reflecting that damages in the Drexel and Milken matter fell mostly on failed thrift institutions, rather than on commercial banks.

Criminal Restitution Activities

FDIC staff members coordinate professional liability activities with the Justice Department whenever criminal conduct by professionals is suspected at a failed institution. The underlying loss that is the basis for a PL claim, especially a fidelity bond claim, may also be the basis for a criminal proceeding. Such conduct and the resulting loss ultimately may be the basis for a criminal restitution order that is payable by the wrongdoer to the FDIC as receiver of the failed institution.

During investigations the FDIC investigators and attorneys are alert to any evidence of possible criminal wrongdoing. Whenever appropriate, they make criminal referrals to the Justice Department and the FBI. From the 1980s to the early 1990s, many thou-

sands of such referrals were made. After FIRREA's enactment, the FDIC and the RTC set up offices and criminal units dedicated specifically to facilitating the cooperative effort begun by interagency bank fraud working groups.³⁴ Staffed by agency attorneys and investigators with professional liability expertise, the criminal units were mandated to assist federal law enforcement authorities in their investigations and to help U.S. attorneys in any prosecutions. In addition to preparing criminal referrals, the criminal units also coordinated agency responses to grand jury subpoenas and, later, efforts to locate and recover assets subject to court-ordered restitution.

Under the Victim and Witness Protection Act, criminal restitution is available to the receiver of failed financial institutions that were victims of bank fraud.³⁵ An order of restitution may be mandated as part of the defendant's criminal sentence and is often made a condition of probation. The process of obtaining a restitution order begins when a defendant charged with bank fraud is found or pleads guilty in a criminal proceeding. At that time, a request for restitution is prepared for submission to the court before sentencing. Usually written in the form of a letter to the sentencing judge, the restitution request documents the losses that the criminal conduct caused the institution, sets forth an analysis of the receiver's standing to obtain restitution under the Victim and Witness Protection Act, and requests a specific amount of restitution. Under the act's provisions, the court considers a number of factors in arriving at a restitution amount, such as the amount of losses to the victim, the financial resources of the defendant, and the financial needs and earning ability of the defendant and the defendant's dependents. The assistant U.S. attorney responsible for the criminal case is provided with an advance copy of the restitution letter, which usually is sent to the court by the prosecutor shortly before sentencing.

Since 1988, when the Justice Department and the banking agencies implemented their coordinated task force approach to the problem, more than 5,500 individuals have been convicted of various major financial institution fraud crimes.³⁶ Approximately one-third of those convicted felons were former directors and officers of their institution, and the remainder includes a significant number of attorneys, accountants, and other professionals. Courts have ordered them to pay several billion dollars in restitution to the defrauded institution or, in the case of an institution's failure, to the FDIC. The FDIC continues to work actively with the Justice Department to collect outstanding criminal restitution orders. Most of the criminal defendants have very limited assets. The FDIC has therefore succeeded in collecting only approximately \$100 million to date in FDIC and

34. Begun in the mid-1980s, the groups encompassed the Treasury Department and the Securities and Exchange Commission, as well as the Justice Department and various bank and thrift regulatory agencies. In addition to the National Bank Fraud Working Group in Washington, numerous local working groups and task forces existed nationwide. The working group network facilitated the resolution of myriad interagency issues and sometimes disparate goals.

35. See *U.S. Code*, volume 18, section 3579.

36. The Justice Department includes as a "major" financial institution fraud any case in which the fraud or loss exceeded \$100,000; the defendant was an officer, director, or shareholder; or the scheme involved multiple borrowers at the same institution.

RTC criminal restitution. Professional liability investigators and attorneys at the FDIC and the RTC played an integral role in the coordinated law enforcement effort.³⁷

Outcomes and Results

Total professional liability collections from January 1986 to December 1996 exceeded \$5 billion. From 1990 through 1995, in particular, the FDIC and the RTC together collected a total of \$4.5 billion from all professional liability operations. Of that total, \$2 billion were collected on behalf of the FDIC receiverships, and \$2.5 billion from the RTC (including the Drexel and Milken recoveries). See table I.11-1 for a summary of the professional liability recoveries and outside counsel expenses.

Of the \$4.5 billion, the FDIC and the RTC collected more than \$1.2 billion on accounting liability claims, mostly from the global settlements with four national auditing firms. Operations at the two agencies contributed in approximately equal proportion to the \$500 million collected on attorney malpractice claims during the six years after FIRREA's enactment. The agencies recovered \$1.3 billion on director and officer claims. During this period, the agencies also collected approximately \$300 million from fidelity bond insurers for dishonest or fraudulent acts covered under those specialized insurance contracts.

From 1990 through 1995, most of the costs for professional liability operations were for outside counsel.³⁸ The RTC often retained counsel to investigate potential claims for a large number of failed thrifts, as well as to pursue any resulting litigation.³⁹ The FDIC usually retained outside counsel only after it appeared likely that a lawsuit would be approved and the assistance of outside counsel would be required to conduct the litigation. Because of the complexity and resource-intensive nature of the cases, however, both agencies used outside law firms to bring most of the lawsuits.⁴⁰

37. See the 1995 *Department of Justice Financial Institution Fraud Special Report* (final report prepared by the special counsel for financial institution fraud).

38. As shown in table I.11-1, \$1 billion were spent on outside counsel, consultants, and experts from 1986 through 1996. Outside counsel expenses attracted significant public and congressional interest. See, for example, *Professional Liability and the RTC Contracting With Lawyers*, Subcommittee Hearing on General Oversight, Investigations, and the Resolution of Failed Financial Institutions Before the House Committee on Banking, Finance, and Urban Affairs, 103d Cong., 1st Sess., March 30, 1993.

39. The FDIC has conducted its PL investigations using its own staff of investigators and attorneys, and occasionally supplemented that staff with outside contractors and consultants. The RTC adopted a different practice, not only because of the heavy workload that was imposed immediately on a newly established operation, but also because the RTC, as an agency scheduled to terminate at the expiration of its mission, sought to minimize the hiring of permanent staff.

40. The use of outside counsel is the predominant practice for large receivers and other insurance company enterprises that manage liability claims. Beginning in 1993, the FDIC set up separate in-house litigation units within its PLS. Those units have handled a modest part of the professional liability caseload, but have been effective in resolving cases and reducing outside counsel costs. They also have allowed the FDIC to pursue some smaller meritorious cases that otherwise would not have been cost-effective.

Conclusion

Professional misconduct was a notable factor in the enormous losses resulting from the financial institution crisis of the 1980s and the early 1990s. The professional liability program was therefore an important part of receivership operations. Sifting through hundreds of failures, the FDIC and the RTC reviewed thousands of potential claims relating to conduct by former directors, officers, attorneys, accountants, appraisers, brokers, and other professionals formerly affiliated with failed banks and thrifts. The agencies actively pursued those claims that were both strong on the merits and likely to be cost-effective in light of accessible assets and insurance coverage. In the end, the professional liability program contributed more than \$5 billion in cash recoveries to the receivership efforts.

The professional liability program yielded benefits to the public in addition to the actual cash collections by the agencies. Those advantages are most apparent in the area of criminal restitution and law enforcement. The professional liability program also had an effect on awareness of professional standards, which directly benefits the public by enhancing discipline among professionals.

Not surprisingly, the professional liability program at the FDIC and the RTC was controversial from the start, spawning nationwide discussion and debate over basic legal and policy principles. Many of the professionals sued were respected people in their communities, and some were public figures and politicians. Although many of the claims involved outright fraud, most of the lawsuits alleged that the professionals were grossly derelict in performing their duties to the failed institution. Thus, most defendants in professional liability lawsuits are honest citizens who neither committed crimes nor specifically intended to cause the failure of the institutions. It was therefore inevitable that the professional liability program would be the subject of substantial public interest, including numerous hearings before Congress.

Defendants frequently accused the FDIC and the RTC of being too aggressive in bringing lawsuits. They charged that the agencies were seeking to impose new, stringent standards of conduct retroactively. Others criticized the agencies for bringing too few suits and for settling claims for amounts that were insufficient, considering the extent of the losses or the defendant's personal assets. Still other critics contended that sensitivity to professional liability lawsuits has made it difficult for financial institutions to obtain good professionals at banks and thrifts.

Table I.11-1**Professional Liability Recoveries and Outside Counsel Expenses****1986 - 1996**

(\$ in Millions)

Year	FDIC		RTC	
	Recoveries	Outside Counsel Cost	Recoveries	Outside Counsel Cost
1996*	\$81.1	\$15.1	\$114.8	\$33.0
1995	231.7	22.1	222.7	75.7
1994	239.9	33.2	511.6	100.0
1993	266.5	43.5	364.3	134.6
1992	609.8	85.2	288.4	69.8
1991	319.3	87.0	31.7	49.8
1990	363.1	79.6	11.2	3.4
1989	147.9	32.0	4.2	N/A‡
1988	90.0	20.8		
1987	71.5	15.2		
1986	83.3	10.9		
Subtotals†	\$2,504.1	\$444.6	\$1,548.9	\$466.3
		Drexel/Milken†	1,028.8	106.0
Totals	\$2,504.1	\$444.6	\$2,577.7	\$572.3

* Although all recoveries are by the FDIC after the December 31, 1995, sunset of the RTC, collections can still be traced to thrift institutions inherited by the FDIC.

† The recoveries and costs to the RTC under the Drexel/Milken global settlements are reported separately, below this subtotal line, and as part of the line showing total recoveries and costs for the FDIC and the RTC. Approximately 6.5 percent of collections under the Drexel/Milken settlements were allocated to thrift institutions managed by the FDIC under the FSLIC Resolution Fund. Those relatively smaller Drexel/Milken collections to the FDIC are not reported separately, but are included within the annual figures for the FDIC above.

‡ Not applicable

Source: FDIC, Legal Division.

The Radisson Lord Baltimore Hotel, a registered historic landmark near the Inner Harbor in Baltimore, Maryland, was sold by the FDIC at its December 1992 auction for \$8.5 million.



During the crisis years, the FDIC and RTC acquired approximately \$410 billion in assets that were targeted for asset disposition. By the end of 1997, less than \$5 billion of those assets remained with the FDIC.



CHAPTER 12

Evolution of the Asset Disposition Process

Introduction

This chapter provides an overview of the various asset disposition methods employed by the Federal Deposit Insurance Corporation (FDIC) and the Resolution Trust Corporation (RTC) in their various capacities. The chapter also describes how the FDIC and the RTC adapted their asset disposition methods to meet the enormous challenges during the 1980 through 1994 period. Chapters 13 through 17 describe in greater detail the evolution and issues associated with specific asset disposition methods.

Between 1980 and 1994, the FDIC handled the resolution of 1,617 failing or failed banks with total assets of \$302.6 billion, and from 1989 to 1995, the RTC resolved 747 failing or failed thrift institutions with total assets of \$402.6 billion. During 1980 to 1989, the Federal Savings and Loan Insurance Corporation (FSLIC) also acquired a significant volume of assets when it resolved 550 thrifts with total assets of \$219 billion. Altogether, from 1980 to 1994 these agencies resolved 2,912 banks and thrifts with assets of \$923.8 billion. (See chart I.12-1.) (In 1995, the RTC resolved two thrifts with assets of \$0.4 billion.)

The FDIC disposed of the majority of the assets in failed or failing banks at the time of resolution by selling them to assuming banks. Of the \$302.6 billion in failed bank assets, about \$230 billion, or 76 percent, were sold immediately at resolution to assuming banks. The remaining \$72 billion in assets were retained by the FDIC and disposed of over time. Those remaining assets were usually the most difficult and problematic to resolve.

The RTC sold a relatively smaller percentage of assets at the time of resolution, and instead disposed of the assets either during conservatorship (before closing) or after completion of the resolution transaction. Of the \$402.6 billion in assets from failed thrifts handled by the RTC, \$75.3 billion, or 18.7 percent, were handled at the time of

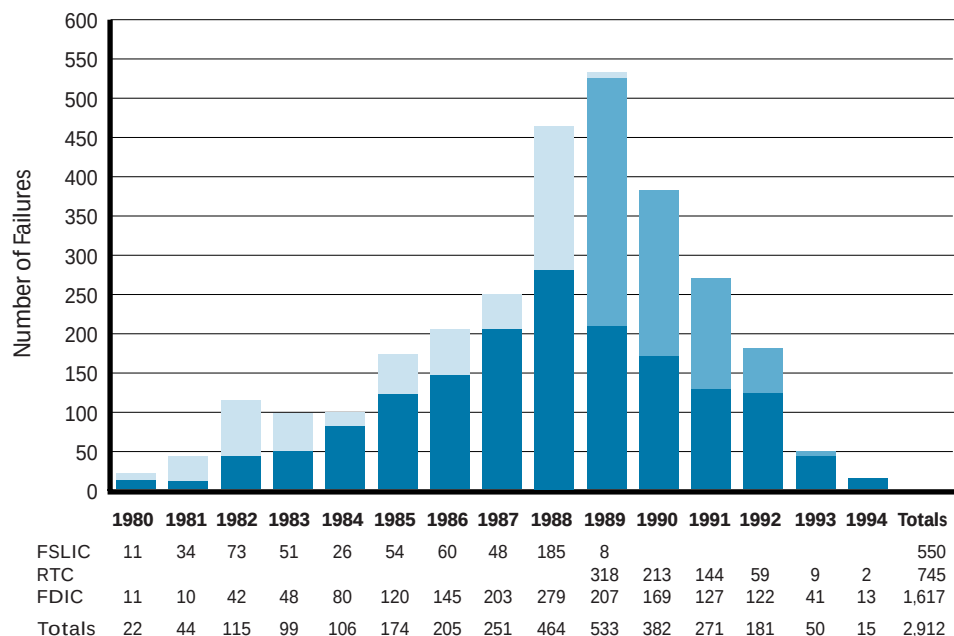
resolution. Of the remaining \$327.3 billion in assets, \$157.7 billion, or 39 percent, were disposed of while the institutions were in conservatorship, and \$169.6 billion, or 42.3 percent, were retained by the RTC for disposal after resolution. The more liquid or easier-to-sell assets often were the ones sold during conservatorship, while the harder-to-sell assets usually were sold after completion of the resolution process.

The volume of bank and thrift assets in liquidation rose steadily in the 1980s and peaked in the early 1990s. The rise corresponded with the dramatic surge in bank and thrift failures discussed in chapters 2 through 7. The FDIC's asset portfolio peaked at \$43.3 billion in 1991 and the RTC's at \$83.1 billion in 1991. Combined bank and thrift assets in liquidation peaked in 1991 at \$126.4 billion. (See chart I.12-2.) To put that number in the proper context in terms of assets, the FDIC/RTC would have been the second largest financial institution in the country at that time.

The disposition methods discussed in this chapter (and in chapters 13 through 17) relate to the liquidation of approximately \$410 billion in assets that the FDIC and RTC did not sell to an assuming bank during the resolution process. After resolution, the FDIC needed to liquidate \$72 billion in assets from failed banks, along with an

Chart I.12-1

**Combined Number of Failures (Banks and S&Ls)
1980–1994**

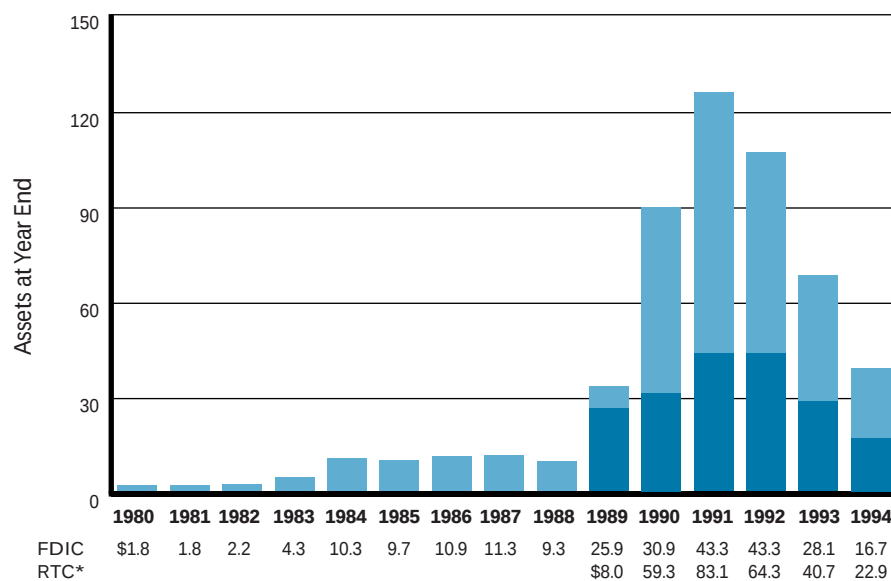


Figures include FDIC and FSLIC open bank assistance transactions.

Source: Reports from FDIC Division of Research and Statistics.

Chart I.12-2**Combined Bank and S&L Assets in Receivership
1980–1994**

(\$ in Billions)



*Does not include \$47.3 billion of assets in conservatorship.

Source: FDIC Division of Resolutions and Receiverships and RTC Statistical Abstract.

additional \$11 billion in assets received from the FSLIC. The RTC needed to liquidate \$327 billion in assets not sold to assuming banks.

Generally, all three agencies had two basic policy goals for disposing of the assets of failed financial institutions: (1) to dispose of the assets as soon as possible without upsetting local markets, and (2) to maximize the return to receiverships. The factors and methods used to decide when to hold versus when to sell assets, or when to litigate versus when to compromise, evolved in response to the circumstances of the times. At the beginning of the crisis years (1980 to 1994), the FDIC used in-house staff to liquidate assets one at a time. By the end of the crisis years, more sophisticated methods had evolved, including securitized sales of assets and equity partnerships with private-sector firms.

Asset Disposition at the FDIC Before 1980

Between the Great Depression and the 1980s, few banks failed, and those that did were relatively small. Between 1934 and 1979, a total of 566 banks failed, or, on average, about 12 per year.¹ Those banks had total assets of about \$9.2 billion, or an average of \$16.3 million per bank. Excluding three larger bank failures in the 1970s, the average asset size of the banks that failed during that period was only about \$3.7 million.

Although there were not many bank failures or failed bank assets before the 1980s, the majority of the assets in the banks that did fail were retained by the FDIC for liquidation. Of the 566 bank failures between 1934 and 1979, 315, or 55.7 percent, were deposit payoffs, and 251, or 44.3 percent, were purchase and assumption (P&A) transactions. In a deposit payoff, the FDIC retained all of the failed bank's assets. In a P&A transaction, a large portion, usually at least 50 percent, of the assets was retained.

Even though the FDIC retained most failed bank assets for liquidation, the pre-1980 asset disposition workload was not significant. Because of the large number of failures in the early to mid-1930s, assets in liquidation peaked at \$136 million in 1940 (the value in current dollars is \$1.6 billion). Over the next three decades, however, the number of failures decreased, and the volume of assets in liquidation, which was only \$2 million in 1952, did not reach the 1940 level again until 1971. The FDIC liquidation activity did escalate in the 1970s, as several large banks failed in 1974, and the volume of assets in liquidation reached \$2.6 billion. By the end of the decade, the volume had decreased somewhat to a total of \$1.9 billion, but was well above the pre-1970 totals.

During the FDIC's early years, when few banks failed, a team of career FDIC employees, perhaps no more than two or three people, depending on the bank's size, was sent to manage the receivership. The FDIC team hired failed bank employees on a temporary basis to assist the career staff in the liquidation process. After several years, when the workload decreased sufficiently, the FDIC would shut down the receivership, close the office, and dismiss the temporary employees. After a receivership closed, the career employees would move to the site of another failed bank to set up receivership operations. Thus, the FDIC employees lived a fairly nomadic lifestyle, never staying in one place for more than a few years at a time.

Early procedures for disposing of assets were relatively straightforward. In a P&A transaction, the first step was to see if any additional assets could be sold to the acquiring bank. The acquiring bank would look at its list of new depositors to see if those depositors had loans held by the receivership. If they looked like good customers, the acquiring bank would purchase and rewrite the customer's loan and pay off the debt held by the FDIC as receiver. Usually, the FDIC offered no discounts. This process would go on for several weeks as the bank figured out which assets it wanted and which ones it would leave behind. The process worked well during periods of stable or

1. If one excludes the failures in the 1930s, the average number drops to 6.2 per year.

decreasing interest rates because borrowers were not at risk of a significantly higher interest rate on their new loans. In addition, the acquiring bank was not at risk of holding a new loan with a below-market rate of interest if it renewed the loan at or near the existing rate. However, during periods of increasing interest rates, it was not to the borrower's advantage to pay off existing loans that had more favorable rates of interest. In those instances, if the loans were not in default, the FDIC would have to hold them to maturity, a situation that sometimes resulted in the FDIC's retaining a larger portion of the failed bank's assets than it was accustomed to owning.

After the assuming bank completed its activity, the FDIC would focus on liquidating the remaining assets. Although few written policies and procedures were in place at the time, the FDIC preferred that borrowers find refinancing and pay their loans off in full. If borrowers could not obtain refinancing from the assuming bank, the FDIC asked them to look elsewhere. If refinancing was not available, the FDIC expected borrowers to meet the terms of their loans and pay them off in full at maturity. The FDIC's field staff had little flexibility in offering discounts or compromises at reduced value. While not done on a widespread basis, the staff would receive authority from Washington to settle for reduced amounts to the extent necessary.

During the 1950s and 1960s, the FDIC would "offset" the amount a borrower owed on all delinquent loans against that person's deposit balance, thereby reducing the overall payment to the depositor and ensuring that the FDIC collected a higher, if not full, amount on the loan. For performing loans, the FDIC often withheld offsetting deposits pending individual negotiations. Usually, the result was that deposits and loans were "netted" against one another so that only the remaining balance was paid by or owed to the FDIC.

That approach reduced the FDIC's initial outlay of funds for payoff cases. From 1934 to 1965, 8 percent of the deposit accounts and 5.3 percent of the total deposits in resolutions handled as deposit payoffs were paid by offsets.² The FDIC did not keep similar records on withheld deposits because they were negotiated and ultimately resolved.

The offsets and withholding method of collection, however, had an adverse effect on local communities. Depositors could not use their funds until decisions could be made about offsets. In addition, once decisions were made, the failed bank's customers often had less liquidity than they had before. The issue received considerable attention in 1963 when the Chatham Bank of Chicago, Chicago, Illinois, failed, and the payoff had significant repercussions for the local community. As a result of that failure, the FDIC changed its policy so that it offset only delinquent loans or officers' and directors' funds against potential liability, and it stopped the practice of offsetting or withholding all mutual loans and deposits. Depositors with funds over the insurance limit retained the right to offset those amounts against loans to the failed bank. That strategy usually

2. FDIC, *1965 Annual Report*, table 124.

worked to the depositors' advantage because, although they owed the full amount of their loans, they would probably collect less than full value on uninsured funds in the absence of the offset or netting arrangement.

In the 1970s, three notable bank failures signaled a new era for the FDIC's asset disposition activities. Those failures included the United States National Bank, San Diego, California, in 1973, with assets of \$1.3 billion; the Franklin National Bank, New York, New York, in 1974, with assets of \$3.6 billion; and the Banco Credito y de Ahorro Ponceño (Banco Credito), Ponce, Puerto Rico, in 1978, with assets of \$712 million. Those three large bank failures caused a substantial increase in assets in liquidation, which in turn prompted the FDIC to begin re-evaluating its asset disposition practices.

During the late 1970s, with rising interest rates, prospective purchasers would not pay full book value for loans. In 1976, to facilitate sales in that environment, the FDIC issued a directive that stated that loans (especially mortgage loans) could be priced according to their current market value and sold. The directive suggested that the FDIC would not hold such loans, nor collect payments for their future value, but would instead sell them for their present value. As a result, in 1976, the FDIC conducted a mortgage loan sale at a small liquidation office in New Jersey and from 1976 to 1979 conducted approximately 10 competitive residential and commercial mortgage loan portfolio sales (known as bulk sales) totaling approximately \$50 million.

During that period, P&A agreements also gave assuming banks exclusive rights to purchase mortgage loans at a discount within 60 days after a bank failure. As a result, in 1978, the FDIC sold about 5,000 mortgage loans in one transaction and a \$100 million mortgage loan portfolio in another transaction after the Banco Credito failure.³

Asset Disposition Activities After 1980

In the early 1980s, bank closing activities began a steady rise that peaked in the early 1990s. As a result, bank assets in receivership also increased dramatically. The FDIC faced many new challenges, as bank closing activities were directly affected by regional economic factors. The Midwest and Plains states experienced an agriculture crisis that led to the closing of many farm banks and the acquisition of a large volume of agriculture-related loans. Real estate values declined in California, resulting in an increase in bank closings and assets in receivership on the West Coast. In the Southwest, problematic energy loans led to the closure of many banks, the most infamous being Penn Square Bank, N.A., Oklahoma City, Oklahoma. In the Northeast, the FDIC dealt with the savings bank crisis. Recognizing that the volume of bank closings and assets in liquidation could no longer be administered efficiently from Washington, D.C., the FDIC

3. Stephen Douglas, on-site FDIC liquidator, excerpt from an interview.

expanded and decentralized its organizational structure. It also began exploring new and creative ways of disposing of the rapidly increasing volume of assets.

Regionalized Liquidation Activities

Beginning in November 1982, in response to the rapidly accelerating number of “problem banks,” the FDIC began to expand its liquidation and claims presence by organizing its operations into regions. It opened regional offices in Atlanta, Chicago, Dallas, Kansas City, New York City, and San Francisco, making those offices responsible for all liquidation activities occurring within their geographical territory.

Later, each region became responsible for several consolidated offices that the FDIC established at different locations within the region’s territory. As banks were closed, the assets retained would be brought into the nearest consolidated office for liquidation, generally within three months. That new approach provided economies of scale and improved asset marketing techniques by presenting opportunities for packaging similar loan products from different failed banks for sale to private investors.

One of the key monitoring methods the FDIC used to measure consolidated office performance was the cost-to-collect ratio. FDIC management estimated that, based on historical experience, it would cost an average of \$.10 to collect \$1.00 from the assets held in inventory at each consolidated office. It used the 10 percent rule as an informal gauge of consolidated office performance. National competition among consolidated offices for the lowest cost-to-collect ratio also affected asset disposition strategies. Consolidated offices were quick to get on board with bulk sale initiatives because of the low cost and high return of disposing of assets in bulk.

Reorganization of liquidation operations provided the FDIC with the flexibility to adapt its operations to meet the expanding workload of the crisis years. Such regionalization was accompanied by delegations of authority and additional field responsibility. The regional and consolidated offices also provided a firm base of operations that contributed to the orderly absorption of the FSLIC in 1989, the start-up of the RTC that same year, and the transition of the RTC into the FDIC in 1995.

The Energy Crisis

The fall of crude oil prices in 1981 had a severe effect on banks in energy-producing southwestern states. The gasoline shortage in the 1970s had convinced the public that crude oil supplies were limited, and projections made by experts at that time indicated that crude oil prices could increase to \$100 per barrel. The price of crude oil did increase rapidly to more than \$40 per barrel, thus validating the projections and causing the valuation of estimated reserves in the ground to increase exponentially. Almost any loan amount was considered reasonable, based on those leveraged values. That sense of security created a frenzy to lease acreage, drill discovery wells, estimate reserves from the preliminary production, and rush to lease more land. The increasing demand drove up

the prices of leases, supplies, and all services. Even though the income from production still took months or years to recoup the cost of drilling, loan volume continued to increase. As interest rates rose during that period, banks continued to lend, and the projected profits enticed borrowers to agree to the higher rates. When the bottom fell out of crude oil prices, energy loan losses increased and many banks fell into insolvency.

As a result, the FDIC acquired a large portfolio of energy loans and related assets and, at one time, became the largest owner of drilling rigs in the world. The FDIC hired employees from the local regions with the knowledge and skills to resolve those specialized assets. Over time, FDIC staff became more knowledgeable in energy lending as well. They were required to identify the exact type of ownership interest in a gas or oil well held as collateral and interpret the attendant legal instruments. They also had to understand reserve estimations and the values assigned from cash flow projections.

Because of the collapse of the energy market and poor loan documentation, collection of loans was difficult. The FDIC relied on secondary sources of recovery such as calling letters of credit and selling collateral equipment.

Agricultural Crisis

In the early 1980s a severe downturn in the agriculture sector began to take its toll on agricultural banks. By 1985, agricultural bank failures had peaked at 62 for the year, accounting for more than 51 percent of total bank failures. The FDIC as receiver was then in the business of working out distressed farm credits.

The disposition of agricultural loans acquired from failed banks started off poorly. The majority of field liquidation staff and regional management had little knowledge of agricultural operations and lending practices. Farm or livestock operations are usually seasonal, with cash flow occurring at different times from year to year, depending on when the crops or livestock are sold. Farm borrowers were accustomed to borrowing funds for living expenses or paying at the time of sales. At the time, releasing proceeds from the sale of collateral or advancing money to borrowers for such expenses were uncommon practices for the FDIC. Compounding the problem was the fact that the FDIC's field staff had limited delegated authority. Typically, requests for advances or releases of proceeds to borrowers had to go to the regional office. Delays in processing such requests impaired the farmers' ability to pay their bills, make critical purchases, and develop business plans.

Smaller community banks had maintained the practice of repeatedly renewing their farm loans. Such renewals were usually done on a quarterly basis, depending on the needs of the farmer. The FDIC told farmers to refinance their loans at other banks, but in most cases there were few good banks from which to borrow. Thus, one of the FDIC's basic collection practices of moving good customers to good banks did not work in the agriculture crisis, and entire communities were affected.

In response to complaints that the FDIC's collection policy was harsh and demanding, the FDIC held town meetings immediately after farm bank failures to explain its

policies and procedures to local communities. In addition, the FDIC provided its staff and management with training and written agricultural guidelines to help them handle this crisis. Furthermore, the FDIC put programs in place to keep agricultural loans within the banking system or to sell them immediately after a bank's failure. To encourage sales to the private sector, the FDIC offered discounts on the portfolios.

By early 1986, the FDIC had entered into an agreement with the Farmers Home Administration (FmHA), under which the FmHA and the FDIC would provide personnel at bank closings, make direct loans, and help farmers restructure their debt. That program helped the FDIC verify collateral values and compromise debt. It also provided on-the-job training for less experienced liquidators. Up to that time, the FDIC's collection efforts had been geared toward "stemming" the losses and not increasing outstanding debts. In response to the agricultural crisis, the FDIC adapted its techniques to acknowledge that in rural lending it may be necessary to advance funds to ensure that the value of collateral, such as crops and livestock, would be maintained.

Moreover, as a result of the farm crisis, the FDIC learned to be more sensitive to the public's perception of its actions and to be more flexible in applying collection techniques according to the type of loan and borrower. Those lessons proved invaluable as the 1980s progressed.

Creation of the Resolution Trust Corporation

In August 1989, Congress enacted the Financial Institutions Reform, Recovery, and Enforcement Act (FIRREA) and provided for the establishment of the Resolution Trust Corporation to resolve the savings and loan (S&L) crisis. The RTC immediately inherited 262 conservatorships from the FDIC, which had acted in the place of the FSLIC as conservator for the insolvent institutions. Headquartered in Washington, the RTC opened regional offices in Atlanta, Dallas, Denver, and Kansas City. It also established 14 consolidated offices and 14 sales centers. Initially staffed with FDIC employees, the RTC hired additional employees from the private sector and, in 1991, reached its staffing peak at 8,614 employees.

Although the resolution of insolvent institutions was the initial priority of the RTC, disposition of assets retained from those institutions would become the RTC's biggest challenge. The 262 conservatorships initially acquired by the RTC contained assets of \$115 billion. Shrinking those institutions by curtailing new lending activity and selling assets was a high priority.

For the most part, the RTC also continued to place institutions into conservatorship before resolution. During its lifetime, the RTC disposed of \$157.7 billion in assets from institutions while they were in conservatorship. It retained an additional \$169.6 billion in assets, which it disposed of after resolution.

The asset disposition methods the RTC used were driven mostly by the legislative mandate of FIRREA. FIRREA required that assets be disposed of in a manner that (1)

maximized return and minimized loss, (2) minimized the impact on local real estate and financial markets, and (3) maximized the preservation of the availability and affordability of residential property for low- and moderate-income individuals. FIRREA further required that the RTC hire private-sector contractors for asset disposition if such services were available in the private sector and if the use of those services were practicable and efficient.

One of the RTC's biggest challenges was balancing the requirement to sell assets quickly while obtaining the highest possible price without being accused of "dumping." The challenge was especially difficult when the RTC was attempting to dispose of hard-to-sell real estate properties. The RTC also had to face criticism for packaging assets only for institutional investors. That criticism resulted in the RTC's development of small investor programs designed to include a wider range of potential investors.

About one-half of the RTC's assets were commercial and residential mortgages. The other half consisted of owned real estate, other loans, other assets (including subsidiaries), and securities. The RTC placed nonperforming loans, owned real estate, and some of the other assets with contractors and usually placed performing loans with conventional loan servicers. Those assets were then disposed of through various initiatives, such as loan sales, auctions, securitizations, and partnerships with private-sector firms. Those methods of disposition are discussed below and in chapters 13 through 17.

Developing Asset Marketing Activities

As bank resolutions and assets in liquidation began increasing in the 1980s, the FDIC could no longer effectively and efficiently dispose of assets without changing its methods. Several factors influenced the FDIC to move toward selling loans rather than holding them to maturity.

At that time, high interest rates had caused rapid deterioration in the value of the FDIC's relatively large commercial and residential mortgage portfolio. Because of the rising rates, the FDIC had to retain the loans rather than sell them, as it had done in the past. The growing cost to the receiverships caused by the reduction in value prompted a review of existing policies.

In addition, consolidated offices were strained by continuously hiring more staff, leasing more space, and expanding their operations as assets from failed banks continued to mount. It was no longer practical to assign all assets to account officers and work them individually in house. A \$1,000 asset required an account officer, an asset file, booking of the asset to an asset management system, and the same labor-intensive support activities required for a \$1,000,000 asset. By selling smaller assets, the FDIC would be able to maximize the efforts of its account officers by allowing them to focus on the larger, more complex assets.

Before 1980, asset marketing in the FDIC had been fairly limited. Early attempts focused primarily on pricing and selling assets, such as performing or residential mortgages and installment loans for which established markets were already in place.

From 1982 through 1984, as asset inventories increased and bank closing activity accelerated, FDIC policies began to emphasize bulk sales for broader classes of assets, including delinquent and charged-off loans. In 1984, the FDIC formalized the loan sales program and officially labeled it “bulk sales,” which later was called “asset marketing.” The program’s purpose was to accelerate the disposition of assets acquired from failed banks. Implementation of the program occurred within the various regional offices, consolidated offices, and field sites, with policy oversight coming from Washington, D.C. Consolidated offices set up specialized staff to work exclusively on loan sales. Because no established markets existed at that time, the intent was to build those markets with small (less than \$25,000 in book value) delinquent loans. The FDIC began by offering a pipeline of small products in the market. The total book value of each package ranged from \$1 million to \$2.5 million. Over time, FDIC offices created substantial lists of potential buyers, which led in 1987 to a computerized national database accessible by all offices. After potential buyers were included on the database, they would receive announcements of sales that met their interests.

FDIC management held the position that all assets were potential candidates for sale. Yet, it also was a time of experimentation. Although the FDIC marketed large nonperforming commercial mortgages together, they generally were bid for individually, with mixed results. During that time, before the sealed bid approach became the accepted bidding method, the FDIC tested several different bidding mechanisms. It was not until the 1990s that large portfolio sales (upward of \$100 million and more in book value) became a significant part of the FDIC’s marketing program.

In 1990, the FDIC contracted with a national mortgage servicer to handle the increasing volume of performing commercial and residential mortgage loans. An FDIC sales force, assisted by an adviser and due diligence firms, sold the serviced mortgages.

The focus on the sale of assets was a major milestone in the evolution of asset disposition methods within the FDIC. From 1986 to 1994, the FDIC sold more than 800,000 loans with a total book value of more than \$20 billion.

RTC asset marketing occurred in several ways. Initially, loan sales were conducted from conservatorships using that institution’s staff. As the RTC formalized its operations, regional sales centers became involved in packaging and selling assets. In September 1990, the RTC established a national sales center in Washington, D.C., that assumed direct responsibility for overseeing the sale of assets. A capital markets group in Washington, D.C., also put together securitized sales of residential and commercial mortgages.

In the field, as institutions failed, the RTC contracted out nonperforming assets to asset managers, while using conventional loan servicers to service performing loans. The various asset marketing vehicles of the RTC would then package assets from contractors and servicers for sale.

By 1990, the RTC was relying predominantly on private-sector firms to evaluate, package, and market loan portfolios. The use of private firms, particularly those with established reputations, lent more credibility to the RTC’s valuation methodology, due

diligence work, and marketing techniques. Furthermore, FIRREA required the agency to use the private sector whenever that strategy was deemed efficient and cost-effective.

The RTC used seller financing as a marketing tool for portfolio sales on a much larger scale than did the FDIC. The RTC's use of seller financing came about after a nationwide decline in real estate markets and a credit crunch that forced the agency to adopt more aggressive marketing tools.

The RTC also differed from the FDIC in its asset valuation procedures. With the exception of its handling of performing loans, the FDIC generally relied on in-house staff to value assets for bulk sale purposes. To arrive at values, account officers estimated projected collections from all sources of recovery, subtracted anticipated expenses, and applied a present value to the cash flows.

The RTC, however, relied on an asset valuation methodology developed in coordination with a real estate and financial consulting firm. That methodology attempted to value individual assets as investors would perceive their value. The RTC relied predominantly on actual net cash flows, and gave less weight to other more subjective sources of recovery. In general, RTC procedures resulted in lower estimates of value, thus enhancing its ability to find acceptable bids and sell assets more rapidly.

Both agencies used reserves to set base prices for portfolio sales and required wide marketing to ensure maximum competition. The RTC, however, tended to be more market oriented and more inclined to let the market "speak" concerning the acceptability of bids. In contrast, the FDIC was driven more by appraisals and relied more on internal reserves to set guideposts for determining the acceptability of bids.

Representations and Warranties

Representations and warranties are a set of legally binding statements by the seller intended to assure buyers that the assets being sold meet certain qualitative expectations. They are accompanied by obligations to "cure" conditions that are breaches of the original representations, as well as remedies available to the investor if the condition cannot be cured. Such remedies may require a repurchase or substitution of an obligation.

Consistent with an ongoing effort to be more market oriented and generate maximum competition and sales results, the RTC initially gave more representations and warranties associated with loan sale packages than did the FDIC. The majority of the FDIC loan sales were small, nonperforming loan sales that required only limited representations and warranties to market successfully. The warranties stated that there (1) had been no discharge in bankruptcy of debt represented by the loan(s), (2) was no "voidance" of the debt obligation by any court, and (3) had been no release of the debtor by the seller or the failed institution. The representations and warranties generally had a life of 120 days. Beginning in 1993, the FDIC offered more extensive

warranties that were generally consistent with RTC and industry standards on two large sales of nonperforming commercial real estate loans.

FDIC sales of performing residential mortgage loans carried more comprehensive representations and warranties consistent with the Federal National Mortgage Association (Fannie Mae) and the Federal Home Loan Mortgage Corporation (Freddie Mac) guidelines and had a longer life of five years.

In May 1990, after consulting with Fannie Mae and Freddie Mac, the RTC began to provide “market-standard representations and warranties” with most of its whole loan sale programs, excluding auctions, for single-family loan assets and mortgage servicing rights. The representations were identical to those required by Fannie Mae and Freddie Mac in sales to them and were recognized as the customary, or market-standard, representations in the secondary mortgage market. The RTC offered the representations and warranties directly in its corporate capacity. Coverage for loan documentation deficiencies was limited to a maximum of a five-year discovery period. Compensation for any breach of representation discovered during that period would be provided for the life of the loan, but only to the extent that actual losses were incurred as a result of such a breach.

In August 1990, the RTC broadened the scope of the representations and warranties it provided to conform with those customarily given in the secondary mortgage market. The RTC increased the duration of coverage for loan documentation deficiencies from five years to the life of the loan and authorized the repurchase or substitution of another qualified loan if a defect was found that would be adverse to the buyer. The RTC also established the policy that it would provide the representations and warranties in its capacity as receiver of the failed institution, with a guarantee by the RTC in its corporate capacity.

In July 1991, the RTC extended the customary secondary market representations and warranties to sales of whole consumer, multi-family, and commercial loans. The market-standard representations and warranties for multi-family and commercial mortgage loans included environmental representations. Depending on the quality of the loan, the dollar amount of the outstanding principal balance, and the type of underlying real property, the RTC offered one or more of the following environmental representations and warranties:

- “Where is, as is” sale;
- Environmental inspection before bidding;
- Six-month indemnification for large balance assets (with a book value equal to or greater than \$500,000) with monetary cure or repurchase if material contamination was demonstrated; or
- Life of loan indemnification for small balance assets (with a book value less than \$500,000), with monetary cure or repurchase if material contamination was demonstrated.

By 1994, the RTC and the FDIC offered generally comparable representations and warranties for sales of similar loan products, partly because in some instances, such as the bulk sale of performing and nonperforming commercial real estate mortgages (including securitization), the RTC set the market standards. In other instances, the secondary market had already set the acceptable level of representations and warranties, and the RTC and the FDIC then adopted those standards.

Securitizations

The FDIC usually sold performing residential mortgage loans through whole loan sales. In 1986, the FDIC conducted an experimental securitized sale, but it did not use securitized loan sales as a major asset disposition method. The RTC, however, used securitized sales as a means to meet its FIRREA mandate of maximizing return on assets while also liquidating assets expeditiously.

In October 1990, the RTC established a securitization program to facilitate the sale of mortgage loans, which were the largest single category of assets in the RTC inventory. From June 1991 to June 1997, 72 RTC and 2 FDIC securitized transactions closed, representing loans with a book value of \$42 billion for the RTC and \$2 billion for the FDIC. Almost 500,000 residential, multi-family, commercial, mobile home, and home equity loans were securitized. RTC and FDIC securities are traded in capital markets worldwide.

The ultimate analysis of the securitization versus the whole loan sales disposition methods will not be determined until the actual losses realized by the reserve funds are known. Generally, the greater the “seasoning” of the security, the less the default and loss experience caused by principal paydown and equity buildup in the underlying properties. In retrospect, securitization allowed the RTC and, to a lesser extent, the FDIC to dispose of a large quantity of loans under severe time constraints at prices that might not have been realized if subjected to a market of whole loan buyers.⁴

Partnership Programs

The RTC and, to a much more limited extent, the FDIC used partnership programs with private-sector partners as an asset disposition method. In response to the FIRREA mandate to maximize recovery, the RTC concluded that for certain types of assets, equity-retaining transactions might yield greater returns than if assets were sold outright.

Joint ventures (equity partnerships) were structured between the RTC, acting as a limited partner (LP), and a private-sector investor, acting as a general partner (GP). The

4. See Chapter 16, Securitizations.

RTC contributed asset pools (usually subperforming loans, nonperforming loans, and owned real estate [ORE]) and arranged for financing to the partnership. The GP invested both equity capital and asset management services. After the debt was paid off, the remaining proceeds were usually split according to the ownership percentage each respective partner held. The RTC believed that the net present value of the residual income stream, when added to the up-front cash receipts, would be greater than the total proceeds that would have been received from a direct asset sale.

Between December 1992 and October 1995, the RTC created a total of 72 equity partnerships, with a total book value of \$21.4 billion, which were marketed and consummated by the RTC National Sales Center in Washington, D.C. In total, the RTC structured and offered seven types of equity partnerships.

In 1993, in response to a perception that small investors were being excluded from the equity partnership program, the RTC initiated a special series of partnerships that were grouped geographically so that small investors would be able to more readily participate.

The RTC created Asset Management and Disposition Agreements (AMDAs) in response to FIRREA, which mandated the review, analysis, and possible renegotiation of the FSLIC assistance agreements. The AMDA partnership structure required that both the acquirer (GP) and the FDIC (LP) would have equity at risk. The GP's private investors, in addition to contributing to the partnership's capital, accepted responsibility for the management and disposition of the partnership's assets. In return, the GP received distributions from the net recovery on the partnership's assets, but received no management fee.

Although the RTC created only two partnerships using the AMDA structure, their portfolios were sizable because the assets were from two of the largest thrift failures ever resolved by the FSLIC. The AMDA partnerships generated \$2.4 billion in cash, of which \$2.1 billion was paid to the FDIC as manager of the FSLIC Resolution Fund (FRF).

In general, the RTC's and the FDIC's experiences with the partnership programs have proven to be a viable alternative to conventional methods of asset disposition.⁵

Use of Outside Contractors

During the 1980s, another major asset disposition method, in addition to asset marketing, evolved when the FDIC began to use outside contractors to handle large bank failures.

In September 1984, the FDIC entered into a five-year assistance agreement with Continental Illinois National Bank and Trust Company (Continental), Chicago,

5. See Chapter 17, Partnership Programs.

Illinois. Under the agreement, the FDIC acquired approximately \$5.2 billion of the bank's problem loans and other assets and assigned them to "Continental Bank as Administrator." Continental liquidated the assets under the supervision of the FDIC.⁶ The contracting method continued to be used for several subsequent large failures in the mid-1980s. In those cases, the FDIC contracted the asset disposition work with affiliates of acquiring banks.

Those early contracts evolved into the use of Asset Liquidation Agreements (ALAs) and Regional Asset Liquidation Agreements (RALAs). Initially, ALAs were asset management and disposition agreements between the FDIC and asset management organizations that were affiliates of the acquiring bank. ALAs later developed into contracts between the FDIC and private-sector contractors that were not necessarily affiliated with the acquiring bank. The ALA program was designed to facilitate the disposition of distressed assets, primarily nonperforming loans and owned real estate. However, the pools sometimes contained performing loans and failed bank subsidiaries. Ten asset management contracts were issued from 1988 to 1993 that handled assets with a book value totaling \$32 billion.

Because those agreements provided for "cost plus" reimbursement (costs plus incentive fees), the FDIC reimbursed all of the contractors' operating expenses and overhead, which insulated servicers from risk and did not provide incentive to control overhead. In early transactions, incentive fees were a fixed percentage of gross collections, and a deferred incentive fee was provided, depending on the assuming bank's ability to increase the value of the pool over the life of the agreement. Later contracts used more complicated formulas, such as basing incentive fees on the ratio of cumulative net collections to gross pool value. The goal was to maximize the net present value of cash flows generated from liquidation of the pool.

After favorable experiences with ALA contracts in connection with large bank failures, the FDIC created RALAs for asset pools generally below \$500 million in book value. From November 1992 to June 1993, the FDIC issued four RALA contracts to four private-sector contractors, which handled assets with a book value of \$1.2 billion. RALA contracts, which were not cost-plus arrangements, contained a three-tier fee structure composed of management, disposition, and incentive fees. The actual fees on the four contracts were less than 5 percent of gross collections. The RALAs were designed to be monitored by an oversight committee of FDIC personnel to ensure that assets were liquidated, managed, and converted to the highest net present value cash equivalent.

The RTC used private-sector contractors as a matter of practical necessity, as well as in response to the legal mandate to employ the private sector. FIRREA required the

6. See Part II, Case Studies of Significant Bank Resolutions, Chapter 4, Continental Illinois National Bank and Trust Company.

RTC to hire private-sector contractors for asset disposition if such services were available in the private sector and if such services were practicable and efficient.

The Standard Asset Management and Disposition Agreement (SAMDA), first issued in August 1990, was a contract between the RTC and a private-sector contractor for the purpose of managing, collecting, and disposing of distressed assets in a portfolio of any size. The Standard Asset Management Amendment (SAMA) amended a SAMDA contract, reducing the scope of work from asset management and disposition to asset management only. During the course of the SAMDA program, the RTC issued 199 SAMDA contracts, including SAMDA contracts that contained SAMAs, to 91 different contractors. SAMDA contracts paid management, disposition, and incentive fees. In addition, all asset-specific expenses were passed through the contracts, except for the contractor's overhead.

FIRREA also mandated that the RTC would include minority- or women-owned businesses (MWOBs) among its contractors. In the early 1990s, the FDIC also established an MWOB program for contracting.

Contractors played a major role in the crisis years. At the FDIC, the \$33.2 billion in assets disposed of by ALAs and RALAs represented 46 percent of the \$72 billion in assets the FDIC acquired for disposition between 1980 and 1994. Almost all of RTC's assets were placed with asset managers or loan servicers.⁷

Real Estate Sales

Financial institutions that failed usually had significant inventories of owned real estate that they had acquired as a result of deteriorating loan portfolios. As a result of the failure of financial institutions, the FDIC also acquired main bank office buildings and branch office buildings. After resolution, during the asset disposition process, the FDIC also acquired ORE. It acquired properties by foreclosure, deeds-in-lieu of foreclosure, and acceptance of properties in settlement of loan obligations.

Although ORE properties represented a small percentage of total assets for both the FDIC and the RTC, their disposition was highly visible and attracted much public attention. The FDIC and the RTC were criticized for holding properties too long or selling below market value and adversely affecting real estate markets. In the late 1980s, to promote sales and to respond to the criticism, the FDIC introduced policies and procedures to begin auctioning the properties in a manner that was more consistent with private industry standards. The concern for mitigating the effects of large blocks of properties coming onto an already-depressed real estate market carried over to the operation of the RTC. FIRREA included language requiring the RTC to sell real estate for no less than 95 percent of appraised (market) value. In 1991, to facilitate lagging

7. See Chapter 14, Asset Management Contracting.

sales and burgeoning inventories, that language was amended to reduce the minimum sales price to no less than 70 percent of appraised value.

The FDIC primarily used broker listings to sell ORE. Properties would be appraised and listed for sale with a broker, and any offers would be passed on to the FDIC account officer. The account officer would then counteroffer or accept the offer; either action was subject to the approval of the appropriate delegated authority.

The RTC used its SAMDA contractors to dispose of ORE. Contractors would list with brokers and approve sales under their own delegated authority or under RTC-delegated authority.

The FDIC and RTC also disposed of ORE through the auction process. The FDIC began holding ORE auctions in the late 1980s. Those sales consisted primarily of large inventories of small, hard-to-sell properties. The RTC initially prohibited auctions because of the perception that they would adversely affect real estate markets. By 1990, the RTC's ORE portfolio had grown so dramatically that the traditional method of using brokers was insufficient to dispose of large volumes of properties. By March 1991, the RTC had procedures in place for auctions, resulting in regional, national, and in some cases, international marketing. The FDIC and RTC national and regional auctions of non-distressed properties in the late 1980s and into the 1990s met with considerable success; average sales prices ranged from the high 80th percentile to the mid 90th percentile of the appraised values. The 1996 year-end aggregate average FDIC ORE sales-price-to-appraised value ratio was 94.7 percent.

The FDIC had also conducted national auctions for large commercial properties, the first of which was held in New York City in March 1989. Other national auctions followed, with satellite hookups in multiple cities.⁸

The Affordable Housing Program

Marketing and sales of owned real estate were affected in both the FDIC and the RTC by legally mandated affordable housing programs. FIRREA established the framework for such programs and required that the RTC implement an affordable housing program. The purpose was to provide home ownership and rental housing opportunities for families with very-low-, low-, to moderate incomes. Section 40 of the FDIC Improvement Act (FDICIA) of 1991 required that the FDIC establish an affordable housing program for the same purpose. FDICIA anticipated federal funding through congressional appropriations, but funding did not take place until fiscal year 1993. During 1992, the FDIC implemented the affordable housing program without appropriated funds and focused on the sale of single-family properties to income-eligible buyers.

8. See Chapter 13, Auctions and Sealed Bids.

With appropriated funds came credits and grants of up to 10 percent of a negotiated sales price for eligible buyers of single-family properties. Fiscal year 1994 saw increased funding and the broadening of restricted sales to include multi-family properties to nonprofit entities and governmental agencies.

The year 1995 also saw the merger of the RTC and the FDIC's affordable housing management and staff, as set forth in the Resolution Trust Corporation Completion Act (Completion Act) of 1993. The FDIC continues to operate an affordable housing program, but its nature is limited because appropriated funds are no longer available.⁹

Environmental Problems and Issues

In the early 1990s, the FDIC and the RTC developed environmental programs to prepare and train staff to oversee implementation of federal and state environmental statutory provisions, as well as internal policies and procedures. Environmental specialists provide technical advice and recommendations on assets that have highly complex environmental problems or are controversial for environmental reasons. Environmental laws, issues, and risks are significant to the FDIC because they affect asset marketability, valuation, and liability, and they potentially expose insurance funds to losses.

The environmental programs were premised on identifying hazardous environmental conditions or substances, such as underground storage tanks; lead-based paint; damaged, friable asbestos; and special environmental resources, including wetlands, habitats of endangered species, and nationally significant historic sites. The FDIC uses information on environmental hazards to evaluate its potential legal and financial liabilities associated with an asset and how those liabilities would affect foreclosure, purchase, sale, loan workout, or seller financing. Information on special environmental resources assists the FDIC in identifying applicable laws that affect an asset's development potential and in evaluating legally permissible uses that affect its appraised value, as well as the marketing strategy that yields the highest potential return.

To help identify assets with environmental conditions during the S&L crisis, the RTC engaged national contractors with expertise in resource identification and deployed a series of contracting instruments for environmental site assessments. The RTC contracted with The Nature Conservancy, a national nonprofit conservation organization, to identify natural resources, including endangered species, property covered by the Coastal Barrier Improvement Act, and rare natural communities.

Because of the volume of failed S&L assets with environmental conditions, the RTC executed various disposition strategies for those assets, including the use of national sales. The RTC completed two national sales of assets with environmental hazards and one national sale of assets with special resources. In addition, field offices conducted

9. See Chapter 15, Affordable Housing Programs.

sales of environmentally distressed properties. The RTC also adopted environmental representations and warranties for loans collateralized by real estate that were securitized or sold into trust arrangements to maximize its returns while allowing assets that may be found to breach environmental provisions at some point in the future to be repurchased.

Because its portfolio of properties with environmental hazards had grown, the FDIC conducted a nationally marketed sale. When marketing and selling real estate properties “as is,” both the FDIC and the RTC took into account the cost of hazard remediation or corrective action to be done by the purchaser. Consequently, the price of the property was reduced by the estimated cost to remediate.

A primary difference between the RTC’s and the FDIC’s sales of real estate with environmental hazards was the RTC’s use of “buyer remediation agreements.” The RTC, as part of its standard sales documents, established requirements for buyer remediation, including an asset-specific statement and schedule of work, an escrow account for funding such remediation from the sale proceeds, and a system for determining when remediation had been completed.

The FDIC also prefers to have the buyer remediate properties with environmental conditions, but it sells such properties “as is” without formally requiring that the buyer take any corrective action. The FDIC predominantly sells properties with environmental conditions through standard broker listing agreements, and sales documents usually have disclosure and buyer indemnification provisions. Unlike the RTC, however, the FDIC generally discloses only factual information about a property, not the recommendations of an environmental professional or the costs to remediate.

Disposition of Subsidiaries and Other Assets

Liberalization of banking and savings and loan regulations in the late 1970s and early 1980s allowed financial institutions in the United States to use the corporate structure to establish subsidiary companies that were used to engage in what were hoped to be profitable nonbank activities. Through those vehicles, the S&Ls, and the banks to a lesser degree, either conducted real estate development projects directly or used the corporate structures to make partnership investments in real estate-related activities. Partnership structures were either general or limited, and in many cases the financial institution’s role was that of managing general partner (MGP), with all attendant responsibilities and liabilities. Many S&Ls, in addition to conducting real estate activities, created finance subsidiaries to take advantage of interest rate spreads between the institution’s cost of funds and rates available on various collateralized mortgage obligations or mortgage-backed securities. The banks also established subsidiaries to handle trust work for their parent bank or S&L. Insurance subsidiaries were also prevalent and often proved to be quite profitable for the bank or S&L.

Liquidating those corporate and partnership entities proved to be an expensive and challenging activity for the FDIC and the RTC. Some corporate entities were sold as

whole companies, usually for the tax benefits that belonged to the corporate corpus. In most cases, however, individual assets of the subsidiary were sold through normal FDIC and RTC marketing channels. Liabilities of the companies were satisfied, and then the corporation was legally dissolved.

When capital market assets such as mortgage-backed securities, stock portfolios, bond portfolios, and specialized hedge fund-type investments were encountered, the RTC responded by creating a capital markets branch that had the expertise needed to dispose of those specialized assets. Dissolving partnership interests usually involved the same asset disposition activity; however, less formality was encountered in the legal dissolution of the general partnership form.

Treatment of Unfunded Commitments

Up until the mid-1980s, FDIC liquidators operated under the direction that they had the right to disaffirm all executory contracts, such as outstanding loan commitments, made before a bank failed. Such commitments included construction loans with construction activity in process, land development loans, bridge loans, revolving lines of credit, and letters of credit.

During this period, the liquidators had very little written guidance about unfunded loan commitments other than that, as a receiver of a failed bank, the FDIC had the authority to disaffirm such commitments. Lacking such guidance and without much analysis, liquidators routinely notified borrowers that their loan commitments were no longer in effect. Because the majority of borrowers tended to be small- to medium-sized companies, they usually were forced to make other financial arrangements so that their companies would not fail.

Eventually, the FDIC realized that a more reasonable approach would both benefit the borrowers and help the FDIC maximize its return on assets. For example, at a bank closing in 1984, the FDIC agreed to continue funding revolving lines of credit secured by accounts receivables. The portfolio was then quickly marketed for sale. That approach saved many of the individual customers from going out of business while also maintaining the value and marketability of the portfolio. A sale was then consummated shortly after the bank closing, thus benefiting all concerned.

By the 1990s, the FDIC had formalized a policy that considered the significant impact of funding commitments on the borrower's business, employees, and community. It stated that every reasonable effort should be made to lessen the effect of bank failure on borrowers by providing or facilitating interim relief whenever possible. It also stated that account officers should explore all possible avenues of assistance for the borrower. The FDIC wanted borrowers and the public to understand its willingness to consider funding loan or credit commitments, as well as its desire to help receivership borrowers make a smooth transition to a permanent source of funding. In accordance with that new philosophy, the FDIC conducted borrower seminars to discuss how the

FDIC would proceed concerning outstanding loan commitments and provided representatives to answer any related questions.

Conclusion

During the crisis years, the FDIC and RTC acquired approximately \$410 billion in assets that were targeted for asset disposition. By the end of 1997, less than \$5 billion of those assets remained with the FDIC. The liquidation of this enormous volume of assets was accomplished in a timely and efficient manner.

In the early and mid-1980s, the FDIC began a gradual shift to asset marketing and the use of private-sector contractors to handle the increasing volume of bank assets. By the 1990s the FDIC and RTC had built on those early methods and were using sophisticated methods to dispose of assets. Those methods evolved in response to legislative mandates, changing marketplaces, public perception, and the volume of assets that were acquired. Markets were created that had not existed before as asset disposition methods were finely honed to create the greatest returns for financial institution receiverships.

Both agencies displayed an ability to adapt to the rapidly changing economic environment and markets, as well as to explosive asset growth. They faced severe challenges, such as the volatility of workload, fluctuating staffing levels, extensive travel, and multiple office relocations, while having to operate in a “fishbowl” of public and governmental scrutiny. Post-crisis challenges for the agencies’ staff have been equally difficult because of the merger of the RTC into the FDIC and the subsequent downsizing of the FDIC that followed a decreasing workload.

The banking and thrift crisis caused an unprecedented volume of assets to be transferred to the FDIC and the RTC. In response to an overwhelming workload, both the FDIC and the RTC experimented with disposition strategies to facilitate disposition at prices that maximized the overall return.



CHAPTER 13

Auctions and Sealed Bids

Introduction

This chapter reviews the use of auctions and sealed bid marketing strategies by the Federal Deposit Insurance Corporation (FDIC) and the Resolution Trust Corporation (RTC). It examines how the FDIC and the RTC marketed loans through the sealed bid process, how they used auctions to sell loans, and how they used sealed bid sales and auctions to sell real estate that they held.

Asset disposition methods evolved from a strategy whereby FDIC account officers managed individual delinquent loans from beginning to end to a later strategy in which account officers managed loans using asset marketing techniques and auction or sealed bid marketing strategies in single, planned marketing events aimed at the disposal of a high volume of loans. Those strategies focused primarily on the disposition of nonperforming loans and real estate and, to a lesser extent, of performing loan portfolios.

Background

During the early 1980s, the FDIC adopted a workout strategy for dealing with acquired nonperforming loans. That strategy usually involved assigning delinquent loans to specific account officers, who would be responsible for negotiating repayment, restructuring, or settlement of the debts with borrowers. To bring about final debt resolution, they frequently had to use litigation, foreclosure, or sale of available collateral. The strategy was similar to the approach that private and public entities used in handling delinquent loans.

As early as 1976, with the packaging and sale of performing residential and commercial mortgages that originated out of the Birmingham-Bloomfield Bank in a

suburb of Detroit, Michigan, the FDIC began exploring the potential of whole loan sales. In the same year, there were several other whole loan sales; however, the FDIC did not make a concerted effort to package loans for resale until 1984.

Several factors prompted the move toward selling loans. First, the late 1970s and early 1980s were periods of record high interest rates that caused rapid deterioration in the value of the FDIC's mortgage portfolio. The growing cost to the receiverships, caused by severe value erosion, inspired a review of policy guidance. Second, failing bank activity was on the increase and the FDIC saw its receivership asset holdings increase to record levels. To avoid the volatility associated with holding assets, the FDIC adopted a policy of selling performing loans in large packages as early as practicable. It based prices on prevailing market interest rates and loan quality. Essentially, the FDIC sold the packages as sealed bid loan sales at the point of loan acquisition, or soon thereafter, and elected not to speculate on the direction of interest rates.

In a sealed bid loan sale, interested bidders submit their bids, usually in a sealed envelope, for pools they wish to purchase. Each loan pool is sold to the bidder with the highest bid, assuming it satisfies any minimum acceptable bid or reserve requirements of the FDIC. Rights and title to the pool are transferred to the purchaser upon receipt of the bid price, usually payable by wire or certified check.

FDIC Loan Sales Program

By the end of 1984, the FDIC initiated a formal loan sales program, known as the Asset Marketing Program, to accelerate the disposition of assets acquired from failed banks. Implementation of the program originated with the various regional offices, consolidated offices, and field sites with policy oversight from Washington, D.C.

The FDIC's asset marketing efforts at that time were directed toward performing loans of all types and sizes. As workload increased, the FDIC began to emphasize the sale of nonperforming loans, especially those with small individual balances (generally under \$10,000). Although small loans made up the vast majority of the number of loans held by the FDIC, in the aggregate their total value represented a small fraction of the value of the receivership portfolios. Thus, by accelerating the disposition of those small loans, account officers could focus on larger loans that offered higher recoveries. In many cases, smaller loans were service intensive and efforts to collect on those loans were comparable to servicing larger loans with much higher realizable values. The first FDIC sale of nonperforming loans was conducted by the Atlanta office in the fourth quarter of 1985. It was a small sale conducted under regional authority with a value of approximately \$1.5 million.

The FDIC packaged loans in pools based on size, asset quality, asset type, and geographic location. Asset types included installment paper, residential real estate mortgages, commercial mortgages, agricultural loans, charged-off loans, loans secured by mobile homes, timeshare loans, other real estate mortgages, business loans, and

unsecured paper. Account officers assigned individual asset values based on projected cash flows and established minimum reserve prices for each package. The FDIC initially relied exclusively on in-house staff to perform all tasks associated with identifying, preparing, pricing, marketing, and closing loan sale transactions. By the late 1980s and early 1990s, however, it occasionally used contractors to run open outcry auctions and perform due diligence on performing mortgage portfolios and large nonperforming sales; but predominantly, the FDIC used in-house resources.

After firmly establishing asset marketing as an important liquidation strategy, the momentum in the loan sales area began to increase. By the end of the third quarter of 1986, the FDIC had closed 101 sales for the year, resulting in the transfer of 104,000 distressed loans to the private sector. Nationally, goals were set to dispose of all loans with individual balances of \$5,000 or less. In several regions, the target was raised to \$25,000. Because those loans were severely distressed, selling prices averaged in the 2 percent to 10 percent of book value range. The FDIC enjoyed substantial savings, by avoiding long-term servicing costs.

An important outgrowth of the asset marketing effort was increased emphasis on selling loan portfolios immediately after bank failure, which was in contrast to previous strategies in which the FDIC assigned individual assets to account officers for long-term collection activity with the possibility of packaging the assets in pools for sale. In many cases, the FDIC was successful in selling small portfolios soon after a bank failure. For example, in 1986, with the Southwest experiencing a substantial number of bank failures, the Dallas and Oklahoma City offices were forced to pursue portfolio sales immediately upon bank failure. The Dallas office successfully sold a portfolio of performing and nonperforming assets from two new receiverships and packaged the assets according to size and asset quality.

In 1987, 574 sales transactions resulted in the disposition of 91,123 loans. (See table I.13-1.) The total book value sold was \$860.4 million and actual sale proceeds were \$303.3 million, which was equivalent to 92 percent of the estimated value. Because the FDIC was unwilling to provide financing at that time, all transactions were on a cash basis. That year, the FDIC began experimenting more aggressively in the asset marketing arena. It examined bulk sales as a means of selling the remaining portfolios of entire offices that were winding down and ready to be closed. By the first quarter of 1988, the FDIC was able to sell most of the remaining loans in the St. Joseph, Missouri, office. Similarly, the FDIC sold roughly 2,500 loans with a book value of \$54.5 million before closing the Omaha, Nebraska, office. The FDIC expanded and contracted its office locations throughout the 1980s and 1990s. When a large number of banks failed in one part of the country, the FDIC would set up an office close to the customers of those banks. As the local economies improved and fewer banks were closed, the FDIC reduced the number of its office locations in those parts of the country. To effectively reduce the remaining loan inventory of a closing office, the FDIC would arrange a sale of as many of the saleable assets as possible before that office closed.

Also in 1987, the FDIC developed a data processing program that selected loans within specific, predetermined parameters to be packaged for sale. If the loans were performing, the program had the ability to price the package. If the loans were nonperforming, the system could not compute the price, and internal staff or outside contractors would individually value the assets.

As the Asset Marketing Program grew in size and complexity, the FDIC developed policies to cover the basic parameters for conducting sealed bid sales. Those policies established delegation of authority, uniform procedures for estimating asset values, methods for establishing minimum or reserve prices, reporting requirements, appropriate information on disclosure to bidders, guidelines for sale of larger loans, and guidelines for sale of government guaranteed loans.

By using the Asset Marketing Program as a loan disposition strategy in the late 1980s and early 1990s, the FDIC was able to reduce the burden of acquiring a high volume of loans and to increase the liquidity of its insurance fund. The FDIC concentrated on three types of loan sales: small assets, severely distressed assets, and performing loans.

Table I.13-1

FDIC Sealed Bid Loan Sales

(\$ in Thousands)

Year	Number of Loans Sold*	Book Value	Estimated Value	Sales Price	Sales Price as a Percentage of Book Value
1986	128,779	\$341,983	\$156,606	\$177,993	52.1
1987	91,123	860,360	331,071	303,338	35.3
1988	71,865	875,419	315,490	276,061	31.5
1989	28,284	493,132	213,597	210,778	42.7
1990	106,668	1,341,397	673,515	645,596	48.1
1991	143,462	2,119,000	1,413,000	1,452,000	68.5
1992	96,529	4,094,093	3,157,408	3,253,847	79.5
1993	136,347	5,386,787	3,338,579	3,332,402	61.9
1994	63,780	4,562,358	2,608,154	2,654,237	58.2
Totals/ Average	866,837	\$20,074,529	\$12,207,420	\$12,306,252	61.3

* Includes performing and nonperforming loans.

Source: FDIC Division of Resolutions and Receiverships.

RTC Loan Sales Program

The Financial Institutions Reform, Recovery, and Enforcement Act (FIRREA) of 1989 mandated that the RTC dispose of its assets in a manner that would maximize the net present value return from the sale or other disposition of savings institutions and their assets. Early on, the RTC implemented the Bulk Sale Program, which initially focused on the RTC's vast holdings of performing residential and commercial mortgages. At first, the RTC adopted the FDIC methodology of internally packaging and selling asset portfolios, which was a logical step, given that, at that time, most of the RTC staff and the key managers were FDIC employees.

Like the FDIC, the RTC characterized and formulated its sealed bid sales to ensure maximum exposure to investors and purchasers and to secure the highest possible return. The RTC marketed its sealed bid sales widely and opened them to all bidders who either prequalified or paid an up-front "admission" fee. It grouped loans in homogeneous pools by size, asset type, performing or nonperforming status, quality, geographic distribution, and maturity. Other similarities also existed between the FDIC and RTC programs. For example, both agencies priced portfolios using a discounted cash flow methodology, which guided decisions regarding appropriate reserves for each transaction. Both employed aggressive and broad marketing tactics to ensure the maximum level of competition; as a rule, they always accepted the highest conforming bid.

Some critical differences developed between the agencies, however, in how they conducted sales. The RTC had a unique mission, and workload demands were virtually unprecedented. Also, it was a taxpayer-funded agency. Because of its relatively short life, the RTC had to hire many private-sector employees who had different philosophies than the FDIC had on the best strategies to use in selling assets.

By 1990, the RTC was relying predominantly on private-sector firms to evaluate, package, and market its loan portfolios. Wall Street investment houses, as well as other firms with comparable credentials, routinely assisted in all phases of selling those portfolios. The RTC relied on private-sector firms for a number of reasons. First, the RTC was reluctant to hire the additional thousands of employees that would have been necessary to successfully manage the large workload. Second, the RTC portfolio included sophisticated portfolios of securities, real estate projects, and other assets the size and complexity of which exceeded the training and technical skills of most of the existing RTC staff; such portfolio management required the expertise of professionals in the private sector. Third, because the RTC was selling in a depressed market, its use of private firms, particularly those with established reputations, lent more credibility to its valuation methodology, due diligence work, and marketing techniques. Finally, the legislation creating the RTC required the agency to use the private sector whenever it was deemed efficient and cost-effective.

By September 1990, the RTC established a national sales center in Washington, D.C., which assumed direct responsibility for overseeing the sale of assets. It then set up regional sales centers in each field office. The RTC contracted out more of the work

associated with the sales to private firms. One set of contracts was for the due diligence and evaluation work that involved identifying saleable assets, preparing files for investor review, evaluating the product, and pricing. The second set of contracts was for financial analysis from advisers who were responsible for making recommendations on appropriate packaging, marketing methods, negotiations, bid evaluation, and final closing.

The RTC adopted the use of seller financing as a marketing tool for nonperforming asset portfolio sales. That development came about because most of the RTC's assets were real estate based, and disposition was hampered by a nationwide decline in the real estate markets, which forced the agency to adopt a more aggressive posture to achieve loan sales.

Structured Transactions

In 1991, to boost the demand for nonperforming multi-family and commercial mortgages and other real estate, the RTC formally introduced the Structured Transaction Program. A structured transaction was a form of portfolio sale created to achieve a high volume of portfolio sales, as opposed to the sale of commercial assets on an individual basis. The national sales center, and subsequently the regional sales centers, conducted structured transactions by structuring the portfolios into packages based on input from investor groups. They generally organized the packages by institution, by groups of specific products (for example, office buildings, nursing homes, golf courses, offices, and hotels and motels), or by geographic location. They then offered the structured portfolios for competitive bidding. The preferred transaction was one that had 50 to 100 assets and a book value between \$100 million and \$150 million.

The RTC supplied three types of financing: bridge, term, and step-rate. Bridge financing was set up to be refinanced within two years. Term financing typically was a seven-year fixed payment loan to be repaid from the disposition of the asset pool over the life of the loan. Step-rate financing had an initial interest rate below current market rates that progressively increased over the term of the loan. If held to maturity, the interest rate on a step-rate loan eventually would exceed the market rate available at the time of settlement. The RTC designed the step-rate loans to accommodate cash flows from a pool of assets; initially, they might be insufficient to pay a market rate of interest, but as cash flows increase over time, payments on increasing interest rates could be maintained.

The direct costs for selling \$19.6 billion in book value of assets through the Structured Transaction Program was approximately \$173 million, or 0.9 percent of the value of loans sold. Because structured transactions garnered proceeds of \$10.7 billion, however, direct costs represented 1.62 percent of recoveries. (See table I.13-2 for a summary of the RTC structured transactions.)

Asset Valuation Procedures

In determining its asset valuation procedures, the RTC first looked at how the FDIC operated. At the FDIC, which relied on in-house staff to value assets for bulk sale

Table I.13-2

Summary of RTC Structured Transactions 1990–1995

(\$ in Thousands)

Year	No. of Transactions	Book Value	Derived Investment Value*	Sales Price	Sales Price as a Percentage of Book Value
1990	2	\$362,088.8	\$362,088.8	\$259,189.5	71.6
1991	29	5,203,268.9	4,018,809.0	3,246,103.2	62.4
1992	32	8,615,621.1	4,451,556.7	4,013,784.0	46.6
1993	28	5,421,141.9	2,969,252.8	3,153,523.6	58.2
1994	1	28,303.5	28,303.5	28,367.3	100.2
1995	0	0	0	0	0
Totals	92	\$19,630,424.2	\$11,830,010.8	\$10,700,967.6	54.5

* Derived investment value (DIV) was an internal RTC reference to a means of calculating the net present value of a non-performing loan. It was used to establish reserve prices for assets to be sold as whole loans and as a benchmark for nonperforming loan sales.

Source: RTC Megaport Automated Information System.

purposes, account officers would estimate projected collections from all sources of recovery (collateral, guarantors, borrowers, and so forth), subtract anticipated expenses, and apply a present value to the cash flows to arrive at an individual asset's estimated value. The RTC decided to turn to the private sector. Because the sheer volume of work was beyond the RTC in-house capability, it hired private professional firms to perform due diligence and asset valuation work.

The RTC relied on an asset valuation methodology developed by a national real estate and financial consulting firm. That methodology, known as the derived investment value (DIV), attempted to value individual assets packaged for portfolio sales as investors would perceive the value of those assets. Cash flow projections were based predominantly on actual cash flows generated by collateral with little, if any, weight given to increased "lease-ups," guarantor and borrower financials, or other sources that were more speculative and subjective. Critics of DIV believed the methodology systematically generated lower valuations than were appropriate. Critics of the FDIC's approach believed, however, their valuations were unduly optimistic and relied too heavily on in-house staff projections that failed to adequately discount for marketplace realities.

Although both agencies used reserves to set base prices and required wide marketing to ensure maximum competition, the RTC was more inclined to accept bids that were lower than anticipated, thereby relying on the philosophy that the properties were only worth what reasonable bidders were willing to pay. The FDIC's approach was more

appraisal driven and relied more on internal reserves to set guideposts for determining the acceptability of bids. If the bids were not comparable with the internally derived value, they were rejected.

Representations and Warranties

Representations and warranties are a set of legally binding statements drawn by the seller to give buyers the assurance that assets being sold meet certain qualitative expectations. They are accompanied by obligations to cure conditions that are breaches of the original representations, as well as remedies available to the investor, if the condition cannot be cured. Such remedies may require the seller to repurchase or replace an asset in the original pool.

Consistent with an ongoing effort to be market oriented and generate maximum competition and sales results, the RTC initially gave more representations and warranties associated with loan sale packages than was customary at the FDIC. By 1994, the RTC and the FDIC offered generally comparable representations and warranties for the sale of similar loan products. In some instances, such as in the bulk sale of performing and nonperforming commercial real estate mortgages (including securitization), the RTC set the standards. In other instances, such as in large bulk sales of performing residential and multi-family mortgages, the secondary market had already established the acceptable level of representations and warranties.

The majority of the FDIC loan sales consisted of small, nonperforming loans that required only limited representations and warranties. The warranties stated that (1) there had been no discharge in bankruptcy of debt represented by the loan(s), (2) there was no voidance of the debt obligation by any court, and (3) there had been no release of the debtor by the seller or the failed institution. The representations and warranties generally had a life of 120 days.

FDIC sales of performing residential mortgage loans carried more comprehensive representations and warranties consistent with the Federal National Mortgage Association (Fannie Mae) and the Federal Home Loan Mortgage Corporation (Freddie Mac) guidelines and a longer life of five years. In 1993, the FDIC offered more extensive warranties that were generally consistent with the RTC and industry standards on two large pilot bulk sales of nonperforming commercial real estate loan sales. The warranties were extended to a six-month life.

In May 1990, the RTC began to provide standard representations and warranties with most of its whole loan sale programs, excluding auctions, for single-family loan assets and mortgage servicing rights. The representations were devised after consulting with Fannie Mae and Freddie Mac. They were identical to the representations required by Fannie Mae and Freddie Mac in sales to them and were generally recognized as the customary or standard representations in the secondary mortgage market. The RTC offered representations and warranties directly in its corporate capacity. The duration of

the coverage for loan documentation deficiencies was limited to a five-year discovery period. Compensation for any breach of representation discovered during that period would be provided for the life of the loan, but only to the extent that actual losses were incurred as a result of such a breach.

In August 1990, the RTC extended its representations and warranties to conform with those customarily granted in the secondary mortgage market. It increased the duration of the coverage for loan documentation deficiencies from five years to the life of the loan and authorized the repurchase or substitution of another qualified loan if a defect was found that would have been adverse to the buyer. The RTC also established the policy that the insolvent institution would provide the representations and warranties that the RTC would then guarantee.

In July 1991, the RTC extended the customary secondary market representations and warranties to sales of whole consumer, multi-family, and commercial loans. The standard representations and warranties for multi-family and commercial mortgage loans included environmental representations. Depending on the quality of the loan, the dollar amount of the outstanding principal balance, and the type of collateral security, the RTC offered one or more of the following environmental provisions:

- “Where is, as is” sale;
- Environmental inspection before bidding;
- Six-month indemnification for large balance assets (with a book value equal to or greater than \$500,000) with monetary cure or repurchase if material contamination was demonstrated; or
- Life of loan indemnification for small balance assets (with a book value less than \$500,000), with monetary cure or repurchase if material contamination was demonstrated.

Loan Auctions

The FDIC and the RTC have considerable experience with all types of loan and real estate auctions. Historically, auctions were used to sell real estate or assets such as equipment, automobiles, and trucks; however, both agencies expanded the use of that strategy to include pools of both performing and nonperforming loans.

The process was generally the same for the FDIC and the RTC, although initially no formal internal policies existed for auctions. Both agencies stratified loan portfolios into pools for sale based on various criteria: geographic area, asset type, asset quality, asset maturity, and other parameters. Using the appropriate valuation methodology, they valued the loan pools. They then developed a bidder’s information package providing information regarding the auction, the availability of loan information for review by

bidders, and the requirements that bidders must meet to bid and purchase loans at the auction.

The FDIC and RTC packages included the procedures, terms, and conditions of the sale. The loan sale agreements were not negotiable; however, the FDIC or the RTC could modify them before the auction and notify bidders of those modifications. Potential bidders then would return the certification statements and forms before any release of loan information and file review by the potential bidder. The certifications provided bidder qualifications and acknowledged that, according to the criteria provided, the bidders had no ethical conflicts in purchasing assets from the FDIC or the RTC and had the financial means to complete the transaction. In addition, each person who would be reviewing or had access to the loan data had to sign and return a confidentiality agreement. The agreement acknowledged that the loan information provided for review before the auction would be kept confidential and used only for the potential bidder's use.

Approximately four to six weeks before a scheduled auction, the FDIC and RTC allowed all interested and qualified potential bidders to review loan file information. The information was indexed for every loan in a package and included the available loan file documents, credit reports on the borrowers, and payment histories. The FDIC and RTC did not warrant the correctness of any documents.

At the beginning of the auction, announcements were made that governed the sale. The bidding then commenced for each loan package. For those loan packages with a reserve price, the auctioneer would announce that the package would be sold after the reserve price had been met. Successful bidders signed a high-bid acknowledgment and surrendered their "earnest money" checks. When bidders were finished for the day, they were escorted to the contract signing room, where a loan sale agreement was executed.

The terms of purchase required the bidder to wire sufficient funds to increase the deposit under the loan sale agreement to 10 percent of the purchase price within 48 hours of the close of the auction. Within 10 business days of the last day of the auction, the balance of the purchase price had to be wired to the seller. No contingencies existed in the loan sale agreement for financing, and the FDIC and RTC did not provide seller financing.

Neither the FDIC nor the RTC provided representations or warranties on the loan packages sold, but both did provide very limited repurchase provisions. Buyers had 120 days from the closing date to make claims regarding loan qualification for repurchase by the FDIC under the terms of the loan sale agreement (one year from closing for title defects). Buyers had 180 days from the transfer date to make claims regarding loan qualifications for repurchase by the RTC. After that time, no claims were accepted.

FDIC Open Outcry Auctions

By 1987, while managing more than \$11 billion in assets, the FDIC began experimenting with public auctions for selling loans. In August 1987, the FDIC conducted its first open outcry auction of loans. The auction took place in the Wichita, Kansas, office and consisted of 15 separate pools of loans charged off by banks before their failure. A total of 1,166 assets with an unpaid balance of \$10,345,576 were sold for \$176,078, or approximately 1.7 percent of the unpaid balance before expenses. Fifty-two bidders, each paying a registration fee of \$2,500, participated in the auction. The FDIC paid the auctioneer a setup fee of \$5,000, plus 5 percent of the purchase price on pools that sold for 5 percent or less of book value, and an additional 2.5 percent for those sold above that amount; the FDIC split the advertising costs 50/50 with the auctioneer. The assets were offered without representations or warranties and on an all-cash basis.

The auction of charged-off loans led to the FDIC's adoption of a strategy for other loans that was similar to its approach for sealed bid bulk sales; that is, implementation was cautious and, generally, only smaller, more distressed assets were pooled for sale. The FDIC had few loan auctions, more often choosing to adopt the sealed bid approach. The largest loan auction held by the FDIC was in 1995; it generated a relatively small \$10.6 million in sales proceeds. See table I.13-3 for a summary of FDIC loan auctions held after the auction of charged-off loans.

Table I.13-3

FDIC Loan Auctions

(\$ in Thousands)

Auction Date	Location	Aggregate Book Value	Number of Loans Sold	Number of Pools Sold	Sales Price	Sales Price as a Percentage of Book Value
Oct. 1987	Oak Brook, IL	\$7,983.3	392	8	\$2,430.0	30.4
Oct. 1988	San Fran, CA	15,227.1	473	23	3,523.6	23.1
Oct. 1988	Lafayette, LA	15,093.2	37	21	N/A	N/A
Jan. 1989	Dallas, TX	15,838.4	794	26	2,359.9	14.9
Jan. 1990	Irvine, CA	9,491.8	983	12	2,360.0	24.9
June 1995	Dallas, TX	58,840.8	1,438	19	10,570.0	18.0
Totals		\$122,474.6	4,117	109	N/A	N/A

N/A: Not available.

Source: FDIC Division of Resolutions and Receiverships.

RTC Regional Loan Auctions

The RTC conducted its first regional loan auction in June 1991. After conducting 11 more regional loan auctions between June 1991 and December 1992, the RTC began conducting loan auctions nationwide.

The RTC held regional loan auctions to sell the large inventory of small loans that it had acquired. At the beginning of the RTC's operations, each regional office had its own information system. The large number of assets to be converted to those regional systems, along with the lack of sophistication of many of the failed thrifts' own systems, put enormous strain on the resources of the regional offices. As a result, the asset data on the regional information systems was not always accurate. The development of a new, integrated information system for the RTC assets necessitated that the current inventory of small assets be sold so that the new system could be effectively started and staff efforts could be focused on large, complex assets in the RTC's inventory. See table I.13-4 for a summary of RTC regional loan auctions.

Table I.13-4

RTC Regional Loan Auctions

(\$ in Thousands)

Auction Date	Location	Book Value	Number of Loans Sold	Number of Loan Pools Sold	Sales Price	Sales Price as a Percentage of Book Value
June 1991	Chicago, IL	\$56,492.6	3,970	64	\$32,653.1	57.8
June 1991	Denver, CO	61,930.6	4,056	55	23,280.0	37.6
July 1991	Dallas, TX	24,517.5	3,299	22	5,030.0	20.5
Dec. 1991	Denver, CO	93,698.7	5,437	49	46,410.0	49.5
April 1992	Atlanta, GA	203,995.1	3,366	57	105,875.0	51.9
May 1992	San Antonio, TX	24,359.4	1,319	19	4,259.0	17.5
Aug. 1992	San Antonio, TX	17,114.3	1,046	12	6,175.0	36.1
Sept. 1992	Valley Forge, PA	78,243.0	689	38	21,210.0	27.1
Oct. 1992	Dallas, TX	46,030.0	796	27	28,500.0	61.9
Dec. 1992	Phoenix, AZ	19,059.4	45	14	7,133.0	37.4
Dec. 1992 *	Houston, TX	648,442.2	657	39	7,172.5	1.1
Dec. 1992 *	Atlanta, GA	58,840.8	44,000	77	9,377.0	15.9
Totals/Average		\$1,332,723.6	68,680	473	\$297,074.6	22.3

* These two regional loan auctions consisted primarily of judgments, deficiencies, and charge-offs (JDCs)

Source: FDIC Division of Resolution and Receiverships.

RTC National Loan Auction Program

The National Loan Auction Program, which grew out of the regional loan auctions, began in September 1992. Altogether, the RTC conducted eight national loan auctions, with the last one taking place December 13-15, 1995.

Under the direction of the national sales center, the RTC established the national loan auction to provide a common forum for the RTC field offices to market their hard-to-sell loans. The overall goal was to achieve the highest possible prices by providing sufficient concentrations of like assets in geographically similar locations that would attract numerous potential bidders and elicit strong competition. Originally designed to sell only nonperforming loans, the criteria were expanded in 1994 to include marginally performing loans. National Loan Auction V, which was held in September 1994, was the first auction to offer performing loans; specifically, they were performing loans that were not securitizable, were underperforming, or had other problems that rendered them unmarketable by other means.

Central to the success of the National Loan Auction Program was the establishment of the RTC auction center in Kansas City, Missouri, which housed all loan files. There, bidders were able to perform due diligence on copies of files (either documents or microfiche) that had been sent from field offices to the auction center. With its state-of-the-art facilities, including 175 computer workstations available at all times to accommodate investors, the auction center provided for four weeks of investor file review before each auction.

In an effort to maximize the sales price, the RTC stratified loans to produce homogeneous packages. The sales staff first sorted the loans based on performing versus nonperforming status, then by asset type, geographic location, and lien position. Stratification was also controlled to some degree by the RTC Completion Act (Completion Act) of 1993 and by the principles of the RTC's Small Investor Program. That program was designed to appeal to small investors who wished to purchase RTC assets but lacked the resources to bid on the large asset portfolios the agency had been offering for sale. Before requirements of the Completion Act changed the playing field, nonperforming real estate loans with balances of more than \$1 million were sold in multi-asset packages. To make the auction accessible and affordable for the relatively small investor, the RTC's Small Investor Program sales staff attempted to stratify the loans in a way that would keep the average package size under \$2 million.

By trying various combinations of media and by tracking the sources of investor inquiries, the RTC determined that a heavy emphasis on direct mail, with support by limited exposure in *The Wall Street Journal* and a few major regional papers, provided excellent results. In addition, auctioneers made direct calls to previous buyers, as well as to important prospective buyers, to solicit their involvement.

The RTC encouraged investors to do their own due diligence; provided them with all available information about the loans, including trial balance loan detail; and permitted them to view all the documents in the individual loan files. For a nonrefundable fee

of \$250, each investor could receive either a diskette with all the trial balance information or access to the same information on a computer network by modem. Contractor and RTC personnel were on hand to assist investors and answer questions.

While the investors reviewed loan documents, RTC personnel evaluated packages and set reserves. In general, reserves for performing loans were based on market yields, and reserves on nonperforming loans were based on either a percentage of the appraised value of the underlying collateral, or on a percentage of the book value based on the historical results achieved on like assets sold at previous auctions.

Typically, because of the number of packages offered, an auction lasted two or three days. Although many investors took advantage of preregistration, many registration procedures were completed each auction day. RTC attorneys worked with the auction contractor and the bidders to complete documents and to collect the \$50,000 deposit required each day of the auction.

Loan auction experience led the RTC to believe that (1) loan auctions were cost-effective only when the asset inventory was above a critical level; (2) small regional auctions were just as effective as large-scale national auctions; (3) reserve pricing was critical for the sale of difficult, more complex products as a means to guide the market value; and (4) performing standard assets did not need reserve pricing. The bidders would easily establish a market price for those assets. See table I.13-5 for a summary of the RTC National Loan Auction Program results.

The RTC viewed conducting auctions as a successful method for selling a large inventory of small value loans or as a way to reduce its inventory before closing an office. It viewed sealed bid loan sales as more successful when the inventory was smaller, or in the “normal” course of business. The RTC believed that the competitive atmosphere of an open-outcry auction generated higher prices for loan pools than did other sales methods. On the downside, those auctions sometimes resulted in logistical problems after the sales event. Sometimes delays in accounting for the sales led to contractors continuing to manage sold assets and even, in some cases, resulted in assets being sold to more than one buyer. Overall, the RTC believed that its auctions were entirely suitable for the sale of nonperforming loans and nonstandard loans that were hard to sell by other methods.

Real Estate Sales Programs

The disposition of real estate was not of great concern to the FDIC until the early 1990s. Before 1989, the FDIC’s inventory of real estate received from bank failures averaged only about \$300 million, peaking at \$600 million in 1987. Beginning in 1989, the level of inventory increased dramatically as the pace of bank failures increased. In 1989, FDIC’s inventory of real estate jumped to \$5 billion, representing 19 percent of the FDIC’s total assets in liquidation; it would later peak at \$6 billion by year-end 1991. In comparison, the RTC ended 1989 with \$14.6 billion in real estate; it would peak at \$18.1 billion by year-end 1990. In 1991, the RTC began offering seller financing to

Table I.13-5**RTC National Loan Auction Program**

(\$ in Millions)

Auction Number and Date	Book Value	Sales Price	Sales Price as a Percentage of Book Value	Number of Loans Sold	Number of Packages Sold	Number of Buyers	Total Costs	Costs as a Percentage of Book Value	Costs as a Percentage of Sales Price
I Sept 92	\$416	\$248	59.62	6,966	196	39	\$5.2	1.25	2.10
II March 93	501	249	49.70	17,814	190	40	3.8	0.76	1.51
III Aug 93	673	335	49.78	11,198	311	55	4.5	0.67	1.34
IV April 94	318	191	60.06	5,809	225	45	2.8	0.88	1.47
V Sept 94	399	223	55.89	8,814	317	81	3.5	0.88	1.57
VI Dec 94	370	229	61.89	9,786	258	73	3.7	1.00	1.62
VII May 95	353	231	65.44	7,178	296	76	3.9	1.10	1.69
VIII Dec 95	569	403	70.83	5,349	336	96	3.2	0.56	0.79
Totals/ Averages	\$3,599	\$2,109	58.60	72,914	2,129	505	\$30.6	0.85	1.45

Source: RTC National Loan Auction Program Database.

encourage real estate sales in reaction to a market that was severely distressed and lacked more traditional sources of financing.

Sealed Bids

The FDIC has always made a regular practice of employing a sealed bid process for real estate sales. Unlike bulk sales or auctions, sealed bid events were almost always single asset sales until the early 1990s. At that time, the FDIC's inventory increased to such levels that sealed bid marketing efforts included multiple assets, although bids were accepted on individual real estate properties. Typically, sales were advertised in a variety of newspapers, with specific bid dates established. Contract terms were generally all cash, and winning bidders were required to make nonrefundable earnest money deposits. The

RTC also made regular use of sealed bids and operated under procedures similar to those of the FDIC. Generally, sealed bid sales satisfied agency requirements for broad marketing and competitive bidding. In addition, they set a certain date for selling the property, assuming an adequate bid was received. The RTC usually established reserve prices based on a percentage of appraised value. Sealed bid sales, which typically ran for 30 to 60 days, were conducted directly by the account officer or through the services of an exclusive listing broker, known as a lead broker.

The sealed bid process gives all interested parties an opportunity to submit their offers under structured guidelines. The process levels the playing field and eliminates any potential inquiries concerning possible unequal treatment of participants. The process also requires buyers to submit their bids in conformance with the sealed bid instructions, bid format, and prescribed deadlines—or risk being disqualified. The sealed bid sale method has been effective for larger, higher profile assets for which the target market is primarily national in scope and a rapid and extensive marketing campaign seems appropriate. In the early 1990s, the process also facilitated a faster sale, which proved effective for properties that were experiencing significant negative cash flows or holding costs.

Real Estate Auctions

By the late 1980s, the FDIC periodically began holding real estate auctions to dispose of large inventories of relatively small real estate properties such as condominiums and vacant lots. The FDIC saw those sales as opportunities to unload large numbers of labor-intensive properties. During that time, the use of real estate auctions was generally limited to small and distressed properties and connoted the image of a “fire sale,” in which the seller was willing to accept heavily discounted prices to unload undesirable real estate.

Interestingly, fear of a fire sale mentality, or the “dumping” of assets, was prevalent when the RTC was created. As a result, FIRREA included language requiring the RTC to sell real estate for no less than 95 percent of market value—defined as appraised value. Consequently, in the early stages of the RTC’s existence, real estate auctions were prohibited for fear that they would aggravate already distressed markets, reduce prices generally, erode collateral values, and damage the financial standing of banks and thrifts that were heavily invested in real estate markets.

By 1990, the RTC real estate inventory was more than \$18 billion and efforts to sell the inventory through normal channels, such as brokers, were insufficient to move substantial amounts of property. Congressional concerns about the RTC’s slow pace in selling assets, the cost of carrying the inventory, difficulties in managing large numbers of assets, and the continuing decline in real estate prices generally began to change outside perceptions of how the RTC should proceed.

In March 1991, the RTC approved a new real estate pricing policy for all real estate sales and, particularly, authorized the use of auctions to sell real estate. The resulting

effect was significant. The RTC determined that its auctions would require extensive marketing efforts with large-scale regional, national, and possibly international exposure. It planned to sell properties in absolute auctions if the property had an established market value below \$100,000 and if the property had been widely exposed to the market. The RTC would reserve the right to reject any offers that were made in the absence of a competitive bidding environment. It planned to sell all other properties at auctions with reserve prices set at levels to take into account the benefits of an expedited sale, including savings of holding costs and marketing costs. To stimulate bidding, the RTC could set reserve prices at less than the expected sale price, accepting under no circumstances less than 70 percent of the current appraised value, adjusted for any savings of sales expenses or costs as a result of an expedited sale. As the RTC and the FDIC saw their inventories increase substantially and both began acquiring larger real estate properties, they both initiated large-scale national auctions.

National Real Estate Auctions

To promote sales and to respond to criticism that the RTC was slow in disposing of assets, the RTC created the National Satellite Auction. The first of its kind, the auction, based in Dallas, Texas, was scheduled for November 15, 1990, with satellite transmission to nine U.S. cities, as well as to London and Tokyo. More than 71 commercial properties were expected to be included with an aggregate value of \$500 million. Notwithstanding the best of efforts and intentions, the auction was ultimately canceled because the auctioneer was unable to meet a contract commitment for funding. It was a rocky start for the RTC's auction efforts, but the RTC continued to embrace the national auction methodology.

Through its national sales office, the RTC planned, coordinated, and executed many major asset sales, including the sale of real estate pools worth more than \$100 million. The RTC held many national real estate sealed bid sales including the 1992 offering of its first structured portfolio of hotel properties and related loans, which had a book value of approximately \$237 million, and one national real estate auction in November 1991. The office conducted a number of other national sales of unique properties such as mini-warehouses, shopping centers, and nursing homes. The office also developed the National Land Fund strategy to dispose of the hard-to-sell land assets.¹

The FDIC also saw opportunity in employing large-scale real estate auctions. In March 1989, the New York office coordinated the first nationwide auction of large real estate holdings. At the auction, conducted at Christie's in New York City, 14 properties were sold for \$40.7 million, a significant 99.4 percent of their aggregate appraised value.

In December 1991, the FDIC held its first national satellite real estate auction. Properties included in the auction were from 23 states and consisted of 178 commercial

1. For more information, see Chapter 17, Partnership Programs.

properties with an aggregate appraised value of \$443 million. With satellite hookups in five cities, the event attracted 1,000 bidders and yielded \$240 million in cash, plus notes. Of the 178 properties exposed to the market, 115 were placed under sales contracts at an aggregate price equivalent to 82 percent of the portfolio's appraised value. The FDIC offered seller financing on properties with an appraised value of more than \$500,000 and also offered a 5 percent cash discount on those properties.

In 1992 and 1993, the FDIC conducted its second and third national satellite real estate auctions. In addition to selling many properties at auction, the FDIC discovered that the promotion leading up to the events could result in sales before the actual auction date. Typically, a group of properties were targeted for auction. To maintain adequate inventory for the sale and show good faith to investors who spent considerable time and money performing due diligence on those properties, the FDIC typically froze property sales at about the time information packets and brochures were distributed. Investors already interested in properties on the market and scheduled for auction could be threatened by the prospect of having to bid for the property in an open outcry auction environment for fear of either paying a higher price or losing the property altogether. Consequently, a significant number of investors acted to lock in the purchase of the property before the freeze date, thus bringing about earlier sales than might have otherwise occurred.

As inventory levels and asset sizes no longer supported a large national initiative, the FDIC suspended the use of national auctions after 1993 and, instead, relied principally on smaller regional initiatives. See table I.13-6 for a summary of the FDIC national auction results.

Conclusion

The banking and thrift crisis caused an unprecedented volume of assets to be transferred to the FDIC and the RTC. In response to an overwhelming workload, both the FDIC and the RTC experimented with disposition strategies to facilitate disposition at prices that maximized the overall return.

The experience gained from the period clearly indicates that sealed bid sales and auctions are effective marketing strategies for disposing of distressed assets in a timely and effective manner. The multitude of variables involved in evaluating independently unique assets, timeframes, and situations makes it difficult to determine which approach is more acceptable or will generate better returns in a given situation. Sufficient experience has occurred in both the public and private sectors, however, to substantiate both strategies as reasonable approaches to disposing of real estate, loans, and other assets, especially when a large volume of distressed assets needs to be sold within a relatively short time.

In either marketing strategy, the FDIC found that it was important to have good information about the assets before marketing them, because they brought a better price

when the bidders were able to receive good information before bidding. The RTC, more so than the FDIC, found itself with an extraordinary volume of assets. As a result, unlike the FDIC, which up to a point was able to take the assets in, manage them for a short period, clean them up, and then sell them, the RTC generally did not have the luxury of time and would market assets without much prior due diligence. For that reason and because the assets held by the RTC were, on the whole, of a lesser quality, the FDIC was generally able to receive a better sales price.

Table I.13-6

FDIC National Auction Results

(\$ in Thousands)

1992 Auction				
	Number	Appraised Value	Sales Price	Sales Price as a Percentage of Appraised Value
Properties in the Auction	270	\$599,497	—	—
Total Sold at Auction	218	474,365	\$412,170	86.9
Financed Sales	153	373,091	328,665	88.1
Cash Sales	65	101,274	83,505	82.5
Sold Before Auction	144	282,477	261,805	92.7

1993 Auction				
	Number	Appraised Value	Sales Price	Sales Price as a Percentage of Appraised Value
Properties in the Auction	197	\$398,138	—	—
Total Sold at Auction	165	345,138	\$312,231	90.5
Financed Sales	100	219,810	195,514	89.0
Cash Sales	65	125,329	116,718	93.1

Source: FDIC Division of Resolutions and Receiverships.

Although it cannot be said that one type of asset management contract worked better than another type, the private-sector contractors generally performed well under any type of contract, when they were given the proper incentives.



CHAPTER 14

Asset Management Contracting

Introduction

This chapter reviews the types of asset management and disposition contracts used by the Federal Deposit Insurance Corporation (FDIC) and the Resolution Trust Corporation (RTC). The analysis includes a discussion of the evolution, strengths, and weaknesses of those contracts.

Background

During the 1970s and the early 1980s, the FDIC used its internal staff to conduct most of its asset disposition activity. As the number of failures rose and the total volume of assets to be liquidated increased, the FDIC found it more difficult to perform those functions entirely with in-house personnel.

In the mid-1980s the FDIC first began using contractors to manage and dispose of distressed assets with the resolutions of Continental Illinois National Bank and Trust Company (Continental), Chicago, Illinois,¹ and First National Bank and Trust Company of Oklahoma City, Oklahoma City, Oklahoma. By the late 1980s, however, it was standard practice for the FDIC to use contractors for the management and disposition of assets retained from some of the larger bank failures. The RTC, with its large volume of assets, used asset management contractors from the outset.

From 1988 to 1993, the FDIC used 14 asset management contracts to liquidate assets with a book value of more than \$33 billion, or more than 45 percent of the post-resolution assets the FDIC retained for liquidation. The RTC issued 199 Standard Asset

1. See Part II, Case Studies of Significant Bank Resolutions, Chapter 4, Continental Illinois National Bank and Trust Company.

Management and Disposition Agreements (SAMDA) to 91 contractors from 1991 to 1993 to cover assets with a book value of \$48.5 billion.

Continental Illinois National Bank and Trust Company, Chicago, Illinois

On September 26, 1984, the FDIC entered into a five-year assistance agreement with Continental Illinois Corporation, the holding company of Continental. In exchange for assuming Continental's \$3.5 billion debt to the Federal Reserve Bank (Federal Reserve) and providing Continental with an additional \$1 billion in capital, the FDIC received \$1 billion in preferred stock and assets with an unpaid balance of \$5.2 billion. Those assets had a book value of \$4.5 billion at the time of the transaction, and a further write-down to \$3.5 billion was made on the date of the assistance agreement to reflect the assets' troubled status. On the same date, the FDIC and Continental entered into a servicing agreement under which Continental managed the poor-quality assets. While the FDIC owned the assets, Continental set up a special unit called the FDIC Asset Administration (FAA) to manage and dispose of the assets.

About 50 percent of the problem assets were large loans to the energy industry, 20 percent were complex international shipping loans and loans to foreign companies, 20 percent were securities, and approximately 10 percent were commercial mortgages and construction loans secured by large commercial real estate projects from all over the country. As assets were liquidated, portfolio collections² were used first to pay the expenses of administering the pool, which included items such as the administrator's salaries and overhead. Next, collections were applied to the payment of the interest, then the principal, of the Federal Reserve debt.

FAA's asset management staff at its peak totaled more than 250 employees. The FDIC's oversight staff, who were located in the bank, consisted of 7 to 12 specialists who were hired to oversee such areas as oil and gas, owned real estate, and international lending. Another five FDIC employees were accountants and attorneys. An oversight committee composed of FDIC staff reviewed only FAA's asset management and disposition decisions, because the FAA oversight committee had no authority to make disposition decisions. The committee also reviewed FAA's accounting and budgeting systems and processes for accuracy and ensured that FAA complied with the FDIC's policies and procedures.

FAA had unlimited restructuring, settlement, and sales authority on the assets, but there was a capital expenditure limit of \$50,000 per expenditure and an aggregate annual capital expenditure limit of \$100,000 per asset. FAA had no authority to approve indemnifications, and the FDIC field and regional offices had very limited indemnification authority. Because indemnification was a standard feature in international,

2. Portfolio collections were defined as gross collections less authorized asset-related expenses. Continental reported only portfolio collections to the FDIC, so the gross collection amount is unknown.

multi-bank transactions and Continental was, to a large extent, a “banker’s bank” participating in such loans, many workout situations involving indemnifications had to be approved at FDIC headquarters in Washington, D.C. Some problems were encountered in getting a prompt turnaround from FDIC headquarters to obtain the necessary approvals for large workouts involving multiple banks as participants. Consequently, the FDIC decided that when overseeing an asset pool containing large, complex assets such as those at Continental, there were advantages to having more decentralized delegated authority.

The FAA had a “cost-plus” asset management contract, under which the FAA was reimbursed for the cost of its expenses plus incentive compensation, which was based on a tiered scale ranging from 0.6 percent to 2.25 percent of net collections.³ Incentive compensation for the first tier was 0.6 percent times the aggregate net collections between \$250 million and \$1 billion. That percentage increased incrementally through a total of four tiers to 2.25 percent of net collections between \$3 billion and \$3.5 billion.

The incentive fees paid to FAA during the life of the servicing contract were a relatively low \$8 million because of the large interest payments made on the Federal Reserve debt. That amount represents only 0.34 percent in incentive compensation for FAA of the \$2.4 billion in portfolio collections. FAA’s recovery rate (\$2.3 billion in net collections⁴ to \$4.3 billion in book value reductions⁵) was 53 percent. Discounting collections to estimate a net recovery rate (\$1.9 billion in net present value of net collections to \$4.3 billion in book value reductions) results in a recovery rate of 44 percent.⁶

The servicing agreement entered into with Continental was the first of its kind for the FDIC. The FDIC’s experience in this case suggested that the cost of using the private sector to service assets was relatively low and that the contractor’s overall performance was satisfactory. The servicing agreement spared the FDIC from having to hire hundreds of people to manage the \$5.2 billion in distressed assets.

3. Net collections for the purposes of FAA’s incentive compensation were defined as portfolio collections (net of all asset-related expenses) less the administrator’s reasonable direct expenses, such as salaries and overhead, as well as the FDIC’s expenses and interest expenses on the Federal Reserve debt.

4. Net collections here are defined as net collections before interest payments on the Federal Reserve debt over the five-year term of the agreement. As a result, net collections equaled \$2.4 billion in portfolio collections less \$91 million in expenses, which includes administrative expenses (\$70 million), FDIC expenses (\$13 million), and incentive fees (\$8 million).

5. Book value reductions are defined as the decrease in book value of all types of assets resulting from such activities as the collection of loan principal, the sale of an asset, the forgiveness of debt, and the write-off or donation of an asset.

6. Although the original termination of the Continental servicing contract was September 26, 1989, the contract was terminated instead in October 1988, at Continental’s request. The FDIC actually serviced the assets for the last 11 months of the five-year contract. Approximately 85 percent of the net collections within the five-year period were achieved during the four-year period when Continental administered the pool.

First National Bank and Trust Company of Oklahoma City, Oklahoma City, Oklahoma

On July 14, 1986, approximately \$1.5 billion in assets of the failed First National Bank and Trust Company of Oklahoma City were placed in an asset pool under a purchase and assumption transaction. First Interstate Bank, Oklahoma City, the acquiring bank, set up a subsidiary corporation, Consolidated Asset Management Company (CAMCO), to administer and liquidate the \$1.5 billion asset pool.

The CAMCO contract was similar to the FAA contract in that it had a cost-plus feature. The term of the contract was for five years, and the FDIC oversight staff had no authority to make asset disposition decisions. The CAMCO contract was also like the FAA contract because the contractor had unlimited sale and settlement authority, and incentive compensation was based on the dollar volume of net collections. All expenses were paid by the FDIC and netted against collections before the incentive fee was paid.

One difference in the CAMCO contract was that it was between the FDIC and an affiliate of the acquiring bank, rather than with the bank itself. That precedent was followed by other banks that later entered into asset servicing agreements and allowed the “good” bank to further insulate itself from the “bad” bank’s activities. In addition, the percentages that applied to the various tiers of net collections in the incentive compensation formula were higher in the CAMCO contract than those in the FAA contract or in later agreements. As a result, the CAMCO contract was more expensive for the FDIC than was the Continental contract. The higher percentages were included because of the low overall incentive compensation paid to FAA. In this case, though, the percentages proved to be too generous and gave CAMCO fairly high returns. CAMCO received approximately \$31 million in incentive compensation over the course of the contract, which represented about 12 percent of the \$255 million in net collections. Subsequently, the FDIC decided to pursue a more standardized type of asset management agreement to set more appropriate rates of return for asset management contractors. The new type of contract became known as the Asset Liquidation Agreement.

Asset Liquidation Agreements

The Asset Liquidation Agreement (ALA) was a contract between the FDIC and an asset management contractor for the purpose of managing and disposing of distressed assets. It was designed for asset pools with an aggregate book value greater than \$1 billion. Ten ALA contracts were issued between 1988 and 1992 and achieved book value reductions of \$30.5 billion. For the same time period, approximately 45 percent of all the FDIC’s assets were managed by ALA contractors. All of the ALA contracts were completed by the end of 1996; any remaining assets were transferred back to the FDIC when the contracts concluded.

The term of an ALA contract was normally five years with no renewal options. Several contracts were ended early by mutual agreement; the average duration of the 10

ALA contracts was four years and five months. The objective of the ALA was "...the maximization of the present value of net cash flows."

The ALA contract was similar to the FAA and CAMCO contracts in that it was a cost-plus contract in which the FDIC reimbursed the contractor for all operating expenses and overhead, including salaries, benefits, and limited bonuses of the contractor's employees.⁷ The contractor often paid higher bonuses to its employees, but those bonuses were not reimbursable. In addition to the contractor's salaries and overhead, the FDIC reimbursed the contractor for all asset-related expenses. Such expenses included asset searches; foreclosure fees; appraisals; environmental reports; property taxes; and all legal, accounting, and consulting fees related to the management and disposition of the asset pool.

Because of certain companion agreements, acquiring banks of the first eight ALA contracts were able to put additional failed bank assets back to the FDIC through the vehicle of the ALAs if it was determined that the assets should have been classified at the time of the failed bank's resolution. One of the changes made to the "put option" was that in some of the later contracts, the acquirer was penalized for the length of time it took to put back the assets. For example, in the first year there was no penalty, and the FDIC would purchase qualified assets at their book value. During the second year of the contract, however, the FDIC would buy the assets back at a 2 percent discount from book value, and in the third year the FDIC imposed a 5 percent discount.

Evolution of the ALA Program

At first, the ALA contracts were negotiated between the FDIC and an asset management organization that was an affiliate of the acquiring bank. Later, ALAs evolved into competitively bid contracts between the FDIC and private-sector contractors who did not have to be affiliated with the acquiring bank.⁸ The ALA program was designed to facilitate the disposition of distressed assets, primarily nonperforming loans and owned real estate, although the pools sometimes contained performing loans.

The first three ALA contracts occurred in 1988 and 1989 and contained the distressed asset pools of the failed First RepublicBanks, MBanks, and Texas American Banks, all of which were in Texas.⁹ The primary difference between those contracts and the ones that followed was that the assuming bank owned and held title to the assets. A

7. The FDIC could deny expenses if it determined that the costs were excessive or improper or if the contractor was found to be negligent. The contractor's nonreimbursable expenses included items that were not directly related to the liquidation, collection, and management of the pool assets, such as severance plans or any employee benefits that the FDIC considered to be excessive.

8. Only three ALA contracts were competitively bid. Those included the First RepublicBanks (AMRESKO) contract and the last two ALA contracts involving seven banks in New Hampshire (BONHAM) and Dollar Dry Dock Bank (JERNE). (See table I.14-2.)

9. See Part II, Case Studies of Significant Bank Resolutions, Chapters 6 and 7, First RepublicBank Corporation and MCorp., respectively.

subsidiary of the assuming bank usually managed the special asset pool. The FDIC paid the assuming bank the difference between the book value and the estimated market value of the failed bank's assets assigned to the pool. When the assets were later sold or settled, the FDIC also paid the assuming bank the difference between the original estimated market value and the actual value obtained on the assets. Likewise, if the sales price of an asset was greater than its original estimated market value in the pool, the difference accrued to the FDIC. Therefore, although the assuming bank held the assets in title, it did not assume all the normal risks of ownership. By having the assuming bank fund the bad assets, the FDIC reduced its initial cash outlay, thereby preserving the liquidity of the bank insurance fund. However, this strategy raised the overall cost of the transactions to the FDIC because the assuming banks had higher funding costs than did the FDIC. After being given adequate sources of liquidity, the FDIC no longer used that type of funding mechanism.

In the first ALA contract with First RepublicBanks, the incentive fee paid to the contractor was tied to a fixed percentage of gross collections on the pool and limited to a gross dollar amount over the life of the contract. It soon became apparent that this type of contract presented some problems, so the FDIC adjusted the incentive formula on the next two contracts by basing the fee on a percentage of net, rather than gross, collections. Net collections were defined as gross collections less all allowable expenses associated with the pool. The use of net collections rather than gross collections forced the contractor for the first time to take into consideration its cost of collections. In the first ALA contract, the contractor had no motivation to reduce its costs because the FDIC reimbursed all of its expenses and the expenses did not affect the contractor's fee.

Another change to the management contract was that the incentive fee percentage decreased over the life of the contract. For example, the contract might pay 3 percent of net collections the first year, 2 percent the second year, 1 percent the third, and so on. The contract was changed to gradually pay a reduced percentage fee to induce the contractor to dispose of the pool more quickly. That change was considered an improvement over the fixed percentage given in the first ALA contract because it rewarded the contractor on the basis of the time value of money. Also, the FDIC eliminated the dollar limitation on total fees collectable since that could be a disincentive to a contractor toward the end of the contract.

The first three contracts also provided an opportunity for an additional incentive fee at the end of the contract if it was proven that the contractor had improved the value of the pool over the earlier "mark-to-market" value. The formula used to determine this value was a complicated one that considered all collections made over the life of the pool and required the valuation of the remaining assets in the pool at the end of the contract. After the first three contracts, that clause was eliminated because there was no evidence that it was effective as an incentive to the contractors to improve collections. It also proved difficult and costly to implement because of the requirement of a mark-to-market valuation on the remaining assets upon termination of the contract.

The fourth through the eighth ALA agreements occurred in quick succession from February to August 1991. There was little structural difference among those five contracts, although the variables used in the incentive fee formula for each contractor were unique. Some primary changes from the first three contracts were that the assets assigned to the contractors were no longer marked to market, and the FDIC, rather than the acquiring bank, owned the assets.

After analyzing the results of the first three contracts, the FDIC also made some major modifications to the way that it calculated the incentive fee. Rather than basing the incentive fee on a decreasing percentage of net collections, the FDIC took the opposite approach and started paying the incentive fee at an *increasing* percentage of net collections. The FDIC realized that it was harder to motivate the contractor from the middle of the contract term to the end, when collections were more difficult to achieve. Also, as the pool decreased in size, fewer assets were generating income, so the incentives needed to be enhanced for the latter period of the contract. Furthermore, since the ALA contracts were all cost-plus contracts, the FDIC needed an additional incentive to ensure that the contractor made every effort to keep its expenses to a minimum.

To address those concerns, the FDIC developed a more complicated incentive fee formula. The new incentive fee was keyed to the ratio of cumulative net collections to the asset pool's gross pool value. The cumulative net collection amount in the incentive fee formula was derived by deducting the funding costs and twice the amount of the contractor's reimbursable expenses from the gross collection amount. The gross pool value was defined as the aggregate book value remaining in the pool. The formula also increased the incentive fee percentage as the ratio of cumulative-net-collections-to-gross-pool-value increased.

The addition of the factor regarding funding costs to the formula had a negative effect on the incentive fee if the pool balance remained at a high level. The contractor therefore had a strong incentive to reduce the pool balance either through collections and sales of nonperforming assets or through writing off the worthless assets in the pool. The doubling of the expense costs in the incentive compensation formula heightened the contractors' awareness of the need to control expenses. The result was that ALA contractors decreased staffing and other expenses fairly quickly as assets were liquidated and the workload declined.

The FDIC made another change to the incentive fee structure because it wanted a strong internal audit function for each of those ALA contracts. In the earlier contracts, it was difficult to direct the contractor to spend funds in that area because the costs attributed to the audits resulted in a reduction in the contractor's incentive fees. To correct this problem, the FDIC deducted audit costs from the contractor's total expenses in the formula that determined the incentive fees.

In the first three contracts, assets could be added to the pools only if they originated at the failed bank that was the source of the initial contract. Although this restriction helped for bookkeeping purposes if the assets were later put back to the FDIC, it proved inflexible and a hindrance to the operation of the ALA program. The later contracts

were changed to allow the FDIC to add additional assets from any source. That provision allowed the FDIC the flexibility to group loans to one borrower even if they originated at different banks. It also allowed the FDIC to add additional assets from a newly failed bank to an existing ALA contract, thereby saving the FDIC the time and expense of bidding out another contract. The option also allowed the FDIC in a later ALA contract to combine assets from a particular geographic area into one pool to better service its loan customers. The knowledge that additional assets could be added to their pools further motivated the contractors to outperform other contractors.

A major change that occurred in the final two (ninth and tenth) ALA contracts was that the asset pools were competitively bid to outside asset management firms. This process was in contrast to the earlier one, in which the contract terms were negotiated with the successful acquirer of the failed institution. After the contracts were competitively bid, the result was lower incentive fees to the contractors. Although it might seem that the FDIC would have made that change from the beginning to lower its costs, there were several reasons that the change occurred toward the end of the ALA program period, rather than at the beginning. At the inception of the ALA program, the FDIC did not believe that a sufficient number of qualified private-sector asset management firms existed to ensure a competitive bidding environment. Because the ALAs were cost-plus contracts covering asset pools with book values of more than \$1 billion, the FDIC needed to have a high level of confidence in the asset management firm that it would select. In addition, the acquiring bank, rather than the FDIC, owned the assets in the first four ALA contracts, which were consummated from late 1988 to early 1991. Because the FDIC did not hold title to the assets, it was not in a position to competitively bid out the asset servicing contracts. By 1992 the FDIC determined that a sufficient number of qualified, experienced ALA contractors and RTC asset management contractors that managed troubled assets existed to provide competition.¹⁰ The FDIC therefore was comfortable about competitively bidding out the last two ALA contracts. Table I.14-1 shows the Bank One New Hampshire Asset Management (BONHAM) fee structure, which is an example of one of the actual ALA compensation schedules.

Oversight and Operational Controls

An on-site oversight staff composed of FDIC employees managed the ALA contractors. The number of oversight staff ranged from 5 to 10 employees, depending on the size of the contract. The duties of the FDIC oversight staff were related primarily to the disposition of assets. An oversight committee was composed of two FDIC employees and one contractor employee. The committee normally had unlimited delegations of authority in asset disposition matters, thus permitting prompt decision making,

10. The RTC Standard Asset Management and Disposition Agreement contractor program is described later in this chapter.

promoting the contractor's credibility in negotiations with borrowers, and enabling the contractor to close transactions expeditiously.

The oversight committee members and the FDIC oversight staff performed many of the same asset management and disposition functions that were normally performed in an FDIC field office, such as reviewing the largest assets to ensure the proper handling of high-profile or sensitive asset-related issues. The FDIC staff also approved the asset management and disposition procedures prepared by the contractor, addressed congressional and media concerns, and reviewed and approved the contractor's annual audit plan, budget, business plans, staffing levels, and salary structure. In addition, the FDIC staff reviewed and analyzed the contractor's overall expenses and collections and monitored the ALA agreement, a task that involved coordinating the interpretation of the contract with other divisions within the FDIC and working with legal staff on asset disposition and litigation issues.

The FDIC's financial compliance oversight function included a review of the contractor's monthly financial reporting packages, appropriate accounting methodologies, compliance with the contract, and audit reports prepared by the contractor's internal audit department. The FDIC's financial compliance staff reviewed the contractor's accounting policies for compliance with receivership accounting requirements and examined the contractor's accounting manuals for compliance with the FDIC's

Table I.14-1

**Bank One New Hampshire (BONHAM)
Incentive Compensation Schedule**

Net Collection Tier *	Contractor's Compensation (%) †
Less than or Equal to Zero	0.0
Greater than Zero to 16%	0.2
Greater than 16% to 25%	0.5
Greater than 25% to 32%	1.0
Greater than 32% to 39%	1.5
Greater than 39% to 43%	2.5
Greater than 43%	4.5

* The net collection tiers represent the ratio of cumulative net collections to gross pool value. These tiered percentage ranges were the same in all of the ALA contracts. The imputed funding cost used in the calculation of net collections was determined by applying the one-year U.S. Treasury constant maturity rate to the average book value of the current month.

† The contractor's compensation represents the percentage of net collections that the contractor would retain at each level. These compensation schedules were bid by or negotiated with the contractor, and they differed in each contracting schedule.

Source: FDIC/BONHAM ALA contract dated February 12, 1992.

requirements. In addition, they tried to find ways to reduce expenses and fees that were paid by the FDIC; this task involved a review of the contractor's cost allocation methods.

The FDIC's oversight staff inspected the contractor's files, monitored goals against actual results, reviewed portfolio sale cases, and followed up on problems noted in previous site visitations. They also reviewed owned real estate sales and the real estate appraisal process and analyzed property management procedures, lease agreements, and the property tax abatement process. Although the number of FDIC oversight staff was limited, they had sufficient authority to serve as a check-and-balance system for the ALA contractor and to provide direction on how the FDIC wanted the assets to be liquidated. For instance, the FDIC oversight staff approved the salaries of the contractor and also comprised the majority on the oversight committee that determined which expenses were reimbursed, approved or disapproved asset settlements and sales, and either removed assets from a pool or approved the addition of new assets.

Sources of Assets for the Asset Liquidation Agreements

Table I.14-2 summarizes the sources of assets assigned to the ALA program, as well as other pertinent information.

Financial Performance of the ALA Program

Table I.14-3 summarizes the performance of the FDIC's 10 ALA contracts from the inception of the program in November 1988 through June 30, 1996.

Table I.14-2

Sources of Assets Assigned to ALA Contractors

(\$ in Billions)

Failed Bank	Number of Receiver-ships	Date of Failure	Total Assets at Failure	Assuming Bank	Servicing Contracts	Book Value of Assets Assigned to Servicer
First Republic-Banks	41	July 29, 1988	\$33.4	NCNB Texas, National Bank	AMRESKO, a subsidiary of NCNB Texas	\$12.0
MBanks	20	March 28, 1989	15.7	Bank One, Texas, N.A.	Bonnet, a subsidiary of Bank One	4.2
Texas American Banks	24	July 20, 1989	4.7	Team Bank, N.A.	FAMCO, a subsidiary of Team Bank	1.3

Table I.14-2

Sources of Assets Assigned to ALA Contractors

(\$ in Billions)

Continued

Failed Bank	Number of Receiver-ships	Date of Failure	Total Assets at Failure	Assuming Bank	Servicing Contracts	Book Value of Assets Assigned to Servicer
Bank of New England, N.A., Connecticut Bank & Trust Co., and Maine National Bank	3	January 6, 1991	22.0	Fleet Bank of Massachusetts, N.A.	RECOLL, a subsidiary of Fleet	7.5
Maine Savings Bank	1	February 1, 1991	1.2	Fleet Bank of Maine	RECOLL, a subsidiary of Fleet	0.5
Goldome	1	May 31, 1991	8.7	Manufacturers and Traders Trust Company *	Niagara Asset, a subsidiary of Key Bank	0.6
					Niagara Port, a subsidiary of Key Bank	1.1
CityTrust and Mechanics and Farmers Savings Bank	2	August 9, 1991	3.1	Chase Manhattan Bank of Connecticut, N.A.	CARC, a subsidiary of Chase Manhattan Bank of Connecticut	1.5
Seven banks in New Hampshire †	7	October 10, 1991	4.4	First New Hampshire Bank and New Dartmouth Bank	BONHAM, a subsidiary of Bank One	1.7
Dollar Dry Dock Bank (and other Connecticut banks)	4	Various in 1991 and 1992	6.0	Emigrant Savings Bank (and others)	JERNE, a third-party contractor	1.5
Totals	103		\$99.2		10	\$31.9

* Later purchased by Key Bank, Buffalo, New York.

† Three of these failed banks, which were Dartmouth Bank, New Hampshire Savings Bank, and Numerica Savings Bank, FSC, were acquired by New Dartmouth Bank. The other four failed banks were acquired by First New Hampshire Bank and included Amoskeag Bank, Nashua Trust Company, Bank Meridian, N.A., and BankEast. (Both New Dartmouth Bank and First New Hampshire Bank entered into loss sharing assistance agreements with the FDIC on October 10, 1991 as well. See Chapter 7, Loss Sharing, for additional information.)

Source: FDIC Division of Resolutions and Receiverships.

ALA Program Recovery Rates and Expense Ratios

Table I.14-4 is a summary of the book value reductions, gross collections, expenses, and net collections of the ALA program.

Strengths and Weaknesses of the ALA Program

The use of ALA contracts played a key role in the FDIC's approach to the management and disposition of bank assets that it received from bank failures in the late 1980s and early 1990s. The ALA contracts provided a means for the FDIC to handle the high volume of assets it received from the largest banks that failed. From 1988 to 1992, the FDIC contracted on 10 occasions with outside asset management companies to service \$32 billion of assets from failed banks. Those assets represented approximately 45 percent of the residual assets of failed banks that remained with the FDIC during those years. Although the ALA contract is compared later in this chapter to the two other types of asset management contracts that the FDIC and RTC used, the following is a brief overview of some of the strengths and weaknesses of the ALA program.

As an alternative to building up its permanent staff for a short period of time (approximately three to five years), the FDIC was able to contract out the management of the assets. The contractors could hire staff more quickly than the FDIC could, and the ALA fee schedule provided the contractor with a strong incentive to maximize the recovery on the pool assets. Because of the effect of the doubling of expenses on the incentive fee, the contractors were conscious of their staffing costs and therefore downsized quickly as the asset pools were reduced.

The full delegated authority given to the on-site oversight committee was an important factor in timely decision making concerning the assets. To ensure that this authority was not abused, the FDIC assigned some of its most experienced personnel to the oversight committees. The FDIC also set up a review function to ensure that the actions of the oversight committee were reasonable and that those of the contractors were consistent with FDIC policies and procedures.

By eliminating the internal audit costs from the formula that determined the contractors' incentive fees, the FDIC emphasized the importance of the contractors' use of strong internal controls. Because the pools of assets contained a total of more than \$30 billion, it was important for standards to be in place to guard against the potential for waste, fraud, and abuse. The FDIC's Office of the Inspector General audited the large contracts annually and, for the most part, concluded that adequate controls were in place.

As additional ALA contracts were established, the FDIC was able to improve portions of the ALA structure as the FDIC learned from its experience with previous contracts. Primarily, the changes that were made to the standard ALA contract refined the way incentive fees were calculated to improve the quality of the contractor's performance.

Table I.14-3

ALA Program Financial Performance Summary
Inception of Contract through June 30, 1996
 (\$ in Millions)

Contractor (Failed Bank)	Term of Contract	Book Value (plus Mark- to-Market) Reductions	Gross Collections	Total Expense	Net Collections*	Total Expenses/ Gross Collections (%)	Net Collections/ Book Value Reductions (%)
AMRESKO (FirstRepublic Banks)	Nov. 1988 to Feb. 1995	\$11,818 [†] (\$9,145)	\$8,553	\$1,449	\$7,104	16.9	60.1 (77.7)
Bonnet (MBanks)	Jan. 1990 to Dec. 1994	4,179 [†] (3,177)	3,570	591	2,979	16.6	71.3 (93.8)
FAMCO (Texas American Banks)	Feb. 1990 to Jan. 1994	1,318 [†] (980)	1,082	145	937	13.4	71.1 (95.6)
RECOLL (Maine Savings Bank)	Feb. 1991 to Aug. 1995	435	367	72	295	19.6	67.8
RECOLL (Bank of New England)	June 1991 to Dec. 1995	6,450	4,200	634	3,566	15.1	55.3
Niagara Asset (Goldome)	June 1991 to Sept. 1995	607	465	89	376	19.1	61.9
Niagara Port (Goldome)	Aug. 1991 to Mar. 1995	1,035	1,184	81	1,103	6.8	106.6 [‡]
CARC (CityTrust, Mechanics & Farmers Savings Bank)	Aug. 1991 to Mar. 1995	1,429	826	123	703	14.9	49.2
BONHAM (Various New Hampshire banks)	Mar. 1992 to June 1996	1,704	1,107	166	941	15.0	55.2
JERNE (Dollar Dry Dock Bank and other Connecticut banks)	June 1992 to June 1996	1,509	835	96	739	11.5	49.0
Totals		\$30,484	\$22,189	\$3,446	\$18,743	15.5%	61.5%

* Net collections are defined here as gross collections minus total expenses.

† This book value is an estimate of the original book value of this pool that entered the ALA program on a "mark-to-market" basis. The mark-to-market pool values are shown in parentheses for these contractors; mark-to-market valuations were not required for the other seven ALA pools.

‡ Net collections were considerably higher than average due to the type of assets in the portfolio. The pool consisted of marketable subsidiaries and performing consumer loans with above-market rates.

Source: FDIC Division of Resolutions and Receiverships financial performance report dated June 30, 1996.

The ALA contracts also allowed the FDIC to add and subtract assets without adjusting the incentive fee formula. That feature was important because many additions were made to the contracts because of the put process. It was especially advantageous in New Hampshire, where the assets from 7 failed banks were initially placed into the BONHAM pool; ultimately, assets from a total of 15 banks that had failed in New Hampshire were managed in that pool. The FDIC also could pull assets out of the pool if it felt that the assets could be managed better either in-house or by another contractor.

The cost-plus aspect of the contracts made it easy for the FDIC to direct the contractors to perform additional services that might not have been anticipated in the original contract. For example, after the ALA contracts were created, the FDIC instituted its Affordable Housing Program. Although that program cost the contractors more to administer those assets than others in their portfolio did, the additional expense was not an issue because the ALA contract covered the cost.

A number of weaknesses in the earlier contracts were resolved in later contracts as a result of the changes described above regarding the incentive fee formula. As shown later in this chapter, in the comparison of the types of asset management contracts the FDIC

Table I.14-4

**Financial Performance of ALA Program
Inception of Program through June 30, 1996**

(\$ in Millions)

Book Value of Assets Assigned to Program	\$31,991
Book Value Remaining at End of Agreements	<u>1,507</u>
Book Value Reductions	\$30,484
Gross Collections	\$22,189
Less: Expenses	
Incentive Fees	\$532
Reimbursable Expenses	<u>2,914</u>
	<u>\$3,446</u>
Net Collections	\$18,743
NPV of Net Collections*	\$16,432
Ratios (%):	
Incentive Fees/Gross Collections	2.4
Reimbursable Expenses/Gross Collections	13.1
Total Expenses/Gross Collections	15.5
Gross Collections/Book Value Reductions	72.8
Net Collections/Book Value Reductions	61.5
NPV of Net Collections/Book Value Reductions	53.9

* The calculation of net present value (NPV) of net collections used a 6 percent annual discount factor and assumed that collections were received evenly over the life of the contract.

Source: FDIC Division of Resolutions and Receiverships financial performance report dated June 30, 1996.

and the RTC used, the biggest disadvantage to using the ALA contract probably would have been its overall cost. Although the FDIC made adjustments to the fee formulas, the cost-plus aspect of the contract still placed a large portion of the burden of ensuring cost efficiencies on the FDIC rather than on the contractor.

Regional Asset Liquidation Agreements

At the beginning of 1992 the FDIC created a Regional Asset Liquidation Agreement (RALA) that was used for problem assets of smaller institutions. The RALA contract excluded the cost-plus feature that had been used in the ALA program. RALA contractors were reimbursed only for limited and defined asset-related expenses.¹¹

Four RALA contracts, all of which contained asset pools with less than \$500 million in book value, were issued to private-sector contractors from November 1992 to June 1993. Although the RALA contract was designed primarily to liquidate nonperforming loans, performing loans represented more than one-third of the book value of RALA program assets. Book value reductions of \$1.2 billion were achieved in the RALA program, and all assets assigned to RALA contractors had been liquidated or transferred back to the FDIC by the end of 1996.

Structure of the RALAs

The original term of a RALA was four years, with a single one-year renewal option. However, the average duration of the four RALA contracts was three years and one month. The objective of the RALA, as with the ALA, was "...the maximization of the present value of the net cash flows."

The RALA contract contained a performance fee structure that was composed of three elements: management, disposition, and incentive fees. A model was developed before any RALA contracts were issued that projected a breakdown of the three fee types as a percentage of total fees and as a percentage of gross collections. (See table I.14-5.)

The management fee was designed to offset the overhead costs that were borne by the contractor rather than by the FDIC. The RALA contract allowed for payment of a monthly management fee equal to 1.25 percent (annualized) of the gross collections expected during the remainder of the contract.¹² Therefore, as pool assets were sold or

11. The asset-related expenses of a RALA contract consisted of the cost of appraisals, title reports, asset searches, lien searches, advertising, insurance, third-party inspections, court costs, and certain outside counsel legal fees. Additional costs that were considered asset-related included all owned real estate operating and liquidation expenses (including real estate property operating expenses), real estate taxes, property insurance, mortgage interest, property management fees, accounting and auditing fees, leasing commissions, and marketing and selling expenses.

12. The management fee was paid monthly at a fixed percentage of the current targeted cash value (CTCV) of the pool. The CTCV was an estimate of gross collections expected during the remainder of the contract. The management fee was fixed at an annual rate of 1.25 percent, or 0.104 percent on a monthly basis, times the CTCV.

Table I.14-5

Projected Mix of Fees in RALA Compensation Model

Type of Fee	Projected Allocation of Total Fees (%)	Projected Percentage of Gross Collections
Management Fee	25	1.25
Disposition Fee	60	3.00
Incentive Fee	15	0.75
Totals	100%	5.00%

Source: FDIC Division of Resolutions and Receiverships.

settled and the gross collections projected during the remainder of the contract decreased, the monthly management fee decreased accordingly.

The disposition fee was designed to be the primary income generator for the contractor. The FDIC decided to pay the contractor an increasing percentage of net collections as overall collections increased. The estimate of the aggregate gross collections expected from the disposition of the asset pool was referred to as the initial targeted cash value (ITCV). The disposition fee was based on collections relative to the ITCV. The model disposition fee structure is shown in table I.14-6.

The contractor was rewarded with increasing percentages of net collections as cumulative net collections approached the ITCV. That reward was designed to motivate the contractor to attain the highest possible recovery rates on assigned pool assets, because the higher percentages could be reached only by achieving higher cumulative net collections-to-ITCV ratios.

By including net collections in the disposition fee formula, the FDIC encouraged the contractor to minimize asset-specific reimbursable expenses. In calculating net collections, all reimbursable expenses, as well as the management fees paid to the contractor, were deducted from gross collections.

The third portion of the contractor's fee was the incentive fee. Table I.14-7 shows the manner in which the incentive fee was calculated for each of the RALA contracts. The incentive fee was similar to the disposition fee in that it rewarded the contractor for reaching higher levels of the total pool value. It was different in that it tied the contractor's performance to reaching certain goals within specified periods of time.

In addition, the RALA contract permitted the FDIC to withhold incentive fees until certain disposition goals of the contract were achieved, thereby motivating the contractor to dispose of all assets in a pool as soon as possible. The FDIC could retain one-half of the earned incentive fees until the contractor had disposed of almost all of the pool's assets. The retained fees were available for release on a prearranged schedule, from partial release when 90 percent of the asset pool was liquidated to full release when

Table I.14-6**Model RALA Disposition Fee Structure**

Percentage of Net Collections	To Be Applied to:
2.6	the first 37% of initial targeted cash value (ITCV)
4.6	the next 23% of ITCV
6.4	the next 18% of ITCV
11.2	the next 15% of ITCV
16.2	any net collections thereafter

Source: FDIC Division of Resolutions and Receiverships.

the contractor had liquidated more than 98 percent of the asset pool. The provision was designed to motivate the contractor to remain focused on liquidating the total portfolio of assets. The withholding of fees therefore helped to align the contractor's responsibilities with those of the FDIC.

Each of the RALA contracts was competitively bid out before a contractor was selected. The FDIC provided the models shown in tables I.14-5 through I.14-7 to bidders after the pools were established. In addition, the FDIC provided the bidders with its estimate of the ITCV of the pool. The bidding process allowed the contractor to change two of the variables in the RALA compensation model (the ITCV and the disposition fee percentages) in an effort to win the contract. The bidders performed due diligence on the pool of assets and then either accepted the FDIC's ITCV or determined their own estimate of the ITCV. (Three of the four winning bidders used the FDIC's suggested ITCV number, and one of the four, Real Estate Recovery, bid an ITCV amount that was greater than the FDIC's number.) The higher the contractor established the ITCV, the harder it was to reach the higher level tranches of the incentive fee and the disposition fee. Similarly, the bidder could change the disposition fee percentage. The lower the percentage, the lower the overall disposition fee. After the bids were received, the FDIC would analyze the terms of the bids and the effects of the proposed variables to determine the winning bid.

Competition among the bidders resulted in much lower disposition fees than were provided to the bidders from the original model. Table I.14-8 shows the actual fee schedules for each of the four contractors, along with the fee schedule projected in the original model.

Actual Versus Expected Fees Paid to RALA Contractors

The total fees actually paid to RALA contractors during the life of the RALA program were 4.5 percent of gross collections, which was under the 5 percent projected in the

Table I.14-7

RALA Incentive Fee Structure

Percentage of Net Collections	In Excess of the Following Percentage of ITCV	Achieved Within the Following Number of Months of the Contract
4.5	33	12
5.0	54	24
9.0	70	36

Source: FDIC Division of Resolutions and Receiverships.

RALA compensation model. In that respect, the model worked as intended. However, the distribution of fees actually paid differed from what had been expected in the compensation model. For example, actual management fees as a percentage of total fees generated under the RALA contracts exceeded the model's expectations by 18 points, the percentage of actual disposition fees was 43 points less than anticipated, and the percentage of actual incentive fees surpassed incentive fees projected in the model by 25 points. (See table I.14-9.)

Two factors accounted for the differences between the targeted fees in the model and the distribution of fees actually paid to RALA contractors. First, assumptions for targeted rates of collection were built into the compensation model. Those projected rates were 40 percent in the first year of the contract, 25 percent in the second year, 20 percent in the third year, and 15 percent in the final year. The contractors actually disposed of their assets more quickly than was projected in the model, thus resulting in higher incentive fees and lower management fees. On average, the total disposition of assets occurred 12 months before the contractual end of the agreement.

Second, the bidding process permitted the contractor to change two of the parameters of the model, the initial targeted cash value and the disposition fee. In bidding for the RALA contracts, three of the winning bidders used the FDIC's suggested ITCV, while the fourth winning bidder proposed a higher ITCV than that of the FDIC. All four winning contractors bid disposition fees that were well below the FDIC's projected rates in the RALA model, which resulted in lower disposition fees than was originally anticipated.

Oversight and Operational Controls

An oversight team composed entirely of FDIC employees managed the RALA contractors and was responsible for handling individual contracts. (Originally, a separate oversight committee monitored each RALA contract.) However, after the first year of operation the FDIC decided that one group of its oversight personnel could effectively control and over-

Table I.14-8

RALA Disposition Fee Schedule
Projected Model Versus Actual Contractor's Bid Fee Percentages

Net Collections	RALA Model (%)	Real Estate Recovery Bid (%)	CSW Associates Bid (%)	Northcorp Bid (%)	Aldrich, Eastman & Waltch Bid (%)
Up to 37% of ITCV	2.60	0.25	2.25	0.75	0.25
Greater than 37% to 60% of ITCV	4.60	0.50	3.00	0.95	0.50
Greater than 60% to 78% of ITCV	6.40	0.75	4.75	1.05	0.75
Greater than 78% to 93% of ITCV	11.20	1.50	6.00	1.50	1.25
Greater than 93% of ITCV	16.20	5.00	8.00	1.95	1.75

Source: FDIC Division of Resolutions and Receiverships

Table I.14-9

Actual Versus Projected Contractor Fees in RALA Program
Inception Through December 31, 1996

Type of Fee	Allocation of Total Fees		Percentage of Gross Collections	
	Projected (%)	Actual (%)	Projected (%)	Actual (%)
Management Fee	25	43	1.25	2.10
Disposition Fee	60	17	3.00	0.70
Incentive Fee	15	40	0.75	1.70
Total	100	100	5.00	4.50

Source: FDIC Division of Resolutions and Receiverships.

see all four RALA contracts from one location. The primary oversight staff for all four RALA contracts consisted of six FDIC employees during most of the existence of the RALA program. The RALA oversight committee was delegated limited authority. For instance, the RALA oversight committee had \$5 million of settlement approval authority, whereas the ALA oversight committee had unlimited settlement approval authority.

Financial Performance of the RALA Program

The performance of all RALA contractors from inception of the agreements (November 1992) through June 30, 1996, is shown in table I.14-10.

Strengths and Weaknesses of the RALA Program

The RALAs were relatively easy to manage and proved to be more cost-effective than either the ALA or later Standard Asset Management and Disposition Agreement programs. However, it is important to keep in mind that the RALA program was assigned only \$1.2 billion in assets, compared with almost \$32 billion in the ALA program and more than \$48 billion in the SAMDA program. The following briefly summarizes the strengths and weaknesses of the RALA program.

The RALA program's main strength was that its costs were lower than the other contracting programs used by the FDIC and the RTC.¹³ The RALA contract was not a cost-plus contract, which meant that the FDIC reimbursed the RALA contractor for asset-related expenses but did not pay for the contractor's overhead. That arrangement made it easier for the FDIC to control the expenses of a RALA contractor than those of an ALA contractor and provided the RALA contractor with a greater incentive to control their overhead costs because those costs directly affected the contractor's profitability. In addition, less oversight or monitoring was needed because the FDIC was not reimbursing all of the contractor's expenses.

Another feature of the RALA program that controlled costs was the requirement for competitive bidding by the prospective contractors, resulting in disposition fees that were much lower than anticipated. Also, the FDIC paid the contractor its incentive fees only if certain collection goals were attained within prescribed time frames. That constraint accelerated the disposition of the assets, which in turn reduced expenses.

The establishment of the ITCV at the inception of the RALA contract improved the contractor's performance. The ITCV was used by the contractor as a motivational tool to attain its disposition goals (which directly affected its compensation fees) and also by the FDIC to track the contractor's progress. That built-in incentive structure decreased the need for the FDIC to undertake a great deal of contractor oversight.

13. The RTC Standard Asset Management Disposition Agreement contractor program is described later in this chapter.

Table I.14-10**Financial Performance of RALA Contractors
Inception Through June 30, 1996**

(\$ in Millions)

	Real Estate Recovery	CSW Associates	Northcorp	Aldrich, Eastman & Waltch	Totals
Inception Date	11/2/92	12/8/92	2/12/93	6/1/93	
Termination Date	9/30/95	12/31/96	9/30/96	11/30/94	
Initial Number of Assets	221	893	791	550	2,455
Initial Book Value of Assets	\$450	\$148	\$314	\$267	\$1,179
Percentage Liquidated as of June 30, 1996	100	91	97	100	98
Initial Targeted Cash Value (ITCV)	\$378	\$104	\$235	\$210	\$927
Book Value Reductions	\$450	\$135	\$304	\$267	\$1,156
Gross Collections	\$296	\$96	\$197	\$205	\$794
Less: Expenses					
Management Fees	8	2	5	2	17
Disposition Fees	1	3	2	1	7
Incentive Fees	2	2	3	5	12
Reimbursable Expenses	5	4	3	3	15
Subtotal	<u>\$16</u>	<u>\$11</u>	<u>\$13</u>	<u>\$11</u>	<u>\$51</u>
Net Collections	<u>\$280</u>	<u>\$85</u>	<u>\$184</u>	<u>\$194</u>	<u>\$743</u>
NPV of Net Collections	\$260	\$77	\$168	\$187	\$692
Ratios (%):					
Gross Collections/ITCV	78.3	92.3	83.8	97.6	85.7
Total Fees/Gross Collections	3.7	7.3	5.1	3.9	4.5
Reimbursed Expenses/Gross Collections	1.7	4.2	1.5	1.5	1.9
Total Expenses/Gross Collections	5.4	11.5	6.6	5.4	6.4
Net Collections/Book Value Reductions	62.2	63.0	60.5	72.7	64.3
NPV of Net Collections/Book Value Reductions	57.8	57.0	55.3	70.0	59.9

Source: FDIC Division of Resolutions and Receiverships financial performance report dated June 30, 1996.

Another strength of the RALA contract was that the FDIC was permitted to retain a portion of the incentive fees owed to the contractor until certain goals of the contract were met. Also, the RALA contract was clearly written and required few modifications during the four-year history of the RALA program. Thus, few disputes occurred between the FDIC and the contractor; when there were disagreements, most issues could be resolved at the oversight level.

The RALA program's biggest weakness was its lack of flexibility. For example, once the asset pools and the ITCVs were established at the beginning of the contract, the FDIC could not add or subtract assets from the contractor's portfolio. Also, for the RALA compensation model to work properly, an accurate estimate of the ITCV had to be made, because the disposition and incentive fees were contingent upon that figure. If the ITCV was not properly estimated, the contractor could find that there was insufficient compensation for its staff to perform in the manner expected by the FDIC. The contract had no provision to adjust the ITCV after the contract had been bid out. That weakness was especially important in the case of a large pool which normally contains assets with greater book values that are more complex and difficult to value. Therefore, the establishment of a reliable ITCV at the beginning of a large contract is more uncertain.

The RALA contract was less flexible than the ALA contract also because it required the contractors to complete services that may not have been anticipated at the inception of the contract. Because the contractors were not reimbursed for their indirect costs, they were reluctant to provide such services. The FDIC therefore faced some resistance when requesting additional reports or requesting the contractors to endorse programs, such as the FDIC's Affordable Housing Program, that raised the contractors' costs. The ALA contractors were more willing to accept changes because their costs were passed on to the FDIC.

Standard Asset Management and Disposition Agreements (SAMDA)

The SAMDA was a contract between the RTC and a private-sector contractor to manage, collect, and dispose of distressed assets in portfolios of all sizes. Two versions of the SAMDA were created. The first was known as SAMDA I, which began in August 1990, and the second was called SAMDA II, which started in April 1991.¹⁴

A total of 199 SAMDA contracts, of which 160 were SAMDA I and 39 were SAMDA II, were issued to 91 different contractors. The contracts were similar to the FDIC's RALAs in that the SAMDA contracts allowed for the payment of a management fee, a disposition fee, and an incentive fee. In addition, both types of contracts did not

14. Unless specified, references to SAMDA contracts apply to both the SAMDA I and the SAMDA II versions.

reimburse the contractor for its overhead expenses, but did pay for asset-specific expenses. One difference between the SAMDA and RALA contracts was that the RTC required the SAMDA contractor to engage subcontractors for 12 different services, the cost of which was reimbursed by the RTC.¹⁵

In January 1992 an amendment to the existing SAMDA contracts called the Standard Asset Management Amendment (SAMA) was introduced. The SAMA reduced the scope of work from asset management and disposition to asset management only. The SAMA was used in any new contracts issued from January 1992 forward.

At the sunset of the RTC on December 31, 1995, the RTC's interest in all active SAMDA contracts, which included 16 active contracts with \$2.7 billion in remaining assets, was assigned to the FDIC. From the inception of the SAMDA program through December 31, 1996, book value reductions of \$46.4 billion were achieved. Table I.14-11 summarizes the main differences among the SAMDA I, the SAMDA II, and the SAMA.

Evolution of the SAMDA Program

Even before RTC was created, FDIC management assigned to work on the thrift crisis recognized that contractors would have to supplement internal staff in managing and disposing of assets acquired from failed thrifts. By November 1989, the initial RTC research, asset disposition, and contracting units were researching various asset management and disposition agreements used by the FDIC, the FSLIC, and other organizations. And, by February of 1990, RTC management had decided that contractors would be used to manage and dispose of nonperforming assets, service performing assets, and assist in other specific tasks. Work then commenced on developing a standard asset management and disposition contract for nonperforming assets. The first contract was let in August 1990.

The RTC was required by the Financial Institutions Reform, Recovery, and Enforcement Act (FIRREA) of 1989 to use contractors. The act specified that the RTC had to hire private-sector contractors for the disposition of assets if such services were available, practicable, and efficient.¹⁶ Several other legal provisions further complicated the RTC's asset management and disposition task. For example, a challenging mission statement in FIRREA required the RTC to "...manage and resolve institutions...and dispose of any residual assets in a manner that: (1) maximizes return and minimizes loss; (2) minimizes the impact on local real estate and financial markets; and (3) maximizes the preservation of the availability and affordability of residential property for low- and moderate-income individuals." FIRREA also contained a general requirement that the RTC "...identify properties with natural, cultural, recreational or scientific

15. The RTC's 12 mandatory subcontracting services included appraisal services, brokerage services for owned real estate sales and leasing, property management, title work, construction subcontracting, environmental consulting, and surveying services.

16. 12 U.S.C., section 1441a(b)(10)(A)(ii).

Table I.14-11**Summary of the Major Differences Between the SAMDA I, SAMDA II, and SAMA Programs**

Program	Number of Contracts	Inception Date of Program	Types of Fees Paid to Contractor*	Unique Feature of Fee Determination
SAMDA I	160	Aug. 1990	Management, disposition, and incentive fees	Disposition and incentive fees tied to individual asset sales
SAMDA II	39	Apr. 1991	Management, disposition, and incentive fees	Disposition fees tied to performance of entire asset pool
SAMA	NA [†]	Jan. 1992	Management and incentive fees only	NA [†]
Total	199			

* The management and disposition fees were bid by the contractor and varied among the SAMDAs, whereas the incentive fee structure was fixed by the RTC within the contract itself.

† Not applicable, as the SAMA was an amendment to the SAMDA structure, not a separate contract type itself.

Source: FDIC Division of Resolutions and Receiverships.

values of special significance.”¹⁷ In practical terms, that requirement meant that the RTC had to work closely with conservation agencies on the disposition of environmentally and historically significant properties. Finally, FIRREA and the Resolution Trust Corporation Refinancing, Restructuring, and Improvement Act (RTCRRIA) of 1991 mandated the RTC to promote the use of minority- and women-owned businesses (MWOBs) as contractors.

By April 1991, the RTC initiated a major revision to the SAMDA contract, even though two minor revisions to the standard form had already been made. This time, many provisions were revised, but the most significant involved changing the focus on compensation from an individual asset basis to a portfolio basis and how the contract fees were bid. This contract became known as SAMDA II.

The second major change to the SAMDA structure came in January 1992 with the SAMA. By this point, national multi-asset sales had become the RTC's preferred asset disposition method. Because of this change in disposition strategy, the RTC introduced the optional SAMA, which eliminated the contractor's responsibilities to dispose of assets in designated pools. This permitted the RTC to have nonperforming assets

17. 12 U.S.C., section 1441a(b)(12)(F).

managed by contractors on a decentralized basis and to continue with its strategy of centralized multi-asset sales.

To confirm that the RTC was following the best course of action for the disposition of assets through multi-asset sales instead of individual asset sales, it did a study. The study, conducted in December 1992, measured gross and net proceeds from multi-asset sales against gross and net proceeds obtained from the sales of individual assets.¹⁸ The study concluded that the gross proceeds obtained from multi-asset portfolio sales were not significantly different from the gross proceeds (as a percentage of book value) received from similar assets that were disposed of individually in the SAMDA program. However, after all direct and indirect expenses were included, the net recovery from multi-asset portfolio sales was significantly higher than from individual asset sales because of a faster disposition rate and shorter holding periods, which resulted in lower expenses. The conclusion reinforced the RTC's decision about the increasing emphasis on the use of multi-asset sales and reducing interest in individual asset restructures and sales, which had been the specialties of SAMDA contractors.

Overall, the SAMDA program worked well. As the pool of assigned assets diminished, one-year extension periods were replaced with six-month extensions, and many contracts were allowed to expire. Any remaining assets were transferred to other SAMDA contracts. At the beginning of 1995, which was the RTC's last year of existence, 53 of the 199 SAMDA contracts were still active. Because no new assets were being placed into the program and many asset pools were a small fraction of their original inventory, it was more economical for the RTC to use fewer contractors. Therefore, the RTC decided to either consolidate SAMDA assets to the best-qualified contractors or bring them in-house in preparation for the consolidation of the RTC into the FDIC at the end of 1995. During 1995, 37 SAMDA contracts were allowed to expire, and 16 SAMDA contracts remained active at the RTC's sunset date of December 31, 1995, that were transferred to the FDIC for ongoing management. More than 95 percent of the assets assigned to SAMDA contractors were sold or settled during the life of the SAMDA program.

Structure of the SAMDA Contract

The initial term of most SAMDA contracts was three years with two one-year extension options. When available, additional assets were added to the initial pool of assigned assets, and most of the assets assigned to SAMDA contractors were sold or settled within two years. The average duration of all SAMDA contracts was approximately three years and three months. The general goal of a SAMDA contractor was "...to achieve the expeditious sale of the portfolio of assets at the highest net present value in a manner that

18. The study was called the Hard-to-Sell Asset Review Project and was published by the RTC Asset Management and Sales Division.

minimizes detrimental effects of such sales on local real estate and financial markets and enhances the national stock of low- and moderate-income properties.” A SAMDA contractor had to comply with all applicable RTC regulations, policies, procedures, and directives. Furthermore, the contractor was required to act as a fiduciary for the assets under the agreement.

One objective of the SAMDA contract was to provide contractors with sufficient flexibility to manage and dispose of RTC assets without having to seek approval from RTC staff for routine matters or transactions. Also, the contract was designed to enable the RTC to properly control the asset management and disposition process, to ensure that a contractor's efforts were consistent with the policies and procedures of the RTC. Another objective of the SAMDA program was to make sure that adequate records and reporting were established for review and audit. The program also sought to establish an incentive compensation structure that would motivate the contractor to maximize net collections and reward the contractor for collections earlier, rather than later, in the contract's term. Those objectives reflected several of the RTC's goals, which included minimizing its internal staff through the use of private-sector contractors and expeditiously returning assets to the private sector to minimize the cost of resolving the savings and loan crisis.

A SAMDA contractor assumed responsibility for all assigned assets, including the preparation of a preliminary plan for administering the assigned assets and the preparation of an asset management and disposition plan, or AMDP, for each asset in the portfolio. The contractors also managed and serviced the assets and were charged with disposing of the assets in a manner that maximized the net recovery. After the AMDP was approved, the SAMDA contractors generally pursued a compromise and settlement strategy with borrowers for nonperforming loans. If that strategy failed, the collateral was acquired through foreclosure or repossession, and then sold.

For owned real estate assets, SAMDA contractors generally listed the properties with real estate brokers, negotiated sales, arranged for approval of sales, and helped the RTC to close sales. SAMDA contractors were restricted from conducting multi-asset sales, although many of the contractors contributed assets to RTC multi-asset sales events. Each contractor received limited delegations of authority to take asset-related actions, such as entering into a settlement or selling a property. Asset disposition decisions that were beyond the authority of a SAMDA contractor were approved at the appropriate level of RTC delegated authority.

SAMDA I Series

The SAMDA I series contract provided for the payment of a management fee, a disposition fee, and an incentive fee. In their bid, prospective contractors would specify a dollar amount that would be their monthly management fee for the initial pool of assets. The monthly management fee was then divided by the sum of the estimated recovery values (ERVs)¹⁹ of the assets in the initial pool to obtain a percentage relationship. The result-

ing percentage was applied each month against the current month's remaining ERVs to determine the actual management fee to be paid to the contractor. For example, if the fixed monthly bid management fee was \$20,000 and the ERV of the initial pool of assets was \$12 million, then the result would be 0.167 percent. That percentage would then be multiplied by the current month's remaining ERV to obtain the monthly management fee to be paid to the contractor. The result was a proportional reduction in the monthly management fee as the volume of assets declined.

Like the management fee, prospective contractors also bid a disposition fee, although this was expressed as a percentage of net cash collections (all asset specific gross cash received less expenditures) arising from each asset. The disposition fee payable was a function of the bid amount and the relationship between net collections and the asset's ERV. This disposition fee payment schedule is shown in table I.14-12.

The third SAMDA I fee was the incentive fee, which was designed to motivate a contractor to dispose of assets earlier rather than later. The incentive fee percentages were fixed by the RTC contract and were not subject to bid by the contractor. The incentive fee was 20 percent of the earned disposition fee if the asset was disposed of during the first contract year and 10 percent if the asset was disposed of during the second contract year. Incentive fees could only be earned if assets were disposed of during the first two years of the contract.

Additionally, to minimize the prospect of the contract expiring with high-carrying cost assets remaining, the RTC retained 15 percent of all disposition fees payable as a holdback. From this holdback, the RTC deducted all cash expenditures incurred from contract inception for any assets remaining in the portfolio on expiration.

SAMDA II Series

The SAMDA II contract also provided for payment of a management fee, disposition fee, and incentive fee. Unlike the SAMDA I contract, however, prospective contractors bid only one number (known as the "contractor's bid"), which in turn was used to calculate all fees paid under the contract.

The management fee, expressed on an annual basis as a percentage of the estimated value of the asset portfolio, was set to be one-fourth of the effective disposition fee rate. RTC management believed that this ratio would sufficiently motivate contractors to dispose of assets rather than hold them to earn management fees. Because this structure caused the earning of significant fee income not to coincide with the occurrence of a contractor's internal expenses, however, the management fee in the SAMDA II contract was paid at a 50 percent higher rate during the first six months of the contract. Accordingly, the additional management fee income covered the additional expenses incurred

19. The RTC's estimated recovery value (ERV) was the sum of the net present value of the future cash flows for all assets in the pool. An ERV was determined for each asset entering the SAMDA I program when the asset pool was formed; that value was normally used throughout the life of the asset.

Table I.14-12

SAMDA I Disposition Fee Payment Schedule

Disposition Fee Payable (Expressed as a Percentage of the Fee Bid)	Net Collections/ERV Ratio (%)
25	0 to 50
50	51 to 90
100	91 to 110
150	Greater than 110

Source: FDIC Division of Resolutions and Receiverships.

with a new portfolio, such as producing asset management and disposition plans and developing reporting and information systems. This provision was added to allow contractors with little working capital—generally minority- or women-owned firms—to competitively bid for contracts.

Unlike the SAMDA I series, disposition fees in the SAMDA II contract were based on the collection of cash during a particular time period and not upon the occurrence of an event, such as an asset sale. The determination of disposition fees varied because it used a cumulative ratio of the net proceeds of the pool (NPP) to the total recovery value of the pool (RVP). The NPP was defined as gross cash receipts less all expenses, such as earned management fees, all costs associated with mandatory subcontracts,²⁰ taxes assessed against the assets in the pool, costs to insure owned real estate assets, imputed carrying costs, and legal fees. The RVP was the sum of the ERVs of all assets remaining in the pool.

The disposition fee schedule for the SAMDA II contract was designed to provide increasing incentive compensation as the NPP realized by the contractor increased in relation to the RVP. Accordingly, for every additional dollar collected beyond 50 percent of the initial RVP, the contractor was compensated at increasingly higher rates not just for each future cash receipt, but for all previous collections.

One of the expenses factored into the calculation of the NPP was an imputed carrying cost assessment. That assessment was calculated using an annual interest rate of 7 percent that was applied to the remaining RVP of the pool on a monthly basis. The result was that the imputed carrying cost offset the management fee as an incentive to carry an asset. That feature was designed to motivate the contractor to sell the assets as quickly as possible in order to maximize the NPP.

20. Reimbursable asset-related expenses in both SAMDA I and II contracts included the costs of the 12 mandatory subcontractors, data processing system conversion costs, asset file reproduction costs, RTC-mandated reports, asset-related legal costs, other reasonable legal costs that were not asset-related, and other costs “related to RTC-mandated activities” that were authorized in writing. One of the 12 mandatory subcontracting categories, “Property Management, Maintenance, and Leasing,” included owned real estate operating expenses, property taxes, property insurance, leasing commissions, and tenant improvements.

The SAMDA II contract also provided for the payment of an incentive fee. The incentive fee increased the NPP (used in the calculation of the disposition fee) by 20 percent for assets disposed of in the first contract year and by 10 percent for assets disposed of in the second contract year. As in the SAMDA I contract, incentive fees could be earned only if assets were disposed of during the first two years of the contract.

Oversight and Operational Controls

The SAMDA oversight manager was an RTC employee who oversaw the SAMDA contractor. The oversight manager monitored the contractor's technical performance and was expected to ensure that the contractor performed and completed all services required by the contract in a cost-effective and timely manner. In addition to day-to-day monitoring, the oversight manager reviewed the SAMDA contractors quarterly through informal site visitations and semi-annually on a formal basis with a team of reviewers. Also, the RTC Office of Contractor Oversight and Surveillance and the RTC Office of the Inspector General performed periodic formal reviews or audits.

A major drawback to efficiently controlling operations within the SAMDA program was the lack of a complete and fully integrated management information system. The RTC's contractor information system did not capture all necessary asset data, and the recording of asset data was incomplete and sometimes inaccurate. Accounting for asset sales was delayed at times for up to 12 months and was insufficiently monitored for accuracy. Some contractors were paid disposition fees on sold assets by estimating sales expenses rather than by providing proper sales documentation. Although the RTC initially tried to use its contractor information system as a full informational database for management reporting and accounting control, it was in reality effective only as a cash management system, because of system implementation and data integrity problems.

Financial Performance of the SAMDA Program

The information presented in table I.14-13 is a summary of the performance of the SAMDA program from its inception through December 31, 1996.

The entire SAMDA program from inception through December 31, 1996, resulted in gross collections of \$23.3 billion, which represents 50 percent of book value reductions and 92 percent of the ERV of the assets sold. Total expenses of \$4.4 billion resulted in an overall expense-to-collection ratio of 19 percent. Net collections of \$18.9 billion accounted for a recovery rate (ratio of net collections to book value reductions) of 41 percent and a net recovery rate (ratio of net present value of net collections to book value reductions) of 37 percent.

Strengths and Weaknesses of the SAMDA Program

The RTC was formed in August 1989 and was ultimately charged with resolving 747 financial institutions with \$402.6 billion in assets. Because of the need to dispose of a large volume of distressed assets and FIRREA's mandate to use asset management contractors from the private sector, the RTC developed the SAMDA program. The following details the strengths and weaknesses of the program.

One strength of the SAMDA program was that it allowed the RTC to manage and dispose of a large volume of distressed assets through the use of outside contractors so that it did not have to significantly expand its work force. In addition, SAMDA contractors generally had sufficient delegated authority to make most of the asset disposition decisions. A relatively small number of asset disposition cases had to be approved by higher delegated authority levels.

The SAMDA contracts and a SAMA allowed the RTC to use private-sector contractors to manage a large volume of distressed assets, while the RTC disposed of them via multi-asset sales transactions. Furthermore, the SAMDA contracts contained targeted disposition time frames by asset type.

One weakness of the SAMDA program was that too many different contractors (91 in all) were operating under the program, a good number of which were small, start-up companies. Having so many parties (both contractors and internal oversight staff) involved in the program significantly contributed to the need for numerous contract interpretations, the RTC's difficulty in achieving effective oversight, and problems in internal operations, such as audits, fee payments, and systems integration.²¹ Also, performance was inconsistent because many of the start-up companies did not have established track records.

The delayed development of the RTC's contractor information system and its implementation difficulties resulted in the system being generally ineffective either as an accounting and inventory control system or as a management information system for measuring the performance of contractors. It was effective mainly as a cash management system.

One weakness of the SAMDA I contract was that it keyed the payment of disposition and incentive fees to the sale of assets individually. That sometimes caused the contractor to concentrate on the larger assets and neglect the lower valued or hard-to-sell assets.

Another drawback of the SAMDA program was that it was originally designed for a different asset disposition strategy than the one the RTC eventually pursued. The

21. The SAMDA contracts collectively required more than 260 official interpretations of various provisions of the contract during their life span. Most of the issues were related to the SAMDA I contract. Those interpretations generally pertained to the meaning of certain contract language, inconsistencies between actual policy and the language in the contract, and issues involving functional responsibilities, such as the obligations of the contractor after contract termination or fee calculations that differed under certain conditions.

Table I.14-13

**Summary of SAMDA Activity
Inception Through December 31, 1996**

(\$ in Millions)

Total Number of SAMDA Contracts		199
Number of Assets at Inception		100,344
Book Value of Assets Assigned to Program:		
Loans	\$26,937	
Owned Real Estate	19,031	
Other Assets	<u>2,509</u>	
		\$48,477
Less: Book Value Remaining on 12/31/96		<u>2,052</u>
Book Value Reductions, Inception through 12/31/96		\$46,425
Estimated Recovery Value of Assets Settled		\$25,255
Gross Collections*		
Less: Expenses		\$23,293
Management Fees	\$400	
Disposition/Incentive Fees	300	
Reimbursable Expenses	<u>3,739</u>	
		<u>4,439</u>
Net Collections*		\$18,854
NPV of Net Collections*		\$17,369
Ratios (%):		
Gross Collections/Book Value Reductions		50.2
Gross Collections/ERV		92.2
Total Fees/Gross Collections		3.0
Reimbursable Expenses/Gross Collections		16.1
Total Expenses/Gross Collections		19.1
Net Collections/Book Value Reductions*		40.6
NPV of Net Collections/Book Value Reductions*		37.4

* Collections exclude all loan payments made prior to 1993. In addition, collections for all assets withdrawn for sale by the RTC were imputed at the lesser of 90 percent of an asset's ERV or its derived investment value (DIV).

Source: RTC Asset Management System.

change in direction had a significant impact on the operations of the program and resulted in increasing the cost of administering the program. The SAMDA I contract did not contemplate that RTC staff would be selling the assets that were transferred into the SAMDA program. Many SAMDA contractors received disposition fees for SAMDA assets that the RTC later included in multi-asset sales initiatives.

Another problem was that receivership assets were often stratified by type, then distributed to various Washington-based multi-asset sales programs. Asset pools often consisted of like assets from one or more receiverships, and the RTC usually did not create

geographically concentrated portfolios. The result was that many SAMDA contractors had portfolios with geographically diverse assets, which tended to cause inefficiencies in the management and disposition of such portfolios. In addition, in some cases, the RTC's inadequate information systems were severely challenged by the task of providing a full accounting back to the appropriate receivership.

One element that proved expensive was the RTC's requirement that SAMDA contractors engage subcontractors for certain areas of expertise. The reimbursable fees for the subcontractors were, in the aggregate, five times as much as the fees paid to SAMDA contractors. Also, it was difficult for the RTC to control the subcontractors, mainly because of the privacy of the contractual relationship between the SAMDA contractors and their subcontractors. The expenses of the SAMDA program probably would have been lower if the RTC had not mandated the 12 categories of subcontracting.

The SAMDA I compensation formula may not have provided a strong enough incentive for contractors to dispose of assets quickly. Furthermore, the ERV, a key element of the contractor's compensation formula, was not calculated in a consistent manner throughout the RTC.

Finally, the administration of the SAMDA program varied throughout the RTC. In addition, there were frequent changes in the oversight staff, sometimes resulting in insufficient control over the change of key SAMDA contractor personnel.

Summary of the Three Contracting Programs

Table I.14-14 summarizes the main features of the three asset management programs.

Asset Management Contract Financial Summary

A summary of the 213 ALA, RALA, and SAMDA contracts of the FDIC and the RTC is shown in table I.14-15. It includes such items as portfolio mix, gross collections, and net collections.

ALAs Versus RALAs

It is difficult to compare the recoveries of the ALA and RALA programs because they had very different combinations of asset types and because the starting market value of their asset pools was not known.²² A direct comparison is further hindered by the fact that an expense history by asset type is not available for either program.

22. Although the RALA contract did have an ITCV, it represented the sum of all future cash flows, not a market value.

The expense ratios and the recovery rates of the RALA program are better than those of the ALA program (as shown in table I.14-15). However, the significant differences in asset composition, asset volume, and regional and macroeconomic conditions prevailing when the contracts were in effect make a true comparison between the two programs difficult. If the market values of each of the pools had been accurately determined at the start of each program, it would have been somewhat easier to compare the results of the ALAs and RALAs. That was not done, though, so overall conclusions on financial performance are difficult to draw.

The asset pools of the ALAs and RALAs were reviewed for distinctive features that could affect the recovery results. One of the ALA pools for Goldome, known as the Niagara portfolio, consisted mainly of readily marketable operating subsidiaries and performing consumer loans with above-market rates. In the RALA program, one of the pools, known as the Aldrich, Eastman and Waltch (AEW) portfolio, contained a significant number of performing mortgages that were readily marketable and would not incur the usual disposition costs.

The overall expense-to-collection ratio of the RALA program was 6.4 percent, which was less than half of the 15.5 percent ratio for the ALA program. However, owned real estate made up 15 percent of the assets in the ALA program, whereas no owned real estate was included in the RALA program.²³ Although the net collections-to-book value reductions ratios show that the ALA and RALA programs were somewhat similar at 61.5 percent and 64.3 percent, respectively, the net present value effect on the figures widens the gap to 53.9 percent and 59.9 percent. That finding seems to indicate that the RALA program performed more effectively because of its ability to keep costs low through the use of the ITCV and by deleting the cost-plus feature that had been used in the ALAs.

Although significant differences exist between the two programs, some broad observations can be made. For instance, the ALA contracts seemed to work well with larger asset pools and were adaptable when assets were transferred in or out of the contractor's portfolios; however, the ALA contracts required extensive oversight. The structure of the RALAs controlled costs more effectively than the ALAs did, primarily because RALA contractors paid for their own overhead and because the ITCV established at the beginning of the contract helped the FDIC to monitor the contractors and also allowed the contractors to monitor themselves. Although the changes to the later RALA program improved the performance of contractors, the changes resulted in a loss of flexibility, because the RALAs did not allow for changes in the asset pools or the ITCV.

23. Although the RALA pools originally did not have owned real estate, a minimal number of properties were acquired through foreclosure.

Table I.14-14**Summary of the Structures of the Contractor Programs**

Program	Number of Contracts	Asset Source	Types of Assets	Term of Contract	Fees Paid to Contractor	Cost Reimbursement
ALA	10	Large failed commercial banks (for asset pools over \$1 billion in book value)	Performing and nonperforming loans, owned real estate, and subsidiary assets (owned real estate was 15% of assigned assets)	5 years	Incentive fee	All reasonable pool-related expenses (cost-plus)
RALA	4	Small failed commercial banks (for asset pools under \$500 million in book value)	Primarily nonperforming loans, some performing loans (no owned real estate at inception of contracts)	4 years, plus one optional 1-year extension	Management, disposition, and incentive fees	Pass-through of asset-specific expenses, excluding overhead of contractor
SAMDA	199	Failed S&Ls controlled by the RTC (various sized asset pools)	Primarily nonperforming loans and owned real estate (which was 39% of initially assigned assets)	3 years, with three 1-year renewal options	Management, disposition, and incentive fees *	Pass-through of asset-specific expenses, excluding overhead of contractor

* A majority of the SAMDA contracts were later amended with the SAMA provision that eliminated the disposition fee.

Source: FDIC Division of Resolutions and Receiverships.

SAMDAs Versus ALAs and RALAs

As shown in table I.14-15, the recovery rate (ratio of net-collections-to-book-value-reductions) of the SAMDA program was 41 percent, as compared to 62 percent for the ALAs and 64 percent in the RALAs. The net recovery rate (ratio of net-present-value-of-net-collections-to-book-value-reductions) for the SAMDA program was 37 percent, in contrast to 54 percent for the ALAs and 60 percent for the RALAs. However, a much higher portion of total assets consisted of owned real estate, and nonperforming loans were a higher percentage of the loan portfolio in the SAMDA program than in the other two programs. The overall quality of SAMDA assets was therefore lower than that of the ALA and RALA assets.

Given the significant differences in the asset mix and asset quality among the three programs, the only fair way to compare recoveries would be to compare the net recovery

Table I.14-15

Summary of Contractor Financial Performance Inception Through December 31, 1996

(\$ in Millions)

	ALAs	RALAs	SAMDAs	Totals
Number of Assets	84,610	2,455	100,344	187,409
Book Value of Assets in Program:				
Performing Loans	\$4,091	\$440	\$0	\$4,531
Nonperforming Loans	19,900	760	26,937	47,597
Owned Real Estate	4,800	0	19,031	23,831
Other Assets	3,200	10	2,509	5,719
Total	\$31,991	\$1,210	\$48,477	\$81,678
Book Value Reductions	\$30,484	\$1,156	\$46,425	\$78,065
Gross Collections	\$22,189	\$794	\$23,293 [†]	\$46,276
Expenses:				
Management Fees	0	17	400	417
Disposition/Incentive Fees	532	19	300	851
Reimbursable Expenses	2,914	15	3,739	6,668
Total Expenses	\$3,446	\$51	\$4,439	\$7,936
Net Collections	\$18,743	\$743	\$18,854 [†]	\$38,340
NPV of Net Collections *	\$16,432	\$692	\$17,369 [†]	\$34,493
Ratios (%):				
Gross Collections/Book Value Reductions	72.8	68.7	50.2	59.3
Total Fees/Gross Collections	2.4	4.5	3.0	2.7
Reimbursed Expenses/Gross Collections	13.1	1.9	16.1	14.4
Total Expenses/Gross Collections	15.5	6.4	19.1	17.1
Net Collections/Book Value Reductions	61.5	64.3	40.6 [†]	49.1
NPV of Net Collections/Book Value Reductions	53.9	59.9	37.4 [†]	44.2

* The net present value calculations (NPV) used the average one-year U. S. Treasury constant maturity rate during the term of the contracts and assumed that net collections were received evenly during the term of the contract.

† Collections exclude all loan payments made prior to 1993. In addition, collections for all assets withdrawn for sale by the RTC were imputed at the lesser of 90 percent of the asset's ERV or its derived investment value (DIV).

Source: ALA and RALA data is from the FDIC Division of Resolutions and Receiverships financial performance report dated June 30, 1996. SAMDA data is from the RTC Asset Management System as of December 31, 1996.

values to the starting market values of the pool. Unfortunately, that comparison is not possible because of the differences in asset valuation methodology among the three programs. The assets of the SAMDA program were appraised with a different asset valuation technique, which was ERV, than the techniques used in the ALA and RALA programs, which were gross cash recovery and ITCV, respectively. Without a standard

asset valuation methodology, one cannot fairly compare the effectiveness of the three programs.

The expense-to-collection ratio of the SAMDA program was 19 percent in comparison to 16 percent for the ALAs and 6 percent for the RALAs, as shown in table I.14-15. However, the comparison of the expense ratios does not consider or adjust for the differing asset quality and types among the three programs. The large quantity of owned real estate in the SAMDA program was a major reason for the 19 percent expense-to-collection ratio when the collections and expenses of the SAMDA program are further segregated by asset type. An analysis of the SAMDA program's expense ratios and recovery rates by asset type is shown in table I.14-16.

As shown in table I.14-16, although the expense-to-collection ratio of the total SAMDA program was 19.1 percent, the expense-to-collection ratio for all non-real estate assets was 9.5 percent. This table also shows that owned real estate sales represented 40 percent of the book value reductions, but accounted for 70 percent of the asset disposition expenses.

The 9.5 percent expense-to-collection ratio associated with non-real estate SAMDA assets was substantially lower than the 15.5 percent expense ratio of the ALA program and was approximately 3 percentage points higher than the expense ratio of the RALA program. (See table I.14-15). More than one-third of the assets in the RALA program were performing loans, but there were almost no performing loans in the SAMDA program. Although the disposition costs of nonperforming loans were not tracked in any of the three programs, such costs are known to be substantially higher than those for performing loans. The reason for those higher costs is mainly the time and effort needed

Table I.14-16

**Performance of SAMDA Contractors
Inception Through December 31, 1996**
(*\$ in Billions*)

	Owned Real Estate Assets	Non-Real Estate Assets	Total Assets
Book Value Reductions	\$18.7	\$27.7	\$46.4
Gross Collections	\$9.6	\$13.7	\$23.3
Less: Expenses	<u>3.1</u>	<u>1.3</u>	<u>4.4</u>
Net Collections	\$6.5	\$12.4	\$18.9
Ratios (%):			
Gross Collections/Book Value Reductions	51.3	49.5	50.2
Total Expenses/Gross Collections	32.3	9.5	19.1
Net Collections/Book Value Reductions	34.8	44.8	40.6

Source: RTC Asset Management System.

to explore compromise and settlement options, initiate foreclosure, and take other legal actions needed to protect the receivership's interests.

In summary, although the recovery rate of the SAMDA program is substantially lower and its expense-to-collection ratio is much higher than the other two programs, its lower quality of assets may have accounted for most of those differences. Because the market values were not determined for the original portfolios in each of the programs, it is impossible to make fair comparisons regarding their effectiveness.

Contractor Versus In-House Asset Management and Disposition Strategies

The FDIC has used private-sector contractors in addition to in-house staff to manage and dispose of distressed assets since the mid-1980s. When determining the suitability of contracting for such services, the FDIC considers whether using contractors would provide it with the best financial benefit.

The Federal Deposit Insurance Corporation Improvement Act (FDICIA) of 1991 required the use of private-sector contractors when such needed services were available in the private sector and when the FDIC determined that the use of such contractors was "...practical, efficient, and cost-effective." The main factors the FDIC used when deciding whether to use contractors included the projected cost of available alternatives and the collection revenues projected under various alternatives. Staffing flexibility was also an important factor, as was the availability of asset-specific expertise. Other factors were a desire to service assets locally (thereby lessening customer disruption) and consideration of certain characteristics that were specific to an individual asset pool.

The FDIC has tracked the cost of the disposition of failed bank assets by year of failure since 1986. Included in this information are the asset disposition expenses for the FDIC's in-house asset management and disposition activities and those for the FDIC's asset management and loan servicing contractors. (See table I.14-17.)

As shown in table I.14-17, from 1991 through 1995, the cumulative asset disposition expense-to-collection ratio for ALA and RALA contractors was 14 percent, which was approximately 2 percent less than the ratio for FDIC's in-house asset disposition activities. Legal expenses and accounting costs are included in both in-house and contractor asset disposition expenses in these calculations. However, the expense-to-collection ratios of the ALA and RALA programs are understated because there were certain "soft costs" included in the administration of the ALAs and RALAs that were not included in their asset disposition expenses. Those included some costs of contractor oversight, contractor audits and reviews, Washington headquarters support, and general receivership administrative expenses. The hidden costs of the ALA and RALA programs partially offset the 2 percent difference between the expense-to-collection ratios. Therefore, the expense-to-collection ratio for in-house disposition activity was close to the expense-to-collection ratio of the FDIC's asset management contractors during this time period.

Table I.14-17

Asset Disposition Expenses-to-Collections Ratios 1991 Through 1995

(\$ in Millions)

Asset Management Entity	Asset Disposition Expenses	Gross Collections	Asset Disposition Expenses/Gross Collections (%)
In-House	\$2,412	\$14,886	16.2
Contractors:			
ALA and RALA Contractors	2,421	17,137	14.1
National Loan Servicing Contractors	70	2,534	2.8
Subtotals	2,491	19,671	12.7
Totals	\$4,903	\$34,557	14.2

Source: FDIC Division of Finance.

Conclusion

Both the FDIC and the RTC needed to use the expertise of private-sector contractors for asset management during the 1980s and early 1990s when a huge volume of assets from failed banks inundated the agencies. The contractors enabled the FDIC and the RTC to dispose of more than \$78 billion in original book value of distressed assets from 1985 to 1996. The hiring of contractors for a relatively short period of time (three to five years) gave the agencies great flexibility to tailor the needs of an asset pool to the particular expertise of the private sector asset manager while preserving a core staff of FDIC and RTC employees. Once a manageable level of distressed assets was reached, the contracts either expired under their terms or were terminated, and the agencies moved the assets back in-house to be managed by FDIC and RTC personnel.

Contracting by the FDIC and the RTC evolved over time because of the type and quality of the underlying assets, the current goals and needs of the two agencies at the time each contract was entered into, and the lessons learned by the agencies from experience with prior contracts. For example, modifications from earlier contracts better aligned the interests of the contractors with those of the FDIC and the RTC. In addition, the FDIC and the RTC learned that better results were obtained when they located their oversight staff as close to the assets (and the contractor) as possible, especially during the first 12 to 18 months of the asset management contract. The agencies also found that the more stable the continuity of the oversight staff was, the better the contracting process worked. That was true for most of the ALA and RALA contracts under the FDIC, but not for many SAMDA contracts with the RTC. Finally, to enable the FDIC to effectively measure and track a contractor's performance, the FDIC found that the estimated market value of the original asset pool should be determined at the inception

of the contract. A standardized asset valuation methodology needs to be instituted and consistently applied to asset pools at the inception of all asset management contracts.²⁴

Although it cannot be said that one type of asset management contract worked better than another type, the private-sector contractors generally performed well under any type of contract when they were given the proper incentives. By the end of 1996, all of the assets assigned to ALA, RALA, and SAMDA contractors had been sold, settled, or transferred back to the FDIC.

24. The FDIC is in the process (as of early 1998) of fully incorporating a standard asset valuation estimation (SAVE) methodology into all of its business operations. The SAVE methodology will be used from the time a financial institution fails until the receivership is terminated.

Affordable housing was considered an area in which the nation could glean social benefit from the financial crisis by providing an opportunity for low to moderate income households to realize their dream of home ownership or to improve their standard of living at affordable rent levels.



CHAPTER 15

Affordable Housing Programs

Introduction

The volume of assets handled within the affordable housing programs of the Resolution Trust Corporation (RTC) and Federal Deposit Insurance Corporation (FDIC) were relatively minor compared to the total assets sold by both corporations. For the period of 1980 through 1994, in fact, less than one-half of 1 percent of the total assets liquidated were disposed of in the affordable housing programs. The RTC and FDIC viewed the programs as significant, however, because of their mission to provide low- to moderate-income housing within a larger program designed to minimize costs and maximize overall returns. Affordable housing was considered an area in which the nation could glean social benefit from the financial crisis by providing an opportunity for low- to moderate-income households to realize their dream of home ownership or to improve their standard of living at affordable rent levels.

Virtually overnight the RTC became accountable for the disposition of thousands of properties through its Affordable Housing Disposition Program (AHDP). With the exception of the Farmers Home Administration (FmHA), no federal agency holding foreclosed real estate had ever targeted such a volume of property for an affordable housing program. To reach its goals the RTC implemented many innovative strategies, such as coordinating target marketing with a vigorous seller financing program geared to low- to moderate-income buyers, nonprofit organizations, and public agencies. During its life, the RTC sold 81,156 units of multi-family properties and 27,985 units of single-family properties to low- to moderate-income and very-low-income families, or sold them for the benefit of those families.

As part of the Federal Deposit Insurance Corporation Improvement Act (FDICIA) of 1991, Congress requires the asset disposition efforts of the FDIC to meet five criteria, one of which is to preserve affordable housing. Because the FDIC does not

use public funds for its operations, it required a separate federal appropriation for an affordable housing program. The FDIC first received such public funding in fiscal year 1993; the funding continued for a three-year period.

The FDIC recognized that the large discount costs associated with placing multi-family properties through an affordable housing program would create a disproportionate drain on its limited appropriations. Therefore, the FDIC Affordable Housing Program (AHP) initially focused on the sale of eligible single-family properties to qualified families. As the amount of the annual appropriation increased, the FDIC, for a short while, also sold multi-family properties. Through its efforts, the FDIC's AHP placed 2,073 single-family properties with low- to moderate-income families and sold 18 multi-family properties, which included 533 units.

RTC Affordable Housing Disposition Program

The RTC Affordable Housing Disposition Program was established by section 501 of the Financial Institutions Reform, Recovery, and Enforcement Act (FIRREA) of 1989.¹ Regulations governing the AHDP were issued in April 1990, with the basic statutory obligation being to ensure the preservation of affordable housing by providing home ownership and maintaining rental opportunities for moderate-income, low-income, and very-low-income households. The two components of the AHDP were the Single-Family Program and the Multi-Family Program. In 1991, with the extensive amending of FIRREA by the Resolution Trust Corporation Refinancing, Restructuring, and Improvement Act (RTCRRIA), the RTC added condominium units to the AHDP and generally treated them as single-family properties.

The RTC classified households as low-income when their income did not exceed 80 percent of the area median income as established by the U.S. Department of Housing and Urban Development (HUD). For example, in Denver, Colorado, the income limit for a one-person household was \$27,200, and the income limit for an eight-person household was \$51,300. In Hartford, Connecticut, the income limit for one person was \$28,150, and the income limit for an eight-person household was \$53,050. The RTC classified very-low-income households as those with income that did not exceed 50 percent of the area median income as established by HUD. Rents that could be charged to those households were restricted according to a formula based on income figures for the area of the property.

1. Section 21A(c) of the Federal Home Loan Bank Act, as amended by section 501 of the Financial Institutions Reform, Recovery, and Enforcement Act, *U.S. Code*, volume 12, section 1441a (1989).

Single-Family Program

The Single-Family Program included properties that had four units or less and that fell within the valuation range specified in the statute. The valuation range varied, but in 1997 was \$67,500 for a one-unit house and up to \$107,000 for a four-unit property. Properties had to be sold to qualifying households whose members agreed to live in the property as their personal residence for at least one year. The properties also could have been sold in bulk to nonprofit corporations or public agencies that agreed to either rent to lower-income families (those earning no more than 80 percent of the median income for the area involved, adjusted for household size) or sell the properties to qualifying households whose members agreed to live in the properties for at least one year.

To be considered a qualifying household, the household had to have an income that was no more than 115 percent of the area median income as determined by HUD and adjusted for household size. An exception to that requirement, provided in the 1991 amendments, permitted the sale of a single-family property to a household that was renting the property at that time, regardless of income, provided the household members agreed to occupy the property as their residence for at least one year after purchase.

The program required potential purchasers to complete certifications of owner occupancy and of income eligibility, along with the purchase contract. At closing, the purchaser executed a land use restriction agreement (LURA). The LURA included an agreement stating that the new owner intended to occupy the property as a principal residence for one year following closing and that the RTC could recapture 75 percent of the profits if the new owner sold the property within that year. The special warranty deed given at closing referenced the LURA as follows: “. . . subject also to the covenants and restrictions set forth in the Land Use Restriction Agreement executed by [Grantor] and [Grantee] concurrently with this deed.” Condominium properties had the same residency requirement and recapture provision as the single-family LURA.

When the RTC sold single-family or condominium properties to a nonprofit organization or public agency, the organization or agency also was encumbered with a LURA that imposed rental and resale restrictions. The RTC designed that LURA so it could be released as the organization or agency resold each individual unit, at which time that LURA was replaced by the standard single-family LURA described above.

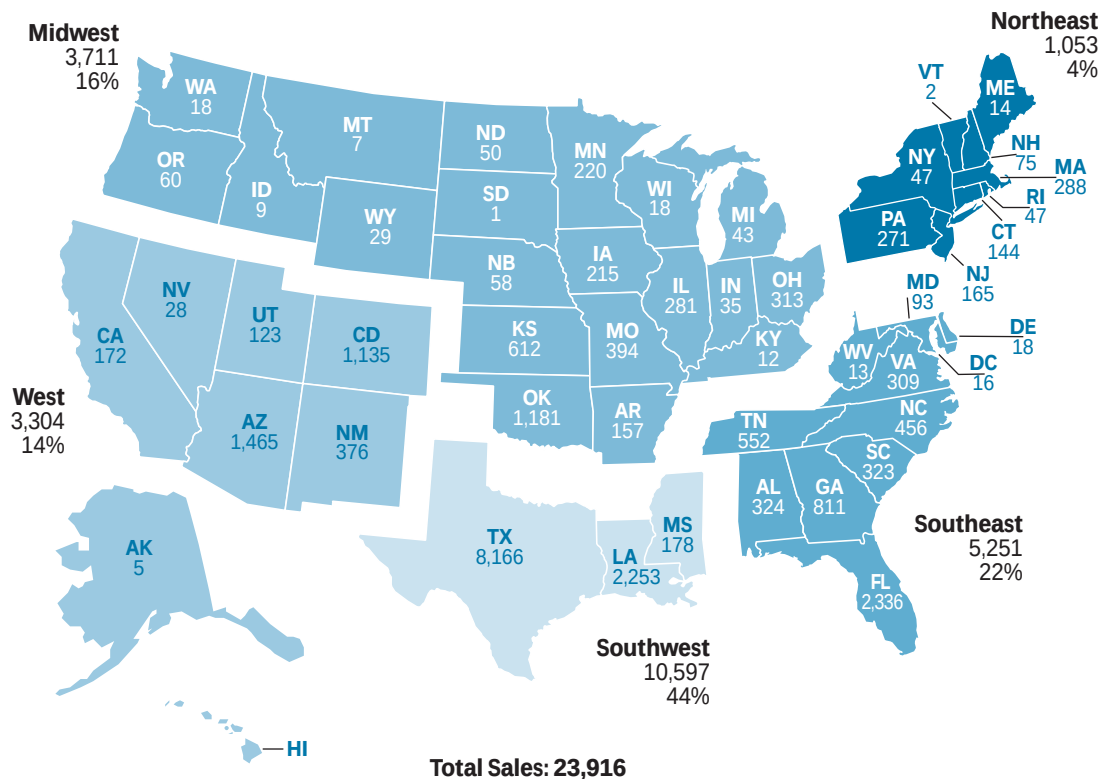
From the inception of the AHDP, the RTC sold single-family properties to numerous nonprofit organizations. Although a variety of organizations participated in the program, the majority tended to be local community-based organizations that specialized in providing home ownership opportunities for low-income families. Of all single-family assets sold through the program, 66 percent were in the southeastern and southwestern areas of the country. (See chart I.15-1.)

Multi-Family Program

Multi-family properties in the AHDP were those with five units or more that fell below the value periodically established by HUD. The LURA for a multi-family property restricted the property's use for 40 years from the date of closing or 50 years from initial occupancy, whichever time span was greater; during that time, at least 35 percent of the units had to be rented to lower-income households. At least 20 percent of the households residing in those properties had to be from very-low-income households. Purchasers of the RTC's multi-family properties often agreed to increase the percentage of income-restricted units, even though the RTC's goal always was to keep a balance of restricted and unrestricted income households in each property. The LURA was terminated when a property was foreclosed by an institutional lender that was not a party

Chart I.15-1

The RTC's Affordable Housing Disposition Program Single-Family Properties Sold



Source: FDIC Division of Resolutions and Receiverships.

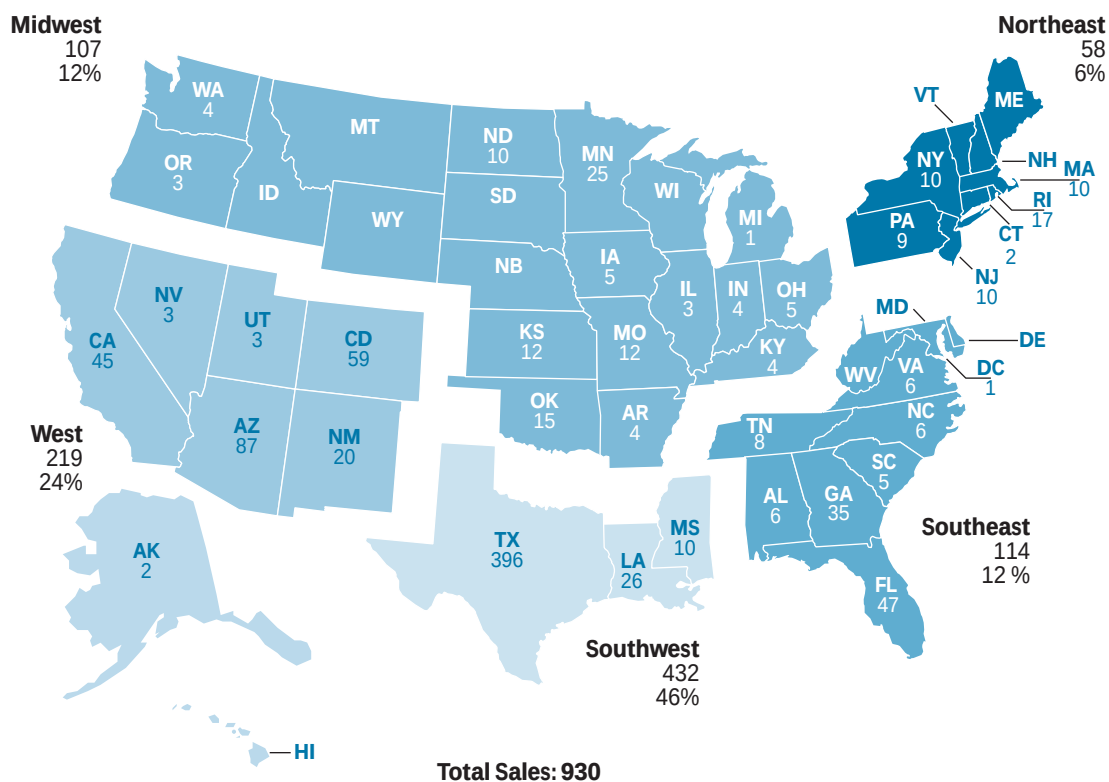
related to the borrower, as long as the foreclosed owner did not later acquire a controlling interest in the property. Of all multi-family assets sold, 70 percent were located in the southwestern and western areas of the country. (See chart I.15-2.)

RTC Program Components

During the AHDP's five-year existence, the RTC developed many strategies for marketing affordable housing. Those strategies, discussed below, include using clearing-houses, retaining technical assistance advisers (TAAs), developing seller financing, establishing repair funding, developing a direct sale program, adjusting the value for a reduced

Chart I.15-2

The RTC's Affordable Housing Disposition Program Multi-Family Properties Sold



Source: FDIC Division of Resolutions and Receiverships.

price, developing a donation policy, establishing an exclusive marketing period, and using auctions and sealed bids.

Clearinghouses

The RTC used state housing finance agencies and Federal Home Loan Banks (FHLBs) as clearinghouses for listing available affordable properties. The lists, which were free to the public, contained key property information, such as location, description, price, and the broker contact. The Housing Opportunity Hotline, which the RTC initiated in Texas for lower-priced, single-family foreclosed properties of eight federal agencies, also used the clearinghouses.

Technical Assistance Advisers

The RTC retained community-based organizations as technical assistance advisers. They were nonprofit organizations or public agencies located in every state where the RTC owned property marketed under the AHDP. TAAs provided training and assistance for single-family purchasers, who were, for the most part, first-time home buyers. They also conducted training on how to buy a house, helped the buyers complete the income certifications required by the AHDP, and provided post-closing seminars on the homeowner's responsibilities, such as those related to maintenance, mortgage, and insurance.

The TAAs also played a significant role in the RTC's Multi-Family Program. They helped identify local nonprofit organizations and public agencies interested in owning multi-family properties. They brought to light for the RTC the fact that many local public-housing authorities had never considered expanding their programs to include low-income and moderate-income housing. TAAs helped those agencies and nonprofit organizations conduct feasibility analyses and also helped identify state and federal sources of acquisition and rehabilitation financing.

TAAs performed some of the services traditionally provided by brokers; that is, they brought buyers and sellers together. In addition, TAAs performed many innovative tasks that were essential if disenfranchised communities with serious housing problems were to benefit from the affordable housing properties. Among those innovative tasks was creating a targeted market for the sale of both single-family and multi-family properties.

Seller Financing

Often, an RTC affordable property could not attract conventional financing because of the property's location, condition, and income history. In addition, many single-family buyers and nonprofit corporations eligible for the program could not qualify for acquisition financing with traditional lenders. Because of those financing limitations, the RTC developed a seller financing program for both single-family and multi-family properties.

The program offered 97 percent seller financing on single-family properties and 95 percent financing on multi-family properties sold to nonprofit organizations and public agencies. Loans totaling \$170 million for 5,726 single-family purchases were made. In addition, the RTC paid the closing costs for its single-family buyers. The RTC also developed its own underwriting programs with less restrictive requirements than conventional underwriting. That underwriting program was particularly important for nonprofit borrowers because lenders generally view them as poor risks. When analyzing a multi-family loan application, the RTC's underwriters focused on the income potential of the property rather than the capital resources of the borrower.

Under its direct sale program (see details provided later in this chapter), the RTC also offered bridge loan financing to public agencies. That financing allowed a public agency to temporarily finance a property for a two-year period until the agency could locate a nonprofit corporation to purchase the property or arrange conventional financing to finalize its own purchase of the property. If financing was not available, the RTC could then provide permanent financing on more conventional terms. The RTC made 44 bridge loans to public agencies with an original balance of \$58.6 million. The RTC also provided financing for capital improvements and operating expenses during the bridge loan period. As an incentive to find a nonprofit buyer, the public agency was eligible to receive 5 percent of the loan balance when the bridge loan was repaid.

Seller financing was important because much of the single-family inventory did not meet Federal Housing Administration (FHA) standards. Bridge loans were also instrumental in selling multi-family properties to nonprofit organizations and public agencies. The RTC provided seller financing for 25 percent of single-family properties and for 33 percent of multi-family properties sold. See table I.15-1 for the number of properties sold using RTC seller financing.

Table I.15-1

RTC Seller Financing

(\$ in Thousands)

Type	No. of Properties	Sales Price	Loan Amount	Loan Amount/ Sales Price (%)
Single-Family	5,726	\$183,814.2	\$170,153.5	92.6
Multi-Family	275	401,367.5	331,872.3	82.7
Bridge Loans	44	58,645.0	63,069.0	107.5
Totals	6,045	\$643,826.7	\$565,095.8	87.8

Source: RTC quarterly auction reports.

Repair Funding

A significant component of the Single-Family Program was its repair program. Properties sold to lower-income buyers had to be in good condition. Because the buyers would not have the reserve capital necessary for repairs, particularly at the time of closing or shortly thereafter, the RTC committed up to \$5,000 to repair each property in its inventory.

Direct Sale Program

As the result of a legislative amendment, the normal clearinghouse marketing period designed to sell to the highest bidder was suspended, and the direct sale program started in May 1992. The program targeted sales of multi-family properties to nonprofit organizations and public agencies, which the RTC quickly discovered did not have sufficient capital to purchase those properties. Nor did they have the ability to mobilize quickly enough to be competitive with private investors. To level the playing field, the RTC offered two sequential exclusive 30-day marketing periods to public agencies and nonprofit organizations. If no public agency or nonprofit buyer emerged during that period, the RTC offered the properties to all qualified buyers.

The initial program offered eligible property to public agencies first, in a 30-day marketing period. The RTC defined “public agency” as a federal, state, or local governmental or public entity, including a public housing agency, with a jurisdiction to operate in the area where the property is located. Those agencies may have included local housing authorities, state and local housing finance authorities, community development agencies, state or local mental health or developmentally disabled agencies, school districts, or publicly chartered institutions of higher learning. The program also made special RTC bridge financing, with a low down payment, available to those agencies.

If no public agency expressed interest during the marketing period, then nonprofit organizations became eligible purchasers during an exclusive nonprofit 30-day marketing period. If, at the end of those marketing periods, neither a public agency nor a nonprofit organization expressed interest in purchasing the property, the RTC placed the property in the clearinghouse for 90 days for marketing to all qualified buyers who committed to the minimum set-aside requirements. If the property remained unsold after that period, the RTC could sell the property outside the AHDP.

To facilitate the noncompetitive approach, the RTC adopted a bidder evaluation process, in which it asked interested public agencies and nonprofit organizations to submit a notice of serious interest (NOSI). The RTC then evaluated the NOSIs for the applicants’ history of community service, history of property ownership and management, nonprofit and public agency legal status, and financing needs. After determining the organization with the highest overall score, the RTC proceeded to negotiate the sale of the property.

Reduced Price

For multi-family properties marketed after January 1994, the RTC set the actual purchase price at what was called the affordable market value (AMV). The AMV was calculated according to a standardized RTC methodology modeled on FHA underwriting guidelines. The RTC used the methodology to adjust the appraised value downward to reflect the (1) net affect on income of the required 35 percent low-income set-aside, (2) current and anticipated operating costs, (3) current interest rates and terms for RTC seller financing, and (4) current physical condition of the property based on a physical needs assessment and phase I environmental report. The AMV served as the sales price. Of the properties adjusted, the average AMV was 66.7 percent of appraised market value. Rather than seeking the highest bidder, the RTC sought a buyer with the capability to own and manage the low- and moderate-income property successfully. For single-family properties, initial guidelines required a sales price of 80 percent or greater of appraised value. In March 1991, Congress authorized the RTC to sell single-family properties with no minimum pricing to benefit more program-qualified households.

Donation

Because of the large inventory of assets with nominal value, especially in the southwestern area of the United States, the RTC developed a policy that allowed the donation of a property to a nonprofit organization or public agency, at no cost, providing the assets would be conveyed for the public good. Qualifying uses for such conveyances included single-family and multi-family affordable housing, homeless shelters, transitional housing, day care facilities for children of low- and moderate-income families, open urban spaces, and assets used for nonprofitable public purposes, as designated by the secretary of Housing and Urban Development.

More than 1,000 single-family and 73 multi-family assets were donated through that program. The RTC sometimes placed a demolition LURA on multi-family properties with the requirement that the recipient of the donation replace the structure with affordable housing.

Exclusive Marketing

Just as the exclusive marketing period under the direct sale program helped nonprofit organizations and public agencies that sought to purchase multi-family properties, an exclusive marketing period for single-family properties did the same for low-income households. Congress established a 90-day marketing period for single-family properties. During that period, the RTC listed the property in the clearinghouse and offered it exclusively to nonprofit organizations, public agencies, and income-qualified buyers. The 90-day marketing period gave the RTC's TAAs adequate time to locate

qualified buyers, complete the paperwork establishing qualified buyer status, make an offer, and educate single-family buyers.

Auctions and Sealed Bids

To dispose of a large number of single-family properties, the RTC also used open outcry auction and sealed bid events as marketing techniques in the AHDP. More than 198 auctions or sealed bid events occurred between 1990 and 1995.

An article in a 1992 edition of the RTC's *The Silver Lining* illustrated the positive side of using open outcry auctions to dispose of single-family properties (see exhibit I.15-1); however, negatives also were associated with that method of selling to low-income families. One such negative was that although potential purchasers had the opportunity to view the property before the auction, some properties were sold sight unseen, without prior knowledge about the condition of the property. Also, at times, income certifications were not properly completed, and because of the fast pace of the auction, purchasers sometimes found themselves bidding more than the property's worth.

Difficulties the RTC Faced

In its efforts to meet the strict requirements of FIRREA and other legislation, the RTC faced a number of difficulties. It had to establish guidelines for determining the nonprofit status of its applications and for verifying the intent of purchasers to occupy its single-family properties. In addition, the RTC had to deal with monitoring land use restrictions and in facing drawbacks arising from bulk sales of multi-family properties.

Determination of Nonprofit Status

FIRREA established its own criteria for determining nonprofit status rather than using the criteria established by the Internal Revenue Service (IRS). As a result, the RTC was involved in determining the validity of a nonprofit corporation's status under the RTC's statute, regardless of its status under the Internal Revenue Code. FIRREA defines a nonprofit as "a private organization (including a limited equity cooperative)—(i) no part of the net earnings of which inures to the benefit of any member, shareholder, founder, contributor, or individual; and (ii) that is approved by the Corporation [RTC] as to financial responsibility."

Early in the direct sale program, the RTC did not inquire into the nonprofit status of its applicants. It simply accepted a nonprofit corporation's own statement. However, it quickly became apparent that several organizations could not meet the RTC's definition of "nonprofit" because of their financial arrangements with officers and employees. As a result, the RTC developed a nonprofit certification requiring information on board

members' compensation, property managers' compensation, and proposed financing arrangements. The certification requirements were based on IRS cases involving the validity of nonprofit status under the Internal Revenue Code section 501(c)(3). Although the certification was useful in providing additional information about the

Exhibit I.15-1

Texas 'Lone Star' Sells 989 Properties: Biggest Affordable Auction Yet

Over 16,000 attended the largest RTC affordable housing auction ever, the Lone Star, running in nine Texas cities from November 10-19, 1991. The mammoth sale of 989 homes for \$29.1 million revealed some encouraging trends for those seeking sorely needed low-income housing. Chief among these trends are the following:

- 35 percent of Texas buyers were minorities (18 percent Hispanic, 10 percent Black, 5 percent Asian).
- A majority, or 56 percent, of purchasers had low incomes (under 80 percent of the Texas area median income). The average household income was \$22,902.
- 72 percent of buyers were first-time home buyers.
- Properties sold brought 77 percent of appraised value.

Average sales prices per city ranged from \$44,100 in El Paso to \$19,600 in Dallas. Average buyer income per city ranged from \$25,100 in Houston to \$19,600 in San Antonio. Corpus Christi had the highest percentage of buyers with incomes under \$25,000—84 percent.

Some cities had extraordinary minority participation, such as El Paso, where 89 percent of the winning bidders were minorities, mostly Hispanic. Houston had 45 percent minority buyers, almost half of which were Black. Nearly all of San Antonio's minority purchasers (31 percent of total) were Hispanic.

Among those was Nery White, 27, a single-parent mother of two boys. White was going about her business installing a security system for a homeowner in San Antonio, Texas, when her clients happened to mention there was an RTC auction in town in one week. This wasn't the first time she'd heard about it. She got curious. And in one week, she got a condo for \$6,000.

"I pay \$500 a month in rent," she related after winning the bid at the RTC auction on November 16. "That's \$6,000 a year. I just bought a condominium for the same amount I paid last year in rent. But now I have a home for life."

White was amazed. "I have struggled very hard on the edge, as a taxpayer. But it's gratifying. I really need it."

Source: RTC, newsletter, *The Silver Lining*, January-February 1992.

nonprofit buyers, it added an additional cost to the program because it required trained personnel to evaluate the information and obtain full completion of the certification.

Single-Family Certificate of Intent to Occupy

FIRREA required the purchasers of single-family properties to certify in writing that the family intended to occupy the property for at least one year. In addition, the family had to “intend” to occupy the eligible single-family property as a principal residence.

When developing its program documents, the RTC faithfully followed the language of the statute, not foreseeing that fraudulent buyers would purchase the property for investment purposes, immediately renting the property without ever having lived there themselves. The certification language, which required the purchasers to merely recite their intent to live in the property for one year, made it impossible to prosecute those buyers successfully.

Subsequently, the RTC revised its certification to include an acknowledgment that the buyer would occupy the property immediately after closing and that the new owner had a duty to amend or supplement the certification if there were any changes in occupancy. That revision significantly strengthened the RTC’s position when prosecuting program fraud, because buyers who did not occupy the property after closing could not successfully argue that their intent had changed between the time the certification was executed and the closing.

Also, in contrast to its previous practice of relying on neighbors to call and report program violations, the RTC instituted a 90-day contact letter program. Under that program, 90 days after the closing date, the RTC sent a certified letter to the buyer at the property address asking the buyer to reaffirm the agreement to live in the property for one year. If the buyer did not return the requested reaffirmation within a certain time, or the certified mail was returned indicating the buyer did not live at that address, the RTC referred the matter to its Office of Inspector General (OIG) to determine if program fraud had been committed. When the OIG found a program violation, it referred the matter to the U.S. Department of Justice for civil or criminal prosecution.

Incomplete Land Use Restriction Agreements

Initially, the RTC had great difficulty monitoring its land use restriction agreements. Early in the program, with its primary focus on maximizing sales, the RTC had established no central collection point for LURAs. As a result, when the RTC later attempted to locate all LURAs to begin its monitoring and compliance program, it had difficulty locating the documents and had to recover them from individual property records. Furthermore, the RTC discovered that the portion of the LURA form stipulating the number of units restricted to lower-income and very-low-income tenants often had not been completed.

In addition, RTC policy permitted contractors that managed and sold properties on the RTC's behalf to close sales using standard documents, without submitting them for legal review. (For further information, see "Use of Contractors" in this chapter.) Although many of those contractors were licensed real estate brokers and agents, they had not been trained in the use of those documents. Many did not complete them properly or failed to get them signed or recorded.

To correct that problem, the RTC initiated a campaign to train the contractors involved in its program. Later, it began to assign only one contractor from each of the field offices to AHDP sales. That contractor was chosen on the basis of previous performance. Ultimately, however, the success of the program depended on the contractor's employees and their dedication to the AHDP.

Aggregation of Units in Bulk Sales

Although FIRREA permitted bulk sales of multi-family property with aggregation of all restricted units in one property, the RTC discovered drawbacks to that approach early in the program. The sale of 26 multi-family properties to the Transactions Funding Corporation was the initial event that kicked off a round of media attention and congressional hearings regarding the policy of bulk sales. (See exhibit I.15-2.) A key goal of the RTC's AHDP was that multi-family properties contain a balance of restricted and unrestricted income households. Some bulk purchasers, however, chose to aggregate units so that a single property was entirely rent-restricted, while their

Exhibit I.15-2

RTC Closing Largest Affordable Housing Sale to Date—\$75 Million

The Resolution Trust Corporation has consummated the largest sale to date under its Affordable Housing Disposition Program. In November, the RTC sold 26 multi-family properties, located primarily in Texas, for approximately \$75 million to Transactions Funding Corporation, Atlanta, Georgia, an affiliate of General Electric Capital Corporation, Stamford, Connecticut. The sale was an all-cash transaction, and was over five times as large as the former largest sale.

"This transaction proves that our program can offer a way for investors to pursue their profit-making objective, while at the same time participate in the effort to make affordable housing properties available," said Lamar Kelly, RTC deputy executive director for asset and real estate management.

Source: RTC, newsletter, *The Silver Lining*, January-February 1992.

other properties had no restrictions. Administration of the “aggregation” provision in that manner raised questions regarding the consistency of the approach with the statutory mandate that the RTC conduct operations in a way that “maximizes the preservation of the availability and affordability of residential real property for low- and moderate-income individuals.” If only a portion of the properties marketed through the AHDP were actually subject to deed restrictions, then fewer properties were made available at restricted rents to low-income individuals.

In response, the RTC modified its policy. On June 12, 1992, the RTC initiated a policy that stated that when more than one multi-family property is purchased from the RTC as part of the same negotiation, the RTC will require that not fewer than 15 percent of the dwelling units in each separate property purchased be made available to low-income or very-low-income individuals.²

Use of Asset Management Contractors

The results of initially using standard asset management and disposition agreement (SAMDA) contractors for the disposition of AHDP-qualified properties proved to be unacceptable. The SAMDA contractors had no financial incentives to market the properties as prescribed in the affordable housing regulations. Otherwise eligible properties would be pooled with higher valued, unqualified properties and marketed under standard procedures. Also, SAMDA pools often were not marketed by a SAMDA contractor in the geographic region of the affordable housing qualified properties.

Those difficulties were addressed by the RTC initiating standard asset management amendments (SAMAs).³ The SAMAs focused the contractor’s responsibilities on managing the properties, rather than on disposition of the properties. The responsibility for disposition shifted from the contractors to the RTC.

Monitoring and Compliance Program

The scope of the initiatives the RTC implemented to meet the requirements of legislation required the development of a monitoring and compliance program.

2. “Final Statement on Policy on Lower Income Occupancy Requirements for Bulk Sales in the Multi-Family Affordable Housing Disposition,” *Federal Register* [57 FR24937], August 11, 1992.

3. For further information, see Chapter 14, Asset Management Contracting.

Land Use Restriction Agreements

The land use restriction agreements recorded against multi-family properties and single-family properties, which were sold to nonprofit organizations or public agencies, were effective for the greater of 40 years from the date of closing or 50 years from the date of initial occupancy. Those LURAs imposed rent restrictions on a percentage of the property's units through the LURA's term. The RTC entered into memoranda of understanding with 32 state housing finance agencies and 2 nonprofit organizations that agreed to monitor compliance for the term of the LURAs.

As part of its monitoring and compliance program to inform and guide the monitoring agencies, the RTC produced the *Monitoring and Compliance Manual* for the state agencies and the property owners. The manual contained the necessary forms for reporting income and tenant information to the monitoring agency, although owners could also use RTC-developed computer software to file the required reports, which they had to submit monthly until the property reached full compliance. After the property achieved compliance, the property owner submitted the reports annually. They also paid required annual fees of \$50 per rent-restricted, multi-family unit and \$250 per single-family unit to cover monitoring program costs. Property owners could bring any questions or concerns regarding a LURA on any property to the monitoring agency. The RTC gave the monitoring agencies the authority to resolve questions about program enforcement, providing the agency did not contradict state statute or the LURA. It also gave the monitoring agencies the authority to adjust monitoring fees and to adopt their own penalties for noncompliance, free from the RTC's supervision. Those fees belonged to the agency and were its sole compensation for the monitoring service.

Under the terms of the loan documents, the LURAs on single-family properties sold to nonprofit corporations and public agencies terminated upon the subsequent sale of the single-family property or condominium to a qualified family. At that time, a new LURA was substituted, releasing the original LURA and imposing the RTC's one-year ownership and recapture requirements. If a new LURA was not executed, the original LURA would remain as the official record.

If an owner failed to comply with the LURA, the RTC or its monitoring agency might apply to a court for an injunction or the appointment of a receiver to operate the property. The terms of the LURA entitled the RTC or the agency to reimbursement of attorney's fees if it prevailed. Interestingly, both the statute and the LURAs gave affected very-low-income and lower-income families, state housing finance agencies, and any agency, corporation, or authority of the United States government the right to enforce the low-income occupancy requirements.

Recapture of Single-Family Sales Proceeds

Under its LURA, the RTC was entitled to recover 75 percent of net profits if a single-family property was sold within one year of its purchase by a qualified buyer. The recapture provision also applied to condominiums. The provision was triggered if the sale contract was entered into during the year after the original closing, regardless of when the sale took place. The restriction continued to be used for the RTC single-family properties that were sold by the FDIC after the RTC was shut down. It was also used for single-family properties that were originally sold to nonprofit organizations or public agencies when the properties were resold to qualified buyers.

Recapture and Reinvestment of Profits Agreement

Most multi-family properties sold after May 1992 were sold under the direct sale program. Those properties were subject to both a LURA and a recapture and reinvestment of profits agreement (recapture agreement). The recapture agreement entitled the RTC to 50 percent of the net profits from any sale occurring within two years after purchase from the RTC. In addition, if the original owner was a nonprofit organization or public agency, the owner was required to invest its 50 percent of the profits toward providing additional affordable housing.

The RTC introduced the recapture agreement after several purchasers immediately resold their properties and received significant profits. Because the RTC's AMV was substantially lower than the appraised value, after taking the property's anticipated income with restricted units into account, those profits were viewed as an unfair windfall. The recapture agreement helped the RTC satisfy its goal of increasing the stock of affordable housing by requiring sellers to reinvest profits into other affordable housing ventures.

Affordable Housing Advisory Board

The Affordable Housing Advisory Board (AHAB), an advisory committee defined by the Federal Advisory Committee Act, *U.S. Code*, volume 5, appendix 2, J let. seq., was established by the Resolution Trust Corporation Completion Act to advise the Thrift Depositor Protection Oversight Board and the FDIC Board of Directors on policies and programs related to the provisions of affordable housing.⁴ The RTC issued the AHAB's original charter on March 9, 1994, and the FDIC rechartered the board on February 26, 1996, after the RTC was shut down.

Members of the AHAB are the secretary of HUD, who serves as chairperson; the chairperson of the Thrift Depositor Protection Oversight Board (or the chairperson's delegate); the chairperson of the FDIC Board of Directors (or the chairperson's dele-

4. In 1991, RTCRIA replaced the RTC Oversight Board with the Thrift Depositor Protection Oversight Board.

gate); four persons appointed by the secretary of HUD to represent the interests of individuals and organizations involved in using affordable housing programs; and two persons who were members of the former National Housing Advisory Board, which had provided advice to the RTC Oversight Board.

The Completion Act required the AHAB to meet four times annually, and more frequently if so requested by the FDIC Board of Directors. Meetings were open to the public and included testimony from experts in the field who had personal experience in purchasing affordable housing properties or wanted to make policy or procedural recommendations before the board. Meetings were held throughout the country, but primarily in areas where FDIC and RTC affordable housing assets were concentrated.

The Cost of the RTC's Affordable Housing Disposition Program

The General Accounting Office's (GAO) audit of the RTC Affordable Housing Disposition Program in September 1994 attempted to identify the RTC's costs of administering the program compared with the sale of other RTC real estate. Several factors prevented both the GAO and RTC management from making conclusive statements regarding the costs of the program. Knowledge of the price at which the RTC could have sold the AHDP property in its regular disposition program, property holding costs, and the length of time to sell outside the AHDP were data that the RTC did not maintain, thereby preventing an accurate cost analysis of the program.

It is possible, however, to make one comparison between the two sets of real estate transactions. The ratio of sales price to appraised value of an eligible single-family property sold in the program was 75 percent, compared to 80 percent for an eligible property sold outside of the program. Similarly, the ratio of sales price to appraised value of an eligible multi-family property sold in the program was 70 percent, compared to 74 percent for eligible properties sold outside the program.⁵ See table I.15-2 for a comparison of single-family and multi-family sales under AHDP.

Assuming the same percentages of appraised value could have been obtained for properties sold in the program as for those sold outside the program, then the RTC would have forgone approximately \$92.8 million in collections through its use of an affordable housing program. Because eligible properties first had to unsuccessfully go through a marketing effort as an affordable housing property before they could be sold outside the program, the loss of income assumption may be reasonable and, if anything, conservative.

5. Multi-family total appraised value for "sold affordable" is a cumulative total from the program's inception and consequently includes assets sold before and after the AMV was used to set the purchase price (see RTC Program Components, Reduced Price). Data on 184 multi-family properties that had established AMVs show that the average AMV was 66.7 percent of the appraised value.

Table I.15-2**RTC Sales of Properties Eligible for the Affordable Housing Disposition Program**

	Single-Family		Multi-Family	
	Affordable	Non-Affordable	Affordable	Non-Affordable
Number of Properties	22,898	10,662	856	377
Number of Units	27,244	13,726	90,794	25,408
Total Appraised Value	\$878,455	\$342,660	\$1,429,751	\$401,485
Total Sales Price	\$659,033	\$272,360	\$1,005,831	\$297,123
Sales Price/Appraised Value (%)	75.0	79.5	70.4	74.0

Note: Conveyance sales (properties donated) are not included above.

Source: RTC quarterly auction reports.

The \$92.8 million figure does not incorporate the added costs the RTC incurred by operating the AHDP. When considering the money that was spent on repairs to single-family properties (approximately \$25 million), closing costs for single-family properties (approximately \$19 million), forgiven application fees for multi-family seller financing (approximately \$355 thousand), and the administrative costs of the TAAs and outreach programs, all of which were not used for other RTC asset sales, then the added cost to taxpayers from the program grows to more than \$135 million.

The FDIC Affordable Housing Program

The FDIC program was established by section 241 of FDICIA, which amended the Federal Deposit Insurance Act (FDI Act) of 1950, adding section 40, “FDIC affordable housing program.”⁶ Because the FDIC is privately funded, the program was operational only to the extent that it received a federal appropriation. The Department of Veterans Affairs, HUD, and the Independent Agencies Appropriations Act of 1993 provided the AHP’s first year of funding. Because the AHP was the only aspect of the FDIC’s operations that

6. U.S. Code, volume 12, section 1831q(c)(1).

required a separate federal appropriation, it was, by design, administered and accounted for separately from all other sources of FDIC funding.

Aside from the section 40 provisions pertaining to the appropriated program, section 123 of FDICIA, "FDIC Property Disposition Standards," requires the FDIC to conduct its disposition activities in a manner that (1) maximizes present value return, (2) minimizes losses, (3) ensures adequate competition, (4) prohibits discrimination based on race, sex, or ethnic group in the consideration of offers, and (5) maximizes the preservation of the availability and affordability of residential real property for low- and moderate-income individuals. The final factor, which is related to providing opportunities for affordable housing, is separate and apart from the provisions governing the appropriated program.

Background

Although modeled after the RTC program, the FDIC Affordable Housing Program was much smaller in scope. With \$5 million of appropriated funds for fiscal year 1993, \$7 million for fiscal year 1994, and \$15 million for fiscal year 1995 (later reduced to \$3.7 million), the AHP provided credits or grants to 2,073 qualified buyers of affordable single-family properties and subsidized the sale of 533 units of affordable multi-family properties. The program included properties held by the FDIC in both its corporate and receivership capacities obtained from the Bank Insurance Fund, Savings Association Insurance Fund, and Federal Savings and Loan Insurance Corporation Resolution Fund institutions. (See table I.15-3.)

Funding and Size of Program

The major difference between the FDIC and RTC affordable housing programs was in the funding of the programs. The FDIC program was operative only insofar as congressionally appropriated funds, specifically earmarked for its program, were available to cover the administrative and property subsidy costs incurred by the program. In contrast, the RTC's program operated with general funds available to the RTC and was not dependent on a specific appropriation. See chapter 4, Evolution of the RTC's Resolution Process, for a discussion of the general difficulties encountered with the congressional funding of RTC activities.

During the first and second years of the AHP, the appropriated funds were not sufficient to allow the FDIC to discount all of the properties that would have been eligible for the program. For example, some of the multi-million-dollar apartment projects that could have been marketed through the program at the time would have resulted in discounts totaling hundreds of thousands of dollars. In response to that issue, the annual appropriation legislation allowed the FDIC to modify, at its sole discretion, the statutory requirements so that the available money could be put to the most efficient and beneficial use.

That discretion enabled the FDIC to concentrate its efforts on single-family properties. Also, the discretionary language allowed the FDIC to be more creative in the way it provided discounts, which led to the FDIC's providing credits or grants on properties in lieu of straight discounts. (See "Credits or Grants" later in this chapter.)

During fiscal year 1995, the FDIC appropriated program was significantly curtailed because of the congressional rescission of \$11.3 million of the \$15 million originally appropriated for that year. Since fiscal year 1995, the FDIC has maintained a limited nonappropriated program.

Single-Family Program

The FDIC was dependent on congressional appropriations to fund its affordable housing programs. Because the appropriations were not sufficient to fund all the affordable housing properties it received, the FDIC concentrated the available money on single-family properties where the funding needs were modest. From 1993 to 1995, the FDIC sold 2,400 single-family units for a total sales price of \$91.4 million, or 82.6 percent of the appraised value.

Table I.15-3

FDIC Sales of Properties Eligible for the Affordable Housing Program

(\$ in Thousands)

Year	Number of Properties Sold		Number of Units Sold		Appraised Value		Sales Price		Sales Price/ Appraised Value (%)	
	Single-Family	Multi-Family	Single-Family	Multi-Family	Single-Family	Multi-Family	Single-Family	Multi-Family	Single-Family	Multi-Family
1993	980	1	1,124	208	\$49,440	\$1,900	\$41,566	\$650	84.1	34.2
1994	681	7	808	228	37,381	3,299	30,920	1,223	82.7	37.1
1995	412	10	468	97	23,831	1,852	18,934	1,701	79.5	91.8
Totals/ Averages	2,073	18	2,400	533	\$110,652	\$7,051	\$91,420	\$3,574*	82.6	50.7

* The difference between the appraised value and the sales price is the appropriated subsidy.

Source: FDIC quarterly auction reports.

Property Eligibility

In the AHP, eligible single-family properties included residential properties with appraised values less than or equal to the FHA mortgage loan limits for particular areas, and they were subject to maximum statutory caps as shown below:

- One-family units/condos \$101,250
- Two-family units \$114,000
- Three-family units \$138,000
- Four-family units \$160,000

Upon acquiring marketable title to eligible properties and procuring the services of a listing broker, the FDIC restricted the sale of those eligible properties to low- and moderate-income buyers for the first 180 days. Following that period, if the properties remained unsold, they were made available to other interested buyers. Of the 4,121 properties available for sale through the AHP, the FDIC sold 58 percent to qualified purchasers.

Notifications Through Clearinghouses

While conforming with FDICIA, the FDIC notified the appropriate state housing finance agencies and the FHLBs concerning the availability of eligible properties so that those clearinghouses could disseminate property information to prospective purchasers.⁷ Also, recognizing that some properties might ultimately sell for less than their appraised value, a number of properties with appraised values exceeding the FHA mortgage loan limits (or statutory caps) were also included on the FDIC's list of available properties.

Qualified Purchasers

The FDIC defined a qualified purchaser as a household with an adjusted income of less than 115 percent of the median income for the area in which the property was located, indexed by the size of the household. Under the FDIC definition for the same geographic area, a household composed of five people would have a higher income qualification threshold than a household composed of two people. To verify qualified purchasers, the FDIC used a certification process and required the submission of an income qualification worksheet and supporting documentation.

7. *U.S.Code*, volume 12, section 1831q(c)(1).

Credits or Grants

The FDIC made credits or grants available to qualified buyers for an aggregate amount of up to 10 percent of the purchase price. Those subsidies, paid for entirely with congressionally appropriated funds, were used in one or more of the following ways:

- As down payment assistance;
- For buying down mortgage points;
- For closing costs;
- For buyer counseling; or
- As direct discounts on purchases.

The subsidies were available during fiscal year 1993 until June 1994, when the FDIC and RTC developed a buyer's assistance package for a joint sales initiative. They adopted the assistance package in the final months of fiscal year 1994 as the standard credits and grants approach for the duration of the FDIC and RTC programs.

From the assistance package, qualified buyers could receive the greater of 3 percent of the gross sales price or \$1,500 toward customary closing costs. For third-party-financed sales, buyers received an additional 7 percent of the gross sales price toward financing or closing-related costs for a total of 10 percent in buyer assistance. Seller-financed sales provided some alternative financing benefits designed to assist the purchaser. (The RTC was required by law to provide information regarding the availability of seller financing to minority- and women-owned businesses and minority-sponsored nonprofit organizations.)

Restrictions

Purchasers were subject to the same one-year occupancy requirement that the RTC enforced. If a property was resold within one year from the settlement date, the purchaser was required to remit 75 percent of any profit to the FDIC.

Existing Tenants

The FDIC offered existing tenants the opportunity to purchase their residences, whether or not they were income-qualified, before offering them through the AHP marketing program. Only income-qualified existing tenants were eligible, however, for the program's credits or grants.

Auctions

The FDIC conducted seven affordable housing auctions. Each of those events involved the active participation of local lenders, who provided financing for some of the sales. Participating banks viewed their participation in those auctions as one facet of their compliance with the Community Reinvestment Act; it allowed them an opportunity to meet the credit needs and help provide housing to low- and moderate-income households in their community. The FDIC expended a great deal of effort and planning in conducting those auctions. It gave particular attention to ensuring that all properties were habitable and had marketable title. Also, the FDIC conducted buyer awareness seminars for participants to ensure that each prospective purchaser understood the house-buying process and the rules of the auction.

Donations

Occasionally, the FDIC acquired properties of nominal value that failed to sell under established marketing procedures. When underlying holding and marketing costs were taken into consideration, potential future benefits to the FDIC were further diminished. In those instances, the FDIC often transferred title or otherwise donated properties, at no cost, to a nonprofit organization or public agency, providing it demonstrated a commitment that the properties would be used for the public good.

The properties owned by the FDIC that qualified for conveyance included single-family and multi-family affordable housing, homeless shelters, transitional housing, day care facilities for children of low- and moderate-income families, open urban spaces, and assets used for nonprofit public purposes. When appropriate, the FDIC asked the acquiring party to enter into a LURA to ensure the continued use of the property for the public good. See exhibits I.15-3 and I.15-4 for comments regarding donated properties.

Multi-Family Program

In response to a Completion Act requirement to unify the FDIC and RTC programs, the FDIC and RTC ratified a plan to merge the programs when feasible. That agreement, which was approved on April 22, 1994, provided a framework for the FDIC and the RTC to coordinate their efforts and take advantage of the RTC's multi-family marketing capabilities. The FDIC and RTC marketed certain FDIC owned multi-family properties under the provisions of the RTC direct sale program. Marketing of the assets was the joint responsibility of the FDIC and RTC, while management responsibility for the properties remained with the FDIC. The joint effort was accomplished within the limits of the appropriated funds available to the FDIC's AHP.

Because of funding limitations, the FDIC conducted few multi-family sales through the AHP. During fiscal years 1993 and 1994, it sold only two multi-family properties on

a subsidized basis, while fiscal year 1994 brought just one subsidized sale, which was conducted in cooperation with the RTC and the RTC's TAAs. During 1994, because the transactions were economically feasible without the use of a subsidy, the FDIC conducted six additional sales without the use of the appropriated funds. All nine properties sold in 1993 and 1994 included units set aside for affordable housing. In fiscal year 1995, the FDIC conducted 10 additional subsidized sales. See exhibit I.15-5 for comments regarding a Multi-Family Program sale.

Public, Private, and Nonprofit Cooperation

The FDIC program made extensive use of public, private, and nonprofit sector partners to leverage its limited resources. Involvement of those parties was evident in FDIC's auctions, which included the participation by lenders, the Federal National Mortgage Association (Fannie Mae), and community groups. Another example of such cooperation involved the Massachusetts Bankers Association and some of its affiliate members who facilitated a donation through the Make-A-Wish Foundation, conveying an FDIC affordable property to the family of a terminally ill child who had contracted the AIDS virus. The child's wish was for his family to finally own a home.

In early 1994, in New England, the FDIC initiated a pilot program of neighborhood revitalization and reinvestment. The program studied an urban area that had experienced an economic downturn. Part of the effect of the downturn was the number of foreclosed properties in that area owned by various institutional investors. As a result of the study, the FDIC implemented initiatives such as a program in Holyoke,

Donations: How They Work to Provide Affordable Housing

Exhibit I.15-3

The Midwest Service Center donated a six-unit apartment building in Kansas City, Missouri, under the FDIC's Affordable Housing Program. The recipient was Mennonite Housing, a nonprofit organization established in 1978 for the purpose of rehabilitating property to provide transitional housing to the homeless and permanent housing for very-low-income senior citizens. This was the second property donation arranged by the Midwest Service Center.

Source: FDIC HomeSteadier, 3rd quarter, 1994.

Exhibit I.15-4

On August 1, 1994, the FDIC's Southwest Service Center donated 18 distressed properties and three vacant lots located in McKinney, Texas, to the Community Housing Fund, a nonprofit organization. The effort to accomplish these donations was spearheaded by Mary Williford of the Affordable Housing Program department of the SWSC and Account Officer Marilyn Caldwell. The Community Housing Fund rehabilitates and builds homes to meet the needs of the low- and moderate-income families throughout the United States.

Massachusetts, in which an effective partnership was forged between the FDIC management and the town's debtors, municipal officials, other agencies, and bankers. They worked together to facilitate the most cost-effective conveyance of collateral interests in nominal value, multi-unit properties to the control of municipal authorities for disposition and development.

In Connecticut, the pilot program was instrumental in holding a statewide study that culminated in legislation to charter revitalization zones and roll back various regulatory prohibitions to community development. The initiative was recognized by the White House, which, in 1995, entered into a national partnership with the neighborhood revitalization zone effort in Connecticut. The pilot later was adopted throughout the FDIC.

The Nonsubsidized FDIC Affordable Housing Program

The FDIC Affordable Housing Program under section 40 technically terminated on September 30, 1995, because Congress did not appropriate funds to support the AHP in fiscal 1996. However, as noted earlier, the FDIC has another statutory requirement regarding affordable housing in section 123 of FDICIA, which regulates the FDIC's disposition of assets when acting in its corporate, receivership, or conservatorship capacities. Section 123 directs the FDIC to conduct its asset disposition operations in a manner guided by five factors, which include maximizing the preservation of the availability and affordability of residential real property for low- and moderate-income individuals.⁸ Through section 123, The FDIC implemented an affordable housing program that could operate without an annual congressional appropriation, yet be consistent with FDIC's overall statutory responsibilities.

Key Dates

From the time FIRREA first established the RTC and FDIC affordable housing programs, many changes and additions altered the programs. See exhibit I.15-6 for a summary of affordable housing activity by key dates.

8. Section 40(m)(4) of the Federal Deposit Insurance Act, *U.S. Code*, volume 12, section 1831q(m)(4), provided that the FDIC would not be liable to any depositor, creditor, or shareholder because the disposition of properties in accordance with the requirements of section 40 affected the amount of return on such properties. The statutory protection available under section 40 is not available for the non-appropriated program.

Conclusion

Although some significant resolution and disposition policies of the RTC were severely criticized, the Affordable Housing Disposition Program was widely viewed as an important redeeming feature of the government's handling of the savings and loan crisis. Congress implicitly stated that if taxpayers had to pay for the savings and loan cleanup, then something positive, in this case a greater supply of low-income housing, should be part of the package. During approximately five years of operation, the RTC accomplished its mission in the area of affordable housing by providing 109,141 units to very-low-, low-, and moderate-income households.

The success of the RTC's AHDP, however, came at a high price, although the total costs that resulted from implementing the program may never be known. As indicated in the 1994 GAO study, the RTC had not maintained a database for recording all the costs associated with the AHDP. For example, no means exists for estimating costs for the effects of reduced pricing caused by the restrictions for targeted purchasers and the effect on value associated with the LURAs. The conservative estimate in this chapter of \$135 million in added costs, compared to what disposition of assets would have cost without an affordable housing program, does not include estimates for some of the unrecorded AHDP costs. The added costs of RTC's AHDP are not high when viewed in relation to the total costs of the RTC as a whole, but may well be considered significant when viewed within the smaller confines of the Affordable Housing Disposition Program itself. The RTC sold more than \$2 billion in affordable housing units, compared to the \$402.6 billion in total assets that the RTC managed and sold.

As part of FDICIA, Congress appropriated funds for the FDIC to implement a limited Affordable Housing Program. Initially, it appropriated \$27 million for a three-year period so that the FDIC AHP would not draw on deposit insurance funds. During

Exhibit I.15-5

Bobbie White House: Serving Those in Need

The FDIC completed the sale of the property known as the Bobbie White House, located in Boston, Massachusetts, to the Citywide Land Trust for conversion into housing for people with substance abuse problems or AIDS. The Bobbie White House is a part of Victory Programs, Inc., a Boston-based multi-service agency providing individualized treatment programs to people recovering from alcohol and drug addiction, particularly those with medical and psychological problems including AIDS and HIV. The residence is a wheelchair-accessible brick row house containing 13 studio apartments located in Boston's South End.

Source: FDIC HomeSteader, 3rd quarter, 1994.

fiscal year 1995, the appropriation was reduced by \$11.3 million, and the program was effectively terminated. Although the overall size of the FDIC program was far smaller than the RTC program, the FDIC used appropriated funds to accomplish the objective set before it: to provide affordable housing to low-income families. The FDIC AHP provided housing for 2,933 lower-income households.

During the financial crisis of the 1980s and early 1990s, the RTC and FDIC were presented with an unprecedented volume of residential real estate for disposition. Both agencies took that unique opportunity to work diligently within regulatory guidelines and restraints to maximize the number of properties that could be placed into the hands of thousands of low-income households.

Exhibit I.15-6**Affordable Housing Key Dates**

August 1989	FIRREA required that the RTC develop a program for selling residential properties to provide affordable housing opportunities. In response to that provision, the RTC established the Affordable Housing Disposition Program.
January 1990	The RTC Oversight Board gave the RTC authority to implement a 100-unit pilot program of single-family properties under the AHDP. Broad guidelines for the program were established.
March 1990	The RTC Oversight Board issued a policy authorizing the RTC to use up to \$6 million to purchase mortgage revenue bond commitments with state and local housing agencies to finance single-family properties under the AHDP. Over the following six months, the RTC negotiated mortgage revenue bond commitments in 12 states for more than \$200 million. The largest commitment was with the state of Texas. Those bond issues enabled AHDP purchasers to obtain below-market-rate financing to purchase single-family properties.
July 1990	The RTC Oversight Board issued guidelines for the conveyance of properties with no reasonable recovery value. Over the course of the RTC's life, more than 1,000 properties with no reasonable recovery value were made available to nonprofit and public agencies for public usage. Conveyance uses ranged from homeless shelters in inner cities to bungalows in the Rio Grande Valley made available to migrant workers for homeownership. No-cost conveyances in Ft. Worth, Texas, to the Liberation Community were highlighted on the ABC television network national evening news on July 17, 1991.
August 1990	The AHDP Final Rule was published in the <i>Federal Register</i> . The issuance of that rule marked the beginning of the AHDP. The RTC Texas office placed 200 multi-family properties for sale under the AHDP.
October 1990	The RTC Oversight Board gave the RTC the authority to sell AHDP properties at 80 percent of appraised value (as opposed to the FIRREA mandated 95 percent of appraised value).

Exhibit I.15-6**Affordable Housing Key Dates**
Continued

February 1991	The RTC issued seller financing guidelines authorizing low-down-payment financing for single-family properties sold under the AHDP. Multi-family properties could be financed under the AHDP with 15 percent down payments. The RTC held a national training seminar in Washington, D.C., in November 1991 and, over the next six months, held training events in 13 RTC field offices.
March 1991	Congress authorized the sale of single-family properties in the AHDP in conservatorships. Congress also authorized the sale of single-family properties without regard to a minimum sale price. (Previously, 80 percent of appraised value had to be achieved.)
June 1991	The RTC Oversight Board approved the RTC's proposal to provide low-down-payment seller financing to nonprofit organizations and public agencies under the program.
December 1991	FDICIA implemented the FDIC Affordable Housing Program subject to receiving a congressional appropriation.
December 1991	The RTC issued its first repair policy providing that up to 25 percent of a property's sale price (or \$5,000, whichever is greater) could be spent on rehabilitation to bring the property up to code to meet lender-required repairs.
December 1991	Congress revised the AHDP to (1) permit direct negotiated sales of multi-family properties with nonprofit organizations and public agencies, and (2) impose a one-year owner occupancy requirement for purchasers under the AHDP. The National Housing Advisory Board was created as a forum for providing public input into the AHDP sales process.
May 1992	The first indictment for defrauding the AHDP was handed down to a broker who helped straw buyers (otherwise eligible buyers who purchased property on behalf of non-eligible buyers) purchase under the program.
May 1992	The AHDP issued a revised rule for carrying out the provisions of the 1991 funding bill.

Exhibit I.15-6**Affordable Housing Key Dates**
Continued

May 1992	The RTC initiated its multi-family direct sale program implementing the program authorized in the 1991 funding bill.
July 1992	The RTC hired four firms to perform underwriting on multi-family seller financed transactions.
October 1992	The FDIC received its first appropriation of \$5 million to operate its program during fiscal year 1993.
October 1992	The Housing Opportunity Hotline pilot was initiated in Texas with the lower-priced single-family foreclosed properties of eight federal agencies. That pilot pivoted off of the RTC's successful model of using state housing agencies and Federal Home Loan Banks to serve as clearinghouses to provide interested purchasers with single-family property lists. The Completion Act expanded the pilot to all 12 FHLBs.
October 1992	A \$100 million financing commitment was made by Fannie Mae to purchase mortgages on multi-family properties sold under the AHDP.
January 1993	The RTC issued its <i>Monitoring and Compliance Manual</i> for monitoring the long-term affordability of the AHDP. The RTC released a comprehensive computer package for monitoring those properties. During 1992 and 1993, the RTC held more than a dozen training events for its state monitoring agencies and homeowners throughout the country.
February 1993	The RTC was authorized to broaden seller financing policy.
October 1993	The FDIC received a \$7 million congressional appropriation for fiscal year 1994.
December 1993	The Completion Act directed that the RTC Affordable Housing Disposition Program and the FDIC Affordable Housing Program be unified and that the program take into consideration the experience of the RTC. Unification was to occur in a manner that best achieved an effective and comprehensive affordable housing program management structure.

Exhibit I.15-6**Affordable Housing Key Dates*****Continued***

October 1994	The FDIC received a \$15 million congressional appropriation for fiscal year 1995.
November 1994	The RTC implemented certain provisions of the Completion Act, which required that preferences be given to homeless providers who offered to purchase commercial properties and who purchased certain real estate owned for homeless housing and shelters. The RTC also established a preference for homeless providers who purchased certain commercial real estate owned for offices and administrative purposes. RTC's marketing literature was required to include narrative notifying potential buyers of the applicability of those provisions. The RTC established additional procedures to regularly notify homeless provider organizations of the current RTC inventory.
December 1994	According to the RTC Final Rule, section 1609.12, published in the <i>Federal Register</i> , October 19, 1994, the RTC had to list all of its single-family and condominium properties and multi-family properties with clearinghouses. The RTC also formally implemented its direct sale program. It established two 30-day marketing periods for multi-family properties offered under the direct sale program—an initial marketing period for public agencies and another for nonprofit organizations. Later, the RTC combined those two marketing periods into one 45-day period in which it marketed the property simultaneously to both public agencies and nonprofit organizations. The RTC was required by the Completion Act to provide information regarding the availability of seller financing to minority- and women-owned businesses and minority-sponsored nonprofit organizations.
August 1995	Congress rescinded \$11.3 million of the FDIC AHP's \$15 million fiscal year 1995 appropriation, effectively terminating the program.

More than \$42 billion (almost 22 percent of the mortgages and more than 10 percent of all of the RTC's assets) were sold through the RTC's securitization program.



CHAPTER 16

Securitizations

Introduction

In October 1990, one year after the Resolution Trust Corporation (RTC) was created, a securitization program was established to facilitate the sale of mortgage loans. This chapter focuses on the creation, development, and performance of this program.

Overview

Mortgage loans were the largest single category of assets in the RTC's inventory. In August 1990, the total volume of those loans held in RTC-controlled institutions was estimated to be more than \$34 billion. The size of this portfolio led the RTC to explore the concept of securitization as a method for broadening the potential range of mortgage loan purchasers because the market for mortgage-backed securities was large and well developed.

Securitization is the process by which assets with generally predictable cash flows and similar features are packaged into interest-bearing securities with marketable investment characteristics. Securitized assets have been created using diverse types of collateral, including home mortgages, commercial mortgages, mobile home loans, leases, and installment contracts on personal property. The most common securitized product is the mortgage-backed security (MBS). The following types of mortgage loans are most suitable for securitization.

Conforming Residential Loans

Conforming residential loans are single-family, performing (one-to-four family) mortgage loans that conform to Federal National Mortgage Association (Fannie Mae) and Federal Home Loan Mortgage Corporation (Freddie Mac) guidelines and/or standards. In 1997, these agencies had more than \$3 trillion of outstanding mortgage securities backed by conforming residential loans.

Nonconforming Residential Loans

Nonconforming residential loans are single-family, performing (one-to-four family) mortgage loans that do not conform to Fannie Mae or Freddie Mac standards. Private-sector sellers and government agencies other than FDIC and RTC securitized more than \$159 billion of nonconforming mortgage loans between 1990 and 1997.

Multi-Family Residential and Commercial Loans

Multi-family residential and commercial loans are performing mortgages that secure residential (5+ family) and commercial properties. Although private-sector sellers securitized more than \$135 billion of multi-family loans between 1992 and 1997, the market for these securities is still evolving.

The RTC's single-family mortgage loan portfolio was unique because most of the loans did not conform to the standards required by Fannie Mae or Freddie Mac. Because most of the RTC's loans were originated for retention in the lender's portfolio, some of the loan underwriting criteria deviated from normal secondary market standards. For example, there were loans with cross-collateralization, loans with nonstandard interest rate indexes, loans with high loan-to-value ratios, loans with no mortgage insurance, and many loans that had documentation deficiencies.

The RTC needed not only to maximize the return on its asset sales, but also to liquidate assets expeditiously. Early on, the most common method it used to move assets quickly was to sell mortgage loans through "whole loan" sales. Three types of whole loan buyers generally bid on these sales packages: (1) portfolio investors, (2) investment bankers, and (3) junk buyers. The last two categories of buyers tended to heavily discount any product that could not be readily made into investment-grade quality. Portfolio investors usually did not discount as heavily as the investment bankers and the junk buyers, if the portfolio generated sufficient yield, the loans were collectable, and the documentation was enforceable. Even though the RTC standardized the review process implemented by its contractors for due diligence (a thorough review of the individual loans or properties) and loan sale advisory services, the mortgage loans it held suffered from credit and delinquency problems and document deficiencies. Consequently, most buyers of RTC mortgage loan packages tended to be investment bankers and junk buyers. As a result, the RTC was not generating the return it expected on its whole loan

sales. Returns were often in the 85 percent to 90 percent of book value range for performing residential mortgage loans.

One of the RTC's most successful whole loan sales took place in the summer of 1990. That sale was referred to as the Atlanta Pilot program, in which \$17 billion of residential mortgage loans were sold for prices ranging from 93 percent to 99 percent of book value. Within months of the Atlanta Pilot program sale, officials at the RTC received calls from Fannie Mae and Freddie Mac about origination standards for various thrift institutions that were in the RTC conservatorship program. It was discovered that many of the loans that were sold in the Atlanta Pilot program had documentation deficiencies that were subsequently corrected by the purchaser. These corrections changed the status of the loans from nonconforming to conforming, and enabled the purchaser to submit the corrected loans for resale to Fannie Mae and Freddie Mac. Loans that were conforming except for the loan balance were subsequently resold to investors through private securitization programs. In both instances, when the loans were resold, the original purchasers received prices significantly higher than the original purchase price. These events made it clear that the RTC could receive higher prices by leaving out the intermediary. As a result, the RTC began to correct documentation deficiencies itself in order to sell loans directly to Fannie Mae and Freddie Mac. When that was not possible, the RTC sold loans through its own securitization program.

RTC Agency Swap Program

In October 1990, the RTC Oversight Board adopted a resolution that encouraged the RTC to use securitization as a method of disposition for financial assets. The board also directed the RTC to establish a single procedure for facilitating the securitization of mortgage loans from multiple receivership and conservatorship institutions. In November 1990, the RTC executed "master" agreements with Fannie Mae and Freddie Mac, thereby enabling the RTC to sell conforming loans directly to the agencies.

Both Fannie Mae and Freddie Mac are government-sponsored entities that purchase conforming residential mortgage loans from originators and other sellers, package such mortgage loans into more liquid securities (such as mortgage-backed securities and participation certificates), add a guarantee of payment of principal and interest, and sell the securities to investors. An investor in a Fannie Mae or Freddie Mac security receives guaranteed monthly payments of principal and interest that are generated by the mortgage loans underlying the security. Fannie Mae and Freddie Mac receive a fee from the mortgage loan seller for guaranteeing the principal and interest payments to the investor, and also earn interest income on the delay between receipt of principal and interest from mortgagors and payment to the security investors.

Under the RTC's Agency Swap Program, the RTC sold for cash, or swapped, for Fannie Mae or Freddie Mac securities, \$6.1 billion of conforming residential mortgages in competitive auctions. In a typical cash sale, Fannie Mae and Freddie Mac bid

to purchase pools of mortgage loans from the RTC for a cash price that is usually determined by calculating the amount that Fannie Mae or Freddie Mac received on the sale of their securities created from such pools, minus their guarantee fee and other costs. In a swap, the RTC received the Fannie Mae or Freddie Mac securities in exchange for the mortgage loans and then, with the assistance of Fannie Mae or Freddie Mac, sold such securities from the RTC's capital markets trading desk.

For both cash sales and swaps, the Fannie Mae and Freddie Mac master agreements required that the RTC supply credit enhancement for the mortgage loans in the form of cash collateral withheld from the purchase price by either Fannie Mae or Freddie Mac. The cash collateral was invested for the benefit of the RTC and then returned to the RTC when certain criteria were met. In addition, under the Swap Program, the RTC also competitively bid and sold to servicing firms the servicing rights associated with the underlying mortgage loans.

RTC Private Securitization Program

In December 1990, a private securitization program was established to sell the loans that did not conform to Fannie Mae and Freddie Mac standards. This program was established with the following expectations:

1. **Enhanced Asset Recovery Values**—Securitization should enable the RTC to reach a much larger base of investors. The market for whole loan sales was significantly smaller than the market for investors in mortgage-backed securities. As a result, private-market participants estimated that securitization should enable the RTC to increase recovery values, as compared to whole-loan sales, from 0.5 percent to 1 percent for better quality loans and from 2 percent to 10 percent for lower quality loans. The increase in recovery values translated to an additional \$1 billion to \$3 billion for taxpayers.
2. **Expedited Asset Sales**—The securitization process also should enable the RTC to close loan sale transactions more quickly. In a whole loan sale, the purchaser required 6 to 12 weeks between the sale date and the closing date to engage in its own detailed loan file review, in order to verify the due diligence information prepared by or on behalf of the RTC. In a securitized loan sale, the purchasers of the securities did not need to perform a second detailed loan file review, but instead relied on the credit enhancement's making it possible to close within two to three weeks after the sale.

In 1990, the RTC would have preferred to issue securities backed by the full faith and credit of the U.S. government. This feature would have expanded the “universe” of investors, including foreign buyers. Foreign governments would not need to issue a special ruling to make RTC securities eligible investments for mutual funds, because an

RTC government-guaranteed security would probably fit the existing exemption available for Government National Mortgage Association (Ginnie Mae) securities. A direct guarantee would also enable regulated buyers such as banks and thrifts to be subject to markedly lower risk-based capital requirements. With a direct government guarantee, RTC securities would have a zero-risk weight, which is similar to the risk weighting for Ginnie Mae securities.

The RTC's Oversight Board did not support the RTC's issuance of securities backed by a full government guarantee. That lack of support stemmed partly from concerns raised by the Department of the Treasury that (1) the government would retain all of the risk because there was no real asset sale, and (2) issuing a new security with a full faith and credit guarantee by the U.S. government would compete with the securities issued by the Treasury. As a result, the RTC did not use a government guarantee to enhance the credit of RTC securities. Instead, the RTC decided to use cash reserves and other methods to provide credit support. It issued publicly rated mortgage-backed securities for which the senior securities were rated in the two highest rating categories by at least two national credit rating agencies.

Another major issue concerning the RTC's securitization program was personal liability. Under the Securities Act of 1933, directors, officers, employees, and "controlling persons" of a private corporation may be personally liable for errors or omissions in a prospectus used to offer and sell securities. Some of the RTC board members were concerned that they would be sued by investors who purchased RTC securities. The board obtained a legal opinion stating that RTC directors, officers, and employees have a strong case for immunity from such personal liability, pursuant to the Federal Tort Claims Act (FTCA). However, certain ambiguities in the FTCA make it impossible to render a flat "no liability" opinion. Thus, the securitization program could not begin until the issue of personal liability was addressed through legislation. In the RTC Funding Act passed in 1991, the U.S. Senate included a provision that provided absolute immunity from claims based on the 1933 Securities Act, and granted authority to the agency to indemnify employees against common law and other liabilities that were awaiting action by the Supreme Court.

The passage of this legislation enabled the RTC to issue securities. In March 1991, the RTC Board of Directors authorized the filing with the Securities and Exchange Commission of a shelf registration statement (the RTC Shelf) for the issuance and sale of mortgage securities backed by residential loans from one or more RTC institutions. The board also authorized the RTC staff to use competitive procedures to select private-sector firms necessary to implement the securitization of mortgage loan sales. To further encourage the use of securitization as a primary method for asset sales, then-FDIC Chairman L. William Seidman announced that the RTC would sell at least \$1 billion per month using the securitization sales structure.

Securitization Process and Participants

The mortgage loan securitization process of creating a trust to acquire mortgages and issue pass-through certificates to investors typically involves seven key participants. These participants are the seller, underwriter, trustee, servicer, rating agency, accountant, and legal counsel.

The seller is the owner of the mortgage loans sold to the trust and the ultimate beneficiary of the proceeds from the sale of the certificates to investors. The seller may provide some form of guarantee or credit support to enhance the value of the bonds. The seller will also usually provide certain representations and warranties related to the mortgage collateral.

The underwriter receives individual mortgage loan information, analyzes and structures the portfolio into multiple classes of certificates of varying maturities and interest rates, and underwrites (purchases) the securities from the seller. The underwriter then resells the certificates to investors.

The trustee represents the interests of the certificate holders and acts as administrator of the trust. The primary role of the trustee is to compute the amount of monthly distributions payable to the investors and make appropriate distributions. Each month, an account statement is prepared by the trustee that summarizes the cash received by the trust and explains the calculation of the amounts paid to the investors of each class of securities. The trustee is usually responsible for the preparation of the trust's income tax return and the related informational tax filings. The trustee for publicly rated securities must provide backup servicing for the securitized loans in case the appointed servicer is unable to service the loans. The trustee must also make advances for delinquent mortgage payments if the primary servicer fails to do so. For this reason, the trustee must have an unsecured debt or deposit rating of no more than one full rating level below that of the securities issue (that is, if the RTC issues double A rated securities [AA], the trustee must have an unsecured debt or deposit rating of single A [A]).

The servicer performs the traditional mortgage loan servicing functions of collecting and accounting for borrower's payments and resolving delinquent loans. The servicer prepares special reports for the trustee and forwards the monthly mortgage collection payments to the trustee so that investors in the securities may be paid. The servicer also transmits funds and special reports to the trustee.

Rating agencies evaluate the transaction structure, the underlying pool of assets, and the expected cash flows, and determine the extent of loss protection that should be provided to investors through various forms of credit enhancement. Securitization transactions typically involve the use of credit enhancement to create securities that have a very high level of credit quality. To achieve the highest ratings from the national credit rating agencies, mortgage-backed securities must satisfy cash flow, delinquency, and loss coverage tests that make default almost impossible. The rating agencies have developed loan loss models to estimate the required level of loss protection for a securitized mortgage loan pool. They use the Great Depression as a benchmark to estimate the level of losses

that may occur if a mortgage pool is subjected to stressful economic conditions. Cash flow scenarios are run that subject a pool of mortgages to “stress tests” for which losses and delinquencies are assumed to be two to three times greater than the losses experienced in the Great Depression. The rating agencies monitor the performance of the transaction over time and adjust credit ratings as appropriate.

An accounting firm performs initial statistical data and accounting validation. The firm also provides “comfort letters” to underwriters and investors verifying the accuracy of information printed in the prospectus supplement to the securities offering.

Legal counsel writes and reviews all materials (including the prospectus and the prospectus supplement in the case of publicly offered certificates) related to the offering of the securities. Counsel also must ensure that the certificates and the underlying mortgage loans satisfy Real Estate Mortgage Investment Conduit (REMIC) eligibility requirements. In addition, legal counsel prepares the pooling and servicing agreement and negotiates the terms of the agreement on behalf of the seller, servicer, and trustee. Counsel also oversees the process of closing the transaction and ensures that all necessary documentation is prepared and executed.

Transaction Structure

RTC mortgage loans are conveyed to a trust that subsequently issues a series of mortgage-backed securities collateralized by the subject loans. These transactions constitute the sale of the beneficial interest in the loan portfolio. Almost all mortgage-backed securities are either guaranteed by a government-sponsored entity (Fannie Mae, Freddie Mac, or Ginnie Mae), or rated by national credit rating agencies (Standard & Poor's Rating Services, Moody's Investors Services [Moody's], Duff & Phelps Credit Rating Co., or Fitch Investors Services, L.P.) on the basis of private credit enhancement. The Oversight Board of the RTC authorized the RTC to use various types of credit enhancement: mortgage pool insurance, bond insurance, bank letter of credit, reserve fund or spread account, overcollateralization, and senior-subordinated structures.

Because of the cost and difficulty of obtaining third-party credit enhancement (such as bond insurance, pool insurance, and letters of credit), most private-market mortgage securitization transactions use some form of internal credit enhancement (for example, overcollateralization, reserve funds, spread accounts, or senior subordinated structures). The RTC used a number of sources for credit support, including cash reserve funds, subordination, excess interest, and overcollateralization. Table I.16-1 illustrates the structure of a typical RTC securitization transaction using a combination of a cash reserve fund, subordination, and excess interest as credit enhancements.

Cash Reserve Funds

For each transaction, cash reserves were funded by the RTC out of the proceeds of the offering. The funds were held in accounts by a collateral security agent, generally the same entity as the trustee, and were invested in cash and securities that met the credit rating agencies' definition of eligible investments. The reserve fund serves as the primary and most liquid source of credit support. It is used to protect investors against all shortfalls and losses, regardless of the cause. The reserve funds cover items such as delinquent principal and interest, interest rate shortages, and realized losses on liquidation of assets. The example in table I.16-1 required a \$296 million cash reserve or 26 percent of the mortgage loan's unpaid principal balance.

Table I.16-1

RTC Securitization Transaction

1994-C1

(\$ in Millions)

Mortgage Loans

Number of Loans	2,117
Number of Financial Institutions	238
Unpaid Principal Balance	\$1,138

Cash Reserve Fund Balance

26% of Unpaid Principal Balance	\$296

Bond Classes

Rating:	
AAA	\$740
AA	57
A	102
BBB	68
BB	125
B	46
	<u>\$1,138</u>

Interest Rate (%)

Mortgage Loan (WAC)*	9.45
Security (WAC)*	<u>7.45</u>
Excess	2.0

* Weighted Average Coupon

Source: FDIC Division of Resolutions and Receiverships.

Subordination

RTC securitization transactions contained one or more subordinate classes. Subordination provides protection to the senior certificate holders by requiring that the junior certificate holders absorb any shortfalls and losses until the balances are reduced to zero. Generally, once a senior class of security holders has been paid in full, principal payments are re-allocated to pay down junior classes of security holders. This feature preserves the integrity of each transaction and the intention that all senior classes have priority of payment over the junior classes.

Excess Interest and Overcollateralization

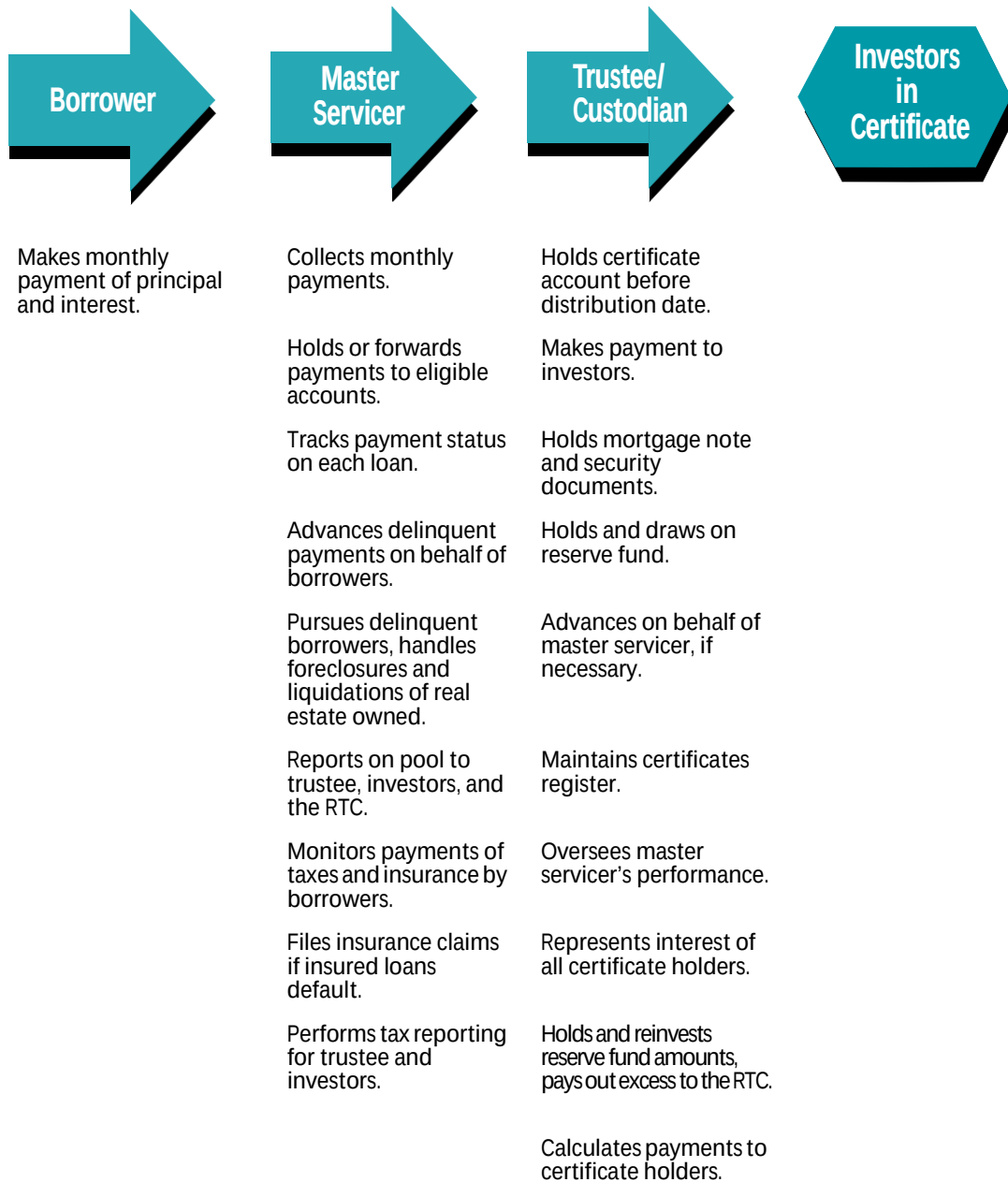
Excess interest is defined as the difference between the interest rate paid to investors by the security and the interest rate on the underlying mortgage loans. In most RTC transactions, excess interest is used to accelerate the payment of the subordinate security classes. At the beginning of the transactions, there were significant amounts of excess interest on RTC securitizations. In some cases, the excess interest is used to replenish the reserve fund to a certain level before it is distributed to security holders. The result of using excess interest to retire class balances is that the principal balance of the outstanding securities is reduced relative to the mortgage pool, thus creating overcollateralization. Such overcollateralization provides an added cushion against losses above the reserve fund and subordination. Because excess interest is applied to the subordinate classes, depending on the prepayment experience and the interest rate environment, the prepayment of the subordinate classes may be accelerated. In some instances, the subordinate classes may pay down at an accelerated rate, some at faster rates than the senior classes. Changes in the interest rate environment may affect the amount of excess interest available to pay down securities. In a low-rate environment, higher coupon loans (which produce the greatest amount of excess interest) prepay at faster speeds, thus reducing the pool's ability to generate excess interest and slowing the buildup of overcollateralization. In a stable- to high-rate environment, prepayments are slower, thus allowing the securities to generate excess interest and build up overcollateralization. The flow of funds in a typical securitization transaction is shown in table I.16-2.

Residuals

The residual cash flow represents the difference between the income stream generated by a pool of mortgages and the cash flow necessary to fund a series of collateralized mortgage obligations or real estate trust bonds. Residual value is the economic value or money received by the bondholder of a transaction when the bonds have been paid off and cash flows from the mortgage collateral are still being generated. Residual value also arises when the proceeds amount from the sale of the mortgage collateral as whole loans is greater than the amount needed to pay outstanding bonds.

Table I.16-2

RTC Securitization—Flow of Funds



Source: Lehman Brothers Completed Transactions Book, Security Series 1991-1 (July 1991).

The First Transaction—Residential Securitization

In June 1991, the RTC began its securitization program with the issuance and sale of RTC Series 1991-1. This transaction consisted of \$426 million of residential loans that were originated and serviced by Columbia Savings and Loan Association, Beverly Hills, California, and were nonconforming to Fannie Mae or Freddie Mac standards. The portfolio consisted of adjustable rate mortgage (ARM) loans that were tied to either six-month Treasury bills (T-bills) or the one-year constant maturity Treasury (CMT) index. The six-month Treasury-indexed loans were adjusted monthly, and the one-year CMT loans were adjusted on a six-month or an annual basis.

Securitization

During the structuring process for the first RTC securitization transaction, the issue of whether to include delinquent loans (loans for which payments were more than 30 days late) in the pool arose. The industry standard is to exclude delinquent loans when forming a collateral pool for any new offering of mortgage securities. This practice exists because the rating agencies require much higher credit enhancement levels for delinquent loans and diverging from this practice might make the securities appear less attractive to investors. The concern was that there would be a tremendous pricing concession associated with the inclusion of these loans, in addition to a substantial increase in the reserve fund. The underwriter for 1991-1 conducted a sensitivity analysis to determine the impact of including delinquent loans. The analysis used a “delinquency pricing concession” to estimate the above-market level yield premium that would be demanded by investors to compensate for the inclusion of those loans in the pool. As a result of the analysis, which valued the pricing concession at 0.05 percent, the RTC decided to include loans that were up to 89 days delinquent in the sale pool. This was the first time mortgage-backed securitization transactions had included delinquent loans.

There were six classes, or tranches, of security certificates, one for each of the three interest rate indexes represented in the loan portfolio and one interest-only (IO) strip for each of these indexes. These certificates were rated AA by two credit rating agencies. The loss coverage requirement (cash reserve) determined by the rating agencies was 12 percent in order to issue AA-rated securities. Table I.16-3 illustrates the classes of securities that were issued in securitization series RTC 1991-1.

The underwriter and the financial adviser reviewed various credit enhancement options and recommended the use of a reserve fund. They determined that the reserve fund credit enhancement structure would result in the best combination of favorable execution of the sale of the certificates, limited recourse to the RTC, and maximization of net proceeds.

Table I.16-3**RTC Residential Mortgage Loan Pass-Through Certificates***Series 1991-1*

Loan Group A-1	Loan Group A-2	Loan Group A-3
6 month bond equivalent yield T-bill (rate adjusted monthly)	1 year CMT (rate adjusted semiannually)	1 year CMT (rate adjusted annually)
\$380 million Class A-1	\$43 million Class A-2	\$38.5 million Class A-3
IO Class X-1	IO Class X-2	IO Class X-3

Note: The residual and the IO strips were retained by the RTC as receiver of Columbia Savings and Loan Association, Beverly Hills, California.

Source: Prospectus supplement for RTC 1991-1.

The AA rated securities (tranches A-1, A-2, and A-3) on RTC Series 1991-1 were sold at a price of 100.50 percent, 100.75 percent, and 100.75 percent, respectively. All expenses were deducted from the gross sales proceeds. Expenses included, but were not limited to, the following items: (1) underwriters' fees; (2) due diligence fees; (3) accounting fees; (4) printing fees; (5) rating agency fees; (6) trustee expenses; (7) financial adviser fees; and (8) a cash reserve fund. Expenses for this transaction were approximately \$3.5 million, so that the securitization generated net sales proceeds of \$425.3 million on \$426 million in residential loans.

Subsequent RTC securitization transactions were structured in a manner similar to the first transaction except for two major differences: (1) the mortgage loans that were used as collateral for later transactions were originated and serviced by multiple RTC conservatorship and receivership institutions, as opposed to one institution, and (2) a cross-index structure was used. In a cross-index structure, the interest rate paid to investors is not tied to any of the interest rates on the underlying collateral (mortgage loans). The RTC frequently issued securities bearing an interest rate tied to the London Interbank Offered Rate (LIBOR) when the interest rates on the underlying mortgage loans were tied to U.S. Treasury indexes or cost of funds indexes.¹ Use of the LIBOR index allowed international investors to easily purchase RTC securities, because the securities were based on a familiar and frequently used interest rate index. International investors in LIBOR-based RTC securities were able to match their cost of lending to their cost of funds, thereby boosting international secondary market acceptance of these securities.

1. LIBOR is the interest rate in London that offers "Eurodollars" in the capital markets worldwide. The cost of funds indexes represent the monthly weighted average cost of funds for depository institutions whose home offices are in various Federal Home Loan Bank districts.

Securities issued with cross-index structures created a basis-risk concern for the rating agencies. Basis-risk occurs when securities are issued on the basis of a single index while being supported by a collateral pool containing varying indexes. This situation creates the risk that the interest to be paid on the securities will exceed the net interest received on the collateral, thus resulting in a payment shortfall. The rating agencies used very conservative assumptions based on historical index movements to ensure that there was enough credit support available to investors to cover this risk. In some of the RTC securitization transactions, this risk was covered in two ways: by requiring that additional money be added to the cash reserve fund and by using excess interest payments to accelerate the paydown of classes that were subject to basis-risk.

By October 1991, the RTC completed 12 residential and multi-family securitization transactions totaling more than \$5 billion. In the four months since the program's first sale, the RTC had become one of the largest issuers of mortgage backed securities; the volume of mortgage securities issued was exceeded only by Fannie Mae and Freddie Mac. Before its termination in December 1995, the RTC would complete 45 residential securitization transactions totaling \$25 billion. The RTC mortgage-backed securities were an important component of the overall portfolio of securities traded in the secondary markets of the United States and Europe.

Commercial Securitization

The RTC has been credited with expanding and educating the marketplace by creating unique and complex securitization structures to sell its commercial mortgage loans. In the past, securitization structures had been used to sell performing residential mortgage loans rather than commercial mortgages because commercial mortgages were perceived to be riskier because of the lack of homogeneity in loan term, size, and structure. The securitization of commercial loans evolved from a \$6 billion market in 1990 to an \$80 billion market in 1997. The commercial securitizations that were completed before 1990 were private placements issued by commercial banks and life insurance companies. Structures were simple, involving the issuance of one or two tranches of rated certificates that were secured by one or several commercial properties. Because the collateral involved only a few properties, the analysis of these transactions was very detailed and "property specific." Investors attracted to commercial securitization were primarily those that had a considerable level of commercial real estate expertise and that were able to conduct their own analysis.

The RTC's commercial loan portfolio was originated by savings and loan institutions in the 1980s, which was a growth period for the commercial real estate industry. During this time, commercial mortgage lenders often employed liberal origination guidelines to compete for loans. Consequently, the quality and integrity of the mortgage loans suffered. Many lenders did not require borrowers to regularly submit updated financial or property information for approved loans. Problems in the commercial loan

portfolios were similar to those in the RTC's residential portfolio: The loans were originated by multiple lenders, loan documents were missing, and, in some cases real estate taxes and insurance premiums were in arrears and were not being addressed by the lender. These characteristics, coupled with generally lower quality real estate, resulted in the highest credit enhancement levels ever assessed by rating agencies for commercial loan securitized pools.

The RTC began its commercial mortgage securitization program in January 1992 with its first issuance of publicly rated commercial mortgage-backed securities. The structure that was used to issue the commercial securities was similar in many ways to the structure that was used to issue residential securities. (See table I.16-4.) Each transaction was structured as a multiclass pass-through, backed by fixed rate and adjustable rate mortgage loans that were divided into multiple loan groups. Each of these loan groups supported a specific class (or classes) of securities, and usually contained loans with similar indexes or other similar characteristics. ARMs with high lifetime interest rate floors often were grouped with fixed rate loans. The existence of several loan groups greatly contributed to the complexity of RTC commercial mortgage transactions.

The rating agencies required large cash reserve funds to protect classes from experiencing losses that may result from the poor performance of their corresponding loan groups. The cash reserves also take into consideration any losses that might be attributed to basis-risk and, in some cases, the availability of excess interest.

To alleviate concerns about document deficiencies and uncertainty about collateral quality, the RTC had to provide extensive representations and warranties for the commercial securitizations. The representations and warranties covered most aspects of the mortgage loans, the properties, and the documentation. In the event of a breach of any representation or warranty, the RTC was required to cover any monetary loss or expense incurred. In addition, the RTC could repurchase a loan that was the subject of a breach of a representation and warranty. The RTC also provided an environmental indemnification for each transaction. If a breach of an environmental representation and warranty occurred, the RTC had the option of curing the related problem within 90 days' notice or of repurchasing the related mortgage loan at its principal balance plus interest.

Many of the early RTC transactions did not allow the servicer much flexibility to work out delinquent loans. Later, RTC commercial mortgage transactions allowed the servicers greater latitude to work out delinquent loans. In most of the RTC commercial transactions, the servicing functions were divided between a master servicer and a special servicer. The master servicer was responsible for collections and general administration of all current loans and for those that were up to 59 days delinquent. Loans that were more than 59 days delinquent were transferred to the special servicer, who was responsible for resolving delinquent loans and advancing loans through the foreclosure and bankruptcy process. The special servicer was also responsible for the management of real estate owned (REO) properties. The addition of the special servicer was intended to ensure that an entity was highly experienced in the workout, asset management, and liquidation of commercial real estate. The special servicer had broad flexibility to

Table I.16-4

**Commercial Mortgage Loan Pass-Through Certificates
Series 1992-C1**

85% Class A 1 Rating Aa2 Fixed Rate \$304mm	
Loan Group 1F Fixed rate loans	Loan Group 1A ARMS with 8%+ floors
85% Class A 2 Rating Aa2 1 Month LIBOR \$146mm	
Loan Group 2 ARMS with various interest rates	
6% Class B* Rating A3 1 Month LIBOR \$32mm	
Loan Group 2	
9% Class C† Rating Baa2 1 Month LIBOR \$47mm	
Loan Group 2	
Residual	
Reserve Fund 30% (Funded from sales proceeds)	

* Payments to holders of Class B securities are subordinate to holders of Classes A-1 and A-2.

† Payments to holders of Class C securities are subordinate to holders of Classes A-1, A-2, and B.

Source: *Lehman Brothers Completed Transaction Book, 1992-C1*, February 1992.

modify, waive, or amend the terms of the mortgage loans. All modifications were submitted for approval to the RTC, which had to respond to the proposal within 10 days; otherwise, the servicer's proposal was automatically approved. The special servicer received fees tied to a percentage of each loan that was worked out and/or returned to the master servicer as a performing loan. All servicers for securitization transactions had to be approved by the rating agencies.

Initially, investors were reluctant to accept the RTC's commercial mortgage securitization program. Most market participants remained skeptical after the first few transactions. There were large numbers of delinquent loans, and minimal information was available about transaction performance. The significant number of delinquencies was attributable largely to servicing transfers between the prior servicer and the master servicer. During these transitions, borrowers did not know where to send their payments and some borrowers used this situation as an excuse not to pay at all. Inaccurate information was often transmitted between the servicers and the trustees. In many cases, the servicers and the trustees had independent internal reporting systems. They also had their own method for reporting delinquencies.

In response to this scarcity of information, the RTC created the Portfolio Performance Report (PPR) to provide monthly information to investors and other market constituents about the performance of previously issued RTC commercial mortgage securitization transactions. This report detailed delinquency and loss information on specific mortgage pools and was the first attempt by an issuer of commercial mortgage-backed securities to provide monthly performance information in a standardized format. The report became an industry standard and now is produced by most commercial securitization issuers. The RTC issued and sold \$17 billion of commercial mortgage-backed securities through 27 transactions. Although high numbers of delinquencies and losses were initially anticipated by the rating agencies, these transactions have performed better than expected because of the high level of prepayment activity (many loans were paid in full before their scheduled maturity date). The successful performance of the RTC securities was a significant factor in the further development and standardization of this market. Large commercial banks are now underwriting and originating commercial mortgage loans specifically for securitization.

The FDIC Securitization Program

FDIC performing mortgage loans were generally sold through whole-loan sales. The loan sales strategies used by the FDIC were usually determined on the basis of the analysis of a loan sale adviser. The FDIC mortgage loans, which were acquired from hundreds of receiverships from across the country, had disparate documentation and underwriting criteria, and generally were considered to be nonconforming.

In 1994, the FDIC managed a large portfolio of performing commercial mortgage loans with credit and collateral characteristics that had not been well-received in prior

“whole loan” sales attempts. The FDIC’s loan sale adviser performed an analysis of sales strategies for this portfolio and determined that the FDIC would maximize their value by selling the loans through a securitization. The FDIC used a structure that was similar in many ways to the structure used by the RTC in its securitization program. The major difference was the mechanism for credit enhancement. The FDIC provided a limited guarantee in the form of an interest-free demand note through the Bank Insurance Fund (BIF). The guarantee was based on an amount determined by the credit rating agencies to obtain investment-grade securities. In consideration for the limited guarantee, the BIF would receive the excess interest after payment of the securities’ principal and interest. The loan sale adviser compared the use of a note to a cash reserve structure and determined that the note would be more appropriate for the FDIC because it would be drawn upon only as needed and would provide the FDIC with potential investment flexibility in the future. The note would also allow the FDIC to receive the entire sales proceeds on the date of funding, rather than wait for the delayed return of funds required to be deposited in a cash reserve fund. The FDIC felt that credit enhancement in the form of a cash reserve was more appropriately suited to RTC’s funding and sunset provisions than for BIF receiverships.

In August 1994, the FDIC consummated the sale of \$762 million of performing commercial real estate mortgage loans from 197 failed depository institutions in its first securitization sale (FDIC REMIC Trust 1994-C1). The offering was well received by the market, and investor demand resulted in the interest rates being set at lower yields than were initially offered. The execution of the adjustable rate pool set a record, at the time, for the tightest spread above LIBOR for this type of securitization.

On December 20, 1996, the FDIC completed its second securitization of commercial mortgage loans (FDIC REMIC Trust 1996-C1). This transaction was similar in many respects to the first FDIC commercial securitization. The FDIC sold approximately \$723 million of performing mortgage loans from 180 failed depository institutions by issuing ten classes of securities with an FDIC limited guarantee as a form of credit enhancement. This transaction, like the first one, was well received by investors.

Program Overview

From June 1991 to June 1997, 72 RTC and 2 FDIC securitization transactions closed, secured by conservatorship and receivership mortgage loans with a book value of \$43.7 billion. Almost 500,000 residential, multi-family, commercial, mobile home, and home equity loans were securitized. Credit support (both cash reserves and the FDIC limited guarantee) required for those transactions totaled approximately \$8 billion.

RTC and FDIC securities are traded in capital markets worldwide. As of June 30, 1997, outstanding securities balances had decreased approximately 65 percent to \$15 billion. The most significant decrease was for single-family securitizations, for which the amount of outstanding securities decreased by more than 68 percent (from \$24.4 billion

securities issued to \$7.8 billion securities outstanding). Conversely, the credit reserves as a percentage of outstanding securities have increased over time. For example, on the commercial securities, the initial reserves that were required by the rating agencies averaged approximately 25 percent (\$3.6 billion coverage for \$13.9 billion commercial securities), while the amount of credit coverage available on the outstanding securities as of June 30, 1997 was approximately 55 percent (\$2.8 billion credit support available to cover \$5.2 billion of securities). Even though the amount of actual dollars of available credit reserves decreased, the credit support (percent of credit reserves to bond issues) increased from the original 18.9 percent to 38 percent at June 30, 1997. Statistical information on all RTC and FDIC securitizations is displayed in table I.16-5.

Those securitization transactions involve 14 servicers, 4 trustees, 18 underwriters, and 4 rating agencies. The RTC established a unit to oversee their interest as seller, owner of the credit reserve fund, and residual holder for the outstanding securitization transactions. This unit (which was subsequently transferred to the FDIC) oversees all of the transaction participants by monitoring and evaluating all information related to these transactions. They produce the *Guide to RTC and FDIC Securities (Guide)* which provides details on the cash flow distributions for each transaction. The *Guide* is distributed monthly to more than 900 investors. In addition, the FDIC generates current profiles of RTC-FDIC securitization transactions that are displayed daily on the Bloomberg Financial Network.

The most significant ongoing activity that the FDIC performs in administering these securities is the “call termination” process. The pooling and servicing agreements govern the servicing of the RTC-FDIC securitized transactions. Each of these agreements contain “early termination” provisions that vary, but typically provide for termination of the trust when the current security balance is 25 percent, a benchmark common in residential transactions, or 10 percent of the original security balance, typically found in commercial transactions. When the security balances reach these levels, the trustee for the transaction is responsible for soliciting competitive bids for the remaining collateral. This process is known as the “auction call.” To the extent that the proceeds from a prospective auction satisfy the requirements of the termination price (enough funds are received to purchase outstanding securities), the trustee may complete the sale and retire the trust. If the bids do not satisfy the termination price, the trustee must decline to complete the sale and will solicit competitive bids from time to time until proceeds from the sale are sufficient to meet the termination price and to retire the trust. Upon termination of each trust, funds remaining in the credit enhancement reserves for each transaction are released to the FDIC. The FDIC, as owner of the residual, has a vested interest in ensuring that the trustee markets and conducts the call termination process in a manner that provides for maximum return on the remaining collateral in the trust.

The collateral security agreements, which govern the administration of the cash reserves, contain language that automatically allows a reduction in the reserve fund where certain benchmarks are met, as well as at the discretion of the FDIC, if the rating

agencies that rated the transactions confirm that, in their opinion, such a reduction would not adversely affect the rating on the certificates. As of June 30, 1997, the negotiations with the rating agencies under that alternative had resulted in the return of \$709 million of credit reserve funds to the FDIC.

Program Valuation

The RTC and FDIC securitization programs have been analyzed by numerous entities. Rating agencies, FDIC staff, and investment banks have conducted in-depth analyses of these transactions to measure the performance of the program and to provide information to the secondary mortgage markets. Each month, the trustee distributes a "Statement to Certificate Holders" to investors, rating agencies, underwriters, and the seller (the FDIC). This statement provides information on the performance of each security and its underlying collateral. It also includes original and current reserve fund balances; 30-, 60-, and 90-day delinquency data; foreclosure and REO figures; prepayment information; and realized losses. All of this information is categorized by loan group within each transaction.

Table I.16-5

RTC & FDIC Securitizations

As of June 30, 1997

(\$ in Millions)

Type and number of transactions	Bond Issues			Number of Loans			Credit Reserves		
	Original	As of June 30, 1997	Percent Decrease	Original	As of June 30, 1997	Percent Decrease	Original	As of June 30, 1997	Percent Decrease
Single-Family (41)	\$24,351.50	\$7,774.20	68.1	399,946	168,044	58.0	\$3,253.60	\$2,124.90	34.7
Multi-Family (11)	4,472.20	2,158.40	51.7	8,385	3,198	61.9	1,283.10	732.50	42.9
Commercial (18)	13,931.50	5,157.10	63.0	33,870	15,850	53.2	3,596.00	2,840.20	21.0
Mobile Home (3)	615.90	90.60	85.3	39,987	16,377	59.0	103.70	69.40	33.2
Home Equity (1)	311.49	0.00	100.0	17,600	0.00	100.0	39.40	0.00	100.0
Totals (74)	\$43,682.60	\$15,180.30	65.2%	499,788	203,469	59.4%	\$8,275.80	\$5,767.00	30.3%

Source: FDIC Division of Resolutions and Receiverships.

Realized losses are the primary factor used to measure the performance of securitizations. A realized loss is the unrecoverable amount of money that is deducted from the reserve fund after a delinquent loan is liquidated. In the RTC single-family securitizations, the master servicer is required to advance delinquent loan payments to the trustee until the property securing the loan is foreclosed upon and then sold. In multi-family/commercial securitizations, delinquent loan advances are funded directly from the credit reserve. When properties securing loans are liquidated, the sales proceeds are used to pay off the loan in full and to reimburse advances made by the servicer or through credit reserves. Payment shortfalls are recovered from the reserve fund. (For example, a servicer advances \$30 on a loan that has remaining an outstanding principal balance [after allowing for the \$30 in advances] of \$100. The property securing the loan is sold for \$85. Of the \$85, \$30 is refunded to the servicer for payment advances, and the remaining \$55 is applied to pay off the outstanding loan balance. Forty-five dollars is deducted from the credit reserve [the amount needed to pay off the loan in its entirety]. The realized loss to the credit reserve would thus be \$45.)

In December 1991, to accurately assess the risk exposure for securitization transactions, the RTC established a loss allowance for credit reserve funds for each transaction on the basis of Moody's actual loss experience for similar types of transactions. This approach provided a good initial methodology for calculating realized losses. From 1992 through 1994, actual losses were compared to estimated losses; it was discovered that loss estimates needed to be revised because Moody's methodology had no mechanism for changing estimates and no provision to incorporate actual loss experience. In 1994, while reviewing losses, the RTC staff also realized that some of the earlier securitizations would soon be subject to auction calls, and with the first early termination on the horizon, the RTC needed to ensure that terminations would be executed successfully and that the value of the residual would be maximized.

Given the importance of careful auction planning, coupled with the need to accurately determine risk exposure, the RTC devised a method to project each transaction termination date and to estimate realized losses. A model was developed to project cash flows for each transaction using available information on prepayments, delinquencies, defaults, and losses. It provides an estimate of credit reserve losses, termination dates, year-by-year cash flows, reserve funds, and residual values for each securitization. The model is run periodically using current information to generate up-to-date loss estimates and transaction terminations. (See table I.16-6.) The loss estimates are included in the FDIC's annual financial statement, which is audited by the General Accounting Office.

At the time of the closing, loss estimates for each securitization were provided by the RTC-FDIC financial adviser and by the rating agencies. In 1994, the RTC began to generate loss estimates using the model. In May 1996, the FDIC compared actual and expected loss estimates from the various sources. The comparison showed that the rating agencies were extremely conservative in their estimates, when compared to estimates by the model and the financial adviser. For example, rating agency-expected losses on the Multi-Family Securitization Program as a percentage of unpaid principal balances

averaged approximately 29 percent, the FDIC model loss estimates averaged 12 percent; the financial adviser estimated losses to be 7 percent, and the actual realized losses were approximately 7 percent. Overall, the losses and recovery rates that were initially estimated by the rating agencies were severely overstated for the RTC-FDIC securitization program, as shown in table I.16-7.

Recovery Rates

Sales price, transaction expenses, realized losses, and expected residuals are factors that are used to calculate recovery rates for the securitization program. The FDIC uses the model to estimate losses and to value the residual on transactions that have not been terminated. Actual realized losses and the residual returned to the FDIC are used to calculate recovery rates for terminated securitization transactions. Interest income (approximately \$25 million per month) is not included in the valuation of the cash reserve because the transaction trustees are directed to invest RTC cash reserve funds in Treasury securities. Consequently, the Treasury has immediate use of the money, and no opportunity cost is associated with the reserve funds. Estimated recovery rates for the single-family securitizations and the multi-family/commercial securitizations that have not been terminated are displayed in tables I.16-7 and I.16-8.

The RTC completed 44 single-family transactions and 27 multi-family and commercial securitization transactions, as well as 1 home equity transaction. As of July 1997, three securitizations had been terminated: one single-family, one multi-family, and one home equity loan transaction. In each of those transactions, the call termination provision was triggered, and the trustee auctioned off the remaining loan collateral. Bids for the collateral exceeded the outstanding security balance, thus enabling investors in the remaining bonds to be paid in full and the remaining credit reserve and residual to be released to the FDIC. Actual recovery rates for single-family and multi-family and commercial securitizations that have been terminated are displayed in table I.16-9.

By the time the RTC closed in December 1995, approximately \$24 billion of single-family mortgage loans were sold through the securitization structure for a gross weighted average price of 101.3 percent of the aggregate unpaid principal loan balance. Expenses constituted approximately 1 percent of the aggregate loan balance, thereby reducing the proceeds received on single-family securitization transactions to approximately 100.3 percent. The FDIC model estimated realized losses, residual values, and transaction termination dates; these figures were included to calculate net recovery rates. As of September 1997, the estimated net recovery rate on single-family securitizations that had not been terminated was 98.5 percent of the aggregate unpaid loan balances.

As of June 30, 1997, \$17.7 billion of multi-family and commercial mortgage loans had been securitized by the RTC and the FDIC. The FDIC continued to use securitization after the RTC closed in December 1995. The multi-family and commercial loans were sold through securitization for a gross weighted average price of 99.1 percent of the

aggregate unpaid principal loan balance. Expenses on commercial securitizations are approximately 1.5 percent of unpaid principal balances, thus reducing the proceeds received to approximately 95.6 percent. The inclusion of realized losses (which are generally expected to be high for commercial loans) produced an estimated net recovery rate of 90.7 percent. Expected residuals were not included in the recovery rate calculation on commercial securitizations because of the uncertainty of losses; losses on commercial mortgage securitization pools may occur in ways other than through loan liquidation. Loan modifications and discounted mortgage loans may result in reserve fund deductions. In 1994, the RTC and its special servicers decided that modified or amended mortgage loans and REO properties should be written down to their realizable value.

Table I.16-6

Projected Final Call Dates, Reserve and Residual Values

First Ten Residential Transactions

As of March 31, 1997

(\$ in Millions)

Transaction	Issue Date	Original Collateral Balance	Call Percent	Rate	Estimated Call	Initial Reserve	Released Reserve	Cumulative Loss to March 1997	March 1997 Reserve	Released and At Call Reserve	Loss March 1997 Forward	Moody's Total Loss	Model Total Loss	Residual NPV (0%)	Residual NPV (20%)
91-01	6/91	\$425.8	2	6/11	\$51.3	\$0.0	\$24.6	\$26.7	\$22.3	\$4.4	\$12.8	\$29.1	2.0	1.6	
91-02	7/91	579.6	10	6/99	133.3	84.4	15.1	33.8	29.7	4.1	19	19.2	59.7	37.6	
91-03	8/91	476.2	2	9/10	128.6	59.3	6.7	62.5	59.4	3.2	18.4	9.9	1.7	0.8	
91-04	8/91	453.4	10	10/00	79.5	44.3	4.6	30.6	29.5	1.1	14.9	5.7	40.5	19.6	
91-05	8/91	183.8	2	11/08	19.3	6.1	2.1	11.1	10	1.2	4.8	3.3	0.1	0	
91-06	9/91	606.3	10	8/01	127.3	60.4	7.1	59.8	56.9	2.9	18.2	10	0.2	0.1	
91-08	9/91	290.2	25	10/98	36.3	0.0	4.3	32	31.2	0.8	5.2	5	1.5	1.1	
91-09	9/91	211.7	12	8/97	17.5	0.0	17.5	0	0	0	2.6	17.5	2.7	2.4	
91-10	10/91	201.4	12	3/99	22.7	0.0	3.2	19.4	18.8	0.6	5.7	3.9	2.3	1.5	

Source: FDIC Division of Resolutions and Receiverships.

Losses on modified loans generally tend to offset or are larger than the expected residuals; consequently, expected residuals are not used to calculate net recovery rates.

On the RTC's single-family transactions, the recovery rates for securitizations were higher than original estimates by loan sales advisers. The reason for this discrepancy was that, initially, excess interest payments accelerated prepayments of the tranches in the security, which in turn created enormous residuals. From the inception of the securitization program through 1994, no value was given to the residuals created through securitizations. After 1994, more accurate residual information was generated through the model. The increase in the value of the residuals, combined with lower-than-expected losses generated recovery rates that were higher than anticipated for the securitization program overall.

Conclusion

The RTC managed the liquidation of \$402.6 billion (book value) in assets. Of this amount, approximately \$193 billion (about 48 percent) represented residential, multi-family, and commercial mortgages. More than \$42 billion (almost 22 percent of the mortgages and more than 10 percent of all of RTC's assets) were sold through the RTC's securitization program. When the RTC was dissolved on December 31, 1995, only \$8 billion of the original \$402.6 billion in assets remained to be liquidated. The RTC's liquidation program was therefore deemed successful. Some of that success must be credited to the securitization process. The securitization disposition strategy used by the RTC created new markets with strong participants. These strategies also paved the way for an increasing number and variety of issuers seeking convenient and expedient ways to recapitalize "nontraditional" mortgage loans.

Although the best disposition method for single-family mortgage loans may be to sell them directly to Fannie Mae or Freddie Mac, the majority of RTC single-family mortgage loans were nonconforming; that is, they were not eligible for sale to the agencies because of the stringent underwriting requirements demanded by Fannie Mae and Freddie Mac. The RTC therefore needed other alternatives.

RTC securitization transactions generally have performed well. As of June 30, 1997, of the 74 RTC and FDIC securitizations, only 3 experienced significant losses. Most of the losses were on transactions that were composed of loans that originated from a single institution with poor loan underwriting standards or from loans concentrated in a single state, which, in this case, was California. Through June 30, 1997, the credit rating agencies had downgraded five RTC transactions that fit into one of the previously mentioned categories. Diversification of loan pools for securitization results in better performance than homogenous pools from few institutions, or pools with loans located in one state. Although the credit support presently is adequate to cover losses, future adequacy depends on the losses sustained when the remaining assets are liquidated.

Securitization is not a panacea. Market conditions and loan quality appear to be the primary factors that need to be taken into consideration when determining the best disposition strategy for selling mortgage loans. In general, however, it appears that securitization was successful in helping the RTC—and to a lesser extent, the FDIC—achieve its goals.

Table I.16-7

**Credit Reserve Funds and
Expected and Actual Cumulative Realized Losses
As of March 31, 1997**

(\$ in Millions)

Transaction	Date Issued	OMB*	Rating Agency Credit Reserves		Estimated Realized Losses Percentage of OMB		Actual Cumulative Realized Losses	
			Balance	% of OMB	Financial Adviser	FDIC Model	% of OMB	Balance
1991-M1	8/29/91	\$373.3	\$130.6	35	9	15	10	\$37.4
1991-M2	9/24/91	452.6	122.2	27	7	27	24	108.8
1991-M3	9/26/91	183.3	49.5	27	7	23	13	23.5
1991-M4	10/30/91	413.2	107.4	26	7	16	11	46.3
1991-M5	11/26/91	386.8	116.0	30	8	6	3	12.6
1991-M6	12/23/91	651.5	162.9	25	6	15	8	50.3
1991-M7	12/30/91	240.5	69.7	29	7	4	2	6.0
1992-M1	1/29/92	290.6	87.2	30	8	9	4	12.6
1992-M2	3/30/92	520.1	156.0	30	8	6	3	13.6
1992-M3	4/29/92	526.7	158.0	30	8	9	3	16.2
1992-M4	5/28/92	447.7	120.9	27	7	6	1	5.5
Multi-Family		\$4,486.3	\$1,280.4	29	7	12	7	\$332.8

Continued next page

* Original Mortgage Balance

Source: FDIC Division of Resolutions and Receiverships.

Table I.16-7

**Credit Reserve Funds and
Expected and Actual Cumulative Realized Losses
As of March 31, 1997**

(\$ in Millions)

Continued

Transaction	Date Issued	OMB*	Rating Agency Credit Reserves		Estimated Realized Losses Percentage of OMB		Actual Cumulative Realized Losses	
			Balance	% of OMB	Financial Adviser	FDIC Model	% of OMB	Balance
1992-C1	2/27/92	\$496.6	\$148.1	30	8	5	2	\$9.6
1992-C2	3/30/92	370.8	107.5	29	8	11	4	13.3
1992-C3	4/30/92	483.4	144.1	30	4	8	3	15.6
1992-C4	6/30/92	936.0	280.8	30	4	6	2	16.1
1992-C5	7/30/92	884.4	247.1	28	4	7	2	18.4
1992-C6	9/30/92	823.1	246.9	30	5	10	7	54.7
1992-C7	9/29/92	892.8	259.2	29	8	9	4	33.8
1992-CHF	10/29/92	1,464.7	260.9	18	3	8	2	31.3
1992-C8	11/24/92	863.8	196.9	23	4	9	1	10.0
1993-C1	1/28/93	969.7	193.9	20	4	6	1	13.0
1993-C2	3/30/93	723.6	166.4	23	4	4	2	13.1
1993-C3	12/21/93	445.7	111.8	25	4	4	2	6.9
1994-C1	9/29/94	1,139.0	296.1	26	4	4	0	3.1
1994-C2	11/29/94	829.6	199.1	24	4	4	1	6.2
1995-C1	6/27/95	850.5	136.1	16	3	8	0	0.1
1995-C2	12/21/95	326.6	88.2	27	5	11	0	0
FDIC 1994 -C1	8/18/94	762.3	247.7	32	18	4	0	3.4
Commercial		\$13,262.6	\$3,330.8	25	5	7	2	\$248.6
Totals		\$17,748.9	\$4,611.2	26%	6%	8%	3%	\$581.4

* Original Mortgage Balance

Source: FDIC Division of Resolutions and Receiverships.

Table I.16-8

**Estimated Securitizations
All-In Recovery Rate
As of September 30, 1997**
(*\$ in Millions*)

Line		Single-Family	Multi-Family
1	Initial Mortgage Loan Balance	\$24,334	\$18,470
2	Gross Cash Proceeds	24,659	18,305
3	Credit Reserve Fund (initial)	3,079	4,879
4	Issuance Expenses	232	272
5	Net Cash at Closing (line 5 equals line 2 minus [line 3 + line 4])	21,348	13,154
6	Residual	140	38
7	Credit Reserve Fund Release	2,490	3,576
8	Total Cash Proceeds (line 8 equals line 5 + line 6 + line 7)	\$23,978	\$16,768
9	All-In Net Recovery Rate (line 9 equals line 8 divided by line 1)	98.5%	90.7%

Note: Residual estimates were present valued and discounted back to the transaction date.

Source: FDIC Division of Resolution and Receiverships.

Table I.16-9

Actual Terminated Transactions
All-In Recovery Rate

(\$ in Millions)

Line		Single-Family RTC 1991-7	Multi-Family RTC 1991-M7
	Date of Termination	February 25, 1997	June 25, 1997
1	Initial Mortgage Loan Balance	\$863.4	\$240.5
2	Gross Cash Proceeds	863.4	240.7
3	Credit Reserve Fund (initial)	174.0	69.7
4	Issuance Expenses	6.5	4.0
5	Net Cash at Closing (line 5 equals line 2 minus [line 3 + line 4])	682.9	167.0
6	Residual	24.1	7.8
7	Credit Reserve Fund Release	161.6	53.4
8	Total Cash Proceeds (line 8 equals line 5 + line 6 + line 7)	\$868.6	\$228.2
9	All-In Net Recovery Rate (line 9 equals line 8 divided by line 1)	100.6%	94.9%

Note: Residual estimates were present valued and discounted back to the transaction date.

Source: FDIC Division of Resolution and Receiverships.

Equity partnerships can be used as a vehicle to convey a large volume of assets to private-sector management in a relatively short period of time.



CHAPTER 17

Partnership Programs

Introduction

In the late 1980s and early 1990s, the Resolution Trust Corporation (RTC) and the Federal Deposit Insurance Corporation (FDIC) became custodians of an unprecedented number of assets from failed banks and thrifts. The agencies therefore had to develop innovative methods to manage and dispose of the assets. One of the RTC's methods, known as the equity partnership, was a joint venture between the public and private-sectors.¹ The equity partnership strategy was designed to yield recoveries with a higher present value than conventional sales methods by capturing the asset management efficiencies and expertise of the private sector while reserving for the FDIC and RTC the profit from improvement in inefficient markets or unpredictable events.

Although not new to either the public sector or the financial services industry, equity partnerships were new to the RTC and the FDIC. Before this period, neither agency had purposefully created partnerships for the management and disposition of assets, even though both agencies had entered into incentive-based contracts that "shared" recoveries through compensation with private-sector parties. However, none of those contracts were created to explicitly retain upside potential resulting from market recoveries or unpredictable events. In addition, none had caused third-party equity capital to be exposed to downside risk as a result of how well the third party managed the agency's assets assigned to it.

During the early 1990s, the RTC created 72 partnerships with a total asset book value of \$21.4 billion. The FDIC became a partner in two partnerships holding assets having a book value of approximately \$3.7 billion. This chapter reviews the types of

1. The term "equity partnerships" and the derivative terms therefrom pertain to an internal RTC reference to transactions where the RTC entered into partnership and/or trust relationships (as a limited partner) with private sector firms to market and manage assets.

partnerships that the RTC and the FDIC used. It surveys seven different types of equity partnerships in which the RTC acted as limited partner (LP), and reviews the structure and performance of the two Asset Management and Disposition Agreement (AMDA) partnerships in which the FDIC assumed the role of LP.

Background

The concept of having the RTC retain a residual interest in sold assets began in its earliest days.² In fact, the RTC strategic plan issued in December 1989 stated that the “RTC should explore ways . . . in which it can participate through passive equity interests in any extraordinary gains that might be realized by the acquirer of the asset.” However, it was not until December 1992 that the RTC executed its first joint venture transaction.

By the spring of 1992 several events had occurred that caused RTC management to focus on using partnerships as a disposition vehicle. Continued dissatisfaction with the pace of nonperforming asset disposition through customary methods, internal staffing constraints, difficulties in running a large asset management contracting program, pressure not to “sell at the bottom of the market,” and the initial success of the RTC’s securitization program all contributed to an environment that fostered the development of equity partnerships.³

However, arguably the most significant factor was the anecdotal evidence that investors purchasing large RTC asset portfolios leveraged their equity with financing from major financial institutions or by securitization within six months after acquisition. That indicated that the investors were quickly able to establish predictable cash flows from the assets, either by converting them to performing status or by obtaining payoffs that met the investors’ required rates of return. It also indicated that the RTC could obtain higher recoveries by offering such leverage to investors. Given the apparent success that asset portfolio purchasers achieved, RTC staff concluded that it would obtain greater returns if it held a residual capital position in a structure that provided investors a leveraged return. The vehicle for achieving that position was the equity partnership program.

Structure of the Equity Partnerships

Under the equity partnership program, the RTC established joint ventures between itself acting as LP and a private-sector investor, usually a joint venture between an equity

2. On December 31, 1995, the RTC ceased to operate and its functions were legally taken over by the FDIC. All of the equity partnerships originated while the RTC was in operation. To avoid confusion, all references to the limited partner, both before and after December 31, 1995, will generally be expressed as the RTC.

3. See Chapter 13, Auctions and Sealed Bid Sales, and Chapter 16, Securitizations.

investor and an asset management company, acting as general partner (GP). The RTC contributed asset pools (usually subperforming loans, nonperforming loans, and real estate owned [REO]) and arranged for financing of the partnership, while the GP invested equity capital and asset management services. The financing terms required that cash proceeds generated from the liquidation of assets be applied first to the retirement of the debt (usually bonds held by the RTC).⁴ After the debt was paid in full, the partners generally split the remaining proceeds according to the percentage of ownership each partner held. Thus, unlike a direct asset sale, the RTC retained a residual interest, which entitled it to receive some proceeds at closing and, as the assets were liquidated, to receive the remainder of the proceeds periodically throughout the life of the portfolio.

The RTC attempted to align the financial incentives for the LP and GP of the partnership to ensure that the assets in the portfolio would be liquidated in the most cost-effective and mutually profitable manner. RTC staff assumed that the investor's primary incentive would be to maximize the return on its investment. That incentive, by itself, was similar to the agency's objective of maximizing recovery from the asset. However, RTC staff were concerned that unless the partnership was structured properly, the GP could achieve its objective without a commensurate return to the RTC.⁵ Factors considered in structuring the partnerships included the size of the asset portfolio, the type of asset, the expected duration of the partnership, the amount of leverage to provide the investor, and the investors' expected equity capital rates of return.

Although the various types of equity partnerships have different structures, they share many common features. Some of those include the following:

- Proceeds from the disposition of the underlying equity partnership assets were distributed pro rata to both partners. Neither partner held a senior nor a subordinate position.
- All deals required the GP to acquire its interest in the partnership with cash. The RTC's capital contribution was the value of its share of assets conveyed to the partnership.
- The RTC provided funding for interim financing, or working capital, for the partnership.
- The representations and warranties the RTC provided as seller in the equity transactions were limited in their provisions compared with the terms of "normal"

4. In actuality, certain fees were subtracted before proceeds were applied to debt payment, such as fees incurred to create and sell the bonds, and certain asset management and liquidation expenses that were subject to a cap.

5. The RTC had intensively studied the Federal Savings and Loan Insurance Corporation (FSLIC) assistance agreements and concluded that conflicting incentives to prolong the disposition of assets were created when asset managers were given yield subsidies or reimbursement of holding costs rather than compensation derived from asset sales.

financial industry and typical RTC transactions.⁶

- Each agreement prohibited the GP from certain actions, including self-dealing, unless preapproved by the RTC. The agreements prohibited affiliate transactions in the equity partnerships structured as trusts, but permitted them, with notice, in the Multiple Investor Fund (MIF) and Judgments, Deficiencies, and Charge-offs (JDC) partnerships. (The MIF and JDC partnerships are discussed later in this chapter.)
- The GP had full delegated responsibility to conduct the partnership's day-to-day business affairs, such as managing, servicing, and disposing of the assets in the portfolio. The partnership agreement allowed for subcontracting management, disposition, and support functions, if necessary.
- The GP was required to contract with an external accounting firm to perform an annual audit and certify the partnership's financial statements.
- Each partnership reimbursed certain GP expenses that were specified in the agreement. Reimbursement of those expenses was contingent upon the GP's compliance with the partnership's policies.
- The GP had the right to transfer its interest in the partnership upon approval of the LP. The LP, however, had the right to transfer its interest without the GP's consent.
- The LP had the right to remove the GP for cause upon breach of certain covenants and if certain events occurred. In the event of such a removal, the LP had the right to appoint a new GP.

The Evolution and Types of Equity Partnerships

The 72 equity partnerships the RTC created from December 1992 through October 1995 included assets with a total book value of \$21.4 billion and a derived investment value (DIV) of \$3.8 billion.⁷ The following discussion provides a summary of each of the seven types of partnership transactions.

6. For example, although the representations and warranties given by the RTC in the Multiple Investor Fund (MIF) transactions are comparable to those given in whole loan or portfolio sale transactions, the recourse against the RTC is more limited. With most representations, the RTC would not be obligated to pay losses unless the MIF itself did not have sufficient funds to make a payment on its rated debt securities. In other words, the RTC's representations and warranties apply only to the MIF's debtholders and not to its equityholders, and the MIF's equity must be exhausted before the RTC must pay a claim.

7. The DIV is an internal RTC reference to a discounted cash flow valuation for nonperforming asset pools. The DIV is discussed more thoroughly later in this chapter. A DIV was not performed for any of the assets in the JDC program, therefore the DIV total represents the sum of the other six equity partnership types.

N Series

In December 1992, the RTC created the first type of equity partnership, known as the Nonperforming Loan Series for large investors, or N Series. The RTC consummated six N Series transactions, each with an estimated life of five years. Established to move a large volume of identified assets in a single transaction, the average N Series partnership transaction had a book value of \$464 million and a DIV of \$220 million and was targeted for the institutional investor.

The N Series portfolios were made up of commercial and multi-family subperforming and nonperforming mortgage loans. The RTC placed more than 2,600 loans with a book value of approximately \$2.8 billion into the N Series transactions. Those assets had a total DIV of \$1.3 billion. The asset portfolios of the N Series transactions were generally geographically diverse (compared with the later S Series, in which assets were grouped regionally).

The GP in the N Series transactions, which were legally structured as trusts, usually consisted of an investor teamed with an asset management firm.⁸ The RTC sold an asset portfolio to the trust in exchange for cash, Class A certificates representing a 49 percent interest in the trust, and Class B certificates representing the remaining 51 percent interest. The GP (a large investor) purchased the Class A certificates from the RTC. Those certificates provided rights to the investor similar to those that a general partnership interest would have provided in a partnership. The RTC retained the Class B certificates.

The trust issued bonds to third-party institutional investors through open market transactions and used proceeds from the bonds to purchase the assets from the RTC.⁹ A total of \$974.9 million in bonds were issued for the six N Series transactions. Typically, the amount of bonds issued by the trust represented 60 percent of the value of the trust assets before bond issuance. As assets were liquidated, the trust first used proceeds to retire the bonds issued, then distributed remaining proceeds proportionally to the Class A and B certificate holders for the remaining 40 percent value of the trust.

By issuing bonds to third-party investors in the transactions, the RTC obtained several benefits. Most importantly, the RTC received large cash inflows at a time when the RTC needed funds for operations. Secondly, the amount of capital that prospective investors needed to place at risk was reduced and leveraged, thereby creating more interest and competition. In addition, rating agencies and bondholders provided additional

8. Equity partnerships structured as trusts shared some common characteristics. For example, the partners own the trust, and the trust has title to the assets. An independent trustee acts on behalf of the trust and takes direction from the Class A certificate holder (GP), as defined in the legal documents. The trust is a legal entity that accommodates the issuance of securitized debt more readily than does a partnership structure.

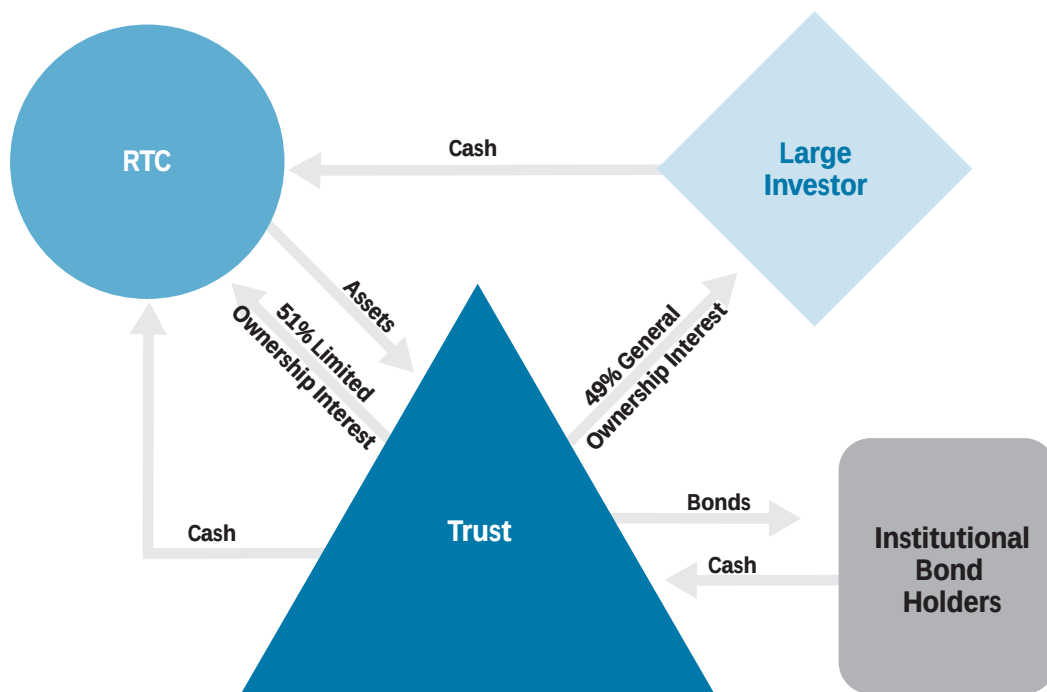
9. In accordance with general market practice, the trust issued and administered the bonds through a separate third-party trustee.

scrutiny to the GP's performance. However, those benefits did increase the execution cost of the transaction. Chart I.17-1 illustrates the structure of the N Series trust.

After a short time, one phenomenon soon became evident: the GP generated cash so quickly from the asset portfolio that the bonds were paid off much earlier than anticipated. For example, the original maturity date for each of the bonds was 10 years from the transaction closing date. All of the bonds were retired, however, after just 28 months, with the average bond being retired in 21 months. Because the bonds were retired so quickly, the RTC determined that, given the additional processing time, transaction expense, and cost of borrowing, selling bonds on the open market was not effective. That fact led to the development of the next generation of equity partnerships, starting with the S Series in September 1993 (discussed later in this chapter), in which bonds were issued by a trust, but were held by a trustee on behalf of the RTC.

Chart 1.17-1

Structure of N Series Trust



Source: FDIC Division of Resolutions and Receiverships.

MIF Series

In January 1993, the RTC completed two Multiple Investor Fund partnerships, also known as the MIF Series, which followed the N Series. Although each had a specified term of 20 years, the GPs estimated that their portfolios would be liquidated in considerably less time. Also designed to sell a large volume of assets in a single transaction, the two MIF transactions included more than 1,000 loans with a book value of \$2 billion and a DIV of \$982 million. However, the MIF Series differed from the N Series in that investors did not bid on specifically identified assets.

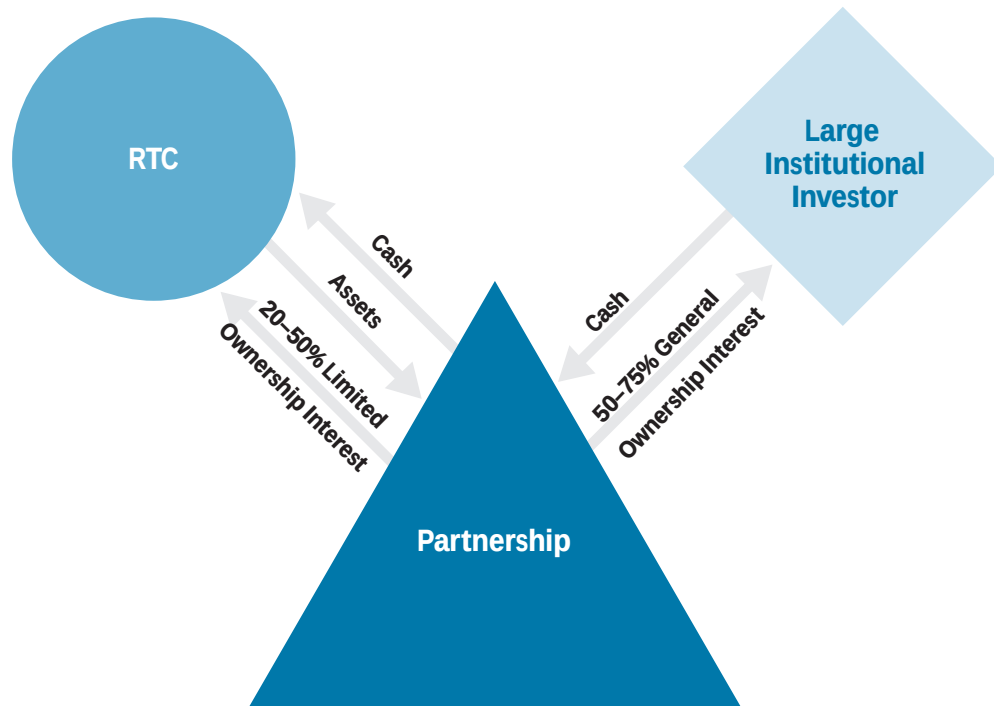
After a widely advertised and highly competitive process, the RTC selected private-sector entities (MIF sponsors) to become the GPs for the MIFs on the basis of their bids for a “blind pool” of unidentified assets that met certain parameters regarding asset size, asset type, and location.¹⁰ To compensate for having to accept virtually all assets delivered at closing, the partnerships had an absolute “Kick Out Right” to require the RTC to repurchase, within a specified period of time, certain assets determined by the GP to be unacceptable. The RTC’s requirement to repurchase assets under the terms of the Kick Out Right was limited to 10 percent of the partnership’s assets as measured by DIV. Although the MIF partnerships were bid in a competitive environment, some terms of the agreement were negotiated later with the winning bidder. The typical underlying assets contributed by the RTC into the MIF partnerships included commercial and multi-family performing and nonperforming mortgage loans and some REO.

The MIFs were legally structured as partnerships. The RTC acted as LP and owned a 25 percent to 50 percent partnership interest, while the GP held a 50 percent to 75 percent interest. Although the MIFs did not formally issue bonds, they did have a bond-equivalent debt feature in which the bond-equivalent debt was secured by the GP’s interest in the partnership.¹¹ The RTC held the note for that debt. The MIF’s first priority for distributing the proceeds was to repay the note due to the RTC; it would then distribute the rest of the proceeds pro rata on the basis of the original ownership interest for the remaining value of the partnership’s portfolio. The bond equivalents for the two MIFs totaled \$497 million; all were retired within 26 months. Chart I.17-2 illustrates the structure of the MIF partnership.

10. Although only two MIFs were completed, three MIFs had actually been slated. One of the MIF sponsors was forced to back out at the last minute when its third-party financing fell through. That was one of the situations that pointed to the need for RTC seller financing to help avoid repeating such a predicament in the future.

11. Certain representations and warranties made by the RTC were for the benefit of prospective bondholders had the RTC interim financing been replaced by a securitization. Because the interim financing was retired through internal cash flows rather than through a securitization, the bondholder representations never went into effect.

Chart 1.17-2

Structure of MIF Partnership

Source: FDIC Division of Resolutions and Receiverships.

Land Funds

In July 1993, the RTC created land funds, the third type of equity partnership. Three land fund offerings spawned 12 partnerships. Designed to share in the profit from long-term recovery and the development of land, each partnership had a defined term of 30 years. The offerings had multiple pools of performing and nonperforming loans and real estate in various stages of development, generally either undeveloped or partially developed land. The 12 land funds included more than 815 assets with a book value of \$2.2 billion and a DIV of \$641 million. The average land fund transaction had a book value of \$185 million and a DIV of \$53 million. The RTC targeted the land fund for the smaller local investor to attract as wide an audience as possible.¹²

12. Catering to the small investor started with the land fund transactions and continued to be a strong factor in future equity partnership offerings, particularly the S Series.

The land fund transactions had the legal structure of a partnership. The GP was usually an asset manager and developer, which was a unique combination of skills for a GP in the equity partnership program. Such expertise was necessary to maximize the value of the land, which was among the most deeply discounted assets in the RTC's portfolio.

In the land fund transaction, the partnership bears the cost of developing the land and deducts expenses before distributing proceeds to the partners. The GP has the right and duty to enhance the value of the partnership. Should the cost to develop a certain asset exceed the limitations of the partnership, the GP can seek third-party sources for additional funding. The GP must secure the LP's consent on that additional financing before the GP can go forward; if the LP withholds consent, the GP must reconsider its plans for that asset.

Given the nature of the assets, the RTC added a special feature to the marketing of that type of partnership that allowed investors flexibility and options. At closing, the GP could choose to contribute 25, 30, 35, or 40 percent of equity and assume a like ownership percentage. The RTC as LP would automatically own the inverse interest percentage.

As assets are liquidated, proceeds are applied first to operating expenses and then to the repayment of the original capital investment amounts pro rata to the GP and LP. After the original investments are recouped, the additional proceeds are then split 50-50 between the GP and LP (to give the GP an incentive to liquidate the rest of the portfolio) for the remaining life of the portfolio and the value of the partnership. Chart I.17-3 illustrates the structure of a land fund partnership.

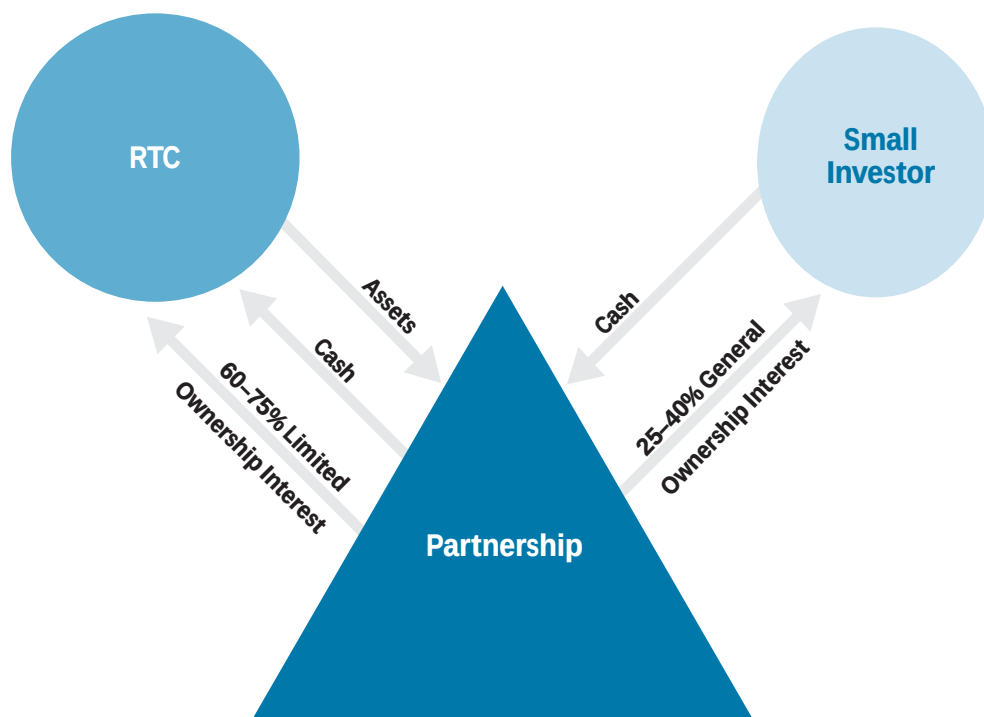
S Series

Starting in September 1993, the RTC began the Small Investor Series, or S Series, equity partnerships. The S Series was specifically targeted for smaller investors as opposed to the N Series or MIFs. Although the assets included in the S Series were of the same individual size and type as in the N Series (typically, commercial and multi-family subperforming and nonperforming mortgage loans), the pools were smaller to enable the smaller investor to participate. The RTC contributed more than 1,100 loans with a total book value of approximately \$1 billion and a DIV of \$466 million to those partnerships. The average S Series transaction had a book value of \$113 million, a DIV of \$52 million, and an estimated life of four years. Nine S Series transactions were completed.

The need to develop the S Series arose from the perception that the RTC was structuring its sales so that only firms with substantial capital would be eligible to compete. Starting in 1993, the RTC gave small investors increased importance by reaching out to them through advertising and designing transactions that conveyed smaller asset portfolios. The change in strategy ultimately worked in the RTC's favor because it opened up the pool of potential investors, resulting in greater competition and higher sales prices.

A unique characteristic of the S Series is that the assets were grouped geographically so that the small investor would have an easier, less costly due diligence process. The following information from the RTC brochure "Small Investor Program" highlights differences between the S and N Series transactions:

Chart 1.17-3

Structure of Land Fund Partnership

Source: FDIC Division of Resolutions and Receiverships.

- The transaction would range in size from \$25 million to \$60 million in market value. That size required that investors provide only \$4 million to \$9 million in private equity, rather than the \$30 million to \$70 million required for the N Series.
- Some of the debt created from the S Series would be retained by the RTC, whereas with the N Series it was all sold to investors.
- The financial adviser would qualify servicers on the basis of their ability to manage assets rather than on rating agency evaluations, which can be lengthy and cost-prohibitive for small firms.

The S Series transactions were legally structured as trusts, which issued bonds that were held by a trustee on behalf of the RTC. The bond debt typically represented 60 percent of the value of the trust. Altogether, the trust issued bonds in the amount of \$284.3 million for the nine S Series trusts. The original maturity date of each bond was 10 years after the transaction closing date. All bonds were retired after 22 months, with

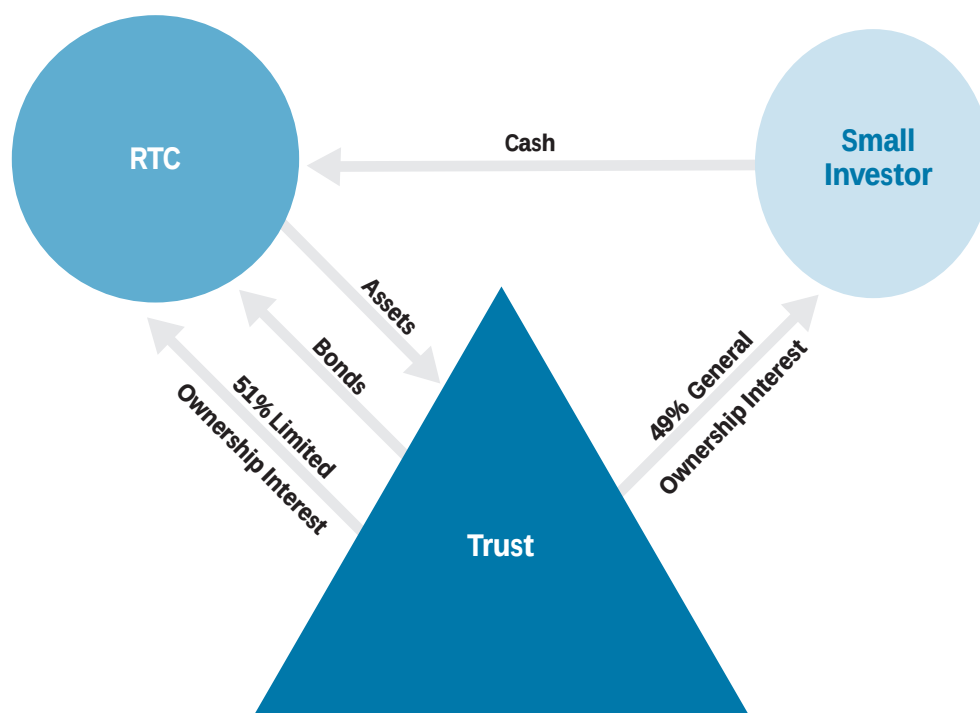
the average bond being retired within 16 months. The GP (a small investor) owned a 49 percent interest in the trust through its ownership of all outstanding Class A certificates. The RTC, acting as LP, held Class B certificates and owned a 51 percent interest in the trust. As assets were liquidated, the proceeds were used first to pay off the bonds until they were retired. For the remaining 40 percent value of the trust, the proceeds were then distributed with 51 percent going to the LP (Class B holder) and 49 percent to the GP (Class A holder) until all assets were liquidated. Chart I.17-4 illustrates the structure of the S Series trust.

Judgments, Deficiencies, and Charge-offs

In December 1993, the RTC initiated the JDC equity partnership program and set up 30 partnerships. The JDC agreements specified a five-year term, with either partner having the option to terminate the agreement after the third year and on each anniversary thereafter, providing that six months' notice was given. Because the assets the RTC contributed to the partnership were impaired by legal constraints or were unsecured and

Chart 1.17-4

Structure of S Series Trust



Source: FDIC Division of Resolutions and Receiverships.

of poor quality, the JDC partnerships typically had a GP that included a firm with collection experience.

The JDC program is the only type of equity partnership that allowed assets to be transferred to the partnerships not only at the beginning of the partnerships but also throughout their life, as pools became available.¹³ As of September 30, 1997, the JDC partnerships had received approximately 137,000 assets with a total book value of \$12.4 billion, which were small balance assets with a book value of approximately \$291 million and JDC assets with a book value of about \$12.1 billion.¹⁴ The average JDC partnership's book value was equal to about \$414 million.

The JDC equity partnership transactions were legally structured as partnerships. The RTC's contribution to the partnership was at an established value of 1 percent of the book value of the JDC assets and of 20 percent of the book value for the small balance assets. Because the true value of the assets to be transferred by the RTC into the various partnerships could not be accurately determined, the RTC established a policy at the outset of the JDC program to value the asset contributions in that manner. The RTC based the valuation methodology loosely upon the RTC's historic recovery rates on JDC assets disposed of through auctions and sealed bids.

The GP contributed cash equal to 0.0101 percent of the assets' book value for JDCs and 0.2 percent of the assets' book value for small balance assets. The first 10 percent of gross collections from the JDCs resolved by the partnerships were placed in a reserve account to cover certain qualified expenses (such as the LP's portion of costs to establish the partnership, annual audit fees, and asset expense reimbursement requests approved by the LP). Remaining collections were distributed with 80 percent going to the LP and 20 percent to the GP for small balance assets and split 50-50 for JDC assets.

The reserve account arrangement was unique to the JDC program. The partnership was generally prohibited from selling assets except during the last six months before the termination of the partnership, unless the LP approved an exception. If, at the end of the partnership, the RTC had not recouped its initial investment, it was entitled to receive 99 percent of the funds remaining in the reserve account. If the RTC had recovered its original investment, the reserve account was to be split 50-50 between the LP and the GP after qualified expenses had been paid.

13. The JDC agreements specified that the partnerships were to receive initial transfers of asset pools in the amount of either \$100 million or \$300 million. After the partnerships received their specified allocation, however, additional transfers of asset pools were reserved for only the most qualified partnerships remaining. The LP ranked the partnerships on a regular basis, primarily by asset disposition performance and compliance of the GP with the terms of the agreement.

14. At the beginning of the JDC program, small balance assets that came from the RTC had to be no larger than \$100,000 in book value to qualify for inclusion in the JDC partnerships; that amount was amended in the fourth quarter of 1995 to be no larger than \$500,000. Although the FDIC began transferring JDC assets that came initially from the FDIC into the partnerships in 1996, no small balance assets of any size that originated from the FDIC were ever allowed into the JDC program. In addition, all JDCs, whether they came initially from the RTC or the FDIC, could be included in the JDC program without regard to their book value.

The GP was expected to fund all expenses of the partnership except those qualified expenses designated to be paid out of the reserve account, as noted above. The partnership agreement required the GP to maintain a minimum balance in the reserve account of at least \$100,000 at all times. If the initial capital contribution in the reserve account was less than \$100,000, the GP could not use the reserve account funds until the \$100,000 minimum level was met; the GP then had to maintain that minimum level.

Because the GP had been required to put up so little of its own money to establish an equity position in the partnership, the qualified expenses of the partnership could quickly erode the reserve account to the required minimum level. A provision in the JDC agreement allowed the GP to submit a request to the LP to approve the use of reserve account funds to cover asset-related expenses under certain conditions, for example, if the estimated recovery for an asset was no less than \$100,000 and the actual expenses were greater than 30 percent of the actual recovery. If those conditions were met, the LP could approve payment from the reserve account in an amount determined to be the lesser of either 80 percent of actual expenses or 80 percent of the estimated expenses (or whatever was determined by both partners to be in the best interest of the partnership). Under the JDC equity partnership structure, the LP was under no obligation to approve the GP's reimbursement requests. That situation illustrated a misalignment of the financial incentives between the partners. Chart I.17-5 illustrates the structure of the JDC partnership.

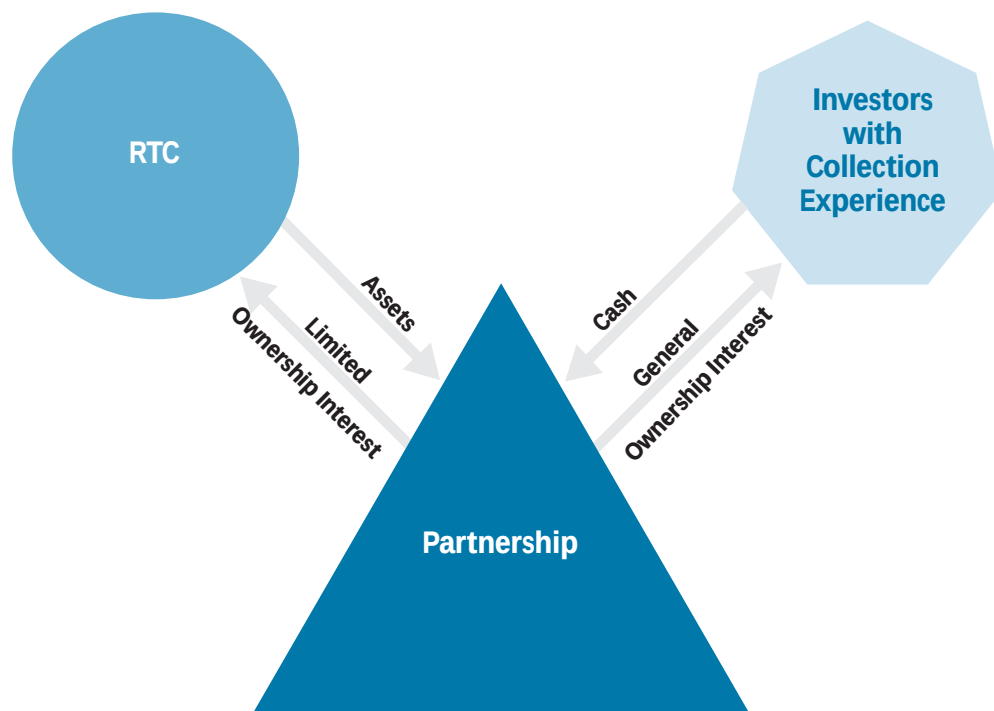
SN Series

In August 1995, the RTC launched the sixth type of equity partnership, the SN Series. Five SN Series transactions were completed with an estimated life of three years. The average book value of an SN Series transaction was \$88 million with a DIV of \$45 million. The SN Series combined aspects of the S and N series so that the RTC could market the SN Series to both smaller and larger investors. The unique feature of the SN Series equity partnership type was that investors could bid either on certain pools or on all of the pools as a whole. The RTC would accept that combination of bids (or bid) that resulted in the highest recovery.

Typical underlying assets for the SN Series were nonperforming commercial mortgage loans. (In comparison, both the S and N series held nonperforming commercial and multi-family mortgage loans.) The RTC contributed more than 500 loans to the SN Series transactions, which had a total book value of \$440 million and a DIV of \$225 million.

Like the S Series, the SN Series transactions were legally structured as trusts, which issued bonds that were held by a trustee on behalf of the RTC. The bond debt typically represented 60 percent of the value of the trust. The GP (either a large or a small investor) owned 49 percent interest in the trust and was a Class A certificate holder. The RTC, acting as LP, held Class B certificates and owned a 51 percent interest in the trust. As assets were liquidated, the trust first used the proceeds to pay off the bonds until they

Chart 1.17-5

Structure of JDC Partnership

Source: FDIC Division of Resolutions and Receiverships.

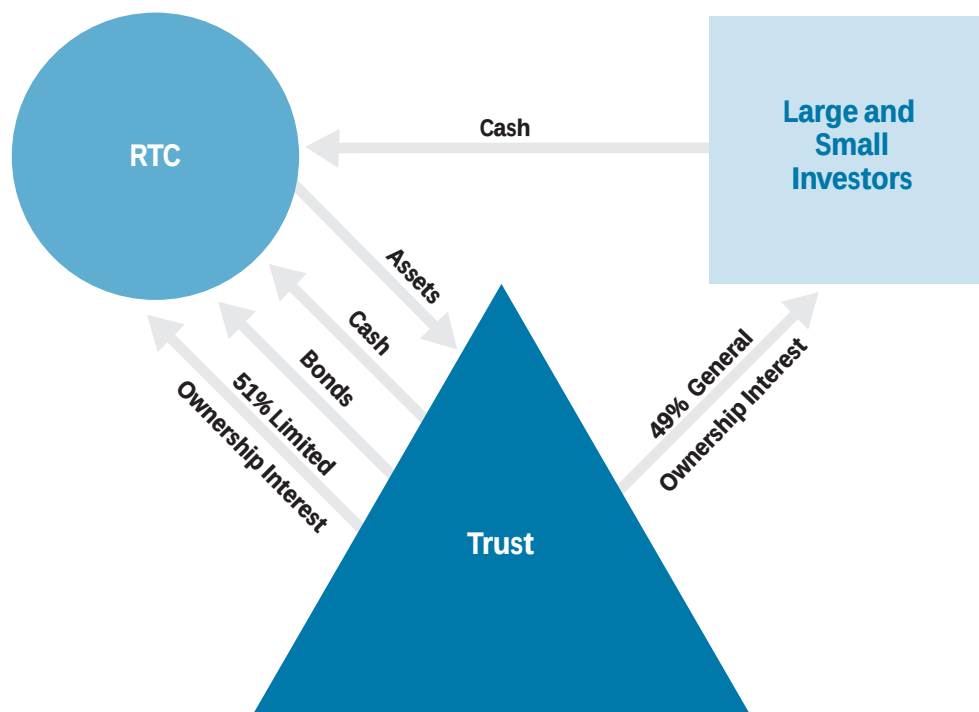
were retired. For the remaining 40 percent value, the trust distributed proceeds with 51 percent going to the LP (Class B holder) and 49 percent to the GP (Class A holder) until all assets were liquidated. A total of \$135 million in bonds were issued for the five SN Series transactions and held by the RTC. As of August 1997, all bonds have been retired except for one bond issue with an outstanding balance of \$5.5 million. Chart I.17-6 illustrates the structure of the SN Series trust.

NP Series

The seventh equity partnership type, the Nonperforming Loan Series for small investors, or NP Series, began in August of 1995, and eight NP Series transactions were completed. They were geared toward the small investor and were marketed near the RTC's closing date (December 31, 1995). The NP Series, which was the smallest of all the equity partnership types, had an average book value of \$67 million and a DIV of \$15 million. Each transaction had an estimated life of three years.

Chart 1.17-6

Structure of SN Series Trust



Source: FDIC Division of Resolutions and Receiverships.

The NP Series transactions were the hardest-to-sell assets in the RTC's portfolio, because they were the true nonperforming loans. Typical underlying assets included (1) nonperforming land loans and land REO, (2) unsecured loans or loans secured by non-real estate collateral (such as business loans), and (3) nonperforming commercial real estate and REO (commercial and multi-family). The RTC contributed more than 623 loans to those eight transactions. The loans had a total book value of \$537 million and a DIV of \$119 million.

The NP Series transactions were legally structured as trusts. The private-sector bidder was given the option to bid at 20, 30, 40, or 50 percent levels of equity ownership in the trust. That option allowed bidders to choose the amount of capital they wished to expose to the perceived risk/return characteristics of the portfolio. Choosing a lower versus a higher percentage of ownership, however, did not "leverage" the buyer's equity investment. The RTC sold its asset portfolio to the trust in exchange for cash, Class A certificates representing 30 percent to 50 percent interest in the trust (because no bids were successful at the 20 percent ownership level), and Class B certificates representing

the remaining 50 percent to 70 percent interest in the trust. The GP (a small investor) purchased the Class A certificates from the RTC, and the RTC retained the Class B certificates.

The trust issued bonds that were held by a trustee for the RTC.¹⁵ As assets were liquidated, the trust used the proceeds first to pay off the bonds until they were retired, and then distributed the remaining proceeds to the LP and GP pro rata for the remaining value of the trust. Only three of the eight NP Series equity partnerships issued bonds. For the three partnerships, \$33.6 million in bonds were issued with an original maturity of 10 years. All of the bonds, however, were fully retired after only eight months. Chart I.17-7 illustrates the structure of the NP Series trust.

Measuring the Success of the Partnerships: Recovery Results

The success of any program should be determined by whether it achieved its objective. As stated in the introduction to this chapter, the equity partnerships were established to obtain higher present value recoveries than conventional methods could by capturing the management efficiency and expertise of the private sector, while reserving for the RTC potential profit from the improvement of inefficient markets or unexpected events. That asset management and disposition strategy also allowed the RTC to move a large number of assets off of its books. This section examines two indicators that can be used to determine the achievement of that objective.

Recovery on Book Value

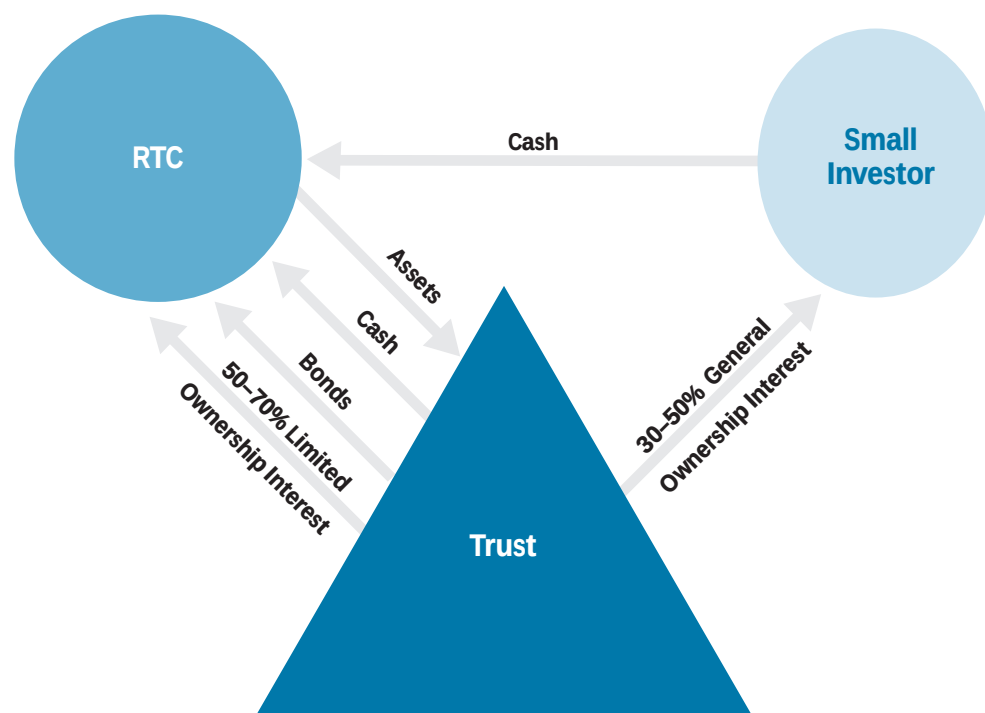
A common tool that the RTC and FDIC management use to measure sales results is the net rate of recovery on the book value (recovery rate) of the assets. That analysis is attractive because recovery rate information is available on virtually every transaction.

The recovery rate is calculated as the net proceeds from the transaction divided by the initial book value of the assets. When comparing the recovery rates achieved by equity partnerships holding commercial and multi-family real estate assets with other disposition strategies employed by the RTC, the performance of the equity partnerships outpaced all other strategies. Although the recovery rates for equity partnerships holding land and construction assets were competitive with other RTC strategies (see table I.17-1), when the recoveries of those same equity partnerships are compared to the DIV, their recovery rates are superior (see table I.17-2).

The recovery rate analysis, however, has some inherent shortcomings. For instance, (1) asset characteristics among comparison pools may not be similar enough for recovery rates to be a meaningful indicator for performance, and (2) the book value derived

15. No bonds were issued for the first five of the eight NP Series equity partnerships.

Chart 1.17-7

Structure of NP Series Trust

Source: FDIC Division of Resolutions and Receiverships.

from accounting records may reflect historical prices adjusted inconsistently from asset pool to asset pool for such items as expenses, income, and legal costs. Considering the first and second shortcomings separately and especially together, viewing the book value approach alone can result in misanalysis. However, when employed with an analysis of recovery on estimated value, recovery on book value can validate overall performance.

Recovery on Estimated Value

Derived Investment Value is an RTC valuation methodology similar to discounted cash flow methodologies typically used by the financial industry to value nonperforming loans. In general, the DIV is a means of calculating the present value of future cash flows expected from liquidating a nonperforming asset net of expenses. It was used to establish reserve prices for portfolio (bulk) sales of nonperforming assets.

Because DIV is a valuation methodology that was used for various types of RTC disposition strategies, a comparison of recovery as a percentage of DIV among RTC

Table I.17-1

**Recovery Rates Achieved by the RTC
RTC Equity Partnerships Compared by Asset Type
Stated As a Percentage of Book Value**
(*\$ in Millions*)

Disposition Strategy for Commercial/Multi-Family Assets			
	NPV of Actual and Projected Collections*	Book Value	Collections as a Percentage of Book Value
SN Series	\$254	\$440	58
N Series	1,573	2,782	57
S Series	571	1,019	56
MIF Series	995	2,034	49
Auctions	211	466	45
MAST (Multi-Asset Sales Transactions) Seller Financing	887	2,053	43
Sealed Bids	3,132	7,472	42
Disposition Strategy for Land and Construction Assets			
Auctions	\$122	\$259	47
Sealed Bids	122	407	30
NP Series	145	537	27
Land Funds	592	2,218	27
MAST Seller Financing	279	1,057	26

Equity partnerships are shown in bold type. The NP Series also contained commercial loans. The RTC data regarding other non-equity partnership transactions is as of June 30, 1995, which was the last time the RTC reported those types of transactions.

* RTC recoveries for the equity partnerships are net of expenses, which are paid by the partnership before distribution. Those recoveries were discounted at a rate representing the three-year Treasury constant maturity rate per Federal Reserve Economic Data to date for actual bond and equity proceeds received through June 30, 1997. Projected bond and equity proceeds from July 1, 1997, through each transaction's estimated termination date were discounted at 8 percent. Termination dates are based on the transaction-specific business plans received from each GP managing an equity partnership. Those recovery rates reflect financing provided by the RTC to the GP, if applicable. The RTC disposition strategies of auctions and sealed bids were done on a cash basis. The MAST seller financing recovery represents net proceeds received at closing and the face value of the note.

Source: FDIC Division of Resolutions and Receiverships (equity partnerships) and RTC Division of Asset Management and Sales (other transaction types).

Table I.17-2

Recovery Rates Achieved by the RTC
RTC Equity Partnerships Compared by Asset Type
Stated As a Percentage of Derived Investment Value*
(\$ in Millions)

Disposition Strategy for Commercial/Multi-family Assets			
	NPV of Actual and Projected Collections*	DIV	Collections as a Percentage of DIV
S Series	\$571	\$466	123
N Series	1,573	1,321	119
SN Series	254	225	113
MAST Seller Financing	887	795	112
MIF Series	995	982	101
Sealed Bids	3,132	3,830	82
Auctions	211	NA [†]	NA
Disposition Strategy for Land and Construction Assets			
NP Series	\$145	\$119	122
Land Funds	592	640	93
MAST Seller Financing	279	306	91
Sealed Bids	122	163	75
Auctions	122	NA	NA

Equity partnerships are shown in bold type. The NP Series also contained commercial loans. The RTC data regarding other non-equity partnership transactions is as of June 30, 1995, which was the last time the RTC reported those types of transactions.

* For transactions conducted before March 1994, the RTC's DIV methodology permitted the use of discount rates ranging from 14 to 25 percent for nonperforming assets. After March 1994, expected cash flows were discounted at rates between 12 and 22 percent.

[†] Not applicable.

Source: FDIC Division of Resolutions and Receiverships (equity partnerships) and RTC Division of Asset Management and Sales (other transaction types).

disposition strategies can reflect the performance of the equity partnerships in comparison with the other strategies. This comparison shows that the equity partnerships had better overall recoveries relative to DIVs. See table I.17-2 for a summary of recovery rates achieved by the RTC.

Like the recovery on book value analysis discussed previously, a number of potential issues could limit the value of using recovery on estimated performance. For example, although DIV is calculated using a narrow range of standard assumptions, the valuation process is still vulnerable to the subjectivity of the various analysts performing the calculations. In addition, the DIV calculations for assets in the S and NP Series transactions were calculated using a revised DIV methodology that generally would result in a higher valuation estimate than would the DIV methodology used for the other transactions.

Although the above analyses attempt to quantify the recoveries experienced from both equity partnerships and traditional liquidation methods, the limitations inherent in the analyses allow for only broad, summary observations. However, taken together, the analyses seem to indicate that the equity partnership structure achieved superior recoveries for the RTC.

It is important to note that certain items, such as the RTC's cost of oversight for the equity partnership program, have not been included in the recovery analyses. Other items, such as the expenses associated with the cost of GAO and FDIC OIG audits and reviews, have not been included for any of the RTC programs. To what extent such expenses vary for particular equity partnerships, partnership types, or the equity partnership program as a whole is unknown.

Evaluation of the Results of the JDC Partnership Program

The RTC deliberately did not value JDCs before their sale to JDC partnerships to avoid the cost of due diligence and valuation on assets that inherently have little or no value. Accordingly, the only method to evaluate recovery performance is to compare their initial contribution value of 1 percent of book value with the current estimate of projected proceeds. Table I.17-3 shows the anticipated recovery rate calculation for the JDC program as of September 30, 1997.

An analysis of the JDC program recovery rate suggests that the RTC may not expect to recover its initial investment. This analysis does not take into account, however, the costs that would have been incurred either directly or indirectly had the assets been held and managed by the RTC directly, including the cost to perform due diligence on the assets to determine whether they were collectible or had value. In fact, approximately 50 percent of the total book value of what was considered the worst of the JDC assets transferred to the partnerships was written off as uncollectible by the partnerships.

Furthermore, the recovery rate of the JDC GP is overstated because the calculation does not take into consideration the expense of pursuing collection on the assets, which was borne completely by the GP (except when the GP petitioned the LP for release of

Table I.17-3

**Recovery Rate Achieved by the RTC
for the JDC Equity Partnership Program**
(*\$ in Millions*)

	LP	GP
Initial Contribution	\$170.0 ^a	\$1.8 ^b
Actual Collections to Date	\$54.8	\$54.8
Projected Collections	+18.6 ^c	+9.6
Total, Actual and Projected Collections	\$73.4	\$64.4
Projected Recovery Rate	43.2%	3,577.8% ^d

^a Estimated to be the corporate purchase amount, which is 1 percent of the book value of the underlying JDCs and 20 percent of the book value of the SBA assets at the time of delivery into the partnerships.

^b Estimated to be 0.0101 percent of the book value for JDC assets and 0.20 percent of the book value of the SBA assets at the time of delivery into the partnerships.

^c Includes estimated future RTC asset collection distributions as well as the expected distributions from the reserve account.

^d This calculation does not include the expense of pursuing collection on the assets, which amount was paid solely by the GP, as these amounts are unknown.

Source: FDIC Division of Finance and Division of Resolutions and Receiverships.

funds in the reserve account to cover certain expenses, as described earlier). The actual amount of the expenses that the GP paid to pursue collections is not known.

Strengths and Weaknesses of Equity Partnerships

One strength of the equity partnerships was that carefully aligned financial incentives encouraged the GP to maximize return while minimizing the holding period of the assets. Those incentives created a single-mindedness between the LP and GP that minimized potential disputes and allowed them to concentrate their energies on getting the most value out of the underlying assets. Moreover, when the market for an asset was too thin or unstable or when asset-specific information was insufficient to allow the market to value an asset without factoring in a substantial risk premium, the equity partnerships provided an opportunity to capture the effects and benefits of market stabilization and better information.

Another advantage of the equity partnerships is that the RTC did not bear the full burden of due diligence and collection expenses. In addition, because the GPs were required to have independent CPA firms perform annual audits, the financial statements were credible. Also, by placing the difficult assets into the equity partnerships, the RTC asset marketing personnel were able to concentrate on loan or other asset sales for which a much greater return on book value was probable.

Experience in seller financing proved to save both time and money while promoting sales competition. RTC's offering of financing terms allowed bidders to place an offer much more quickly because they did not have to pursue third-party financing. The elimination of the expense of obtaining the financing made the transactions more cost-effective. It also allowed more investors to qualify and compete, thereby increasing demand and, as a result, prices.

However, although the equity partnerships worked well in a number of ways, they also had some weaknesses. One was that if the GP made a series of poor business decisions that ultimately placed the equity partnership in jeopardy, the LP could do little about that because that was part of the risk of doing business. Under the terms of the agreement, the LP had to show evidence of fraud or gross negligence before it could replace a GP. Should the LP interfere in the GP's business decisions without cause, the LP would have been considered to be acting as the GP and would have therefore lost its limited liability status. The LP did, however, review the GP's business plans and, acting in its limited capacity, offered suggested courses of action regarding certain assets or situations. In the end, though, the LP had to live with the GP's decisions.

Another weakness occurred when financial incentives became misaligned and tensions were created in the relationship between the GP and the LP. For example, in the JDC equity partnership structure, the GP was required to fund most of the expenses of the partnership. Although the JDC partnerships provided for a reserve account to be established to fund certain qualified asset-related expenses, the GP had to first request approval from the LP before using the reserve account funds. That situation strained the relationship between the GP and the LP at times because the LP was under no obligation to approve those requests.

Tables I.17-4, I.17-5, and I.17-6 summarize characteristics of equity partnerships.

Asset Management and Disposition Agreement Partnerships

The structure of the Asset Management and Disposition Agreement differs from the equity partnerships in certain key areas. For example, the assets contributed to the AMDAs were not subject to bidding in an open market environment, were made up of different asset portfolio mixtures, and were from a sole source, which was an original portfolio of a particular failed savings and loan. Such elements contrast with the equity partnerships, which held competitively bid pools of similar assets obtained from various failed institutions within a certain regional area or throughout the nation.

AMDAs were created by the RTC as a result of FIRREA.¹⁶ FIRREA mandated the review, analysis, and possible renegotiation of certain 1988 and 1989 FSLIC assistance agreements that had been used as a vehicle to resolve failed thrifts. The RTC was to examine the possibility and means of restructuring the transactions in a manner that

16. Although the RTC was responsible for the renegotiation of the FSLIC assistance agreements, the FDIC as manager of the FSLIC Resolution Fund since the dissolution of the FSLIC in 1989 became the limited partner representing the public sector's interest in the AMDA agreements.

Table I.17-4

General Characteristics of the Equity Partnership Types

	Program Inception	Number of Partner- ships	Bonds?/ Bond Holder	Types of Underlying Assets	Target Investor/ Legal Structure	LP/GP Ownership Percentage
N Series	Dec. 1992	6	Yes/ Institutional investors via open market	Commercial and multi-family non- performing loans	Large Investors/ Trust	51/49
MIFs	Jan. 1993	2	No, but bond equivalent/ Held by RTC	Commercial and multi-family non- performing loans, REO	Large Institutional Investors/ Partnership	25-50/ 50-75
Land Funds	July 1993	12	No	Undeveloped and partially developed land (REO and non- performing loans)	Small Investors/ Partnership	60-75/ 25-40
S Series	Sept. 1993	9	Yes/Held by a trustee for the RTC	Commercial and multi-family non- performing loans	Small Investors/ Trust	51/49
JDCs	Dec. 1993	30	No	JDCs and small balance assets (SBAs)	Investors with collection experience/ Partnership	*
SN Series	Aug. 1995	5	Yes/Held by a trustee for the RTC	Commercial non- performing loans	Large and Small Investors/Trust	51/49
NP Series	Aug. 1995	8	Yes/Held by a trustee for the RTC	Non-performing land loans and land REO, unsecured loans or loans secured by non-real estate collateral (such as business loans), nonperforming commercial real estate and REO (commercial and multi-family)	Small Investors/ Trust	50-70/ 30-50

* The LP contributed 1 percent of the book value for JDCs and 20 percent of the book value for SBAs; the GP contributed 0.0101 percent of the book value for JDCs and 0.20 percent of the book value for SBAs.

Source: FDIC Division of Resolutions and Receiverships.

Table I.17-5

Financial Comparison of Equity Partnerships By Type

(\$ in Millions)

Equity Partnership Type	Original Book Value BV of Assets	Derived Investment Value (DIV) of Assets	RTC's Net Collections*	RTC's NPV of Net Collections†	NPV of Net Collections/ BV%	NPV of Net Collections/ DIV%
N Series	\$2,782	\$1,321	\$1,664	\$1,573	57	119
MIF Series	2,034	982	1,094	995	49	101
Land Funds	2,218	641	692	592	27	92
S Series	1,019	466	627	571	56	123
SN Series	440	225	275	254	58	113
NP Series	537	119	154	145	27	122
Totals	\$9,030	\$3,754	\$4,506	\$4,130	46	110

* RTC's collections are undiscounted; expenses have been paid by the partnership prior to the distribution of proceeds to the partners. These collections are composed of actual and projected proceeds through the estimated life of the equity partnerships.

† The net present value of net collections represents a three-year Treasury constant maturity rate per Federal Reserve Economic Data to date (actual proceeds through June 30, 1997) and 8 percent for all future proceeds.

Source: FDIC Division of Resolutions and Receiverships.

would reduce their costs on a net present value basis and to pursue those cost reductions for the U.S. taxpayer whenever possible.

In 1990, the results of the RTC's review of the FSLIC assistance agreements showed that the prepayment of financing notes, the write-down of asset book valuations, and the sale of stock warrants held by the FSLIC Resolution Fund (FRF) would provide the greatest savings. However, some assistance agreements were either too large or too complex to take those types of actions within the confines of the original agreement. In those cases, the RTC determined that the best alternative was to restructure the agreements to eliminate their inefficiencies, which primarily concerned the management and disposition of problem assets. In addition, the agreements linked tax-exempt yield maintenance with loss coverage on assets, thereby creating financial incentives to delay the disposition of assets.¹⁷ To monitor the disposition efforts of the acquirer, the FSLIC had to establish extensive oversight to properly monitor the yield maintenance and loss coverage.

17. The acquirers were allowed to exclude from their taxable income the amount of assistance payments received from the FSLIC. At the same time, the acquirers were allowed to deduct from their taxable income the underlying expenses for which they received assistance payments. That situation allowed the acquirers to realize a financial return in the amount of their effective income tax rate for every assistance claim. Therefore, the FSLIC's assistance payments often had a higher after-tax rate of return for the acquirers than did the acquirer's share of recoveries on the sale of assets covered under the assistance agreement (covered assets). It was therefore more financially beneficial to the acquirers to hold covered assets than to sell them and reinvest in taxable instruments.

Table I.17-6

Listing of Equity Partnerships

Equity Partnership Type	Name of Equity Partnership	General Partner	Original Book Value (\$ in Millions)
N Series	1992 N-1	BT, Sterling, Amresco, American Securities, Soros	\$346
	1993 N-1	N. P. Partnership II, Co.	618
	1993 N-2	AEW/J.E. Roberts/Secured Capital	743
	1993 N-3	BT, Sterling, Amresco, American Securities	324
	1994 N-1	BT, Sterling, Amresco, American Securities	406
	1994 N-2	BT, Sterling, Amresco, American Securities	345
	6	Subtotal	\$2,782
MIF Series	MIF Realty, LP	MIF GEN-PAR, L.P.	\$1,021
	Eastrich MIF, LP	MIF Holding, L.P.	1,013
	2	Subtotal	\$2,034
Land Funds	Land Fund I – West Coast Land Fund	West Coast Equity, L.P. (Colony Capital)	\$416
	Land Fund I – Sun NLF	Sun Partners	981
	Land Fund I – Sunchase Estrella	Estrella Sun	295
	Maco III – NLI/PLC/MACO LP	NLI/PLC/Maco III Assoc. (National Loan Investors)	47
	Maco III – Tennessee Land Investors LP	CRT Land Investors – I, L.P.	14
	Maco III – Potomac Maco LP	Potomac Mid-Atlantic Partners, L.P.	96
	Land Fund II – National Land Investors LP	NLI Land Associates (National Loan Investors)	57
	Land Fund II-Overland Land Fund II LP	Overland Land Fund II	118
	Land Fund II – Dallas I LP	Mortgage Recovery Fund – Land Fund Dallas, L.P.	52
	Land Fund II – Colorado/New Mexico Land LP	Midland Asset Limited Partnership	29

Table I.17-6

Listing of Equity Partnerships
Continued

Equity Partnership Type	Name of Equity Partnership	General Partner	Original Book Value (\$ in Millions)
Land Funds (cont.)	Land Fund II – Land Fund II LP	Mortgage Resolution Corporation	\$29
	Land Fund II – COMAC Land LP	COMAC West Partners, L.P.	84
	12	Subtotal	\$2,218
S Series	1993 S-1	AIG/Ontra I Associates	\$74
	1993 S-2	1993 S-2 Investors, L.P.	112
	1994 S-1	T.K. 1994 S-1, Inc.	100
	1994 S-2	1994 S-CA Investors, L.P.	90
	1994 S-3	T.K. 1994 S-3, Inc.	38
	1994 S-4	AIG/Ontra II Associates	133
	1994 S-5	Baupost Realty/J.E. Roberts Co.	107
	1994 S-6	1994-S Dallas Associates, L.P.	84
	1994 N3/S	AIG/Ontra III Associates	281
	9	Subtotal	\$1,019
JDCs	ARS Limited Partnership	American Recovery Systems, Inc.	\$162
	Asset Recovery Services, Inc.	Asset A.R.M.S., L.L.C.	128
	JDC Partners, L.P.	BJF/IB Partners	156
	CDC Debt Recovery	CDC Debt Recovery Group, Inc.	160
	CVS/JDC Limited Partnership	Chotin-Vargas/Signet, L.L.C.	814
	CNF 1st Associates, L.P. I	CNF Texas, L.P.	408
	CNF 1st Associates, L.P. II	CNF California, L.P.	635

Table I.17-6

Listing of Equity Partnerships
Continued

Equity Partnership Type	Name of Equity Partnership	General Partner	Original Book Value (\$ in Millions)
JDCs (cont.)	Emerson/Checkrite Fed. Recoveries	Emerson/Checkrite Federal Recoveries	\$272
	Government Financial Svcs., L.P.	Government Financial Services	298
	Hudson, Marshall & Stallings, Inc.	Hudson, Marshall & Stallings, Inc.	103
	Investors Collection Svcs., L.P.	Investors Collection Services, Arizona J.V.	441
	MDA/Bain, L.P.	MDA/Bain Limited Partnership	250
	PNL Texas, L.P.	PNL Credit Company, L.L.C.	792
	PNL Southwest, L.P.	PNL Southwest, L.L.C.	113
	Premier Financial Svcs., East	Premier Financial Services, East	175
	Premier Financial Svcs., Texas	Premier Financial Services, Texas	511
	Premier Financial Svcs., West	Premier Financial Services, West	301
	JDC Finance Company, I	Prentiss/FMRC Joint Venture	515
	JDC Finance Company, II	Prentiss/FMRC Joint Venture	348
	JDC Finance Company, III	Prentiss/FMRC Joint Venture	840
	Recoverededge, L.P.	Recoverededge Joint Venture, L.L.P.	571
	Regional Financial Svcs., L.P.	Regional Financial Services, L.L.C.	431
	Republic Credit One, L.P.	Republic Credit Corporation	445
	RER-JDC Limited Partnership	RER Collections, Inc.	422

Table I.17-6

Listing of Equity Partnerships *Continued*

Equity Partnership Type	Name of Equity Partnership	General Partner	Original Book Value (\$ in Millions)
JDCs (cont.)	Stonehenge/FASA Texas JDC LP	Stonehenge/FASA JV #7	\$523
	TCCP California L.P.	Telacu/Carpenter Collection Partners	640
	TCCP Texas L.P.	Telacu/Carpenter Collection Partners	332
	The Reliant Group, L.P.	The Reliant Group	746
	United Collections	United Collections	158
	Value Recovery Group, L.P.	Value Recovery Group Joint Venture I	728
	30	Subtotal	\$12,418
SN Series	1995 S/N 1	1995 S/N 1 Investment Limited Partnership	\$90
	1995 S/N 2	Chillicothe Properties, Inc.	81
	1995 S/N 3	AIG/Ontra V Associates	87
	1995 S/N 4	AIG/Ontra V Associates	119
	1995 S/N 5	Chillicothe Properties, Inc.	63
	5	Subtotal	\$440
NP Series	1995 NP1A	Fourteenth RMA Partners, L.P.	\$83
	1995 NP1B	PNL NP1 L.P.	71
	1995 NP2A	Value Recovery Group, L.L.C.	64
	1995 NP2B	PNL Whiteacre L.P.	127
	1995 NP2C	Mortgage Recovery Fund – 1995 NP2C, L.P.	38
	1995 NP3-1	1995 NP3-1 Investment Limited Partnership	62
	1995 NP3-2	AIG/Ontra VI Associates	51
	1995 NP3-3	Phoenician Investment, L.L.C.	41
	8	Subtotal	\$537
Total	72		\$21,448

Note: The JDC program is the only equity partnership structure that allows additional assets to be transferred to the partnerships after the consummation date. As such, the book values for the JDC partnerships reflect the assets transferred to the partnerships through September 30, 1997.

Source: FDIC Division of Resolutions and Receiverships.

The RTC concluded that to successfully redesign the assistance agreements, an alignment had to be made between the financial incentives of the private-sector parties to the original assistance agreement (the acquirers) and the FDIC. The RTC also determined that it was important to spread risk among the parties and to minimize any governmental oversight of the acquirers that might hinder their initiative and slow down the day-to-day decision-making process.

Evolution and Structure of the AMDA

The AMDA partnership structure was designed so that both the acquirer (GP) and the FDIC (LP) would have equity at risk. The GP's private investors, in addition to contributing to the partnership's capital, accepted responsibility for managing and disposing of the partnership's assets. In return, the GP received distributions from the net recovery on the partnership's assets, but received no management fee. Instead of receiving a management fee, the GP deducted all direct expenses, including its staff and operating expenses that were devoted 100 percent to the asset portfolio, from gross collections before distribution to the partners. Overhead and indirect costs, however, were borne entirely by the GP.

The first AMDA, known as Mountain AMD L.P. (Mountain), closed on January 31, 1993. Mountain was the product of the renegotiations of the FSLIC-assisted acquisition of Columbia Savings and Loan, Englewood, Colorado, as well as other failed thrifts, by First Nationwide Bank (First Nationwide), San Francisco, California, a wholly owned subsidiary of the Ford Motor Company. At closing and on April 30, 1993, the FDIC as LP contributed assets equal to \$339.8 million to the Mountain partnership. The GP, FN Realty Advisors, Inc. (FNRAI), invested \$23.2 million in capital, equaling 6.8 percent of the value of the assets, to the Mountain partnership.^{18,19} Approximately \$9.3 million of the GP's investment was in cash, and \$13.9 million was financed by the FRF. The duration of the Mountain AMDA was set at five years with the option to extend for one year if both parties agreed.

The second AMDA, Brazos Partners, L.P. (Brazos), was formed on June 30, 1993. It was a renegotiation of an assistance agreement completed in 1988 by the FSLIC for the

18. In mid-1994, FNRAI sold, with the approval of the FDIC, its GP interest in the Mountain partnership to Little Muddy Creek Corporation, a U.S. subsidiary of Internationale Nederlanden Bank, N.V., a Netherlands bank.

19. The FRF financed a certain percentage (60 percent for Mountain and 65 percent for Brazos Partners, L.P. [Brazos]) of the GP's capital contribution. That debt bore interest at 9 percent and was payable out of the distributions to the GP. A minimum of 60 percent of Mountain's GP distribution had to go toward the retirement of the debt; 65 percent was the minimum required for Brazos. The seller financing was nonrecourse except that it would be a priority claim on distributions should the partnership be terminated before payoff of the capital loan. Those debts were repaid by the GP more quickly than was required.

failed American Savings, a FS&LA, Stockton, California. The FDIC, as manager of the FRE, agreed to repurchase assets from the acquirer, New West FS&LA, and contributed them as LP to the Brazos partnership. The assets portfolio contributed by the LP was valued at \$1.3 billion. Brazos's private investors (Brazos Asset Management, Inc. [BAM], acting as GP, and Brazos Fort, L.P., and Brazos Worth, L.P., the investor LPs) contributed about \$134.4 million to the partnership.²⁰ That contribution included approximately \$40 million in cash, \$18.8 million of which was in the form of a credit by the FDIC (as the result of the assumption of a FSLIC liability to one of the acquirers of American Savings Bank, F.A.), and \$75.6 million provided through financing by the FRE.²¹ Brazos's investment equaled about 10.1 percent of the value of the assets. Like the Mountain AMDA, the duration of the Brazos AMDA was set at five years with the option to extend for one year if both parties agreed. Chart I.17-8 illustrates the structure of the AMDA partnership.

The value of the assets were initially determined by a mark-to-market valuation performed by third-party investment bankers using the AMDA's modified version of the DIV methodology, which differed from the RTC's methodology because it specified narrower ranges and parameters. The assets were recorded on the books of the partnerships at a negotiated price determined in reference to the mark-to-market values established by the investment bankers.

Assets were transferred to the two AMDA partnerships without representations or warranties provided by the FDIC. The partnerships assumed any outstanding legal or environmental liabilities, as well as any potential lender liabilities. An adjustment was made in the valuation of the assets to account for those assumed liabilities.

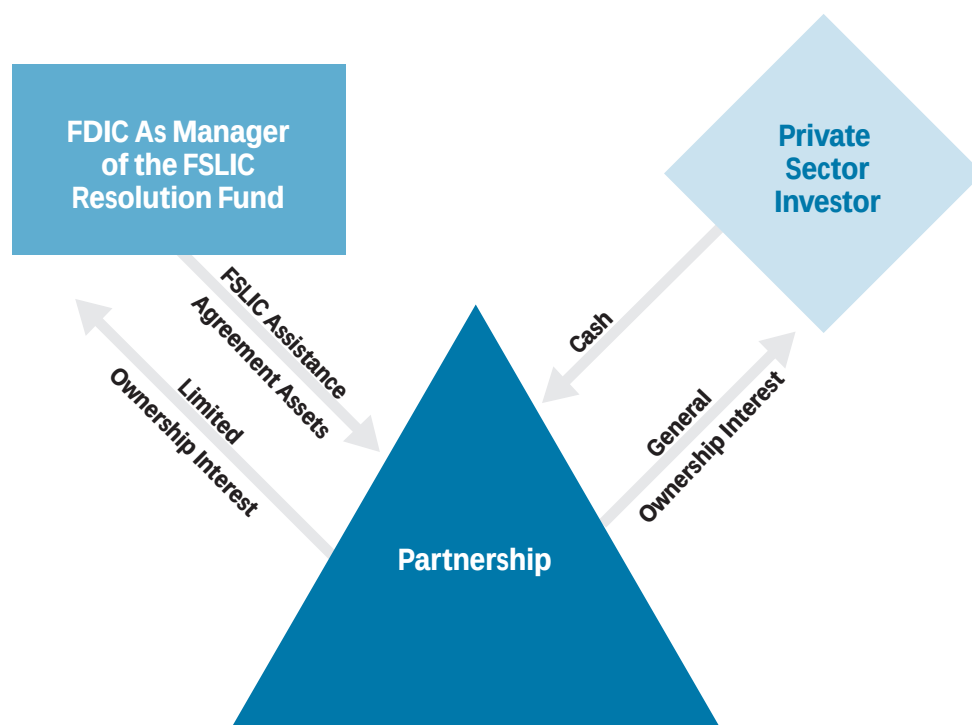
As shown in table I.17-7, Brazos liquidated its portfolio much more rapidly than Mountain did. Although Mountain exhibited a slower disposition rate, it achieved a higher recovery ratio on the assets in its portfolio. As of March 31, 1997, the AMDA partnerships' recovery ratios were calculated to be 157 percent for Mountain, in contrast with 132 percent for Brazos.²²

20. On December 28, 1988, the FSLIC executed one of its largest 1988 transactions with and among Keystone Holdings, Inc.; New American Holdings, Inc.; New American Capital, Inc.; American Savings Bank, F.A.; Stockton, California (New American); and New West FS&LA, Stockton, California (New West). It executed the assistance agreement in connection with the transfer of substantially all of the assets and liabilities of American Savings, a FS&LA, Stockton, California, to New American, New West, and the American Real Estate Group.

21. See footnote 19.

22. The recovery ratio equals the accumulation of all cash flows (net funds collected and distributed) at a given time divided by the initial marked value of the pool to determine the percentage of marked value achieved. The cash flow and the initial value are adjusted by a 9 percent annual indexing factor that is designed to help eliminate the incentive to delay the liquidation of assets awaiting increases in value as a result of inflation or other market factors.

Chart 1.17-8

Structure of AMDA Partnership

Source: FDIC Division of Resolutions and Receiverships.

Partnership Distribution Structure

The partnership distribution structure of the AMDA partnerships was designed to align the private sector's financial interests with the government's goal of maximizing the net present value of recoveries from the management and disposition of problem assets. Partnership distributions were calculated using predetermined tranches based on the ratio of cumulative recoveries to initial marked value. For example, until the time when the GP had achieved cumulative recoveries of up to 60 percent of the initial marked value, the Mountain GP received only 2 percent of the net distributions of the asset recoveries, and the Brazos GP received only 6.5 percent. When the Mountain GP achieved 100 percent of the portfolio's initial marked value, however, it would have received 9.2 percent of the total partnership distributions on an equity investment of 6.8 percent. Likewise, the Brazos GP would have received 13.25 percent of the total partnership distributions on an equity investment of 10.1 percent. (See table I.17-8.)

Table I.17-7

Disposition of AMDA Assets and FDIC's Collections
Cumulative, Per Year
(\$ in Millions)

Years into AMDA	Mountain				Brazos			
	Cumulative Assets Sold	Cumulative Percentage Sold	FDIC's Net Collections	Percentage of FDIC's Total Net Collections	Cumulative Assets Sold	Cumulative Percentage Sold	FDIC's Net Collections	Percentage of FDIC's Total Net Collections
Year 1	\$63.2	18.6	\$127.4	23.9	\$1,025.0	77.0	\$1,240.2	77.9
Year 2	177.0	52.1	319.4	59.9	1,251.3	94.0	1,525.5	95.8
Year 3	286.5	84.3	477.2	89.4	1,312.6	98.6	1,579.9	99.2
Year 4	315.0	92.7	522.2	97.9	1,315.2	98.8	1,587.1	99.6
Year 5 *	339.8	100.0	533.5	100.0	1,331.2	100.0	1,592.8	100.0

* Year 5 includes projected asset sales and collections through the estimated life of each partnership.

Sources: FDIC Division of Resolutions and Receiverships and financial statements of Mountain and Brazos.

Table I.17-8

AMDA Compensation Schedule

AMDA Agreement	Recovery Ratio* Tranche	GP's Distribution Percentage	LP's Distribution Percentage
Mountain	0 to 60%	2	98
	Greater than 60% to 135%	20	80
	Greater than 135%	10	90
Brazos	0 to 50%	6.5	93.5
	Greater than 50% to 135%	20	80
	Greater than 135%	10	90

* See footnote 22.

Source: FDIC Division of Resolutions and Receiverships.

In general, the recovery ratio tranches were designed to motivate the GP to maximize recoveries by providing a direct financial incentive to work the assets. An important objective of the tranche structure was to ensure that the GP had a financial stake in the marginal income or loss resulting from any business decision it made. The tranche structure allowed the government to receive a majority of the proceeds during the early stages of the partnership's life, when proceeds are the most certain. The second tranche provided the greatest possible distribution of 20 percent to the GP, and a recovery at that level should be the most likely outcome. If recoveries of more than 135 percent were achieved, the GP's distribution would fall to 10 percent. The last tranche was structured so that if a recovery at that level was achieved (which could happen if the initial marked value of the assets was too low), the LP would get most of the profit. The last tranche was designed as a self-correcting mechanism to ensure that the GP would not be unduly enriched, yet would still be provided with a respectable return.

Expense Reimbursement

Initially, the FDIC advanced funds to the GP as working capital to cover the initial expenses of the partnership. After the cash flow became positive, the GP quickly repaid the advance. After the repayment, all expenses related to the partnership would be paid from the cash generated by the partnership from sales of properties and settlements of loans. Any staff whose salaries were charged to the partnership had to be devoted exclusively to the operations of the partnership. No affiliated transactions of any kind were allowed unless the FDIC, as LP, approved them.

Compliance Standards

The AMDA GPs were prohibited from engaging in speculative disposition strategies for the assets. The partnership could not change the nature of an asset it received; for example, it could not turn raw land into developed lots. Capital expenditures for an individual asset were limited to 10 percent of the asset's initial valuation. The GP could not sell assets to related parties, engage in affiliate transactions, give representations and warranties beyond the term of the partnership, admit new partners, or engage in transactions of any kind that were unrelated to the partnership's business.

Government Oversight

Although the GP was fully responsible for the operations of the partnership, the LP had the right (at its own expense) to audit the operations of the partnership on an after-the-fact basis. The AMDA also required the GP to obtain annual financial audits of the partnership and to file its own tax returns. In addition, the OIG and GAO had the right to perform audits on the partnership and its related transactions at any time.

To resolve disputes in a rapid manner and with the least harm to the partnership, the AMDA allowed for the creation of a binding three-person dispute resolution panel when disputes or issues arose between the partners or when there were any violations of the terms of the partnerships. That panel would contain a neutral party and one member each from the LP and GP, each of whom was selected by the LP and GP. In the event of a compliance violation, the panel had the right to impose a monetary penalty upon the GP. If the actions of the GP were so serious as to cause harm to the financial viability of the partnership, the FDIC as LP had the right to seek dissolution of the partnership and distribute the proceeds from the liquidation of any remaining partnership assets.

Measuring the Success of the Partnerships—Recovery Results

From the inception of the agreement to September 30, 1997, the Mountain partnership had distributed a total of \$603 million to the partners; of that amount, the GP received \$73.5 million and the FDIC as LP received \$529.5 million. When Mountain's remaining assets are sold, the FDIC expects to receive an additional \$4 million.

For the same period, the Brazos partnership had distributed a total of \$1.8 billion to its partners: the GP received \$13.1 million, the investor LPs (Brazos Fort and Brazos Worth) got \$223.5 million, and the FDIC as LP received \$1.6 billion. The FDIC expects to receive an additional \$5.7 million when the remaining Brazos assets are sold.

Any comparison drawn between the two AMDA partnerships could be misleading. The two partnerships differ in distribution structure (tranche levels), derivation of initial asset valuations (each had an independent negotiation), and composition of asset portfolio (the asset pools and geographic locations were not identical). In addition, several other differences between the two partnerships must be considered.

First, each AMDA partnership was an extension of the resolution efforts begun under individual FSLIC assistance agreements. The GP's previous dealings with those assets under their assistance agreement may have affected the results of the AMDA partnership efforts. For example, the GP of Brazos (the former acquirer of the New West assistance agreement) had received \$3.2 billion in FSLIC assistance payments before the transfer of the assets into the AMDA. The GP of Mountain (the former acquirer of the First Nationwide assistance agreement) had received \$2.9 billion in FSLIC assistance payments.^{23,24}

23. At the start of the New West assistance agreement, the acquirer received \$21.4 billion in book value of assets. During the term of the assistance agreement, the acquirer disposed of assets with a book value of approximately \$18.8 billion, leaving \$2.6 billion to be marked to market and transferred into the Brazos AMDA.

24. The acquirers of the First Nationwide assistance agreement received \$4.9 billion in book value of assets at the inception of the agreement. They liquidated about \$4.2 billion during the course of the agreement, leaving \$738 million to be marked to market and transferred into the Mountain AMDA.

Second, the initial book value of the assets for each of the AMDA partnerships was determined by a mark-to-market valuation performed on the remaining assets in each of the FSLIC assistance agreements. The mark-to-market valuation was negotiated as part of a complex termination agreement entered into by each GP to end the provisions of their FSLIC assistance agreement.²⁵ Therefore, the valuation methodology of the initial AMDA book value was greatly affected by the “give and take” of the individual negotiations.

Finally, the asset portfolios transferred into each of the AMDAs were not similar. For example, the Brazos portfolio was four times the size of the Mountain portfolio. In addition, the Brazos portfolio was concentrated in California, a declining market, while the Mountain portfolio was situated in Colorado, a market that was experiencing a recovery. Without complex adjustments to account for the effects of the local markets in which the portfolios were located, it is difficult to determine which portion of the asset recoveries was achieved because of the success of the partnership.

The most basic method of analysis is the net rate of recovery on the book value (recovery rate) of the assets transferred into the partnerships. That analysis is attractive because the recovery rate information is readily available for each of the transactions. The recovery rate is calculated in this discussion in two ways. Table I.17-9 shows the percentage of the FDIC’s net proceeds from the transaction divided by the initial unmarked book value of the assets from the FSLIC assistance agreements before their transfer to the AMDAs. Table I.17-10 shows those same net proceeds divided by the AMDA negotiated mark-to-market valuation.

To properly compare the two AMDAs on the basis of the historical book value of the assets before the negotiated mark as shown in table I.17-9, the effects of the dissimilarities between the asset type and market location of their underlying asset pools must be taken into account. The general drawbacks to the recovery rate as a percentage of book value methodology already noted in the equity partnership portion of this chapter also apply to this AMDA analysis.

A comparison between the two AMDAs on the basis of the recovery rate as a percentage of marked book value as shown in table I.17-10 is subject to the same considerations as were the comparisons of derived investment value presented for the equity partnerships earlier in this chapter. To analyze the results of the return on marked book value, it is important to consider the negotiated mark-to-market process. In addition, the same concerns about the dissimilarities between asset type and market location that are present in the historic book value analysis are present in the negotiated mark-to-market value analysis.

25. Some portions of the FSLIC assistance agreements survived the termination process.

Table I.17-9

**AMDA Recovery Rates Achieved by the FDIC
Stated As a Percentage of Unmarked Book Value***

(\$ in Millions)

	Actual and Projected Net Collections	Unmarked Book Value	Collections as a Percentage of Unmarked Book Value
Mountain	\$533.5	\$740.8	72%
Brazos	1,592.8	2,947.6	54%

* The unmarked book value is that of the assets transferred from the FSLIC assistance agreement to the AMDA partnership before the initial mark-to-market valuation. FDIC recoveries represent undiscounted actual proceeds received through September 30, 1997, and estimated future recoveries. All receipts are net of expenses, which are paid by the partnership before distribution. This recovery rate analysis does not use the 9 percent indexing factor for determining the recovery ratio tranches. Recoveries do not reflect the FRF financing provided to the GP.

Sources: FDIC Division of Resolutions and Receiverships, financial statements of Mountain and Brazos, and AMDA settlement documents.

Table I.17-10

**AMDA Recovery Rates Achieved by the FDIC
Stated As a Percentage of Marked Book Value***

(\$ in Millions)

	Actual and Projected Net Collections	Marked Book Value	Collections as a Percentage of Marked Book Value
Mountain	\$533.5	\$339.8	157%
Brazos	1,592.8	1,331.2	120%

* The marked book value is the negotiated mark-to-market valuation of the AMDA partnerships. FDIC recoveries represent undiscounted actual proceeds received through September 30, 1997, and estimated future recoveries. All receipts are net of expenses, which are paid by the partnership before distribution. This recovery rate analysis does not use the 9 percent indexing factor for determining the recovery ratio tranches. Recoveries do not reflect the FRF financing provided to the GP.

Sources: FDIC Division of Resolutions and Receiverships and financial statements of Mountain and Brazos.

Strengths and Weaknesses of AMDAs

One strength of the AMDAs was the distribution structure for recoveries, which allowed the FDIC to participate in the upside potential of the mainly nonperforming assets. In particular, the FDIC benefited substantially from that structure in the Mountain AMDA because of the rising Colorado real estate market.

The AMDA was designed so that the private-sector entity had at least a 20 percent marginal income or loss in any business decision made by the GP, even though its equity position overall was substantially less than 20 percent. That design imposed a risk feature that should motivate the GP to act in the best interest of the partnership. As a result, full management control was placed into the hands of a private party whose financial objective was clear—obtaining the highest net present value recovery from the disposition of the assets.

An important element of the AMDA structure was the binding dispute resolution panel to resolve disputes. The purpose of the panel was to limit protracted legal activity between the partners that would drain time, attention, and monetary resources away from the day-to-day activities of the partnership, thereby ultimately harming the recoveries to all parties.

One aspect of the AMDA structure that caused concern was that certain expenses, including personnel costs for staff dedicated exclusively to the operations of the partnership, were subject to the sharing percentages of the tranche structure. The FDIC as LP therefore would pay 80 percent of those expenses in the optimal tranche. The GP had the authority to determine what the partnership would pay for such items as salaries, and the FDIC as the passive LP had to bear the majority of the expense.

Conclusion

Altogether, the RTC and FDIC conveyed assets that had an aggregate book value of more than \$25 billion to partnerships in which they held an interest. Almost half of this amount was sold to JDC partnerships, in which the agencies' primary goals were to place the assets with firms having collection expertise and to share in any unforeseeable recoveries. The remaining half comprises assets contributed to six different equity partnership programs, each targeted for use with distinct asset and investor types, and two AMDA agreements that were a result of renegotiated FSLIC assistance agreements. For all the partnership programs the agencies' primary objectives were to capture the expertise and efficiency of the private sector and to share in the profit achieved from greater market efficiency.

It is difficult, if not impossible, to state which of the seven equity partnership structures worked "best," because each evolved quickly in dynamic markets for different purposes and with different asset types. However, two design features of the equity

partnerships may have contributed to increasing present value recovery. RTC recoveries were generally higher for structures that conveyed smaller sized pools and for structures that had specifically identified assets at the time of bidding rather than those featuring blind pools.

As shown by the RTC and FDIC experience, equity partnerships can be used as a vehicle to convey a large volume of assets to private-sector management in a relatively short period of time. They also can be used for a variety of asset types, for assets of varying quality, and for different investor profiles. Depending on the agency's objectives, the amount of cash obtained at closing relative to future collections can vary. Furthermore, the partnership's ownership structure can be created under several different legal forms, and the seller can hold varying degrees of residual interest.

The RTC and FDIC exchanged the certainty and benefits arising from a complete divestment of ownership for potentially greater recoveries. The agencies, in addition to continuing to bear market risk, incurred ongoing costs for monitoring partnership activities and managing their residual interests. Also, although the structures were designed to shield the passive interest holder from liability arising from legal claims associated with assets held in the partnership, they did not fully exculpate the agencies from pressures that arise from their public status. Nonetheless, the recovery results suggest that the RTC achieved higher recoveries through equity partnerships than through other multiple-asset sales methods it used.

To effectively handle the tremendous volume of legal matters resulting from the rising number of failing financial institutions, the FDIC increasingly turned to outside counsel.



CHAPTER 18

The FDIC's Use of Outside Counsel

Introduction

This chapter describes the Federal Deposit Insurance Corporation's (FDIC) use of outside counsel from 1980 to 1996. It covers the increased use of outside counsel from 1989 to 1993 during the peak of the financial institution crisis, payments to outside counsel during the period, the advent of the FDIC's Outside Counsel Minority and Woman Outreach Program, the formation of a section to oversee the use of outside counsel, the development of uniform policies and procedures governing the use of outside counsel, the use of information systems, and the various statutory provisions that relate to the FDIC's use of outside counsel.

Increased Use of Outside Counsel

The FDIC turned to outside counsel between 1980 and 1988 to handle matters arising from the failure of financial institutions. The use of outside counsel skyrocketed between 1989 and 1993, the peak of the financial institution crisis.

Historically, the FDIC turned to outside counsel to meet an increasing demand for legal services which grew from the increase of receiverships for failed financial institutions. Until 1982, with the exception of legal work in one office in San Juan, Puerto Rico, virtually all legal work relating to the FDIC's role as receiver was managed by FDIC headquarters with a minimal in-house legal staff. As institutions failed in different parts of the country, it was common practice for the in-house staff to retain outside counsel to assist with the daily and long-term legal needs of those receiverships. The need for outside counsel existed because of (1) the limited number of in-house legal staff in relationship to the growing number of receiverships, (2) the diverse geographic locations of the receiverships,

and (3) the wide variety of legal issues arising from those receiverships that required specialized knowledge of state laws and legal practice, as well as federal law. The legal work encompassed a broad range of areas such as foreclosure, loan workout, bankruptcy, contract disputes, asset sales, collecting on notes and guarantees, state and federal tax issues, pension funds, environmental issues relating to the institution's property, torts, and shareholder suits. In addition, the FDIC investigated whether the officers, directors, and other professionals who ran the institutions before failure upheld their fiduciary obligations to the institutions. In many instances, the FDIC determined that the most cost-effective and practicable way for the legal work to be done was to continue to use the outside counsel previously retained by the failed institution. In other instances, and for new work, the FDIC retained new outside counsel.

Beginning in early 1984, the FDIC Legal Division, in conjunction with the then Division of Liquidation, established regional legal offices. Many of the regional offices were supplemented by consolidated offices in which numerous receiverships were handled from a single office. The regional offices oversaw and provided support to the consolidated offices. The FDIC established sizable in-house legal offices in the regional and consolidated offices.

The extensive use of outside counsel by the FDIC between 1989 and 1993 was more a function of the very rapid increase in the FDIC legal workload than of a deliberate management choice. The FDIC employed rapid recruiting programs and hired hundreds of temporary in-house attorneys and support staff to handle the backlog. The tremendous workload left little choice, however, but to refer a large portion of the legal matters to outside counsel, particularly matters related to the liquidation of assets and bank failures.

The Resolution Trust Corporation (RTC) experienced a similar rapid increase in legal work from S&L failures and made extensive use of outside counsel from its inception in 1989 through 1993. Under the Financial Institutions Reform, Recovery, and Enforcement Act (FIRREA) of 1989, the RTC was required to use contractors to carry out its mission when the use of contractors was practicable and efficient. Not until the passage of the Resolution Trust Corporation Completion Act (Completion Act) of 1993 was the RTC required to use in-house legal staff if that staff could provide the same quality of work as outside counsel at the same or lower estimated cost.

The payments to outside counsel increased dramatically during the height of the financial institution crisis. The FDIC continued its practice of handling as much of its work in-house as possible; in fact more than half of its legal workload was performed in-house. Before FIRREA's mandate to use private-sector contractors to the fullest extent possible, RTC matters were referred primarily to outside counsel until 1993, when the Completion Act dictated that the RTC "may only employ outside counsel if the use of outside counsel would provide the most practicable, efficient, and cost-effective resolution to the action."¹

1. *U.S. Code*, volume 12, section 1441a(w)(20).

Outside Counsel Minority and Woman Outreach Program

An Outside Counsel Minority and Woman Outreach Program began in the mid-1980s with efforts to increase the use of minorities and women as in-house attorneys and outside counsel for the FDIC. The FDIC was a pioneer, when compared with other government agencies and corporations, in its efforts to use minority and women attorneys for FDIC work. The FDIC participated in programs sponsored by national minority bar associations, including the National Bar Association, the Hispanic National Bar Association, the Native American Bar Association, and the National Asian Pacific American Bar Association. The FDIC co-sponsored two symposia (in 1992 and 1993) with the national minority and women bar associations in an effort to increase its referrals to minority and women outside counsel. The FDIC was an early participant and the first governmental entity to become a member of the American Bar Association's Minority Demonstration Program. The program was designed to provide an avenue for large corporations to meet minority and women attorneys seeking to provide services as outside counsel, or to serve as in-house counsel. The FDIC participated in several symposia co-sponsored by federal banking agencies in conjunction with the Federal National Mortgage Association (Fannie Mae) and the Federal Home Loan Mortgage Corporation (Freddie Mac).

In addition to its national outreach initiatives, the FDIC field offices undertook local outreach initiatives. The FDIC designated outreach contact persons in each field office and at FDIC headquarters to help staff identify minority and women outside counsel for referrals. Efforts included working with local bar associations to encourage minority- and women-owned law firms to apply to be FDIC outside counsel, holding open houses and seminars to enable minority- and women-owned law firms to become familiar with FDIC work, and visiting firms already working for the FDIC to encourage them to assign minority and women staff to FDIC matters. In addition, the FDIC referred matters to minority- and women-owned law firms that co-counseled with non-minority firms.

Bringing Work In-House

The FDIC continued to perform its legal work in-house as much as possible by increasing its staff to handle an expanding amount of work remaining from failed financial institutions. In 1982, the FDIC established an in-house legal presence in San Juan in response to several bank failures in Puerto Rico. It formed an in-house legal staff in Oklahoma City in response to the Penn Square Bank, N.A., failure and subsequent bank failures in Oklahoma. In 1983 and 1984, in-house legal offices were established in various other locations, including Knoxville, Tennessee, and Midland and Houston, Texas. As the financial institution crisis moved to other geographic areas, similar in-house legal offices were established in other states, including California, Florida, Louisiana, Massachusetts, Missouri, Nebraska, New Jersey, and Oregon, and in other

locations in Texas. The in-house legal offices were part of regional and consolidated offices that included a number of FDIC divisions, most notably the Division of Liquidation, which had primary responsibility for the oversight of the receivership process. In-house staff developed expertise in a number of areas, including transactional work, bankruptcy, and litigation. Even with the expanded staffs and their efforts, however, the FDIC increasingly referred work to outside counsel, because the load was still too much to handle. FDIC attorneys supervised the work of outside counsel.

In an effort to reduce its reliance on outside counsel, the FDIC established several in-house “law firms,” or Legal Services Offices (LSO). The LSOs’ primary function is to supply litigation and bankruptcy support to regional and consolidated offices in designated geographic or “practice” areas. The LSO mission is to provide quality legal services—equal to or exceeding those of private law firms—at substantial cost savings to the FDIC. LSOs were designed to operate like private law firms, similar to “captive” law firms used by large insurance companies. For example, LSO attorneys and paralegals electronically track time spent on each case.

LSOs have been located in geographic areas in which the cost of outside counsel is very expensive. The FDIC established an LSO in New York in 1991, followed by LSOs in Los Angeles, Dallas, Boston, and Washington, D.C. Only the New York and Washington, D.C., LSOs remain. The other LSOs were closed as the legal workload declined. Even with the LSOs assuming much of the legal workload during the early 1990s, other FDIC offices continued to handle a significant amount of legal work in-house as the FDIC historically had done.

The LSOs developed expertise in litigation as well as other areas of law. Legal Division offices did not retain outside counsel in geographic areas served by an LSO without first consulting the LSO to determine whether it could provide quality, timely, and cost-effective legal services. By handling work previously handled by outside counsel, the LSOs assisted the Legal Division in reducing its outside counsel costs. However, because of the large volume of legal work, the FDIC was still required to refer to outside counsel work.

Managing Outside Counsel

As the use of outside counsel increased, the FDIC undertook a number of measures to more effectively manage its outside counsel. The FDIC retained consultants to provide input as to what management tools could assist it in managing outside counsel. The FDIC then implemented many of the consultants’ suggestions such as establishing a separate Outside Counsel Section and implementing nationwide policies and procedures to govern the selection and use of outside counsel.

Separate Legal Division Outside Counsel Unit

In the early 1980s, the FDIC limited its use of outside counsel to only a few firms in each locale to enable those firms to develop expertise in FDIC work. As the amount of legal work increased beginning in 1991, however, the FDIC elected to refer its work to a broad spectrum of law firms. Any firm could apply to be included on the FDIC's List of Counsel Available, which the FDIC reviewed to locate firms for its work.

To more effectively retain, manage, and pay the record number of outside counsel, the FDIC undertook a number of measures. In 1990, it retained outside consultants who provided recommendations for improving the management of outside counsel such as the increased use of alternative fee arrangements to contain outside counsel costs. The existing information systems were surveyed and an information system was proposed to help track and report outside counsel information. Around the same time, the FDIC Office of Inspector General (OIG) retained a large accounting firm to audit the FDIC's management of its outside counsel. The FDIC adopted many recommendations of the consultants and the auditor, including the formation of a separate Outside Counsel Section in early 1991 to handle outside counsel issues. The Outside Counsel Section was responsible for ensuring that the FDIC improved its management of outside counsel.

The Outside Counsel Section was charged with updating and expanding outside counsel policies and procedures that the FDIC had developed since the mid-1980s, developing and administering supplemental policies and procedures as needed, and ensuring that policies and procedures were uniformly applied nationwide. The Outside Counsel Section did not retain outside counsel itself, which enabled the FDIC to avoid the possibility of any special interest in or conflict of interest with any particular outside counsel or potential outside counsel when developing and administering nationwide policies and procedures. Working closely with the FDIC offices that retained outside counsel, the section updated and expanded outside counsel policies and procedures, processed applications submitted by outside counsel interested in representing the FDIC, and maintained the Legal Division's nationwide List of Counsel Available.

The Outside Counsel Section also worked closely with the FDIC's technical staff to develop computer systems for efficiently paying the large volume of invoices from outside counsel. The procedures developed and administered by the section contain a number of checks and balances to ensure consistent application of FDIC policies and to minimize the possibility that an outside counsel may receive improper payment of its invoices.

Legal Division Outside Counsel Conflicts Committee

Outside counsel must be free of any conflicts of interest unless they receive a waiver. For the FDIC to ensure that its outside counsel do not have any unwaived conflicts of interest, the FDIC developed policies that are distributed to all outside counsel before commencing work.

An informal conflicts committee had been operating in the FDIC since 1987 to handle the conflicts of interest that arose from the FDIC retaining outside counsel. In 1990, to deal more effectively with the conflicts of interest and to consistently handle requests for conflict of interest waivers, the FDIC established a joint, more formal Conflicts Committee with the RTC. From 1990 to 1995, the joint FDIC/RTC Conflicts Committee was composed of nine members: four attorneys each from the legal divisions of the FDIC and RTC and a representative from the FDIC Office of the Executive Secretary.

At the height of its activity, the Conflicts Committee considered nearly 900 requests to waive conflicts of interest per year. With urgent needs for outside counsel increasing during the years of the financial institution crisis, it was necessary for the Conflicts Committee to grant waivers for certain conflicts of interests. Multiple safeguards were implemented, however, to protect the interests and confidentiality of the FDIC and the RTC, including placing restrictions or conditions on the usage of some firms, developing automated tracking systems, implementing extensive formal written policies and procedures, and initiating background checks on outside counsel. In 1991, an FDIC conflicts team was formed within the Outside Counsel Section to coordinate the work of the Conflicts Committee, draft policy, and serve as an information resource; a comparable RTC conflicts team was established in mid-1992. In 1996, with the merger of the RTC with the FDIC and the reorganization of the FDIC Legal Division, the composition of the Conflicts Committee was changed to five members, and the two conflicts teams were merged and reorganized.

The FDIC established a network of conflicts coordinators in its offices nationwide. The conflicts coordinators review outside counsel's request for a waiver of a conflict of interest, and if necessary, forward the request to the Conflicts Committee. The Committee reviews the information and determines whether a conflict of interest may be waived and the conditions under which it can be waived. The Committee meets bi-weekly and considers requests for waivers of conflicts of interest on an expedited basis whenever necessary. In addition to the FDIC's internal policies governing conflicts of interest, the FDIC adheres to federal ethics regulations to ensure the fitness and integrity of outside counsel. Conflicts coordinators also monitor general compliance by outside counsel within their jurisdiction for adherence to conflicts policies and procedures.

Outside counsel must disclose all actual or potential conflicts of interest and matters that may present the appearance of a conflict when it submits its application materials. The FDIC must consider the status of outside counsel's conflicts of interest when considering retaining outside counsel. Thereafter, outside counsel has a continuing duty to update such information. Failure to promptly disclose actual or potential conflicts of interest and any matters that may present the appearance of a conflict may result in termination of the firm's service, suspension of new referrals, or other corrective actions. Outside counsel also must observe state bar rules of professional responsibility regarding conflicts of interest, as applicable, and the American Bar Association Model Rules of Professional Conduct. Additionally, there may be other situations that could give rise to actual or potential conflicts of interest, or the appearance of a conflict.

Uniform Outside Counsel Policies and Procedures

The policies and procedures summarized below initially were developed by the FDIC during the 1980s. For example, the regional legal offices were instrumental in developing (1) the application form for use by law firms seeking to represent the FDIC as outside counsel, (2) ceilings on the hourly fees the FDIC would pay outside counsel based on the geographic location of outside counsel, (3) limitations on the amount of fee increases the FDIC would pay its outside counsel, (4) tracking fees for certain types of common legal work to establish budgets based on historical data, and (5) a computerized database of FDIC outside counsel.

Beginning in 1991, after the Outside Counsel Section was formed, the FDIC reviewed, updated, and expanded its policies to manage the large number of outside counsel more effectively, as well as to control costs. The FDIC obtained input from all offices that managed outside counsel to publish and distribute nationwide policies and procedures. As part of the merger of the RTC with the FDIC, the FDIC compared FDIC and RTC outside counsel policies according to the “Best Practices” review. In 1995, the Legal Division began updating a number of its outside counsel policies by incorporating recommendations from that review.

Guide for Outside Counsel

In 1990, the FDIC published separate pamphlets for outside counsel: *A Law Firm's Guide, How to be Considered for Retention by the FDIC and RTC* and the *Guide for Legal Representation*. In 1991, the FDIC combined the two pamphlets into the *Guide for Outside Counsel (Guide)*. The general counsel, in the introduction to the *Guide*, advised law firms that “The Legal Division seeks to provide the FDIC with high-quality legal representation and advice in the most practicable, efficient and cost-effective manner.” The *Guide* is incorporated by reference into the Legal Services Agreement that the FDIC enters into with outside counsel that it retains. The policies summarized below supplement the *Guide* by providing staff and outside counsel with more detailed guidance in a number of areas.

Application Process and Standard Legal Services Agreement

Beginning in 1990, the FDIC required outside counsel interested in representing the FDIC to submit a standard application package to FDIC headquarters. Before that time, each FDIC office handled its own applications from outside counsel. Beginning in 1991, all firms that submitted completed applications to the FDIC were placed on the FDIC's nationwide List of Counsel Available. The List of Counsel Available was distributed periodically to the FDIC offices that used outside counsel. Since 1992, the List of Counsel Available has been accessible electronically to staff in FDIC offices that used outside counsel.

FDIC staff referred to the List of Counsel Available to locate outside counsel in particular geographic areas. Only the law firms that were on the List of Counsel Available were eligible to enter into Legal Services Agreements (LSA) with the FDIC. An LSA is effective for a term of two years. The matrix attached to the LSA lists the personnel in the law firm who provide services to the FDIC and the rates for providing those services. Before establishing the List of Counsel Available in 1991, the FDIC maintained the List of Counsel Utilized. The List of Counsel Utilized included only those firms that were actually providing services to the FDIC.

Outside counsel submit the following information to the FDIC in its application package: (1) statement of the firm's expertise, the principal focus of the firm's practice, (2) proof of or detailed information about its malpractice insurance coverage, (3) statement of the firm's willingness to absorb the cost of developing an understanding of the FDIC's specialty areas of law, and (4) a disclosure of conflicts of interest or appearances of the same. The firm provides information about the members of the firm who practice in each area of expertise, including their number of years of experience; examples of experience; state licenses; length of time with the firm; status as a partner, associate, or paraprofessional; usual billable rates; and proposed discount rate to the FDIC.

Legal Division "Cap" Policy

The FDIC adopted its Statement of Policy and Procedures Concerning Limitations on Fee Payments to Outside Counsel (Cap Policy) in February 1991 in response to criticism that it referred an excessive amount of work to a few large law firms. The Cap Policy stated that its purpose was to enable the FDIC to avoid "unwarranted concentration of legal referrals in a few law firms."

Under the Cap Policy, referrals of new matters to law firms that the FDIC had paid more than \$7.5 million in the preceding 12 months required the written approval of the general counsel; more than \$5 million but less than \$7.5 million, the written approval of a deputy general counsel; and, more than \$2.5 but less than \$5 million, the written approval of a deputy general counsel or regional counsel. The FDIC issued quarterly reports (Cap Lists) that identified the firms that had been paid more than \$2.5 million in the preceding 12 months, as well as the firms that were approaching payments of \$2.5 million. The first Cap List, issued for the second quarter 1991, contained the names of 32 law firms.

From the third quarter of 1991 through the end of 1995, the RTC issued a separate Cap List. The FDIC revised its Cap Policy in November 1995 so that payments made by both the FDIC and the former RTC were combined to determine how much firms had been paid during the preceding 12-month period. Even with combining payments made by the FDIC and the former RTC, the Cap List for the fourth quarter 1996 showed only one firm having been paid more than \$2.5 million in the preceding 12 months.

Outside Counsel Selection and Retention Policy

The FDIC's policy on the *Selection and Retention of Outside Counsel* (Selection and Retention Policy) was published in 1992 to ensure that FDIC offices nationwide selected outside counsel in a uniform manner. The Selection and Retention Policy sets forth the factors the FDIC considers in determining whether matters should be handled in-house, as well as the factors used to select outside counsel if outside counsel handles the work. The FDIC uses in-house staff to the extent practicable to provide legal services and support in all legal matters. Certain legal areas have been handled almost exclusively in-house at the FDIC, including employment and labor law, the development and interpretation of regulations and legislation, enforcement actions and other open bank assistance and advice, and the FDIC's own corporate advice and litigation.

The following factors, considered in the aggregate, determine whether the Legal Division handles work in-house: (1) staff workload, (2) staff expertise, (3) case matter type, (4) timeliness of response required for the matter, (5) cost-effectiveness of retaining outside counsel, and (6) geographic location of the asset or venue of the court proceeding. If the FDIC determines that it cannot handle matters in-house according to the Selection and Retention Policy, staff referring matters to outside counsel consider not fewer than three outside counsel whenever possible. Circumstances may exist, however, when competitive contracting is impossible or impractical, such as with time-sensitive matters, matters handled by inherited counsel, confidential matters, and matters in which only one law firm maintains specific knowledge of the matter.

The following factors contribute to the decision of which firm to retain: (1) the Cap Policy, (2) the capacity of the firm, (3) cost (that is, the firm's rates should be competitive), (4) expertise, (5) geographic location, (6) lack of conflicts of interest, (7) minority/women information, and (8) reputation.

In 1996, the FDIC updated the Selection and Retention Policy, making significant modifications that included requiring documentation of both the decision to refer a matter to outside counsel and the choice of counsel. Another modification was, as an internal control, that either a senior FDIC manager or a committee of FDIC staff review and sign the documentation used to select outside counsel to ensure compliance with the Selection and Retention Policy.

Outside Counsel Evaluation Policy

In October 1992, the FDIC adopted a nationwide evaluation policy for outside counsel. The policy was based on practices followed by different offices. The nationwide policy ensured that all FDIC offices applied uniform criteria in assessing outside counsel's performance. The FDIC revised the policy in 1996 to require that FDIC offices follow these procedures:

- Use a standard Outside Counsel Evaluation Form that is signed by a supervisory attorney;

- Annually evaluate outside counsel paid more than \$5,000 per year;
- Immediately evaluate outside counsel paid more than \$100,000 for a matter upon completion of that matter;
- Conduct evaluations in a timely manner;
- Maintain copies of the evaluation forms; and
- Refer to evaluations before referring matters to outside counsel.

The FDIC reviews outside counsels' performance in the following areas: (1) quality of work, (2) cost consciousness, (3) responsiveness, (4) case management, and (5) compliance with and knowledge of FDIC policies and procedures.

Retention of Minority and Women Personnel of Majority Law Firms

In 1992, the FDIC issued its policy encouraging the referral of work within majority law firms to minority and women personnel. The policy states that "Every reasonable effort should be made to become aware of all minority and women personnel of majority firms and to retain them on FDIC matters."²

Malpractice Insurance

In October 1992, the FDIC adopted a policy that requires law firms retained by the FDIC to maintain malpractice insurance, except in certain circumstances. Malpractice insurance is not required for firms that are retained solely to represent the FDIC on appeal. Neither is coverage required for firms retained to liquidate assets (or to represent the FDIC in litigation related to the liquidation of assets) when the aggregate value of those assets is less than \$250,000. Outside counsel are required to maintain adequate malpractice coverage when representing the FDIC on all other matters, including liquidations exceeding \$250,000 in value.

Encouraging Competition Among Outside Counsel

The FDIC expects to receive legal representation at fees and rates that reflect substantial discounts from outside counsel's usual rate structures and welcomes offers involving alternative rate structures such as blended, flat, contingent, and other innovative rate proposals.

In April 1993, the FDIC provided its staff with guidance concerning that goal in the policy entitled *Encouraging Competition Among Outside Counsel*, which states that the FDIC is to obtain the best possible legal services for the lowest available cost. The policy states that whenever "it is both economical and feasible, every effort should be made to negotiate alternative billing arrangements."

2. The FDIC is reviewing this policy in light of the Supreme Court's decision in *Adarand v. Peña*.

Co-Counsel Guidelines

In 1993, to facilitate the referral of work to minority- and women-owned law firms in co-counsel arrangements, the FDIC issued its *Co-Counsel Guidelines for Minority and Women Outreach Program (Co-Counsel Guidelines)*. The *Co-Counsel Guidelines* state that “The case plan should ensure significant participation by the minority- or women-owned law firm in substantive legal matters.”³

Outside Counsel Case Budgets

In April 1996, the FDIC updated its policy on case budgets according to the “Best Practices” review. Outside counsel were required to submit budgets on standard forms for all matters, not just those with anticipated fees greater than \$25,000. The former RTC had required budgets for all matters on standard forms that it tracked electronically on the RTC Legal Information System.

Byrd Amendment Policy

The Byrd Amendment prohibits the expenditure of congressionally appropriated funds by any recipient of a federal contract for lobbying agency or congressional officers or employees and members of Congress in connection with the making, awarding, extension, continuation, renewal, amendment, or modification of any federal contract, grant, loan, or cooperative agreement.⁴ In March 1996, the FDIC established a written policy to comply with the Byrd Amendment.

Under the Byrd Amendment, outside counsel must submit certifications and declarations concerning lobbying activities when the FDIC has paid or expects to pay more than \$100,000 in fees and expenses to outside counsel. In March 1994, the RTC published a directive on the Byrd Amendment and formally incorporated the Byrd Amendment requirements into its contracting procedures issued in July 1994. The FDIC incorporated provisions of the former RTC policy.

Ensuring Compliance with Policies and Procedures

In an effort to ensure the effectiveness of its outside counsel policies and procedures, the FDIC periodically reviewed how offices implemented these policies. In addition, the FDIC's Office of the Inspector General reviewed FDIC payments to outside counsel to determine whether outside counsels' billing practices conformed to FDIC policies.

3. The Co-Counsel Guidelines currently are being reviewed in light of the Supreme Court's decision in *Adarand v. Peña*.

4. See *U.S. Code*, volume 31, section 1352.

Independent Legal Division Internal Review Office

In 1992, the FDIC established an independent Internal Review Office (IRO) to examine compliance with a broad range of corporate policies and procedures, including those governing outside counsel. The IRO visits FDIC offices on a one-to-two-year cycle. IRO reviews provide a mechanism to ensure that the FDIC efficiently and uniformly manages its outside counsel and that offices remain in compliance with outside counsel policies and procedures. The IRO continues the work originally performed by the regional offices. (Teams from FDIC regional legal offices periodically visited the legal consolidated offices to review operations, including the management of outside counsel.)

OIG Audit of Legal Division Payments to Outside Counsel

In 1990, the FDIC's Office of Inspector General began reviewing FDIC payments to outside counsel. In 1993, the OIG began contracting with independent public accounting firms to perform the audits; in 1994, it issued 21 reports; and, in 1995, it issued 26 reports. The OIG selected high-billing outside counsel and typically reviewed samples of invoices to determine whether outside counsel complied with Legal Division billing policies and procedures. According to the *Guide for Outside Counsel*, law firms are required to keep their billing records for at least four years after final payment for that purpose.

In 1996, the OIG audit functions dramatically increased in volume with the transition of the RTC and its OIG audit program into the FDIC's audit program. In addition to the 32 reports issued by the FDIC OIG in 1996, the RTC audit program brought 44 unresolved 1995 audits. The FDIC OIG issued another 48 audits already commissioned by the RTC OIG, for a total of 124 outstanding RTC and FDIC audits in 1996. To handle the unresolved RTC audits throughout the FDIC divisions and offices, the FDIC chief financial officer convened a task force to address the situation. The project became known as the RTC Backlog Project. The Legal Division had the largest part of the work, with 44 reports containing more than 600 OIG recommendations. The task force met every two weeks from March through October 1996 and accomplished the resolution of all 600 recommendations at the same time the audit staff continued to address the 1996 FDIC and RTC OIG audit reports.

The workload of the audit program continues to be substantial with an expected 60 new audit reports to be issued in 1997. The OIG has projected that, beginning in 1998, it will initiate only 10 outside counsel audits per year because of the decline in the Legal Division's use of outside counsel.

Information Systems

As the FDIC referred an increasing number of matters to outside counsel, it developed centralized computer systems to assist it in tracking and managing referrals, as well as

processing invoices for payment. These systems have the additional capability of generating statistical information concerning the use of outside counsel.

Case Management System (CMS)

When the FDIC began referring matters to more law firms in 1983 and 1984, it was in the process of decentralizing its operations. To keep track of the law firms being used and to track matters referred to law firms, the FDIC used a minicomputer system. In 1984, the FDIC contracted with an accounting firm to create a database that would track 500 FDIC Legal Division cases that were being handled by outside counsel. That database was used while a mainframe tracking system was being developed. The mainframe system, called the Case Management System (CMS), went into production in January 1986. The purpose of the CMS was to help attorneys keep track of a burgeoning caseload and to assist management with statistical reporting and workload projections. Data from the CMS was used in the bill payment system, the Legal Service Invoice (LSI) System. (See below.) In 1991, the CMS was also interfaced with the FDIC's Financial Institution System database for validating financial institution information, and the Liquidation Asset Management Information System database for validating the account officer assigned to assets. Most of the features of the CMS, as well as the Legal Division systems discussed below, were combined into the Legal Management Information System (LMIS) and the Legal Payment System. The initial LMIS pilot program was implemented in 1995.

RTC Legal Information System (RLIS)

When the RTC established its Legal Division in 1991, it developed the RTC Legal Information System (RLIS) mainframe computer system that tracked information about matters referred to outside counsel, including budgets, and also processed payments to outside counsel. RLIS became operational in 1992 and was merged into the FDIC's Legal Payment System in 1997.

Outside Counsel Information System (OCIS)

Before 1993, when the mainframe Legal Division Information Management System (LDIMS) became operational, outside counsel information was stored in small PC-based systems in each field office and in Washington, D.C. Those systems contained the names and addresses of law firms that were available to perform work for the Legal Division, as well as LSA information.

LDIMS was envisioned as a system composed of several modules that would handle all legal information needs. The FDIC anticipated replacing the CMS and the LSI System with LDIMS. Although the LDIMS Outside Counsel module went online in March 1993, the remaining modules were never implemented. After the FDIC

determined that LDIMS would contain outside counsel information only, the system's name was changed to the Outside Counsel Information System (OCIS). OCIS contained information submitted by outside counsel in the application to the FDIC, including areas of expertise; comments on the firm's conflicts of interests; minority and women ownership status; FDIC legal services agreement information, including effective and expiration dates; and some rate schedules. In 1997, information contained in OCIS was converted to the Outside Counsel Application Tracking System (OCATS), while legal services agreement information was transferred to the Legal Payment System. (See below.)

Fee Bill Payment Systems

Before the fall of 1990, the FDIC did not maintain an information system for processing invoices submitted by outside counsel. Fee bills for legal services were paid using a payment authorization voucher (PAV). Legal Division staff in the field offices and in Washington, D.C., prepared the PAVs and forwarded them to the Fee Bill Unit in Washington for review and approval. After the PAVs were approved, the Fee Bill Unit sent them to the Division of Finance for payment.

As the payments to outside counsel continued to increase, however, it became apparent that the Legal Division required the assistance of an information system to ensure that fee bills were being paid in a timely manner and that the appropriate procedures were being followed throughout the process.

Accelerated Payment Program

Because the FDIC was required to use an increasing number of outside counsel as institutions failed, its payment systems were not able to process the large volume of invoices submitted by outside counsel in a timely manner. Additionally, because the FDIC was unable to process the large number of unpaid fee bills that remained after the dissolution of the Federal Savings and Loan Insurance Corporation (FSLIC), a large backlog arose.

In the fall of 1990, the FDIC instituted a program called the Accelerated Payment Program (APP) in an effort to pay outside counsel in a timely manner. Law firms that submitted the FDIC's simplified payment form were paid promptly, although the firms were still required to submit detailed invoices with supporting documentation. The FDIC completed a review of those detailed invoices separately to ensure that payments and proper disallowances were made correctly.

Legal Services Invoice System and RLIS

In the fall of 1991, the FDIC implemented the Legal Service Invoice System for paying outside counsel invoices; the RTC implemented RLIS in March 1992. Those informa-

tion systems enabled the legal divisions to track the entire fee bill payment process and ensure that bills were paid promptly. Both systems contained many checks and balances to ensure that invoices submitted by outside counsel were reviewed before payment. The Legal Division summarized its key fee bill payment policies in the *Guide* and provided outside counsel with detailed instructions in separate fee bill payment manuals.

Statutory Provisions Relating to the Use of Outside Counsel

Before 1989, no specific statutes directly governed the FDIC's use of outside counsel. With the enactment of FIRREA, which created the RTC, certain management and operational requirements were mandated for the new entity. FIRREA required the RTC to use private-sector service providers when such service providers were practicable and efficient. Given the volume of closed institutions inherited by the RTC at its creation and the prospect of hundreds of institutions closing, the resources of the Legal Division were stretched to the limit; therefore, law firms became one of the many private-sector service providers used by the RTC.

The Completion Act addressed many RTC and FDIC programs. Several Completion Act provisions concerned the RTC Legal Division's use of outside counsel, specifically the selection and retention of outside counsel. Additionally, the Completion Act contained several provisions affecting the selection and retention of outside counsel that expressly apply to the FDIC. The Completion Act also called for cost-consciousness and inclusion of minority- and women-owned businesses and law firms in the RTC's contracting practices. It also identified who within the RTC could execute contracts and modifications and required the inclusion of a specific notice provision in all such documents. The notice provision advised the contractor that only those contracts signed by a duly authorized contracting officer were valid. As a result, the RTC Legal Division developed and implemented a Warranted Legal Officer Program. The program limited the number of individuals within the RTC Legal Division authorized to execute engagement letters or contracts.

The RTC management reforms contained at least three provisions that affected the hiring of outside counsel regarding minority contracting or cost savings. The RTC was required to establish guidelines for achieving the goal of a reasonable, even distribution of contracts to the various subgroups of the classes of minority and women-owned certified businesses and law firms. A 5 percent threshold was established. Thus, contracts were to be evenly awarded to not fewer than 5 percent of all minority- and women-owned certified contractors. Furthermore, the RTC was directed to establish reasonable goals for those entities contracting with it to subcontract with minority- and women-owned businesses and law firms. The procedures provided that the RTC could not enter into any contract for services, including legal services, where the contractor would receive fees or other compensation of \$500,000 or more, unless the RTC required the contractor to subcontract with minority- or women-owned businesses, including law

firms. While the procedures provided for exceptions and limited waiver authority to exclude a contract from the requirements, the procedures also provided for the periodic review (submission of quarterly reports) of such exceptions.

Concerning controlling outside counsel costs, the Completion Act provided the following:

(20) Management of legal services. - To improve the management of legal services, the Corporation - (A) shall utilize staff counsel when such utilization would provide the same level of quality in legal services as the use of outside counsel at the same or a lower estimated cost; and (B) may only employ outside counsel - (i) if the use of outside counsel would provide the most practicable, efficient, and cost-effective resolution to the action; and (ii) under a negotiated fee, contingent fee, or competitively bid fee agreement.⁵

While the language of the Completion Act applied expressly to the RTC, it also was underscored as applicable to the FDIC in separate provisions of the act that revised various sections of the Federal Deposit Insurance Act (FDI Act) of 1950.

One of the Completion Act's separate provisions identified legal services as an additional service available to the FDIC when managing and disposing of assets of a receivership. However, the FDIC was advised that legal services in the private sector should be obtained only when their use is most practicable.

The amended provision of the FDI Act reads as follows:

In carrying out its responsibilities in the management and disposition of assets from insured depository institutions, as conservator, receiver, or in its corporate capacity, the Corporation shall utilize the services of private persons, including real estate and loan portfolio asset management, property management, auction marketing, legal, and brokerage services, only if such services are available in the private sector and the Corporation determines utilization of such services is the most practicable, efficient, and cost effective.⁶

The Completion Act also instructed the FDIC to use outside counsel sparingly and to accomplish previously established minority- and women-owned law firm outreach goals. In addition, this section of the Completion Act created a certification requirement by the chairman of the Board of Directors of the FDIC. The chairman must certify, among other things, that:

(x) the Corporation has improved the management of legal services by - (I) utilizing staff counsel when such utilization would provide the same level of quality in legal services as the use of outside counsel at the same or a lower estimated cost; and (II) employing outside counsel only if the use of outside

5. See *U.S. Code*, volume 12, section 1441a(w)(20).

6. 12 U.S.C., section 1821(d)(2)(K) as amended by section 3(d) of the Completion Act.

counsel would provide the most practicable, efficient, and cost-effective resolution to the action and only under a negotiated fee, contingent fee, or competitively bid fee agreement.⁷

The Completion Act further required that the FDIC chairman of the board certify that the FDIC “is implementing the minority outreach provisions mandated by section 1216 of the Financial Institutions Reform, Recovery, and Enforcement Act of 1989.”⁸ Those certifications must be made to Congress before or during the fiscal year in which the FDIC seeks to expend amounts appropriated for payments by the secretary of the Treasury to the Savings Association Insurance Fund for losses incurred by the fund in fiscal years 1994 through 1998. The Completion Act appeared to codify the RTC's minority/women-owned contracting outreach initiatives.

Conclusion

To effectively handle the tremendous volume of legal matters resulting from the rising number of failing financial institutions, the FDIC increasingly turned to outside counsel. The use of outside counsel peaked in 1991, when the combined FDIC and RTC direct and indirect payments to outside counsel reached \$701 million. It should be noted that a factor contributing to the extensive use of outside counsel was that the RTC, according to FIRREA, was required to use private-sector contractors, including outside counsel, whenever practicable and efficient for carrying out its mission. In an effort to reduce payments to outside counsel, however, the RTC, under the Completion Act, was directed to use in-house resources before retaining outside counsel. The FDIC historically had used in-house staff for a significant amount of its legal work.

To more effectively retain, manage, and pay the record number of outside counsel during the financial institution crisis, the FDIC Legal Division retained outside consultants to provide recommendations on improving its management practices. The Legal Division responded to the recommendations it received by developing uniform policies and procedures for the selection, retention, and management of outside counsel.

7. 12 U.S.C., section 1821(a)(6)(E) as amended by section 8(b) of the Completion Act.

8. 12 U.S.C., section 1821(a)(6)(E) as amended by section 8(b) of the Completion Act.

The positive product of internal controls—the prevention of mistakes and problems—is not easily quantifiable and often goes unnoticed. The negative aspects of internal controls, however, are rarely missed.



CHAPTER 19

Internal Controls

Introduction

This chapter provides an overview of the evolution and implementation of internal control programs at the Federal Deposit Insurance Corporation (FDIC) and the Resolution Trust Corporation (RTC). Internal controls provide management with reasonable assurance that its programs are effectively and efficiently executed; waste, fraud, and abuse and misappropriation of assets are minimized; financial statements are reliable; and compliance with the law is ensured.¹ From 1980 to 1994, the FDIC, the RTC, and the Federal Savings and Loan Insurance Corporation (FSLIC) resolved 2,912 failed institutions. The agencies disposed of a portfolio of assets that dwarfed those of any other public or private sector entity and undertook contracting efforts that were second only to the Department of Defense in magnitude.

With the dramatic growth in the FDIC and the RTC came an increase in their vulnerability to instances of inefficiency and ineffectiveness, as well as waste, fraud, and abuse and misappropriation of assets. As the workload and staffing expanded enormously and the operations grew in complexity, traditional FDIC internal control methodologies provided insufficient assurances. When the RTC was created as an entirely new entity, it was assigned responsibility for 262 savings and loan (S&L) conservatorships with \$115 billion in assets at its inception. If not properly controlled, the resolution of the financial institution crisis had the potential to become a crisis of its own. Accordingly, the internal control programs at the FDIC and the RTC had to be

1. The term “reasonable assurance” is an internal control standard defined by the General Accounting Office (GAO) Standards of Internal Controls for the Federal Government (1983). Reasonable assurance is a satisfactory (not absolute) level of confidence in achieving internal control objectives and safeguarding resources, given considerations of costs, benefits, and risks.

adapted to meet the radically changing dimensions of their management responsibilities. In addition, mounting public concern over the financial institution crisis and new laws subjected virtually every aspect of the agencies' activities to outside scrutiny. Internal controls therefore played an increasingly vital role in the operations of the agencies.

From 1980 to 1994, the FDIC and the RTC encountered three major areas of high vulnerability: (1) contracting and contract management, (2) information systems, and (3) asset management and disposition. Although mistakes and problems occurred in each of the areas, the FDIC and the RTC identified and resolved them. The internal controls that were developed contributed to the FDIC's and the RTC's efforts in preventing a loss of public confidence in the two agencies.

Changing Roles and Operational Risks of the FDIC and the RTC

Because there had been few bank failures in the 1970s, the FDIC's internal control requirements for liquidation of the banks' assets were not extensive. Between 1985 and 1992, however, 2,461 banks and S&Ls failed, an average of about one per day over a period of eight years. (See chart I.19-1.)

During the 1980s and early 1990s, sweeping legislation affected the FDIC, created the RTC, restructured the banking and S&L industries, and expanded the internal control practices of independent federal agencies. Staffing requirements also created significant demands on the FDIC and the RTC. The FDIC started the 1980s with 3,598 employees, who focused primarily on bank examinations and supervision. FDIC staffing peaked in 1992 with 15,044 employees. Although regulatory supervision of institutions continued to be a high-profile function of the FDIC, the largest staff increase occurred in the FDIC's asset management division, which went from a staff of 432 at year-end 1979 to 6,608 in mid-1993. Large staffing increases also were necessary at the RTC. Created in 1989 with the transfer of a few hundred FDIC employees as its core of technical experience and management, the RTC reached its peak staffing level at 8,614 in 1991.

In addition to managing the risks associated with such a large increase in staff, the FDIC and the RTC had to address significant risks in other areas. The agencies were responsible for acquiring the services of and overseeing thousands of private sector contractors and accounting for millions of dollars of related expenses. Moreover, resolution of the failed banks and S&Ls and liquidation of the assets of these institutions required managing sophisticated financial transactions involving millions and even billions of dollars.

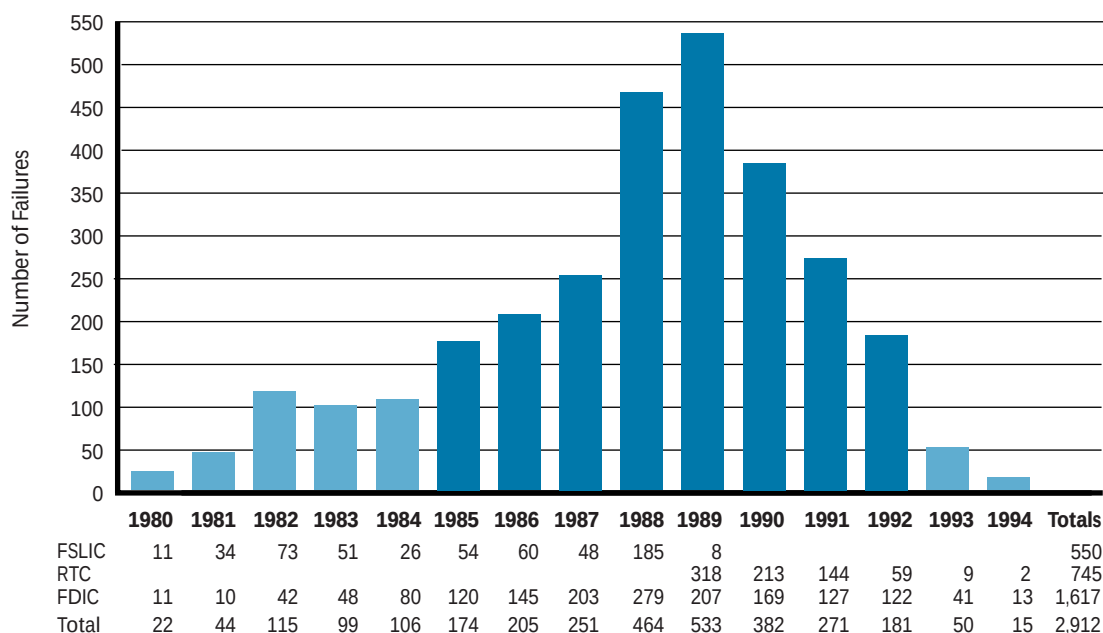
Accuracy of asset information was another key issue for the agencies. They had to expand and control their information management systems and computer resources. Merging the huge volume of financial data from each institution's system into a reliable central system of information was an especially difficult and problematic challenge. The failed banks and S&Ls used an assortment of proprietary and commercial

record-keeping systems that contained data that was difficult to assimilate into the agencies' systems.

As the workload increased, the FDIC and the RTC decentralized their asset management and liquidation operations. Beginning in 1983, the FDIC established regional and consolidated field offices in various states. At its peak, it had 23 consolidated field offices. The RTC also used a decentralized structure, which at its peak had 14 consolidated offices. As the financial crisis increased and decreased in various regions of the country, the agencies opened and closed offices. Managers of the offices were given significant delegated authority over the operations. This flexible organizational structure led to a number of innovations that proved beneficial, but made it more difficult to standardize and coordinate internal controls, policies and procedures, and information systems.

Chart I.19-1

**Combined Number of Failures
(Banks and S&Ls)
1980–1994**



Figures include FDIC and FSLIC open bank assistance transactions.

Dark blue bars represent the time frame when most failures occurred. From 1985 to 1992, a total of 2,461 banks and S&Ls failed.

Source: FDIC Division of Research and Statistics.

Increased Performance Accountability

Throughout the financial crisis of the 1980s and early 1990s, the performance of the FDIC and especially the RTC came under the scrutiny of a wide range of public and private sector entities. The press, specialized economic interest groups, Congress, private citizens, and the General Accounting Office (GAO) all developed a heightened interest in the agencies' activities.

Government reform legislation, enacted from 1989 to 1991, elevated the FDIC's and the RTC's standards of performance accountability. First, the agencies were made subject to the provisions of the Inspector General Act of 1978, pursuant to amendments enacted in 1988.² Consequently, the FDIC and the RTC each established an Office of Inspector General (OIG) in 1989 and 1990, respectively. Second, the FDIC implemented the standards of the Chief Financial Officers Act (CFOA) of 1990. The CFOA required government corporations to submit to Congress annual management reports that included financial statements and independent audits of those statements. In addition to implementing the CFOA, the FDIC implemented the provisions of the Federal Managers Financial Integrity Act (FMFIA). Language in FMFIA reiterated the need for internal controls but, more significantly, addressed the need for federal managers to evaluate controls against GAO-established standards and required managers to report to Congress on their internal control systems and plans to correct significant weaknesses. Both the FDIC and the RTC established chief financial officer (CFO) positions and increased the independence of their internal review programs.³

In 1991 Congress passed another federal act that affected the FDIC's internal controls methodology. With the enactment of the Federal Deposit Insurance Corporation Improvement Act (FDICIA), the FDIC was required to describe to Congress semi-annually its efforts to maximize the use of private sector resources. Provisions in FDICIA also required management and auditor reports on the effectiveness of internal controls, independent audit committees, and accounting reforms in ensuring reliable financial reports.

In December 1992, the GAO concluded that the FDIC's Bank Insurance Fund (BIF) should be added to its list of designated high-risk areas because of the depletion of the fund and the need for improved accounting rules and bank examinations to "shore up" and maintain the well-being of the nation's system of deposit insurance.⁴

2. In 1989, under the Financial Institutions Reform, Recovery, and Enforcement Act (FIRREA) enacted that year, the RTC was directed to comply with the 1988 amendments.

3. The RTC first established the position of CFO in January 1991 and restructured and increased the authority of the position in June 1993; the FDIC established the CFO position in November 1992.

4. GAO, Bank Insurance Fund (GAO/HR-93-3), December 1992. In 1990, the GAO began a special effort to review and report on the federal program areas considered to be high risk because they were especially vulnerable to waste, fraud, and abuse and misappropriation of assets. In December 1992, the GAO published its first reports on the fundamental causes of problems in designated high-risk series areas.

Another high-risk area the GAO identified was the RTC's management of its asset disposition and contracting activities and its information systems.⁵ In 1989, the GAO began allocating substantial resources for monitoring the BIF and the RTC's operations. The GAO determined that the RTC, as a federal program with billions of dollars of taxpayers' money, was highly vulnerable to loss through waste, fraud, and abuse and misappropriation of assets. As a result, the GAO dramatically heightened its focus on deposit insurance regulation. When Comptroller General Charles Bowsher testified before the Senate Committee on Governmental Affairs in January 1993, he emphasized the dramatic change in focus by stating that "deposit insurance is an area where we have spent a lot of money in the last four years. It is an area we didn't spend a dime on up until fiscal year 1989."⁶

In 1995, because of the positive results of the initiatives by the FDIC and the RTC over a period of approximately two years, the GAO removed the BIF and the RTC from the high-risk series.⁷ In the GAO review of the RTC's response to the management reforms mandated by the RTC Completion Act (Completion Act) of 1993, the GAO found that the RTC and the RTC Oversight Board had initiated actions to implement all the reforms.⁸ In a later review, the GAO stated that the RTC's efforts reflected a significant commitment to implementing needed management improvements and, coupled with intervening legislation, addressed many of the identified deficiencies.⁹

Accounting Industry Changes

The accounting industry's guidelines and internal controls audit methodology were also evolving during the 1980s. Traditional audit methods had focused on specific controls that failed during the audit review period and not necessarily on the overall system. Attest auditing was a traditional methodology that was appropriate to the organizational needs of the time.¹⁰ Because the approach focused on historical events, however, the standards did not account for the evolving needs of the management controls of large, complex organizations. Additional pressures were on the accounting industry because some of the independent public auditors were experiencing extensive operational growth and quality control problems caused in part by efforts to meet the increased demand for their services from the FDIC, the RTC, and the banking industry.

5. GAO, Resolution Trust Corporation (GAO/HR-93-4), December 1992.

6. *Congressional Record*, 103rd Congress, 1st sess., January 8, 1993, S. Hrg. 103-177.

7. GAO, *High Risk Series: Quick Reference Guide* (GAO/HR-95-2), February 1995.

8. GAO, *Implementation of the Management Reforms in the RTC Completion Act* (GAO/GGD-95-67), March 1995.

9. GAO, *Efforts Under Way to Address Management Weaknesses* (GAO/GGD-95-109), May 1995.

10. Attest auditing is commonly associated with a financial statement audit whereby an auditor tests the financial numbers and writes an opinion attesting to the validity of the statement.

The definition of internal controls was also being reviewed and updated during the 1980s and the 1990s. In 1983, the GAO's "Standards for Internal Controls in the Federal Government" defined internal controls as "the plan of organization and methods and procedures adopted by management to ensure that resource use is consistent with laws, regulations, and policies; that resources are safeguarded against waste, loss, and misuse; and that reliable data are obtained, maintained, and fairly disclosed in reports."¹¹ The Treadway Commission, in its 1992 report, defined internal controls as "a process, effected by an entity's board of directors, management and other personnel, designed to provide reasonable assurance regarding the achievement of objectives in the following categories: effectiveness and efficiency of operations; reliability of financial reporting; [and] compliance with applicable laws and regulations."¹² As the new accounting industry procedures and standards for internal controls were being developed, the FDIC and the RTC began incorporating those controls into their operations.

The FDIC's and the RTC's Internal Control Programs

In the 1970s and early 1980s, the FDIC's Office of Corporate Audits (OCA) used generally accepted auditing standards to conduct audits and investigations of all activities within the FDIC.¹³ The OCA operations were designed to (1) safeguard the assets of the FDIC; (2) perform a management control function for the board of directors; (3) minimize waste, fraud, inefficiency, and excessive costs; (4) recommend improvement of fiscal and operational controls; and (5) provide information in the form of audit reports to the board of directors and management.

With the failure of Penn Square Bank, N.A., Oklahoma City, Oklahoma, in 1982 and of the Butcher-related chain of banks headquartered in Tennessee in 1983, the FDIC began to expand its control systems and internal audits to meet the growing volume and complexity of the liquidation workload. The FDIC hired independent public auditors in far greater numbers to help conduct audits. The workload of the OCA also increased. In 1984, the OCA issued 51 audit reports and, just two years later in 1986, it

11. GAO, *Standard for Internal Controls in the Federal Government*, 1983.

12. In 1985 the American Institute of Certified Public Accountants created the Treadway Commission in response to congressional and public criticism that many of the financial institution failures were caused by the failure of the institutions' auditors to detect fraud. The commission studied the "expectation gap" between the public's and the auditors' perception of audit functions and responsibilities in distinguishing between business failure and audit failure.

13. In 1989, the OCA was designated as the FDIC's Office of Inspector General, in compliance with the 1988 amendment of the Inspector General Act of 1978. The main responsibilities of the Office of Inspector General, an independent office, are to audit the programs and operations of the FDIC and investigate complaints of waste, fraud, and abuse and misappropriation of assets. Section 5 of the amendment requires the submission of a semiannual report to Congress.

issued 157 audit reports. Thereafter, throughout the crisis years, the number of audit reports issued remained high.

In 1984, as part of enhancing internal controls, the FDIC's asset management division introduced an expanded internal visitation program aimed at providing site managers with an evaluation of their operation as well as suggestions for improvement. The visitations were designed to review all facets of division procedures and were conducted out of the headquarters or regional offices by sending FDIC staff with subject matter expertise to the office being reviewed. The program yielded returns in operating efficiencies as well as improved audit findings, especially regarding internal controls. With the increasing workload on the FDIC staff and the expansion of the review and audit programs, however, management determined that the peer-reviews were no longer sufficient or practical. In 1985, to compensate for the lack of dedicated internal review capability, the FDIC established full-time, professional internal review positions in the regional offices.

When the RTC was created with the enactment of the Financial Institutions Reform, Recovery, and Enforcement Act (FIRREA) in August 1989, it was confronted with challenging internal control issues, such as the requirements to use outside contract services extensively and to report in great detail to the newly created RTC Oversight Board. On the RTC's first day of operation, the oversight board adopted the FDIC's procedures as an initial source of policies and procedures including internal control guidelines. Over the next 21 months, RTC management determined that the internal controls should be enhanced. In May 1991, the oversight board asked the Treasury deputy secretary and the Housing and Urban Development deputy secretary to lead a working group to direct three tasks: (1) to coordinate efforts among the board, the RTC, OIG, and the GAO to improve the RTC's management of assets, methodology to estimate asset values, cash controls, and overall internal controls; (2) to make sure that the RTC put in place an "early warning" system to identify potential problems; and (3) to ensure that the RTC had a system to track the implementation of corrective actions and to verify achievement of expected improvements.

In response to the working group's recommendations, the oversight board assigned the responsibility and oversight for RTC internal controls and security reviews of the critical financial and management systems to senior management. The board also assigned accountability for each system and its data to the program or office managers who were the primary users of the system. All department heads were responsible for evaluating their component financial subsystems. System audits included a review of general application, processing, and access security controls to ensure that data produced by a system was accurate, reliable, and safeguarded against unauthorized manipulation. In addition, the GAO and OIG conducted periodic audits of the RTC's financial and other systems.

In the early 1990s the FDIC and the RTC expanded their internal review functions. Internal review officers reviewed field offices in terms of their implementation of major programs to ensure that statutory requirements were addressed, that the programs as

designed met their objectives efficiently, and that programs and policies were being implemented and followed. They also performed internal reviews on request to address the particular needs of senior management. The FDIC integrated a risk-based internal control process to improve management controls and to satisfy the requirements of the CFOA. Risk-based internal controls are based on the accountability of management for identifying inherent risks of the operations and on the requirement that management must then develop and implement procedures and policies to reduce the consequences of any identified material risk to an acceptable level.¹⁴

The agencies' new internal review risk-based framework incorporated three additional control components into the traditional process. The first component was initiating a formalized, proactive risk management process that identified management accountability from the field level up to the headquarters level and tied the control of inherent risk to the accomplishment of program objectives. Critical controls of operational processes (event cycles) were "flowcharted" and updated on regular cycles. Tests were performed to evaluate controls for applicability and effectiveness, and corrective actions for control problems were then monitored until they were resolved. The identification and sharing of effective practices among offices contributed to the evolution of better risk management processes.

The second control component of the internal review framework was holding the chief financial officer and senior management responsible for managing weaknesses in internal controls. The third component was creating and maintaining independent management reporting systems on observed material control weaknesses. Each agency's system identified weaknesses and corrective actions to be taken and reported the status of internal controls to corporate and senior management.

In March 1992, the RTC published a directive on policies, standards, and responsibilities for the development, maintenance, and evaluation of internal controls for its programs and administrative activities. A key component of the directive required the RTC's chief executive officer to establish policies and procedures necessary for operating an RTC-wide program of internal controls. It also directed the agency to submit to its oversight board an annual statement and report on internal controls. RTC senior managers were responsible for designing, implementing, and maintaining effective internal controls within their organizations.

The FDIC also published its internal controls policies and procedures. By 1993 the FDIC had dedicated an entire office in New Jersey to the internal review of the asset management and liquidation activities.

14. The term "inherent risk" refers to "the relative potential for fraud, waste, abuse or mismanagement due to the nature of the function of the accountability unit without regard to the control environment." FDIC, *CFOA Manual*, 1997.

Examples of Significant Issues and Management Actions

During the 1980s and early 1990s, three major FDIC and RTC operational sectors emerged as areas of high vulnerability: (1) contracting and contract management, (2) information systems, and (3) asset management and disposition. Mistakes and problems in those areas ranged from isolated events to significant issues in major systems and program areas. For example, contracting and contract management dealt with the performance and cash management of thousands of contractors. Problems in information systems centered on the lack of consistency of data for hundreds of thousands of assets that had to be converted from a variety of systems used by the failed institutions. The asset management and disposition area focused on controls that were needed to address new techniques in the mass marketing of loans and real estate, including innovations such as securitization, national auctions, and partnerships.

Contracting and Contract Management

In the area of contracting and contract management, the FDIC and the RTC were subject to statutory requirements. The RTC, as directed by provisions in FIRREA, used private sector contractors whenever practical and efficient. With the enactment of FDI-CIA in 1991, the FDIC was authorized to use the services of private sector contractors specifically for managing and disposing of assets from failed institutions when practical and efficient. Contracting and contract management were extremely important areas because contractors were used in key operational functions such as asset management and sales.

By the spring of 1990, the RTC was coming under increasing public pressure to accelerate the resolution of the conservatorship institutions. In March 1990, in response to that pressure, the RTC announced that it would liquidate 141 conservatorship institutions by June 30, 1990, and that the initiative would be known as Operation Clean Sweep (Clean Sweep).¹⁵

Clean Sweep exceeded the goal of 141 resolutions; the RTC resolved 155 failed S&Ls in 31 states with total assets of \$44.4 billion. The closings, however, had been done so quickly that inadequate consideration had been given to coordinating the records and accounting systems at the institutions being closed with the systems in place at the RTC. As of March 1991, the records and the general ledger of RTC's western region were out of balance by \$7 billion, and without an accurate accounting of the number of assets and their value, the assets could not be properly marketed.

Clean Sweep's accounting problems received extensive press coverage and criticism. In response, the RTC's western regional office quickly initiated a reconciliation project and contracted with a large accounting firm for assistance. The project to reconcile the

15. See Chapter 4, Evolution of the RTC's Resolution Practices.

systems was called the Asset Stratification and Reconciliation Project, which became known as Western Storm.

Western Storm, which cost \$25 million, came to epitomize overall RTC contracting issues; it was discovered that sound contracting controls and procedures had not always been employed in hiring the contractors. In reports to Congress, the RTC's OIG and the GAO stated in general that systemic contracting flaws were identified in the following areas: (1) planning for major areas before awarding contracts, (2) ensuring fair and open competition in awarding contracts, (3) obtaining approval from the proper levels within the RTC organization, (4) adequately monitoring and overseeing contractors' charges, and (5) failing to have a system to provide information on contractor performance.¹⁶ Western Storm was significant because it brought about heightened attention to overall weaknesses in the RTC's contracting process and resulted in major management initiatives to improve internal controls in this important area.

In 1992, as a result of Western Storm, the RTC reviewed the contracting process and made broad revisions to its contracting policies and procedures and more clearly articulated contractor oversight and administration responsibilities. In 1993, management had either implemented or submitted plans to implement every contracting-related recommendation that the OIG had made and had initiated a comprehensive training program on the fundamentals of contracting, contract administration, and the roles and responsibilities of the oversight manager.

Earlier, the RTC had implemented other contract management measures. In January 1991, it established the Office of Contractor Oversight and Surveillance to engage and direct independent public accounting firms to perform on-site reviews of contractors. Those reviews provided the RTC with assurance on the viability of the contractors' financial and administrative operations by addressing, in part, internal controls and cash management procedures, as well as compliance with RTC policies and procedures.

The FDIC responded to the challenge of asset management contracting by improving its procedures for overseeing contractors employed to service large pools of assets obtained from multi-million-dollar bank failures. To deal with that large volume of assets, the FDIC used a staff with extensive and specialized experience in the private sector to continuously review the actions of the contractors. Through the efforts of its on-site oversight staff, independent site visitation teams, and outside audits directed by the OIG, the FDIC ensured that contractors complied with the terms of the service agreements and that assets were managed in a manner that maximized the corporation's recovery.¹⁷

16. OIG, *Semiannual Report to Congress*, October 1, 1991–March 31, 1992; OIG, *Western Region's Asset Stratification and Reconciliation Project*, February 2, 1992; GAO, *Summary of GAO Products on RTC*, July 1993; GAO, *Summary of RTC: Western Storm Investigation and Related Contracting Deficiencies*, August 6, 1992.

17. For more information on FDIC and RTC contracting, see Chapter 14, Asset Management Contracting.

Information Systems

In the area of information systems, comprehensiveness, accuracy, reliability, and security were central control issues. The FDIC and the RTC needed reliable information about their inventory of assets and about the performance of the disposition efforts, claims administration, and other resolution and receivership initiatives. To a large extent, those concerns became contracting oversight issues because both agencies required private sector expertise for information management.

Large, complex, proprietary information systems could take years to develop and implement, but neither the RTC nor the FDIC could commit to such a timeframe and still meet their accelerated asset disposition schedules. Risks in the information systems area were compounded by the magnitude of the workload, the large number of different financial systems previously used by failed institutions whose data had to be converted to new systems, and the often abysmal quality of the records of the failed institutions. Furthermore, the agencies' decentralized office structure increased the risk that the development of management information systems would not be adequately coordinated.

The RTC recognized the need for a cash and management information system to transfer funds between the RTC and its asset management contractors and to provide a means to oversee and account for actions of its contract asset managers. In July 1990, the RTC contracted for the design, development, implementation, and operation of what was to become known as the Asset Manager System (AMS). Initial OIG and GAO audit reports to Congress criticized the development process and the design of the AMS, but the RTC initiated corrective action.¹⁸ Beginning in 1992, the RTC implemented OIG recommendations by performing additional field-testing on AMS and producing documents for AMS, including adequate source code documentation, an installation plan, and operations and maintenance manuals.

The FDIC's asset management system, the Liquidation Asset Management Information System (LAMIS), began operation in 1984. At the time, the diversity and volume of assets acquired from failed institutions were less complex. With the growing crisis, however, LAMIS needed to be enhanced. Audits by the GAO in 1991 and 1993 and by the OIG in 1992 and 1993 found deficiencies in data integrity, response time and availability, effectiveness of system support activities, and the degree of system functionality in supporting liquidation goals and objectives.¹⁹ The FDIC took actions to

18. OIG, *Semiannual Report to Congress*, April 1992–September 1992; OIG, *Development and Implementation of the Asset Manager System*, September 24, 1992; GAO, *Corporate Strategy Needed to Improve Information Management* (GAO/IMTEC-92-38), March 1992; GAO-RTC, *Status of Asset Manager System* (GAO/IMTEC-92-34BR), March 5, 1992.

19. GAO, *Loan Sales Jeopardized by Systems and Other Internal Control Problems* (GAO/IMTEC-91-61), August 1991; GAO, *Asset Management System/Liquidation of Failed Bank Assets Not Adequately Supported by FDIC System* (GAO/IMTEC-93-8), February 1993; OIG/FDIC, *Information Systems Audit of LAMIS* (92-060) 1st quarter 1992; OIG/FDIC/IS, *Audit-Owned Real Estate System Processing* (93-131) 4th quarter 1993.

correct the deficiencies by implementing an extensive data integrity program, which was a broad-based effort. Program teams included managers and subject matter experts from several FDIC divisions. As a result of the program, the FDIC engaged private-sector contractors to service smaller valued assets, thus allowing FDIC staff to devote more time to improving data integrity for the larger assets. The program also allowed the FDIC to reassess required data elements, issue policy changes requiring account officers to certify the accuracy of required data elements on all assets in their portfolios, and establish quality assurance groups at the offices. The project initiatives resulted in a series of software program enhancements, which were installed by October 1996.

Asset Management and Disposition

In the area of asset management and disposition, major liquidation functions and internal controls had to be coordinated to effectively dispose of assets acquired from the failed institutions. With such dramatic growth in the number and value of the assets at both the FDIC and the RTC, asset disposition internal controls were under constant revision. For example, during 1987, when 251 bank and S&L failures occurred, the FDIC and the FSLIC together held \$18 billion in assets at year end. At year-end 1989, with a combined total of 533 failures, the FDIC and the RTC (the FSLIC had been dissolved into the FDIC) together held \$81.2 billion in assets.

Significant issues in the area of asset management and disposition were related to national marketing initiatives, asset valuation methodologies, appraisal acquisition and evaluation, cash management practices, the recovery of tax benefits from assisted institutions, and the management and oversight of subsidiaries. Traditional asset disposition methods and markets were broadened with innovative programs such as securitizations and national auctions. Because some of the approaches were new, however, historical information was not available for designing controls and measuring performance.

Both agencies established internal oversight and review functions to monitor the financial results and compliance with established policies and procedures. To accomplish the goals of the policies and procedures, the RTC used such techniques as engaging private industry experts to develop disposition strategies for its large, sophisticated asset portfolios. The FDIC established procedures to increase the effectiveness of initiatives such as national bulk sales and the selling of assets at the time of resolution to accelerate the disposition of assets.²⁰

The RTC also had devised a number of marketing strategies in an effort to quickly dispose of its assets. The Widely Marketed Portfolio Program was one such strategy. Under the program, which began in March 1991, a qualified investor could select assets from a list of assets that had been unsuccessfully offered through auctions or sealed bids.

20. For more information, see Chapter 12, Evolution of the Asset Disposition Process, and Chapter 13, Auctions and Sealed Bids.

Minimum acceptable sales prices were established by the RTC, and the assets had to have been previously available to individual purchasers for at least six months. The first transaction attempted under the program was approved in July 1991 and involved the potential sale of hotels and office buildings worth up to \$500 million to Patriot American Investors, LP (Patriot).

OIG audits of the Patriot transaction found that although the RTC took several positive steps to implement the transaction and the portfolio sales program, concerns remained about the length of time and the amount of resources required to complete the transaction.²¹ As of July 1992, after spending more than 12 months proposing more than 550 properties to Patriot, the RTC had executed sales contracts for only 30 properties and had agreed to sell 2 additional properties to Patriot, with the total transactions being worth approximately \$178 million. During the same time, the RTC had completed numerous bulk sales using other disposition methods that resulted in the disposition of more than \$3 billion in assets. Given its success with bulk sales, the efficiency and effectiveness of the Widely Marketed Portfolio Program compared to other sales techniques was questioned. As a result, the RTC elected not to conduct future sales under that program.

The RTC's Transition to the FDIC

Upon enactment of the Completion Act on December 17, 1993, the statutory end of the RTC was slated for December 1995. The Completion Act required the FDIC and the RTC to establish an interagency task force to develop and implement appropriate internal controls to transfer the assets, personnel, and operations of the RTC to the FDIC. The task force was to be composed of FDIC and RTC personnel appointed by the FDIC chairman and the RTC CEO, respectively.

The task force, which was established in February 1994, created subgroups for each of the key areas and designated senior managers to coordinate planning for transition activities with responsible offices in each of the functional areas identified. The primary responsibility for coordinating the implementation of needed transition control activities of those groups was assigned to the Internal Control Policy Committee (ICPC), which was chaired by the CFOs of both agencies. The primary role of the ICPC was to ensure that internal controls employed during the transition were adequate to guard against financial loss, delays in the discharge of RTC responsibilities, or loss of public confidence. The ICPC also assumed a secondary responsibility for ensuring that the controls remained in place in the post-transition organization and that the FDIC operations that were receiving RTC activities accepted responsibility for the work that needed to be completed.

21. OIG, *Semiannual Report to Congress*, April 1, 1992–September 30, 1992.

The task force was also directed to identify, evaluate, and resolve differences in FDIC and RTC operations. The task force was to determine the “best practices” and recommend which of the management, resolution, or asset disposition systems of the RTC should be preserved for use by the FDIC.

The ICPC required each functional task group to develop a management hierarchy responsible for planning and executing the transition at the office level and to develop a plan of action detailing the general methodology to be used for the transition. To ensure a successful transition, the ICPC established milestones to monitor progress.

The ICPC mission was completed after the post-transition validation of the effectiveness of the internal controls in June 1996, and the receipt of a certification letter from FDIC managers accepting responsibility for all matters and functions that had undergone transition. As a result, the transition was accomplished without any negative audit commentary from the OIG or the GAO.

Conclusion

Properly designed and executed internal controls are usually transparent to program performance. The positive product of internal controls—the prevention of mistakes and problems—is not easily quantifiable and often goes unnoticed. The negative aspects of internal controls, however, are rarely missed. First, the “identification and response” (accountability for the problem and corrective action) aspects of internal controls are inherently unpleasant and have punitive connotations. Second, documentation of the internal control processes themselves often requires time- and labor-intensive procedures. In a climate of explosive growth and streamlined operations, basic control elements, such as segregation of duties, accuracy cross-checks, and authorization and verification procedures, are too easily dismissed as unnecessarily burdensome.

The experience of the FDIC and the RTC during the financial crisis of the 1980s and early 1990s demonstrated that internal controls, to be effective, must be vital, ongoing processes. Coordinated controls must be in place for each operational situation. As changes occur, management must be flexible and controls must be adapted accordingly to address the changing risk requirements.

The internal controls programs of the FDIC and the RTC evolved from a general environment of checks and balances with programs integrating self-evaluations, internal review and audit, and external audit to a flexible safety net of interrelated controls at all levels of operation. The agencies were able to rapidly expand and contract, or to decentralize and centralize, their operations to accomplish strategic program objectives without losing management control. The FDIC and the RTC succeeded in resolving the crisis without material management and financial problems that could have resulted in the loss of public confidence.

Robert Larsen, chairman of the RTC’s Audit Committee, stated in the *Wharton Real Estate Review*, that “the mostly scandal free administration of literally billions of taxpayer

dollars has gone, in most respects, unrecognized and unreported.”²² In the same article, Larsen quoted John Robson, undersecretary of the Treasury in the Bush administration, who worked with the RTC in its early years, from *The Washington Post*:

At the very moment when a ferocious, national, political debate quite legitimately centers on the question of whether the federal government has failed in vast areas of its responsibilities, it is appropriate to celebrate a government program that has really worked. Perhaps it is too much to expect that the RTC and its Oversight Board be commended for effectively and rapidly cleaning up a mess that might have been avoided in the first place, and that cost the taxpayer billions to fix. But it is hard to deny that the overall performance of these agencies was terrific.

22. Robert C. Larsen, “The RTC: Dispelling the Myths,” *Wharton Real Estate Review*, vol. 1, no. 1 (Spring 1997).



Acknowledgments

Managing the Crisis: The FDIC and RTC Experience is the result of a study conducted by the FDIC on the banking crisis of the 1980s and early 1990s. It examines the evolution of the processes used by the two agencies to resolve banking problems, protect depositors, and dispose of the assets of the failed institutions. In conjunction with this book, a related symposium was held in April 1998 to discuss the resolution and disposition techniques used during the crisis period.

The study would not have occurred without the vision of former FDIC Chairman Ricki Helfer, who initiated the project, and the continued support of then-Acting Chairman Andrew C. Hove, Jr.

The project team was ably led by William R. Ostermiller, who organized and managed the writers, researchers, and editors for this project. The book would not have been completed without his dedication and effort. Two other members of the project team also deserve special mention and thanks. Martha Duncan-Hodge and Kate McDermott time and time again went above and beyond the call of duty to keep the project on track. They helped guide the project along from start to finish. Special thanks also go to the individuals named below for their contributions along with their creativity, diligence, and perseverance.

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Every effort was made to ensure the accuracy of the information contained in this study and to provide an impartial assessment of what occurred. As is the case with any history, however, the interpretations made by those who have written it are important to its structure and conclusions and these interpretations are not necessarily those of the Federal Deposit Insurance Corporation.

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Other Acknowledgments

Much of the data provided to the project team and some of the early analysis used was gathered and provided by an earlier team headed by Craig A. Rice. The results of that

group's efforts provided a valuable foundation for this project. I want to acknowledge the important contributions to that effort by Robert Arsineau, Edward Barker, Richard Brown, Thuan Le, Jean Litzler, Marsha Martin, Robert Polarek, Betty L. Tartt, Eric L. Winge, and Hugo A. Zia.

Many others in the FDIC Division of Resolutions and Receiverships analyzed data, reviewed chapters, and helped in a variety of ways. Important contributions were made by George C. Alexander, Martin W. Becker, Bruce E. Brown, Frank C. Campagna, Robert L. Carman, Michael C. Clark, James E. Crum, Nancy Deyerle, Stephen C. Douglas, Joseph A. Fanelli, Carlos M. Fiol, Mitchell L. Glassman, Kathleen M. Halpin, Stacey L. Hayashi, Sharon C. Lusk, James A. Meyer, Frederick J. Ozyp, Lorraine Padgett, Gail Patelunas, Richard O. Romero, Thomas A. Rose, Russell S. Rumelt, Robert C. Schoppe, Gary A. Seale, Patrick J. Shute, Joci M. Spector, Alan P. Strom, Leslyee Sullivan, William C. Thomas, and Susan E. Whited.

The FDIC Legal Division provided valuable assistance throughout the project, with special thanks to Henry R. F. Griffin and Barbara I. Taft for coordinating the support efforts. Valuable contributions were made by Richard T. Aboussie, Paul D. Arends, Jock A. Banks, Thomas P. Bolt, Kevin Carver, Robert G. Clark, Chris J. Conanan, Patricia E. Davison, Thomas M. Dietz, John P. Dolan, Jacqueline Edwards, David G. Eisenstein, Elizabeth Falloon, David Fisher, David M. Gearin, Christopher L. Hencke, Howard Herman, Douglas H. Jones, Charlotte M. Kaplow, James Lantelme, Mark A. Libera, Donald B. McKinley, JoAnne Morris, Richard H. Mounts, Richard J. Osterman, Richard W. Owen, Richard I. Peyster, Michael B. Phillips, Elliott M. Pinta, Carl A. Polvinale, Rodney D. Ray, Catherine A. Ribnick, Leslie Sallburg, Thomas A. Schulz, Cynthia Z. Shaughnessy, Gregory B. Smith, R. Penfield Starke, Gregory Taylor, John V. Thomas, Barbara Starke Tishuk, Arturo Vera-Rojas, and Patrick S. Vincent.

In addition, the FDIC Division of Research and Statistics provided valuable analytical and editorial services to the project. We acknowledge the help of Thuan Le in the analysis of the statistical data. We also acknowledge the analytical help in Part I provided by James E. Heath, Brian D. Lamm, James A. Marino, Jack Reidhill, and Steven A. Seelig. We appreciate the editorial and analytical support in Part II provided by Lynn Shibut and William R. Watson. For help in the development of the project's statistical database, we acknowledge the assistance of Heather Gratton, Bruce McWilliams, Lynn Shibut, and Katie A. Wehner.

We also acknowledge the valuable editorial work and extensive proofreading of James P. Battey, Marjorie C. Bradshaw, and Elizabeth A. Ford in the FDIC Office of Corporate Communications.

We wish to thank Brent D. Harral, Thomas N. Hearn, and Michael J. Rubino in the FDIC Division of Administration for their help on a number of contracting matters that arose during the course of the project.

James D. Collins, of the Executive Office, provided us with needed guidance and insight into the topic of internal controls, and we wish to thank him for his assistance.

We also want to thank the FDIC Division of Finance for their assistance. We acknowledge the help in obtaining data provided by Casey Catterton, Kenneth R. Fitzgerald, Timothy H. Hobbs, Alvin E. Kitchen, Elvis J. Nelson, Richard Sassoon, and Mark Weaver. We also acknowledge the helpful reviews of draft chapters by Bobby R. Bean, Bret D. Edwards, Arthur D. Murphy, David R. Wiley, and Louis E. Wright.

Thanks also goes to Richard Brown and Maureen Sweeney of the Division of Insurance.

We appreciate all the work done by the technical and support staff throughout the FDIC over the course of the project, especially the efforts of Denise S. Anthony, F. Cynthia Ballard, Gloria W. Massey, and Jacqueline B. Richardson.

We would like to thank Addie M. Hargrove and her staff in the Graphics Department of the FDIC Division of Administration for designing the book cover and for their help with publishing the book.

Several persons outside the FDIC devoted time to the project by either meeting with us or providing helpful reviews of draft chapters. In particular, we want to thank Donald W. Crocker, vice chairman of J. E. Robert Company, Inc., Christopher Kallivokas, chief executive officer of RER Financial Group, Inc., and Sherwin R. Koopmans, a former FDIC manager.

—John F. Bovenzi
Director
Division of Resolutions and Receiverships

Managing the Crisis:

**The FDIC and RTC Experience
1980–1994**



Federal Deposit Insurance Corporation

Washington, D.C.

August 1998



First published by the Federal Deposit Insurance Corporation in 1998.

Material in this book may be reprinted or abstracted if this publication is credited.

This publication may be obtained electronically via the Internet at:
<http://www.fdic.gov/databank>

ISBN 0-9661808-2-8

Library of Congress Catalog Card Number: 98-72818



Foreword

While banks are now recording record levels of profit, it was not too long ago that the stability of our nation's financial system was at stake. In the period between 1980 and 1994, almost 3,000 banks and savings and loan institutions either failed or required government assistance. During that tumultuous time, the Federal Savings and Loan Insurance Corporation (FSLIC) insurance fund became bankrupt and the Resolution Trust Corporation (RTC) was created. Meanwhile, the Federal Deposit Insurance Corporation's (FDIC) insurance fund was being severely tested.

Managing the Crisis: The FDIC and RTC Experience is the second of two studies conducted by the FDIC concerning the financial events that shaped this time period. The first study, *History of the Eighties: Lessons for the Future*, reviewed and analyzed the circumstances that led to the failure of so many banks. This second study examines the manner in which the FDIC and the RTC handled the bank and thrift failures. It documents the evolution of the methods used to resolve failed institutions, pay depositors their money, and dispose of the large volume of assets that remained.

I would like to extend my gratitude to John Bovenzi for serving as director and overall editor of this study. I would also like to recognize former FDIC Chairman Ricki Helfer for instituting this study and Acting FDIC Chairman Andrew Hove, Jr., for directing the program through its development. I want to thank those individuals acknowledged on the pages that immediately follow for undertaking this project and for bringing to light the efforts of all the FDIC and RTC employees who helped to resolve the crisis, restore financial stability, and maintain public confidence in our financial system.

Finally, and most significantly, I would like to thank everyone who worked at the FDIC and the RTC during this difficult period. They were the ones who actually "Managed the Crisis" and in no small way contributed to the economic prosperity that followed.

—Donna A. Tanoue, Chairman



CHAPTER 1

Overview

Part I of this publication, Resolution and Asset Disposition Practices, detailed the processes used by the Federal Deposit Insurance Corporation (FDIC) and the Resolution Trust Corporation (RTC) in resolving failing banks during the banking crisis of 1980 through 1994. Part II, Case Studies of Significant Bank Resolutions, presents case studies of the 10 most notable problem banks to illustrate some of the FDIC's resolution processes. The case studies also show the effects on the FDIC of changes in banking legislation in the 1980s and 1990s. Although a representative sample of problem banks was selected, three of the case studies involve banking entities in Texas because that portion of the country suffered most from the banking crisis. The bank studies (see table II.1-1) are presented in chronological order.

Structure of the Case Studies

Because the individual financial institutions selected for the case studies were unique in both their characteristics and their resolutions, it was neither possible nor logical to present all of the case studies in the same format. Certain information, however, is important for each study, and all information is presented essentially in chronological order.

Each case study begins with an Introduction that explains what is unique about the bank and its resolution and why it was chosen for this publication. A General Description of the bank follows the Introduction, and after that a Background section on the events or activities that got the bank into trouble.

Following the Background, each case study provides information about the resolution process itself and may discuss the marketing, bidding, and bid selection for the bank. There may be a discussion of the Structure of the Transaction. Portions of each

study will discuss Shareholder Litigation (if any), the Stock Transactions (for those resolutions in which the FDIC provided capital assistance), and the FDIC's Resolution Costs. Each case study ends with a discussion of the Lessons Learned from the resolution and the resultant Effect on Future Resolutions.

Resolutions

To fully appreciate the case studies, it is necessary to understand that the powers and tools available to the FDIC in resolving failing bank situations were quite limited when the banking crisis began. Gradually, as the banking crisis proceeded, the FDIC received expanded powers through new legislation.

Table II.1-1.

Significant Bank Resolutions

(\$ in Millions)

Chapter	Name of Financial Entity and Location	Short Name	Total Assets	Resolution Cost	Resolution Date	Key Issues
2	First Pennsylvania Bank, N.A. Philadelphia, Pennsylvania	First Penn	\$7,953	\$0	04/28/80	First large open bank assistance
3	Penn Square Bank, N.A. Oklahoma City, Oklahoma	Penn Square	517	65	07/05/82	Largest payoff at that time
4	Continental Illinois National Bank and Trust Company, Chicago, Illinois	Continental	33,633	1,104	05/17/84	Largest bank ever resolved
5	First City Bancorporation of Texas, Inc. Houston, Texas	First City	11,200 and 8,852	1,069 and \$0	04/20/88 and 10/30/92	Open bank assistance; bridge banks
6	First Republic Bank Corporation Dallas, Texas	First Republic	33,448	3,856	07/29/88	Open bank assistance; bridge banks
7	MCorp, Dallas, Texas	MCorp	15,749	2,840	03/28/89	Bridge bank
8	Bank of New England Corporation Boston, Massachusetts	BNE Corp.	21,754	889	01/06/91	Cross guarantee; bridge bank
9	Southeast Banking Bancorporation Miami, Florida	Southeast	10,478	0	09/19/91	First large loss sharing
10	Seven Failing Banks in New Hampshire Various Cities, New Hampshire	The New Hampshire Plan	4,377	891	10/10/91	Unique resolution strategy
11	CrossLand Savings, F.S.B. Brooklyn, New York	CrossLand	7,269	740	01/24/92	Conservatorship; stock sale
Totals			\$155,230	\$11,454		

In the early 1980s, the FDIC used open bank assistance (OBA) to resolve some of the larger problem banks that were in danger of failing. First Penn, described in Chapter 2, describes the successful use of OBA that resulted in no cost to the bank insurance fund. Another example of OBA is demonstrated in Chapter 4, Continental, the most controversial resolution in the case studies. From that transaction arose the theory of “too big to fail” and fears about inequities in the resolution process, as well as concerns about “nationalization” of banks. Chapter 5 discusses an unsuccessful open bank assistance package to First City, a bank that later failed. Chapter 6, First Republic, illustrates an interim assistance package provided to keep the holding company’s banks open until a more permanent resolution could be completed.

The Garn–St Germain Depository Institutions Act of 1982 gave the FDIC the ability to solicit out-of-state buyers in emergency failing bank situations. This legislation was important in several resolutions, particularly in the large failure situations in Texas, where the local economy had made qualified buyers scarce. See Chapter 6, First Republic, and Chapter 7, MCorp.

The Competitive Equality Banking Act of 1987 gave the FDIC the important resolution authority to establish a bridge bank. A bridge bank allows the FDIC time to evaluate the institution to prepare for a P&A transaction and invite potential purchasers in to perform due diligence reviews of the bank’s records to prepare their bids. The FDIC’s first large bridge bank was established to complete the resolution of First Republic, which is described in Chapter 6. Bridge banks also were used to resolve other large banks, as described in Chapter 5, First City; Chapter 7, MCorp; and Chapter 8, BNE Corp.

The Financial Institutions Reform, Recovery, and Enforcement Act of 1989 gave the FDIC cross guarantee authority, which allows the FDIC to assess other banks in a holding company for the costs of resolving a failing bank within that holding company. This cross guarantee authority was used in the resolution of the failing banks of First City, as discussed in Chapter 5, and BNE Corp. in Chapter 8.

Chapter 3 relates the story of Penn Square, a failed bank for which the FDIC paid off the insured depositors because of a large number of contingent liabilities, and which was the largest payoff at that time. The FDIC’s first loss sharing agreement was in the resolution of Southeast, discussed in Chapter 9. Chapter 10, The New Hampshire Plan, describes how the FDIC addressed the resolution of seven banks that all failed on one day in the same state, using a new transaction structure by grouping and selling the seven banks as two separate franchises. Chapter 11, CrossLand, is the account of another departure from the FDIC’s usual practice, where the FDIC placed a failed mutual savings bank in a pass-through receivership and created a new savings bank that the FDIC operated for 18 months.

Assets

On a number of these large banks, the FDIC used outside asset management firms to work out the problem loans acquired. Chapter 4, *Continental*, describes the FDIC's first use of a contractor to work the FDIC's assets. Several of the other chapters discuss the evolution of the FDIC's use of asset management firms. See Chapter 6, *First Republic*; Chapter 7, *MCorp*; Chapter 8, *BNE Corp.*; and Chapter 10, *The New Hampshire Plan*.

As the crisis deepened, it became apparent that whenever the FDIC took ownership of a failed institution's assets, it bore all the risks and expenses of liquidation. To alleviate this situation, the FDIC developed loss sharing, an important asset disposition process. Loss sharing is discussed in Chapter 5, *First City*; Chapter 9, *Southeast*; Chapter 10, *The New Hampshire Plan*; and Chapter 11, *CrossLand*.

Liabilities

The effect of bank resolutions on an institution's general creditors, shareholders, debtholders, and management staff is discussed in each of the case studies. In three of the studies, the FDIC issued explicit statements fully protecting depositors. Those situations are reviewed in Chapter 4, *Continental*; Chapter 5, *First City (1988)*; and Chapter 8, *BNE Corp.*

Equity

Except for the resolutions of *Penn Square*, in Chapter 3, and the *First City* banks (1992), in Chapter 5, the FDIC provided cash infusions into all the banks in exchange for equity positions. The details on the stock transactions, along with the overall costs to the insurance fund of each resolution, are included in each of the studies. In only one instance did the FDIC fail to recover 100 percent of its investment; see Chapter 5, *First City (1988)*. Chapter 9, *Southeast*, and Chapter 10, *The New Hampshire Plan*, depict the FDIC's use of capital injections specifically to increase the pool of potential bidders.



CHAPTER 2

First Pennsylvania Bank, N.A.

Name of Institution:	First Pennsylvania Bank, N.A.
Headquarters Location:	Philadelphia, Pennsylvania
Date of Resolution:	April 28, 1980
Resolution Method:	Open Bank Assistance Transaction

Introduction

One of the most notable institutions to receive open bank assistance (OBA) from the Federal Deposit Insurance Corporation (FDIC) was First Pennsylvania Bank, N.A. (First Penn), Philadelphia, Pennsylvania. First Penn was Philadelphia's largest bank and the 23rd largest bank in the nation, and its failure would have been the largest in U.S. history.

In 1980, the FDIC confronted the threatened insolvency of a large number of mutual savings banks. The institutions had generally much larger total deposits than the average commercial bank, and virtually all of their deposits were fully insured. No mutual savings bank had failed in the United States since 1939.

The FDIC faced an important issue: How to reconcile the situation with the large commercial bank and the mutual savings banks. FDIC Chairman Irvine H. Sprague summarized the dilemma as follows: "The savings bank problems . . . complicated our deliberations about First Pennsylvania. How could we save a big stockholder-owned commercial bank at the same time we were planning for the failure of all these mutual savings banks?"¹

General Description of the Bank

First Penn was the successor to the first U.S. private bank, which was established in 1782. As of April 28, 1980, First Penn had \$8 billion in total assets and \$5.3 billion in total deposits.² The deposits were in approximately 574,000 accounts. First Penn

1. Irvine H. Sprague, *Bailout* (New York: Basic Books, 1986), 78–79.

2. FDIC, *Historical Statistics on Banking: A Statistical History of the United States Banking Industry, 1934-1992* (Washington, D.C.: Federal Deposit Insurance Corporation, 1993), 617.

operated 69 U.S. offices, including 40 branches in Philadelphia County, Pennsylvania. It also operated branches in the U.S. Virgin Islands, London, and Nassau.

Background

During the 1970s, banks became vulnerable to high and rising interest rates. On February 16, 1971, the \$110 million Birmingham-Bloomfield Bank (BBB), Birmingham, Michigan (a suburb of Detroit), was the first \$100+ million failure handled by the FDIC.³ BBB had invested heavily in long-term municipal bonds, relying considerably on purchased deposits, in anticipation of expected interest rate declines. When interest rates rose, the bank incurred losses and found itself locked into low-yielding, depreciated securities. The experience of BBB did not prevent other banks from subsequently getting into situations in which they became vulnerable to high and rising interest rates.

The U.S. economy had broad-based weaknesses in 1980. Growth in real gross domestic product (GDP) was sluggish for the second consecutive year, and unemployment jumped to 7.2 percent from 5.8 percent in 1979.⁴ Home sales and housing starts were down sharply, but the market for office space remained tight. The Federal Reserve discount rate rose to 11.8 percent and the 30-year mortgage rate was up to 13.8 percent, resulting in higher interest rates for both loans and deposits. There was strong demand for oil around the world, with OPEC restrictions causing oil prices to rise. Substantial deposit amounts shifted from banks and thrifts to money market funds or to market securities, and depository institutions experienced both disintermediation and an increased cost of funds.⁵

The Problem

In the late 1960s and early 1970s, First Penn grew rapidly. From 1967 to 1976, assets increased from \$2.1 billion to more than \$6 billion, but many of the assets became non-performing loans.⁶ The bank resolved a substantial number of loans, but some problems remained. Beginning in 1976, the bank used short-term deposit liabilities to make large

3. FDIC, *Historical Statistics on Banking*, 608.

4. CB Commercial Torto/Wheaton Research, *The Office Outlook*; Bureau of Labor Statistics.

5. Disintermediation is the movement of funds from low-yielding accounts at traditional banking institutions to higher yielding investments in the general market—for example, withdrawing funds from a passbook savings account paying 5.5 percent to buy a Treasury bill paying 10 percent. As a counter move, banks paid higher rates to depositors (but they were regulated or limited), then charged higher rates to borrowers, which led to tight money and reduced economic activity. Since banking deregulation, disintermediation is not the economic problem it once was. John Downes and Jordan Elliot Goodman, *Dictionary of Finance and Investment Terms* (Hauppauge, New York: Barron's Educational Series, 1995), 143.

6. Sprague, *Bailout*, 85.

purchases of long-term, fixed-rate U.S. government securities. Also, in an attempt to stabilize future income at what the bank thought would be high rates, First Penn bought its securities when those investments were earning interests of 7 to 8 percent. By 1979, it held more than \$1 billion in Treasury bonds. About half the portfolio of Treasury issues had maturities of more than 10 years; some 30-year bonds had maturities of 2007 and were paying 7.6 to 7.9 percent a year. But interest rates kept increasing, and First Penn was paying as much as 15.5 percent on deposits by May 1980.⁷ The income from fixed rates on the bonds could not keep pace with the cost First Penn needed to pay on its deposit funds, and the bonds became a burden. As interest rates climbed, the market value of the bonds fell to \$300 million less than their face value.⁸

Additionally, at the end of the first quarter of 1980, 6.3 percent of the bank's loans were not paying interest or were paying interest at a reduced rate. The 6.3 percentage rate was high in comparison to the rest of the industry.⁹ Questionable loans totaled \$328 million, which was \$16 million more than the bank's entire equity capital.¹⁰

The volume of the bank's nonperforming loans, combined with the problem in the securities portfolio, caused a lack of confidence among First Penn's customary sources of deposits and other funds.¹¹ Some of the bank's deposit customers, including regional banks and deposit brokers, began to move their deposits out of the bank, forcing First Penn to seek unusual amounts of credit from the discount window of the Federal Reserve Bank of Philadelphia (Federal Reserve). First Penn was in a poor position, because if it sold any substantial portion of the securities to gain liquidity and cut its interest rate losses, it would have had to recognize extraordinary losses caused by the securities' depreciated value.¹² By the first quarter of 1980, First Penn was paying short-term rates of 15.5 percent to fund \$1.2 billion of fixed-rate securities that earned only 8.7 percent.¹³

The Resolution

On Wednesday, March 26, 1980, representatives from the Federal Reserve and the Office of the Comptroller of the Currency (OCC) met with Chairman Sprague and other FDIC staff at the FDIC offices in Washington to discuss a possible resolution for First Penn. Four options were available: (1) The OCC could close the bank and the FDIC

7. Teresa Carson, "Interest Rate Decline Is Just What 1st Pennsylvania Needed," *American Banker* (May 27, 1980), 1.

8. Sprague, *Bailout*, 85–86.

9. Carson, "What 1st Pennsylvania Needed," 1.

10. Sprague, *Bailout*, 82.

11. "Regulators' Release on Assistance Plan for 1st Pennsylvania," *American Banker* (April 30, 1980), 3.

12. "Regulators' Release on Assistance Plan for 1st Pennsylvania," 3.

13. Carson, "What 1st Pennsylvania Needed," 1.

could arrange a purchase and assumption (P&A) transaction with another institution; (2) the FDIC could arrange an open bank assisted merger with another institution; (3) the OCC could close the bank and the FDIC could pay off the insured deposits; or (4) the FDIC could provide open bank assistance to First Penn itself.

Resolution Alternatives

Both a closed bank P&A transaction and an open bank assisted merger would have required one critical element: a healthy institution able and willing to take on First Penn's deposits and perhaps some or all of its assets. Only one other bank in Pennsylvania, Mellon Bank in Pittsburgh, was large enough to absorb First Penn, but the FDIC was reluctant to concentrate so much of the state's banking resources in one gigantic institution and create the potential for an antitrust situation. The FDIC was not able to look outside of the state, because no statutory authority existed for out-of-state acquisitions.¹⁴

As part of the Omnibus Budget and Reconciliation Act, the limit on deposit insurance coverage was about to be raised from \$40,000 to \$100,000 per insured account, effective March 31, 1980. A payoff of the insured deposits would have required a significant portion of the total FDIC insurance fund, which stood at \$9.8 billion at the end of 1979, and might have weakened public confidence in the FDIC's ability to handle any subsequent failures.¹⁵ Moreover, the FDIC would have had to acquire First Penn's \$8 billion in assets for liquidation, an amount that was more than four times the balance of \$1.9 billion in assets the FDIC already had in liquidation.¹⁶ Paying off First Penn's depositors, therefore, generally was not considered to be a feasible option. Still, a payoff had its proponents. FDIC Director William M. Isaac said, "How else do you maintain discipline in the marketplace?"¹⁷

The only option remaining was open bank assistance, but such a move was unusual and controversial. Although the FDIC had received OBA authority in 1950, it had used it on only four occasions before the crisis at First Penn. In section 13(c) of the Federal Deposit Insurance Act (FDI Act) of 1950, Congress gave the FDIC authority to provide assistance to an open bank, "when in the opinion of the Board of Directors the continued operation of such bank is essential to provide adequate banking service in the community."¹⁸ Specifically, section 13(c) authorized the FDIC to assist directly an operating insured bank when a bank was in danger of closing and its continued operation was essential to maintain adequate banking service in the community. The FDIC was autho-

14. Sprague, *Bailout*, 82.

15. Paul M. Horvitz, "Bending the Law With Good Intentions," *American Banker* (May 8, 1980), 3.

16. FDIC, *1980 Annual Report*, 20.

17. Sprague, *Bailout*, 91.

18. FDIC, *Federal Deposit Insurance Corporation: The First Fifty Years* (Washington, D.C.: Federal Deposit Insurance Corporation, 1984), 94.

rized to make loans to, purchase the assets of, or make deposits in the troubled banks. Section 13(e) of the FDI Act allowed the FDIC to provide financial assistance only to facilitate the absorption of a failed or failing bank by another institution without a finding of “essentiality.”¹⁹ The use of section 13(e), however, wasn’t really an option for First Penn, because there was no suitable merger partner.

Open bank assistance was first used on July 27, 1971, when the FDIC provided assistance to Unity Bank and Trust Company, Boston, Massachusetts, which had \$9.3 million in deposits. On January 18, 1972, the FDIC assisted Bank of the Commonwealth, Detroit, Michigan, which had \$1.5 billion in total assets. Both banks served inner-city neighborhoods that lacked other adequate banking services, and so were considered “essential” to their neighborhoods. The FDIC did not use OBA again until September 20, 1974, when it assisted American Bank and Trust (AB&T), Orangeburg, South Carolina, with temporary funding to provide time to arrange a P&A transaction. AB&T, with \$150 million in total assets, was acquired by another bank just 12 days after the FDIC gave it assistance. Because AB&T was the only source of banking services in 10 of the communities in which it operated, the FDIC could justify providing the assistance. In another situation, the FDIC gave OBA to Farmers Bank of the State of Delaware on March 15, 1976. The bank was partially owned by Delaware and was the state’s sole depository, with \$370 million in deposits. Because of Farmers Bank’s unusual arrangement with the state, the FDIC judged the assistance to be “essential.”²⁰

The FDIC used open bank assistance sparingly, because it was concerned that the assistance would benefit stockholders, materially erode market discipline,²¹ and keep afloat a weakened bank to the possible detriment of the local community.²² Moreover, the FDIC was not entirely satisfied with the results of its assistance to Bank of the Commonwealth, where depositors never reestablished the confidence in the bank that had existed before its troubles. The bank had failed to grow and prosper as projected, it had been sold more than once, its name had been changed, and at the time of First Penn’s problems, the loan provided by the FDIC had not been paid back.²³

First Penn’s Proposal

First Penn hired a Wall Street investment banking firm to put together its proposal for FDIC assistance. At the same time, First Penn looked for an investor to take over the

19. FDIC, *The First Fifty Years*, 95–96.

20. FDIC, *The First Fifty Years*, 95.

21. Market discipline is the depositors’ and bank creditors’ reaction to their perception of risk. There is no market discipline when depositors and other bank creditors perceive that their funds are only minimally at risk, and they place their money in those banks and thrifts that are paying the highest interest rates, without regard to the management or financial stability of the institutions.

22. FDIC, *The First Fifty Years*, 97.

23. Sprague, *Bailout*, 76.

bank, but none was found. The proposal for open bank assistance was presented to the OCC on April 2, 1980, and was then presented to the FDIC the following day. The major points of the plan were as follows:²⁴

- The FDIC would provide a \$300 million, 10-year loan at a concessionary interest rate tied to bank earnings. The bank would repay no principal for five years; after that, it would make payments in 10 percent increments with a lump sum payment due in 1990. The loan would rank on a level with other capital notes of the bank and would be subordinated to all other creditors.
- First Penn would offer the FDIC five million warrants to purchase common stock. The holding company would omit payment of dividends to shareholders for two years.
- The regulators would be allowed to impose certain limits on bank operations, but the bank was not to be unduly hampered by such restrictions.
- The regulators would use their best efforts to help First Penn obtain \$1 billion in lines of credit and term deposits from major banks. First Penn would sell its depreciated government securities and use its loan from the FDIC to cover the loss. The bank would shrink itself and return to being a quality regional institution, less dependent on money market sources of funding.
- With First Penn's shareholders' meeting scheduled for April 29, 1980, the bank would plan to announce the assistance plan at the same time it announced its first-quarter loss.

Upon being presented with an assistance request, the FDIC first looked to determine if the bank could qualify under the "essentiality" rule. The key to being able to provide OBA was determining whether there were grounds to declare the bank "essential" and reasons to hold that First Penn was unique from the dozens of troubled mutual savings banks around the country. The FDIC's legal staff determined grounds for the FDIC's Board of Directors to find First Penn "essential,"²⁵ based mainly on its size. The closing of such a large bank would have had serious repercussions, not only in the local market, but probably nationwide. The Federal Reserve and the OCC also expressed concern about the domino effect of closing First Penn. They argued that disruption of First Penn's business connections would affect U.S. and international banks.

24. Sprague, *Bailout*, 87–88.

25. Frank L. Skillern, Jr., Draft Memorandum to Irvine H. Sprague, "Analysis of the FDIC's Authority Under Section 13(c) of the Act," April 11, 1980; Frank L. Skillern, Jr., Memorandum to the FDIC Board of Directors, "First Pennsylvania Bank, N.A., Bala-Cynwyd, Pennsylvania, Application for Assistance under Section 13(c)," April 28, 1980; Sprague, *Bailout*, 91.

Terms of the Assistance Transaction

The FDIC rejected First Penn's plan as presented, but during the next few weeks, negotiated an assistance agreement. On April 28, 1980, the FDIC, the Federal Reserve, and the OCC jointly announced a \$500 million assistance package to assure the viability and continued strength of First Penn. The key elements of the agreement were as follows:²⁶

- The FDIC would provide a five-year subordinated note for \$325 million, which was interest free for the first year and had a rate for the remaining four years of 125 percent of the yield on the FDIC's investment portfolio, which at the time earned 8.54 percent. The FDIC's note was senior to all other subordinated debt except for the bank note (see below).
- A group of 27 leading banks in the Philadelphia area and the nation would provide a five-year subordinated note for \$175 million, at an interest rate equal to Citibank's one-year certificate of deposit rate (adjusted annually). The bank loan was senior to all other subordinated debt. The assistance from the other banks was deemed necessary to instill the confidence in First Penn that was lacking when the FDIC previously assisted the Bank of the Commonwealth in 1972 without any private-sector contribution.
- The Federal Reserve would provide a \$1 billion bank line of credit through access to the Federal Reserve discount window.
- Because the loans from the FDIC and the banks were intended to shore up First Penn's capital while it sold off the government securities with low interest rates, the FDIC would require First Penn to immediately sell off a first installment of those securities large enough to cause a \$75 million loss. That action would reduce the severe interest drain on the bank.
- The transaction would include 20 million warrants for stock purchases in the bank's holding company by the FDIC (13 million) and the 27 bank lenders (7 million to be split among the banks) at an exercise price of \$3 per share.²⁷ (The inclusion of the warrants became one of the most important aspects of the assistance package.) The warrants would be good for seven years, and First Penn would be required to invest proceeds from any exercise of warrants into equity capital of the bank. The warrants effectively would dilute shareholder interest in the bank and decrease any return the existing shareholders might receive as part of First Penn's recovery.

26. Sprague, *Bailout*, 94–97.

27. The exercise price was the price at which each warrant could be exchanged for one share of stock on any given date.

- First Pennsylvania Corporation, the holding company for First Penn, would be required to invest \$55 million in proceeds from the sale and liquidation of its finance and mortgage company subsidiaries into bank capital, dispose of or restructure its securities dealer subsidiary, and pay dividends only with specific FDIC approval.
- During the life of the loans, the bank and the holding company and affiliates would be subject to special reporting requirements, supervision, and FDIC approval of operating plans.
- Holding company shareholders would be required to approve the transaction.

The assistance agreement was approved and consummated on May 29, 1980.

After the Transaction

Regarding the warrants obtained in the First Penn transaction, a lawsuit was filed in August 1980 by one of the stockholders of the bank. The suit disputed the FDIC's authority to hold an ownership interest in the holding company. In June 1983, the court ruled that the FDIC's assistance powers under section 13(c) of the FDI Act were broad enough to allow the warrants.²⁸ The decision came at an opportune time; First Penn had recovered to the point where it wanted to pay off its assistance two years early. Paying off the loan early and terminating the assistance package would enable First Penn to operate independently without the restrictions in the assistance agreement and to pay dividends without the FDIC's approval.

First Penn also wanted the FDIC to sell back its warrants so a new common stock issue could proceed. On November 15, 1983, the FDIC sold back half of the warrants (6.5 million) to First Penn for \$2 per warrant. The bank then paid off its remaining FDIC loan with the proceeds of the stock offering (\$150 million), a new loan from the assisting banks (\$75 million), plus internal cash. Eighteen months later, on May 29, 1985, the FDIC sold its remaining 6.5 million warrants to First Penn for \$30.1 million (\$4.625 per share).²⁹

FDIC Resolution Costs

The First Penn open bank assistance transaction essentially was a zero cost transaction for the FDIC, with its financial exposure being its \$325 million five-year subordinated note. First Penn paid the principal and scheduled interest payments on the note in full.

28. Sprague, *Bailout*, 103.

29. Sprague, *Bailout*, 105-106.

The only real cost to the FDIC was the foregone interest on the first year of the loan, which was part of the transaction as it was structured. If for that first year, the FDIC had charged First Penn a rate equal to 125 percent of the yield on its investment portfolio, matching the rate for the other years, the interest payment on \$325 million would have been about \$34.7 million. Offsetting any foregone interest is the \$43 million the FDIC received during 1983 and 1985 by selling its warrants back to First Penn and the 25 percent higher interest rate charged First Penn relative to the yield on the FDIC's investment portfolio.

Lessons Learned

The FDIC took a risk in allowing First Penn to continue operations. Because First Penn was a large institution, a continuation of losses in its securities and loan portfolios would have had a significant effect on the insurance fund if it had failed. Also, the failure of First Penn may have had a devastating effect on the regional and other large banks doing business with First Penn.

The FDIC reduced its risk in three ways. First, private-sector banks assumed a portion of the risk by extending part of the necessary recapitalization loan. Second, the FDIC obtained warrants for common stock in the holding company, effectively spreading the risk to include shareholders and providing itself with an upside potential. Third, during the life of the loans, the bank and its holding company and affiliates were subject to special reporting requirements and supervision, as well as the FDIC approval of dividend payments and operating plans.

Effect on Future Resolutions

Open bank assistance proved to be effective in the case of First Penn, and the transaction set a precedent for dealing with large failing banks. The FDIC's constraints in finding a buyer or merger partner probably influenced the Garn–St Germain Depository Institutions Act of 1982, which gave the FDIC more flexibility in dealing with failing or failed institutions, including the authority to seek out-of-state bidders for emergency acquisitions.

The effectiveness of the First Penn resolution no doubt influenced the FDIC's handling of the mutual savings banks that were in trouble at about the same time. From November 4, 1981, through October 15, 1982, the FDIC merged 11 mutual savings banks with other financial institutions. In the case of the mutual savings banks, the FDIC's resolution strategy was to force the weaker savings banks to find merger partners among the healthier banks or thrifts. To attract a merger partner, the FDIC guaranteed the acquirer a market rate of return on the acquired assets through the use of an income

maintenance agreement.³⁰ In a 12-month period starting November 1981, the FDIC provided income maintenance agreements nine times to complete such mergers. The distressed savings banks had more than \$13 billion in assets.

The size of First Penn and the mutual savings banks afforded the FDIC an opportunity to develop alternative methods for dealing with large failing banks. Because the failure of a large bank could have had a serious negative effect on the deposit insurance fund, the FDIC used open bank assistance to keep the banks open and allow them a chance to return to profitability. To assist troubled banks needing only temporary assistance, the FDIC developed other forms of assistance, such as net worth certificates.³¹ With the net worth certificates, the mutual savings banks no longer needed to be merged to prevent their failure.

All depositors were protected and senior management was replaced in the First Penn transaction. Those actions would prove to be common features of future open bank assistance transactions. In the First Penn case, shareholders experienced little negative financial effect, but then the FDIC did not experience any real cost, either. Future open bank assistance transactions would impose much larger losses on shareholders. Gradually, outside observers began to question the features of FDIC open bank assistance transactions. The issue was whether or not the costs imposed on participants in a failed bank's affairs were sufficient to obtain the benefit of market forces and the discipline those forces provide on individual behavior. Also, an issue was if market forces were being inhibited, what offsetting benefits justified such actions? The subsequent handling of Penn Square Bank, N.A., and the Continental Illinois National Bank and Trust Company open bank assistance transaction would bring those issues to the forefront.

30. Income maintenance agreements involved the FDIC's paying a merger partner (assuming institution) the difference between the yield on acquired earning assets and the average cost of funds for savings banks, plus spread to cover administrative and overhead expenses related to those assets. In effect, the FDIC guaranteed the acquirer a market rate of return on acquired assets with below-market rates. The FDIC entered into those agreements only if the resulting institution was viewed to be viable. In most cases the senior officials at the troubled institution were required to resign, and subordinated debtholders received only a portion of their investments.

31. For more details, see Part I, Resolution and Asset Disposition Practices, Chapter 3, Evolution of the FDIC's Resolution Practices.

‘Many of you have asked why the FDIC chose to handle the Penn Square failure through a payoff of insured depositors rather than a merger, as we typically do. The answer is simple: we had no choice.’
—then-FDIC Chairman William M. Isaac



CHAPTER 3

Penn Square Bank, N.A.

Name of Institution:	Penn Square Bank, N.A.
Headquarters Location:	Oklahoma City, Oklahoma
Date of Resolution:	July 5, 1982
Resolution Method:	Deposit Payoff/Deposit Insurance National Bank

Introduction

The failure of Penn Square Bank, N.A. (Penn Square), Oklahoma City, Oklahoma, still ranks as one of the Federal Deposit Insurance Corporation's (FDIC's) most publicized, most difficult, and most colorful bank resolutions. Penn Square failed July 5, 1982, with \$470.4 million in deposits and \$516.8 million in assets. By aggressively making large and speculative loans, especially to the oil and gas industries, the bank had grown from \$62 million in assets in 1977 to \$520 million in assets by mid-1982.¹ Penn Square then sold majority interests in those loans to other banks (in the form of loan participations), but retained the responsibility for servicing the entire loan amount.² At its failure, Penn Square was servicing approximately \$2 billion in loans.

Of the \$470.4 million in deposits, only about \$207.5 million were insured. The bulk of uninsured deposits were funds of other banks. After extensive discussions with the Office of the Comptroller of the Currency (OCC) and the Federal Reserve Bank (Federal Reserve), the FDIC made the decision to pay off the insured deposits of Penn Square. A payoff was deemed to be necessary to resolve the failing institution at the least cost to the deposit insurance fund. As a result, Penn Square became the largest bank failure in the FDIC's history in which uninsured depositors suffered losses.

1. Irvine H. Sprague, *Bailout* (New York: Basic Books, 1986), 112.

2. "A loan participation is a sharing or selling of ownership interests in a loan between two or more financial institutions. Normally, a lead bank originates the loan and sells ownership interests to one or more participating banks at the time the loan is closed. The lead bank (originating bank) normally retains a partial interest in the loan, holds all loan documentation in its own name, services the loan, and deals directly with the customer for the benefit of all participants. Properly structured, loan participations allow selling banks to accommodate large loan requests which would otherwise exceed lending limits, diversify risk, and improve liquidity or obtain additional lendable funds." FDIC, Division of Supervision, *Manual of Examination Policies* (1995), 27.

Background

Penn Square, formed in 1960, operated as a small, one-office retail bank with a separate drive-up facility in an Oklahoma City shopping mall. In 1975, Bill Jennings, a former president of Penn Square, created a holding company to purchase the bank with \$2.5 million borrowed from another Oklahoma City bank and little equity. The following year, Penn Square formed a loan department for oil and gas loans. From the beginning, the bank failed to document loans properly. In addition, it based repayment on collateral value rather than on the ability of the borrower to repay, and collateral documentation deficiencies were common.

Moreover, although the OCC set lending limits on the amount of credit that could be extended to any one customer, when one of Penn Square's oil and gas customers wanted to borrow more than that limit, Penn Square would make the loan and sell a participation to another bank. In 1978, Penn Square began selling oil and gas participations to Continental Illinois National Bank and Trust Company (Continental), Chicago, Illinois. In 1979, when the Shah of Iran was forced out of his country and fears of oil shortages created panic buying and a surge in oil and gasoline prices, Penn Square began selling participations in oil and gas loans to other large banks in the country, primarily Seattle First National Bank (Seafirst), Seattle, Washington; Northern Trust Company (Northern), Chicago, Illinois; Chase Manhattan Bank (Chase), New York, New York; and Michigan National Bank (Michigan National), Lansing, Michigan.

As early as May 1977, the OCC examination of Penn Square noted concentrations of credit to oil and gas companies.³ Subsequent OCC examinations in April 1980 and March 1981 found low capital, excessive low-quality loans, inadequate liquidity, inexperienced staff, increasing problem loans, and management problems. Penn Square officials signed an OCC agreement in June 1980 pledging improved lending practices and the maintenance of 7.5 percent capital, but no changes in lending practices were noticeable. Penn Square's external auditors became concerned with the level of loan reserves and gave the bank qualified opinions in December 1977 and March 1981.^{4,5}

In 1981, the Southwest saw a huge increase in commercial loans, particularly in the oil and agricultural industries. In April 1981, oil prices peaked at \$36.95 a barrel and then began to fall. Recessions in oil-consuming nations, conservation efforts, and the

3. "Generally a concentration is a significantly large volume of economically related assets that an institution has advanced or committed to one person, entity or affiliated group. These assets may in the aggregate present a substantial risk to the safety and soundness of the institution." FDIC, Division of Supervision, *Manual of Examination Policies* (1995), 46.

4. On December 19, 1977, Arthur Young and Company wrote: "Due to the lack of evidential data relating to certain real estate and commercial loans, we were unable to satisfy ourselves as to the adequacy of the reserve for loan losses." See Phillip L. Zweig, *Belly Up* (New York: Crown, 1985), 61.

5. On March 13, 1981, Arthur Young and Company wrote, "We were unable to satisfy ourselves as to the adequacy of the reserve for possible loan losses at December 31 [1980] due to the lack of supporting documentation of collateral on loans." Zweig, *Belly Up*, 174.

sale of oil by some Organization of Petroleum Exporting Countries (OPEC) members in excess of their quotas all combined to reduce oil prices in world markets.⁶ The demand for oil rigs reached its peak in the Southwest.⁷ As oil prices continued to decline during 1982, profits for the oil industry in the Southwest slowed.

The Federal Reserve maintained tight monetary policies, and interest rates remained high; therefore, Penn Square paid higher interest rates on deposits, particularly on large certificates of deposit (CDs).

In early 1982, in response to the decline in oil prices, Penn Square's participant banks began pressing Penn Square to clean up the loan participations. Penn Square had sold loan participations to 53 different participant banks; Continental alone held \$1 billion of those participations. Although Chase, Seafirst, and Northern stopped buying participations, Penn Square's new external audit firm presented the bank with a clean audit opinion in March 1982.⁸ Interest rates remained high; the Federal Reserve discount rate was 12 percent in January 1982.

In May 1982, rumors of problems at Penn Square began circulating, which caused a deposit runoff that forced the bank to rely increasingly on brokered funds.⁹ Brokered funds at the bank, which in January had been about \$20 million, reached \$150 million by May 1982.

As a result of its April 1982 examination, the OCC requested Penn Square to raise capital by \$7 million. The OCC also demanded that Penn Square charge off \$10 million in loans. By June 28, 1982, it was apparent that Penn Square would fail. All that was left to decide was how to handle the failure.

The Resolution

On July 1, 1982, at a joint meeting in Dallas, the OCC and the Federal Reserve argued that Penn Square should be sold through a purchase and assumption (P&A) transaction or given open bank assistance (OBA), while the FDIC argued for a payoff. The FDIC, the Federal Reserve, and the OCC then began meeting in Washington to discuss resolution possibilities.

Neither the Federal Reserve nor the OCC wanted to see Penn Square paid off. In the two decades before the 1980s, most failing banks were resolved through P&As that

6. Jack L. Hervey, "The 1973 Oil Crisis: One Generation and Counting," *Chicago Fed Letter*, no. 86 (October 1994), 1.

7. Energy Information Administration, *Annual Energy Review 1988*; Gerald H. Anderson, "The Decline in U.S. Agricultural Exports," *Economic Commentary* (Feb. 15, 1987), 1.

8. Zweig, *Belly Up*, 304.

9. Brokered deposits are large deposits placed by deposit brokers on behalf of their customers. Because of their size, brokered deposits typically earn higher interest rates, from which the broker deducts a fee before passing the interest to the customers.

Table II.3-1**The Last Twelve Bank Payoffs Before Penn Square**

(\$ in Thousands)

Bank Name and Location	Total Deposits	Date
Watkins Banking Company, Faunsdale, Alabama	\$1,660	07/24/78
Village Bank, Pueblo West, Colorado	5,059	01/26/79
Bank of Enville, Enville, Tennessee	3,468	06/16/79
The Farmers State Bank, Protection, Kansas	5,038	09/21/79
Bank of Lake Helen, Lake Helen, Florida	4,229	01/11/80
First National Bank of Carrington, Carrington, North Dakota	11,461	02/12/80
The Citizens State Bank, Viola, Kansas	1,872	06/04/80
The Des Plaines Bank, Des Plaines, Illinois	46,269	03/14/81
Southwestern Bank, Tucson, Arizona	4,749	09/25/81
The Bank of Woodson, Woodson, Texas	3,168	03/01/82
Carroll County Bank, Huntingdon, Tennessee	8,236	04/30/82
Citizens Bank, Tillar, Arkansas	6,723	06/23/82

Source: FDIC, *Historical Statistics on Banking: A Statistical History of the United States Banking Industry, 1934–1992* (Washington, D.C.: Federal Deposit Insurance Corporation, 1993), 615–618.

passed all deposits to the acquiring institution. Past experience suggested that depositors with uninsured funds and others (for example, general creditors) with uninsured liabilities were reasonably certain of being paid. From 1980 until Penn Square failed on July 5, 1982, the FDIC had paid off (protected only insured deposits) only 8 of 38 failed banks. (See table II.3-1.)

Before Penn Square's failure, the FDIC had taken action on several large institutions by fully protecting all depositors in P&A transactions or by providing OBA to keep the institutions open. For example, the FDIC protected all depositors, including the uninsured, when the Franklin National Bank, New York, New York, was declared insolvent by the OCC and closed on October 8, 1974. With \$1.4 billion in assets, Franklin National Bank was the largest bank failure in American history at that time. On April 28, 1980, the FDIC, the Federal Reserve, and the OCC jointly announced a \$500 million OBA package to assure the viability and continued strength of the \$8 billion First Pennsylvania Bank, N.A. (First Penn), in Philadelphia.¹⁰ From November 1981 through October 1982, FDIC provided assistance to accomplish the mergers (and prevent the failures) of 11 mutual savings banks that had total assets of \$14.7 billion and

total deposits of \$12.1 billion. The largest of those banks was the New York Bank for Savings, New York City; it had total assets of \$3.4 billion and total deposits of \$2.8 billion.¹¹

Some government officials were concerned that a payoff of only the insured deposits at Penn Square would have serious adverse effects on the stability of the banking system. Penn Square had about \$470.4 million in deposits, of which only about \$207.5 million were insured in 24,538 accounts. Among the depositors were 29 commercial banks, 44 savings and loan associations, and 221 credit unions.¹²

During the interagency meetings, the Federal Reserve, the OCC, and the FDIC discussed the various resolution alternatives. Although they discussed OBA, the FDIC would have had to determine Penn Square “essential” to its community; but with 36 other banks in Oklahoma City, the FDIC could not make that determination.¹³

Arranging a P&A transaction for the failed bank would have been difficult under any circumstance because Oklahoma laws did not permit bank branching, and few companies would have been able to bid on the institution. In the case of Penn Square, a closed bank P&A transaction might have resulted in the FDIC’s assumption of a large volume of contingent liabilities; the total amount was unknown but was believed to exceed the \$2.1 billion in loan participations sold. Because of the heavy volume of participations and questions about the accuracy of information furnished to loan purchasers, the FDIC anticipated a substantial volume of lawsuits. If the suits were successful, the cost to the FDIC of a P&A transaction ultimately would have been substantially higher than the cost of a payoff.

The FDIC’s concerns over contingent liabilities were based on what is known as “the First Empire decision.”¹⁴ When the United States National Bank, San Diego, California, failed in 1973, the FDIC had attempted to structure a P&A transaction so that certain contingent liabilities involving standby letters of credit, which had been issued to guarantee obligations of companies related to the bank’s controlling stockholder, would not be assumed by either the FDIC in its corporate capacity or by the assuming bank. Instead, the FDIC left those contingent claims in the receivership. The practical effect was that the depositors and general creditors were paid in full through the P&A transaction, and the contingent claimants were left with less than full recovery. First Empire Bank, New York, New York, the beneficiary of the standby letters of credit, sued the FDIC over that issue and won. The Ninth Circuit Court held that arranging for the

10. For further information, see Chapter 2, First Pennsylvania Bank, N.A.

11. FDIC, *Historical Statistics on Banking: A Statistical History of the United States Banking Industry, 1934-1992* (Washington, D.C.: Federal Deposit Insurance Corporation, 1993), 619.

12. Sprague, *Bailout*, 133.

13. In section 13(c) of the Federal Deposit Insurance Act (FDI Act) of 1950, Congress granted the FDIC authority to provide assistance to an open bank, “when in the opinion of the Board of Directors the continued operation of such bank is essential to provide adequate banking service in the community.” FDIC, *Federal Deposit Insurance Corporation: The First Fifty Years* (Washington, D.C.: Federal Deposit Insurance Corporation, 1984), 94.

14. *First Empire Bank v. FDIC*, 572 F. 2d 1361 (9th Cir. 1978), cert. denied, 439 U.S. 919 (1978).

payment of the depositors and general creditors without arranging for payment of the standby letters of credit violated *U.S. Code* 12, section 194, which the court held to require “ratable” distributions from a national bank receivership. The court also held that the FDIC could not structure a P&A transaction that preferred one group of similarly situated creditors to another.¹⁵ Therefore, in the resolution of Penn Square, the FDIC could not have arranged a P&A transaction taking into account payment of the approximately \$2.1 billion in Penn Square’s contingent liabilities.

The only alternative left for the FDIC was to pay off insured deposits.¹⁶ The FDIC decided to use a power given to it by the Banking Act of 1933 and established a Deposit Insurance National Bank (DINB) to pay off the insured depositors. Establishment of a DINB was a seldom-used method for handling failed banks.¹⁷ It had been used on only four other occasions in the preceding 20 years, and the two most recent occasions had been in 1975.¹⁸ A DINB, operating much like an open bank, effectively allowed the FDIC to separate the volume of insured deposits from the uninsured deposits. Customers with insured deposits were treated like customers of a normal bank; they could continue writing checks and leave their savings accounts and CDs in the bank. In addition, they did not have to stand in line to get their deposits (although many at Penn Square did), which was different from a straight deposit payoff, in which every customer had to come to the bank to get an insurance check equal to his or her insured deposit amount.

Penn Square was so much larger than any bank paid off by the FDIC in its history that it would have been difficult to pay it off in the normal manner. The volume of customers with claims for uninsured deposits also was unusually large. Normally, uninsured deposits represent a small percentage of the deposits (less than 5 percent); but Penn Square was a different story, with more than half of the bank’s \$470.4 million in deposits exceeding the insurance limit of \$100,000 per depositor.

By paying off insured depositors, the FDIC’s maximum exposure was the total amount of those insured deposits. Before closing, the amount was estimated to be \$250 million; the actual amount later was determined to be \$207.5 million. Payments to litigants, if they were successful, were the responsibility of the receiver. Had the FDIC used a P&A to resolve Penn Square, it would have had to agree to protect any acquiring bank from unbooked and contingent liabilities. To the extent that those liabilities were established in court, the FDIC would have had to pay full value on those claims.

15. Robert E. Norton, “What Uninsured Depositors Can Expect,” *American Banker* (July 12, 1982), 15.

16. Sprague, *Bailout*, 116–117.

17. A DINB was a new national bank chartered without any capitalization and with limited life and powers. A DINB essentially provided a vehicle for a slow and orderly payoff. DINBs were authorized by the Banking Act of 1933 and were the only procedures authorized for payoffs through August 23, 1935. FDIC, *The First Fifty Years*, 81.

18. DINBs were used for the failed Swope Parkway National Bank, Kansas City, Missouri, and The Peoples Bank of the Virgin Islands, Charlotte Amalie, St. Thomas, Virgin Islands, which failed on January 3, 1975, and October 24, 1975, respectively.

Because Penn Square was resolved through a payoff, the claims established from lawsuits had status in the receivership equal to other general creditors, including the FDIC.

On July 5, 1982 (a holiday), shortly after 8 p.m., the OCC determined that Penn Square was insolvent, closed the bank, and named the FDIC as receiver. Because it was the largest payoff in history, the failure quickly attracted national attention.

The Closing

Planning for the closing of Penn Square and its reopening as a DINB was difficult. Before the closing, the OCC had given little information to the FDIC. Moreover, FDIC personnel were not experienced in dealing with such a large and complex institution and, therefore, had difficulties in determining which accounts were uninsured. The decision to immediately reopen the institution as a DINB before closing out the failed institution's books further compounded the situation.

The new bank, named the Deposit Insurance National Bank of Oklahoma City, opened for business on July 6, 1982.

The FDIC announced that all of Penn Square's assets were being transferred to the receiver and all insured deposits had been transferred to the DINB. Funds deposited in interest-bearing accounts would continue to earn interest at the same rate that the failed bank had been paying. FDIC Chairman William M. Isaac was quoted as saying: "We'll keep the bank open 24 hours a day if necessary to meet the demand. We'll be in the bank all night long if we have to."¹⁹

The process for paying the depositors of Penn Square presented a multitude of problems. The bank's deposit and loan records were neither accurate nor complete, making it difficult for the FDIC to readily make insurance determinations. The FDIC had little more than 72 hours (Saturday, Sunday, and Monday) to review 24,538 deposit accounts, totaling \$470.4 million, for preliminary insurance determinations. The closing team worked around the clock over that weekend to determine deposit insurance coverage and prepare for the opening of the DINB. Even with that extraordinary effort, FDIC personnel could not fully prepare to deal with the sheer number of depositors or to thoroughly discuss what would happen to a depositor with uninsured deposits.

On the morning of July 6th, long lines of depositors waited in the hot Oklahoma sun to get their money. Reflecting on the long lines of Penn Square customers, FDIC attorney Donald McKinley said, "I'll never forget . . . [they were] lined up as far as you could see in a hot July sun out in the parking lot of this little . . . shopping center . . . lined up all the way out in the parking lot forever, waiting to get their deposits, not withstanding all the advertising from the FDIC that through the DINB, you could draw your checks. . . ."²⁰

19. Zweig, *Belly Up*, 410.

20. Donald McKinney, FDIC attorney, interview, 1995.

An Associated Press report described the scene: “Hundreds of depositors seeking their money crowded the former Penn Square Bank on Tuesday as the federal government began liquidating the 21st bank to fail in the United States this year. . . . Many of the bank’s customers paid little heed to Isaac’s assurances that depositors with accounts of less than \$100,000 will get their money back through FDIC insurance. Nearly 100 people stood outside the bank’s doors at noon, waiting to enter the lobby jammed with depositors. A continuous line of cars wound through the drive-in lanes. Bank workers handed out glasses of iced water to those waiting outdoors in the 90-degree heat.”²¹

The FDIC operated the DINB much like a full-service bank. Interest rates remained unchanged on deposit accounts for 90 days, automatic teller machines were available as before, the DINB provided a check cashing service for checks up to \$1,000, and safe deposit boxes were available. The FDIC transferred trust operations to another bank. It also advised loan customers to continue paying loans according to terms, although the DINB had no loan authority because its sole function was to pay off the insured depositors.^{22,23}

Customers with uninsured deposits received receivership certificates representing their claims against the Penn Square Bank receivership. The FDIC gave claims for uninsured deposits general creditor status, which meant that they shared in liquidating dividends with the FDIC and other general creditors from the collection of the bank’s assets by the receiver.²⁴

The Federal Reserve announced that the depository institutions that held receivership certificates could borrow against the certificates at the Federal Reserve’s discount window; the interest rate for such borrowings was 12 percent. The FDIC suggested that the certificates should be valued at about 80 percent of face value. The Federal Reserve agreed to lend up to 90 percent of that discounted amount.²⁵ The U.S. Small Business Administration (SBA) also announced that it would accept FDIC-issued receivership certificates as collateral for loans to businesses hurt in the Penn Square failure.²⁶

Another problem, although short lived, was that some of the local financial institutions would not accept the DINB insurance checks or wanted to put holds on them. That situation caused a near panic, as customers who thought they were being paid returned to the bank complaining that they could neither cash nor deposit their checks. By Wednesday that situation was resolved when the local institutions agreed to accept the DINB insurance checks.

21. Debby Shannon, “Liquidators Reopen Penn Square Bank,” Associated Press (July 6, 1982).

22. Sprague, *Bailout*, 123.

23. Sprague, *Bailout*, 121.

24. The National Depositor Preference Amendment of the Omnibus Budget Reconciliation Act of 1993 has changed the order of priority for receivership dividends. Depositors are now paid before any other class of creditors.

25. Norton, “What Uninsured Depositors Can Expect,” 15.

26. Gordon Matthews, “Court Stalls Chase’s Penn Square Suit,” *American Banker* (July 21, 1982), 3.

Table II.3-2

**Penn Square Bank, N.A.
Receivership Inception Balances**

Asset Type	Balance
Cash and Due From	\$27,695,235
Securities	48,424,725
Installment Loans	22,382,169
Commercial Loans	334,030,402
Mortgage Loans	48,885,019
Owned Real Estate	5,818,718
Other Assets	8,446,206
Overdrafts	15,617,418
Total	\$511,299,892

Note: Does not include loan participations.

Source: FDIC News Release, "FDIC Reports on Receiverships of Penn Square, N.A., and Operations of the Deposit Insurance National Bank of Oklahoma City," PR-90-82 (October 25, 1982).

Penn Square's \$2.1 billion in loan participations complicated the offset process. Initially, the FDIC determined that when a deposit was offset against a loan, the participant's share of the offset would be paid in cash. Subsequently, the FDIC determined that the transaction was a noncash transaction and that the participant's share should be paid with a receiver's certificate.²⁷

Lawyers for the banks that had bought loan participations from Penn Square sued the FDIC in an attempt to get money without waiting for the liquidation of the loans. A federal judge in Oklahoma City turned down a request by Chase to stop the FDIC from using compensating balances left at the failed bank to offset

27. Loan participants usually receive their pro rata share of any payments made by a debtor that augments the receivership estate. The same holds true if the receiver forecloses on and liquidates the underlying collateral. Loan participations may suffer a loss greater than they would otherwise incur, however, if the debtors or receivers exercise their right of offset. Because the offset does not "augment the receivership estate," there are no proceeds to be passed on to the loan participants. The loan participants are therefore left with general unsecured claims against the receivership estate for the amounts they have lost as a result of the offset. The general unsecured claims are likely to be worth far less than the 100 cents on the dollar that direct proceeds or cash is worth.

Table II.3-3

Penn Square Bank, N.A.
Principal and Interest Collections on Loans, Securities, and Other Assets
 (\$ in Millions)

Period Ending	Total Collections
09/30/82	\$175.1
05/01/83	412.2
10/09/84	602.4
12/20/85	660.7

Sources: FDIC news releases—"FDIC Reports on Receiverships of Penn Square, N.A., and Operations of the Deposit Insurance National Bank of Oklahoma City," PR-90-82 (October 25, 1982); "FDIC Estimates 65 Percent Recovery for Holders of Penn Square Bank, N.A., Receiver's Certificates," PR-49-83 (June 17, 1983); "FDIC Reports on Receiverships of Penn Square, N.A., and Operations of the Deposit Insurance National Bank of Oklahoma City, Oklahoma," PR-8-84 (February 7, 1984); "FDIC Provides Status Report on Receivership of Penn Square Bank, N.A., Oklahoma City, Oklahoma," PR-133-84 (October 29, 1984); "FDIC Reports on Receivership of Penn Square, N.A., Oklahoma City, Oklahoma," PR-4-86 (January 13, 1986).

bank liabilities.²⁸ In the suit, Chase disclosed that it had \$212.2 million of loan participations with Penn Square. The Chase suit followed an action initiated by Hibernia National Bank, New Orleans, Louisiana, which had purchased \$24 million in 81 loans from Penn Square.²⁹

At the closing, the FDIC as receiver acquired \$511.3 million in Penn Square assets; the figure was later adjusted to \$516.8 million. Table II.3-2 shows the assets in the original inventory by asset type.

By September 30, 1982, insured deposits in the DINB had been reduced from the beginning balance of \$207.5 million in 24,538 accounts to \$10.5 million in 3,527 accounts. The \$10.5 million consisted of \$6.6 million in demand deposits and \$3.9 million in time deposits.³⁰ According to a December 20, 1985, news release, the FDIC had collected \$660.7 million (including amounts due participants) on Penn Square's assets and, of that amount, paid \$576.9 million dollars on liabilities of the receivership. (See tables II.3-3 and II.3-4.)

28. Compensating balances are average balances required by a bank for holding credit available. The more or less standard requirement for a bank line of credit, for example, is 10 percent of the line plus an additional 10 percent of the borrowings. Compensating balances increase the effective rate of interest on borrowings. John Downes and Jordan Elliot Goodman, *Dictionary of Finance and Investment Terms* (Hauppauge, NY: Barron's Educational Series, 1995), 101.

29. Matthews, "Court Stalls Chase's Penn Square Suit," 3.

30. FDIC News Release, "FDIC Reports on Receivership of Penn Square Bank, N.A., and Operations of the Deposit Insurance National Bank of Oklahoma City," PR-90-82 (October 25, 1982).

Table II.3-4**Penn Square Bank, N.A.****Payments Made from Principal and Interest Collections**

(\$ in Millions)

Payments Made to:	9/30/82	3/11/83	5/1/83	8/16/84	10/9/84	12/20/85	Totals
Loan Participants	\$74.1	\$0	\$136.6	\$0	\$73.6	\$17.5	\$301.8
Federal Reserve	5.7	0	0	0	0	0	5.7
Pledged Deposits	13.0	0	3.9	0	0	0	16.9
Receivership Claimants	0	88.2	0	64.9	0.5	98.9	252.5

Sources: FDIC news releases—"FDIC Reports on Receiverships of Penn Square, N.A., and Operations of the Deposit Insurance National Bank of Oklahoma City," PR-90-82 (October 25, 1982); "FDIC Estimates 65 Percent Recovery for Holders of Penn Square Bank, N.A., Receiver's Certificates," PR-49-83 (June 17, 1983); "FDIC Reports on Receiverships of Penn Square, N.A., and Operations of the Deposit Insurance National Bank of Oklahoma City, Oklahoma," PR-8-84 (February 7, 1984); "FDIC Provides Status Report on Receivership of Penn Square Bank, N.A., Oklahoma City, Oklahoma," PR-133-84 (October 29, 1984); "FDIC Reports on Receivership of Penn Square, N.A., Oklahoma City, Oklahoma," PR-4-86 (January 13, 1986).

On March 11, 1983, the FDIC obtained court approval to begin paying the first liquidation dividend, which amounted to approximately \$88.2 million, or nearly 20 percent of proven claims.³¹ When the FDIC first announced its intention to pay a liquidating dividend on proven claims, others with claims pending in court against the receiver objected because the receiver had made no provision for the payment of their claims. As a consequence, and to protect anyone whose claim was later approved, the FDIC agreed to establish a reserve for the pending claims; the amount of the reserve was set at 85 percent of total pending claims. The court then allowed the FDIC to pay a first liquidating dividend for proven claims.³² On August 16, 1984, the FDIC paid a second liquidating dividend of 15 percent of proven claims, or about \$64.9 million.³³

On December 19, 1985, the FDIC paid a liquidating dividend of 20 percent to holders of proven claims, which brought total dividends paid to 55 percent of proven claims.³⁴ (See table II.3-5 for receivership certificate information as of that date.)

31. FDIC News Release, "FDIC Estimates 65 Percent Recovery for Holders of Penn Square Bank, N.A., Receiver's Certificates," PR-49-83 (June 17, 1983).

32. FDIC News Release, "FDIC Estimates 65 Percent Recovery for Holders of Penn Square Bank, N.A., Receiver's Certificates," PR-8-84 (February 7, 1984).

33. FDIC News Release, "FDIC Provides Status Report on Receivership of Penn Square Bank, N.A., Oklahoma City, Oklahoma," PR-133-84 (October 29, 1984).

34. FDIC News Release, "FDIC Reports on Receivership of Penn Square Bank, N.A., of Oklahoma City, Oklahoma," PR-4-86 (January 13, 1986).

Table II.3-5

**Penn Square Bank, N.A.
Receivership Certificate Information**
(*\$ in Millions*)

	As of December 20, 1985
Number of Receivership Certificates Issued	2,620
Dollar Amount of Certificates	\$459.1
Dividends Paid	\$252.5
Dividends Paid—Percentage	55%

Source: FDIC News Release, "FDIC Reports on Receivership of Penn Square, N.A., Oklahoma City, Oklahoma," PR-4-86 (January 13, 1986).

The DINB closed after slightly more than 13 months, when on August 18, 1983, the FDIC signed an agreement with Charter National Bank, N.A. (Charter National), a newly chartered bank, under which Charter National purchased the remaining \$458.4 thousand in deposits from the DINB.³⁵

The Penn Square Bank receivership was terminated on July 1, 1996. Total dividends paid were \$341.6 million.³⁶ The total cost to the FDIC for the resolution was \$65 million, or 12.6 percent of total failed bank assets.³⁷

FDIC Resolution Costs

The FDIC funded all insured deposits of \$207.5 million for the Penn Square payoff, plus \$16.9 million in pledged deposits, and placed them in the DINB. It also assumed \$5.7 million in debt to the Federal Reserve. All assets of Penn Square, totaling (after adjustments) \$526.8 million (net of participations), were retained in the receivership, and the receivership was responsible for servicing the participated loans. The FDIC operated the DINB until August 18, 1983, when it sold the remaining deposits.

The FDIC's total financial commitment and resolution costs are shown in table II.3-6.

35. FDIC News Release, "Status Report on Receivership of Penn Square," PR-133-84 (October 29, 1984).

36. FDIC Division of Finance.

37. FDIC Division of Research and Statistics.

Table II.3-6**Penn Square Bank, N.A., Resolution Costs
as of December 31, 1995**

(\$ in Millions)

FDIC's Expenses	
FDIC funding of insured deposits	\$207
FDIC assumption of pledge deposit liability	17
FDIC assumption of Federal Reserve debt	6
FDIC's Total Financial Commitment	\$230
FDIC's Recoveries	
FDIC's Recoveries on Assets	\$165
FDIC's Total Resolution Cost	\$65

Source: FDIC Division of Finance and FDIC Division of Research and Statistics.

Lessons Learned

Penn Square grew by paying higher-than-market rates for brokered deposits. FDIC Chairman Isaac, in an address before the uninsured depositors of Penn Square, explained the reasons for the FDIC's decision to pay off the insured deposits of the failed bank.³⁸

The Penn Square debacle was caused by a gross dereliction of duty on the part of the bank's board of directors and management. They were able to perpetrate their abusive practices by obtaining funds—normally through money brokers from banks, credit unions and S&Ls around the nation. These financial institutions, which held 80 percent of the uninsured funds at Penn Square, were motivated solely by a desire to make a fast buck.

Many of you have asked why the FDIC chose to handle the Penn Square failure through a payoff of insured depositors rather than a merger, as we typically do. The answer is simple: we had no choice.

38. FDIC News Release, "Some Straight Talk About Penn Square" (FDIC Chairman William M. Isaac, in an address before the uninsured depositors of Penn Square on October 30, 1984, in Oklahoma City), PR-134-84 (October 30, 1984).

When a merger of a failed bank is arranged, the FDIC must provide protection to the purchaser against any contingent or off-balance sheet claims. Penn Square had sold more than \$2 billion in loan participations to other banks and had outstanding nearly \$1 billion in letters of credit. The potential exposure to loss on the \$3 billion of off-balance sheet claims was staggering. The FDIC is prohibited by law from arranging a merger unless it determines that the cost of the merger will likely be less than a payoff of insured depositors. The existence of the tremendous volume of potential off-balance sheet claims made that finding impossible.

We were under a great deal of pressure that fateful July 4th weekend to arrange a merger. The financial institutions that had purchased loan participations and had uninsured funds at Penn Square urged the FDIC to help bail them out of their problems. If we had done so—if we had tried to bail out these institutions in a situation as egregious as Penn Square—the long-range consequences to our free-enterprise banking system would have been devastating.

If the FDIC had effected a P&A transaction in the Penn Square resolution, it would have strengthened the signal given by the First Penn transaction and the mutual savings bank resolutions that all deposits, at least in banks above a certain size, were, for all practical purposes, fully insured. Penn Square would have been another indicator leading to an erosion of discipline in the markets. After the payoff at Penn Square, uninsured depositors certainly became more sensitive to the possibility of loss. Some banks had difficulty rolling over large CDs. The business of brokers, who divide up large deposits and place them with several banks, was significantly boosted. Depositors generally became more selective in their choice of banks, and the public's concern about the condition of banks was increased.³⁹

Noting the strain that a payoff of insured deposits had on customers with uninsured deposits, the FDIC sought court approval to pay advance dividends.⁴⁰ Many of the customers holding receivership certificates were credit unions and savings and loan associations. Paying advance dividends would ease the strain on the individual institutions and promote the stability of those institutions. By paying advance dividends on claims of customers with uninsured deposits and general trade creditors, the FDIC believed that it would recover more money from the Penn Square receivership than it paid to insured depositors, plus the amount it spent in the liquidation process. Less than a year after closing, the FDIC paid holders of proven claims a portion of their claims, with the amount paid based on the FDIC's collections to date and a conservative estimate of future liquidation recoveries. The FDIC designed advance dividends to ease the pain of

39. FDIC, *The First Fifty Years*, 98.

40. FDIC News Release, "FDIC Estimates 65 Percent Recovery for Holders of Penn Square Bank, N.A., Receiver's Certificates," PR-49-83 (June 17, 1983).

claimants who otherwise might have had to wait substantial periods of time to receive any money above insured deposit amounts.

In many institutions during the banking crisis of the 1980s and early 1990s, brokered deposits became a problem. When institutions faced liquidity shortages, they frequently turned to brokers for large sums of cash in a hurry. The FDIC believes deposit brokering became a problem following the enactment of the Depository Institutions Deregulation and Monetary Control Act (DIDMCA) of 1980. That statute provided for eliminating restrictions on interest rates paid on deposits. That same year, Congress raised the deposit insurance limit to \$100,000. As a result of those changes, depository institutions began to compete for large amounts of deposits through the offering of high interest rates, and many depositors found the highest rates through the services of deposit brokers.

Penn Square's collapse was the largest deposit payoff in FDIC history at that time. Many investors were caught by surprise, and they began seeking full FDIC insurance on their deposits. The failure of Penn Square highlighted the problems resulting from the use of brokered funds; brokered deposits enabled the bank to grow very rapidly and to continue in operation beyond the time when normal market forces otherwise would have prevented it from getting more deposits.

Following the Penn Square failure, the FDIC and the Federal Home Loan Bank Board (FHLBB) studied the problem of brokered deposits. The two agencies sought public comment on the problem through a notice published in the *Federal Register* on November 1, 1983. The two agencies expressed their concern that the practice of deposit brokering "enable[d] virtually all institutions to attract large volumes of funds from outside their normal market area irrespective of the institutions' managerial and financial characteristics."⁴¹

The FDIC and the FHLBB jointly published a final regulatory rule on April 2, 1984. As incorporated into the FDIC's insurance regulations, the rule was effective on October 1, 1984. The rule states the following:

[F]unds deposited into one or more deposit accounts by or through a deposit broker shall be added to any other deposits placed by or through that deposit broker and insured up to \$100,000 in the aggregate.⁴²

That rule, found at 12 C.F.R. 330.13(b) (1985), eliminated "pass-through" insurance for brokered deposits, which essentially treated the broker as the depositor (subject to the \$100,000 insurance limit). Deposit insurance no longer "passed through" the broker to the broker's clients (the actual owners of the funds).

The rule was challenged in court. In 1985, in the case of *FAIC Securities, Inc. v. United States*, the U.S. Court of Appeals for the District of Columbia Circuit ruled that

41. 48 *Federal Register* 50,339 (November 1, 1983).

42. 49 *Federal Register* 13,003 (April 2, 1984).

the regulatory rule adopted by the FDIC and the FHLBB was invalid because it was contrary to the statutory insurance limit of \$100,000 per depositor.⁴³

The court ruling essentially ended the restriction on brokered deposits. In 1989, Congress passed the Financial Institutions Reform, Recovery, and Enforcement Act (FIRREA), which limited some use of brokered deposits simply by prohibiting troubled institutions from accepting brokered deposits. In 1991, Congress passed the Federal Deposit Insurance Corporation Improvement Act (FDICIA), which amended the 1989 statute by prohibiting troubled institutions (that is, institutions that did not meet applicable minimum capital requirements) from accepting funds obtained directly or indirectly by or through any deposit broker. Those institutions were similarly prohibited from offering a rate of interest significantly higher than other area banks.

Effect on Future Resolutions

Seafirst, the largest bank in the Northwest, was the first big casualty precipitated by Penn Square. Losses from Penn Square forced the merger of Seafirst's holding company, Seafirst Corporation, with BankAmerica Corporation (BAC). At the time of the merger, Seafirst had \$9.6 billion in assets and BAC had \$119.7 billion. The resulting \$129.3 billion combination of assets exceeded that of Citicorp of New York by \$1 billion and created what was then the largest financial entity in the country. Seafirst and BAC completed the merger without financial assistance from the FDIC.

When deposit payoffs were conducted subsequent to Penn Square, they generally included payment of an advance dividend to uninsured depositors and other general creditors. Those "modified payoffs," as they were referred to at the time, mitigated the disruptive effects of a bank failure on a local community without providing anything more to uninsured creditors than that to which they were entitled.

In the aftermath of Penn Square the prevalent feeling was that perhaps the FDIC would be a little less ready to protect uninsured creditors at failed depository institutions than it had been before Penn Square. Purchase and assumption transactions remained the preferred procedure for handling bank failures, carrying with them automatic coverage of all depositors. Nevertheless, before Penn Square, no bank of that size had ever been handled without protecting all depositors. The next major event was the Continental open bank assistance transaction in 1984.

43. *FAIC Securities, Inc. v United States*, 768 F. 2d 352 (D.C. Cir. 1985).

**Then-FDIC Chairman
William M. Issac
announced the details
of the history making
financial assistance
package for
Continental Illinois
National Bank and
Trust Company before
a packed press
conference in the FDIC
Washington office.**





CHAPTER 4

Continental Illinois National Bank and Trust Company

Name of Institution:	Continental Illinois National Bank and Trust Company
Headquarters Location:	Chicago, Illinois
Date of Resolution:	May 17, 1984
Resolution Method:	Open Bank Assistance Transaction

Introduction

The Continental open bank assistance transaction is the most significant bank failure resolution in the history of the Federal Deposit Insurance Corporation (FDIC). Continental Illinois National Bank and Trust Company (Continental), Chicago, Illinois, received interim financial assistance from the FDIC on May 17, 1984, and received permanent financial assistance on September 26 of the same year. Continental is the single largest bank ever to require financial assistance from the FDIC in the history of the United States; but it was also noteworthy for several other reasons. First, the FDIC made a public statement before a final resolution, guaranteeing that all depositors and other general creditors would suffer no loss. Second, the FDIC took a significant ownership position in the bank holding company, effectively making Continental a government-owned bank. Third, Continental was the first assisted bank in which the assets acquired by the FDIC were serviced by the bank itself under a separate servicing agreement. Finally, the Continental open bank assistance transaction affirmed for many the notion that certain banks were simply “too big to fail.”¹

1. Most of the institutions considered “too big to fail” were actually closed, with shareholders generally losing their entire investments. The “too big to fail” designation came about because these troubled institutions were resolved by paying off both their insured and uninsured depositors, so that no depositors, or other creditors with the same priority as depositors, lost money.

General Description of the Bank

Continental, a subsidiary of Continental Illinois Corporation (CIC) since the organization of the holding company in 1969, had been in business for more than 124 years and had been assisted in 1933 by the Reconstruction Finance Corporation (RFC) because of an over-investment in utilities loans and out-of-territory lending.² During the two decades before its resolution in 1984, Continental had become an institution striving for growth. During that period, the bank developed extensive international operations; established internal divisions to render specialized services to the bank's oil, utility, and finance company customers; and developed a separate real estate department to make commercial and home loans. Continental also established a large network of correspondent banking relationships in the United States and throughout the world. At its peak in 1981, the bank ranked sixth among multi-national banks and was the largest domestic commercial and industrial lender, employing more than 12,000 people. With approximately \$40 billion in assets, Continental was, as of March 31, 1984, the largest bank in Chicago and the seventh largest bank in the United States, in both assets and deposits. In May 1984, Continental had 57 offices in 14 states and 29 foreign countries.³

Background

Continental had been aggressively pursuing a growth strategy since the late 1970s. By 1981, Continental was the largest commercial and industrial (C&I) lender in the United States. Between 1976 and 1981, Continental's C&I lending jumped from approximately \$5 billion to more than \$14 billion, and total assets grew from \$21.5 billion to \$45 billion. Continental's loans-to-assets ratio increased from 57.9 percent in 1977 to 68.8 percent by year-end 1981; its return on assets (year-end net income divided by year-end assets) stayed at 0.5 percent during the same period, while the return on equity (year-end net income divided by year-end equity) was 14.4 percent.⁴

Indications of Continental's developing problems surfaced in 1982 with the closing of Penn Square Bank, N.A. (Penn Square), Oklahoma City, Oklahoma.⁵ Continental was the largest participant in oil and gas loans at Penn Square and experienced large losses on those participations. Not only were the loans poorly underwritten, there was a clear indication that Continental had not conducted appropriate due diligence on the loans purchased. Continental's own loan portfolio was also experiencing problems, particularly in the energy

2. Irvine H. Sprague, *Bailout* (New York: Basic Books, 1986), 232.

3. United States General Accounting Office, Staff Study, "Financial Crisis Management: Four Financial Crises in the 1980s," GAO/GGD-97-97 (May 1997), 35.

4. FDIC, *History of the Eighties—Lessons for the Future*, vol. 1, *An Examination of the Banking Crisis of the 1980s and Early 1990s* (Washington, D.C.: FDIC, 1997), 236.

5. See Chapter 3, Penn Square Bank, N.A., for more information.

sector. In the second quarter of 1982, after Penn Square failed, Continental reported \$1.3 billion in nonperforming loans and other assets, including participations purchased.⁶

Because Continental had aggressively pursued C&I lending, it had little retail banking business and relatively small total core deposits. It relied primarily on federal funds and large certificates of deposits (CDs) purchased in the secondary market. When Penn Square failed, Continental found itself unable to fund its domestic operations from domestic markets and turned to foreign money markets at higher rates.

In 1982, stock analysts downgraded their earnings estimates on Continental, and its share price dropped nearly 62 percent from its peak the year before.⁷ In addition, the major rating agencies downgraded the bank's credit and debt ratings. Continental had also made significant loans to the less-developed countries (LDC) and was hurt by Mexico's default on its obligations in 1982.⁸ In 1983, two of Continental's major shareholders sold all their Continental stock.⁹

Continental's asset quality and declining income problems continued through 1983 and into 1984. At the end of the first quarter of 1984, Continental's nonperforming loans had increased to \$2.3 billion, due in large part to troubled LDC loans.¹⁰ Its positive net income of \$29 million was derived solely from the \$157 million sale of its credit card business to Chase Manhattan Bank. By April 1984, Continental's share price had dropped again.

Large foreign depositors became nervous after hearing rumors of Continental's imminent failure, and, in May 1984, began a high-speed electronic deposit run on the bank. The run may have been triggered by U.S. investment banking firms, acting on their own, making inquiries in Japan to see if there were any banks interested in taking over Continental. What is certain is that banks in the Netherlands, West Germany, Switzerland, and Japan had increased their rates on loans to Continental. Reuters, the British news agency, picked up that information and put it on its news wire on Tuesday, May 8, 1984. When a second news story came out on Wednesday, May 9, from Commodity News Service that a Japanese bank was considering buying Continental, Japanese and European money was quickly withdrawn. Foreign bankers withdrew more than \$6 billion before May 19. In the U.S., the Chicago Board of Trade Clearing Corporation withdrew \$50 million on or about May 9; word of the withdrawal hit the wire services, and a deposit run ensued.¹¹

By Friday, May 11, Continental's borrowings at the Federal Reserve Bank of Chicago (Federal Reserve) discount window to make up for its lost deposits had reached \$3.6 billion.

6. FDIC, "Report on Continental Illinois" (FDIC, 1985), 12.

7. FDIC, *Lessons for the Future*, 241.

8. FDIC, *Lessons for the Future*, 241.

9. FDIC, *Lessons for the Future*, 243.

10. FDIC, *Lessons for the Future*, 243.

11. Sprague, *Bailout*, 152-153.

By Monday, May 14, the bank announced that it had put together a private funding line of almost \$5 billion from 16 of the nation's largest banks, led by Morgan Guaranty Trust Company of New York. The following lines appeared in an article in the *American Banker*, with a London, England, dateline:

The old-fashioned run on a bank by retail depositors has, on the whole, become a phenomenon of the past because of the safeguards erected over the last half-century. However, the phenomenon of a run on a bank in the Euromarkets is a new challenge for banks, supervisors, and central banks as lenders of last resort.¹²

The Resolution

The resolution of Continental comprised a two-step process involving interim financial assistance initially and permanent financial assistance four months later.

Interim Solution—May 17, 1984

On Tuesday, May 15, the FDIC met with the Federal Reserve and the Office of the Comptroller of the Currency (OCC) to discuss alternatives for working with Continental. Continental's insured deposit accounts totaled only about \$3 billion; its uninsured deposit accounts and other creditor claims totaled more than \$30 billion. Former FDIC Chairman Irvin H. Sprague recalled later, "At first glance, a payoff might have seemed a temptingly cheap and quick solution. The problem was there was no way to project how many other institutions would fail or how weakened the nation's entire banking system might become."¹³ The risks involved in Continental's potential failure extended beyond the bank itself. They included a potential liquidity crisis for other banks with significant foreign deposits, a decrease in foreign investor confidence in U.S. institutions, a severe blow to the unaffiliated depositor banks, and a negative effect on financial markets in general. Many small banks had correspondent bank accounts and federal funds sold to Continental, placing those funds at risk should Continental fail. For the FDIC, permitting Continental to fail and then paying off only the insured depositors (as had happened in Penn Square two years earlier) was not considered to be a feasible option. With more than \$30 billion in uninsured deposits, a liquidity failure would have occurred without FDIC assistance; such a failure could have caused other bank failures and tied up creditors in bankruptcy for years.

In addition to its funding problems, Continental had billions of dollars of troubled loans and many outstanding lawsuits. Those loans and legal entanglements were draw-

12. M.S. Mendelsohn, "Continental Seen as Biggest Banking Setback Since 1931: Run Was the First Instance of Large-Scale Withdrawals of Credit Lines in the International Interbank Market," *American Banker* (May 21, 1984), 1.

13. Sprague, *Bailout*, 155.

backs to attempts to attract a merger partner for Continental. Given the complexity of the problem and the liquidity crisis at hand, there may not have been enough time to structure a merger transaction, even if a potential merger partner had been interested.

Only one alternative remained: to provide Continental with open bank assistance. The FDIC's authority to provide open bank assistance, which the FDIC used in the 1980 near-failure of First Pennsylvania Bank, N.A. (First Penn), had been expanded by the Garn–St Germain Depository Institutions Act (Garn–St Germain) of 1982.^{14,15} Before Garn–St Germain was passed, the FDIC was required to deem a bank “essential” to its community before it could provide assistance. The new legislation eliminated the essentiality test except in instances in which the cost of open bank assistance would exceed the estimated cost of liquidating the institution.

The decision was made to continue funding Continental at the Federal Reserve discount window, and to try to forestall further runs by the injection of cash (in the form of a subordinated note purchase) from the FDIC. On Thursday, May 17, 1984, in a joint press release with the Federal Reserve and the OCC, the FDIC announced that Continental would be provided with interim assistance, which had the following components:¹⁶

- The FDIC issued an explicit guarantee that all depositors (insured and uninsured) and other general creditors of Continental would be fully protected and that service to the bank's customers would not be interrupted in any subsequent resolution.¹⁷
- The FDIC asked a group of seven commercial banks to provide a \$2 billion interim capital infusion through a subordinated note purchase. Four years earlier, 27 large commercial banks had participated in the assistance provided to First Penn to demonstrate the banking community's faith in the bank's recovery. Therefore, seven of the nation's largest banks agreed to share equally in \$500 million of the \$2 billion interim capital infusion.¹⁸ The FDIC provided the remaining \$1.5 billion in subordinated debt. Continental accepted FDIC restrictions

14. For more information, see Chapter 2, the case study of First Pennsylvania Bank, N.A.

15. The Garn–St Germain Act was comprehensive legislation that brought about major changes in federal laws governing the activities of financial institutions. Among the many provisions of the act, two were drafted specifically to enhance the FDIC's failed-bank resolution capabilities. The first dealt with open bank assistance, and the second authorized the Net Worth Certificate Program.

16. Comptroller of the Currency, Federal Deposit Insurance Corporation, and Federal Reserve Board, *Joint News Release* (May 17, 1984).

17. The bankers requested some guarantee statement, expressing concern that depositors might not understand that the large subordinated note virtually committed the FDIC to a transaction other than a deposit payoff, which meant that all depositors would be paid in full.

18. The seven banks were Bank of America National Trust and Savings Association (San Francisco, Calif.), Bankers Trust Company (New York, N.Y.), The Chase Manhattan Bank (New York, N.Y.), Chemical Bank (New York, N.Y.), Citibank, N.A. (New York, N.Y.), Manufacturers Hanover Trust Company (New York, N.Y.), and Morgan Guaranty Trust Company of New York (New York, N.Y.). Other banks subsequently purchased participations in the loan from the FDIC. FDIC, “Report on Continental Illinois,” working paper (1985), Part 2, 3.

related to hiring, replacement, or removal of members of senior management and of Continental's board of directors, as well as to general control of the bank. CIC, Continental's holding company, guaranteed that under certain circumstances assets in the holding company would be used to repay the FDIC.

- To further augment the financial resources available to Continental, a group of 24 major U.S. banks agreed to provide more than \$5.5 billion in funding on an unsecured basis throughout the period during which a permanent solution was developed. The agreement was arranged between Continental and the group of commercial banks for which Morgan Guaranty Trust Company of New York acted as agent. Without the FDIC's explicit guarantee to depositors and general creditors of Continental, that line of credit likely would not have been available.

Senate Banking Committee Chairman Jake Garn (R-Utah) was quoted as saying that the FDIC arrangement for a short-term funding package to assist Continental represented both a concern and a relief: "a concern because such a significant institution has experienced a funding problem and a relief because the doctor has arrived with the medicine."¹⁹ Senator Garn likened the situation to that of First Penn, which was rescued in a similar fashion by the FDIC in 1980. He said that First Penn "ended up better able to service corporate and individual customers" and he hoped the assistance to Continental would "result in a similar recovery in a shorter period of time."²⁰

After the interim solution was in place, the FDIC tried to locate either private investors willing to buy or merge with the bank without FDIC assistance or a partner that would merge with Continental with FDIC assistance. Three of the nation's largest banks sent teams into Continental to review its condition and assess merger possibilities. Continental itself tried to find a merger partner. Foreign banks showed no interest, and investment bankers tried but failed to put together a satisfactory transaction. No serious merger partner or private investor group was found that was willing to acquire Continental at a reasonable price. The various potential acquirers all cited nonperforming loans (including LDC debt), substantial litigation, funding shortfalls, and interstate branching restrictions as problems hindering a merger. During the same time, deposits continued to flow out of Continental, worsening its liquidity problem.

Permanent Solution—September 26, 1984

As Senate Banking Committee Chairman Garn stated, in dealing with Continental the FDIC faced a situation much like that of First Penn. Both banks were large institutions with heavy correspondent relationships, and a payoff of either institution would have had

19. John Morris and Lisabeth C. Weiner, "US Rescues Continental Illinois Corp.," *American Banker* (May 18, 1984), 1.

20. Morris and Weiner, "US Rescues Continental Illinois Corp.," 1.

serious adverse consequences for unaffiliated depositor banks. Both banks had significant amounts of nonperforming loans and other assets. First Penn's nonperforming loans totaled \$328 million, and Continental's nonperforming loans and other assets totaled \$5.2 billion. Both institutions presented the FDIC with the possibility of having to make large cash outlays in the event of a payoff: \$5.3 billion for First Penn and \$3 billion for Continental. In both cases, the FDIC would have been required to take into the receivership a large amount of loans for liquidation if a payoff had occurred. Had the FDIC paid off First Penn, it would have acquired \$8 billion in assets; and had it paid off Continental, it would have acquired more than \$30 billion in assets. At the time of the assistance from the FDIC, both institutions were experiencing deposit runs and were borrowing heavily from the Federal Reserve. In both cases, merger partners were sought, but none could be found. Therefore, both banks applied to the FDIC for open bank assistance.

Differences existed between the institutions, however. First Penn's problems were fairly straightforward, being caused initially by the bank's heavy investment in long-term government securities before a period of rising interest rates. Given time, along with assistance and oversight by the FDIC, the situation at First Penn stabilized and the bank returned to profitability. Continental's troubles, however, resulted from its deteriorating loan portfolio caused by high-risk lending. The full extent of the losses was not clear when assistance became necessary.

Given the lack of a merger partner and the undesirability of a deposit payoff, the FDIC viewed open bank assistance as the only viable solution to the Continental problem. It held discussions with Continental officials to work out the terms of the permanent assistance agreement. They had many issues to resolve: (1) Problem loans had to be removed from the bank to stem its losses; (2) provisions had to be made for funding the bank's operations, including arrangements necessary for its future borrowing from the Federal Reserve; (3) the bank's capital had to be increased; and (4) Continental had to strengthen its management staff and board of directors.

The issue of the holding company debt complicated any assistance plan. Some of the debt instruments required debtholder approval to sell CIC's principal asset, which was Continental. Covenants in the debt instruments prevented infusions of capital into the bank from outside the holding company without the approval of debtholders. Those covenants precluded the FDIC from taking a stock position in the bank, which would dilute CIC's ownership interest in the bank. The debt instruments were widely held around the globe; overseas investors held some of the bonds, and some of the bonds were bearer bonds. Debtholder approval of a transaction giving FDIC stock in the bank would have been difficult, if not impossible, to obtain. Therefore, the assistance would have to be provided to the holding company rather than to the bank itself.

In a payoff or a purchase and assumption (P&A) transaction, the holding company's shareholders would have received nothing or nearly nothing. The FDIC believed that the shareholders' interests should be treated similarly in any assistance package. CIC shareholders did hold some leverage, however, because the assistance would be provided directly to the holding company, which required their approval.

CIC's debtholders were in a much stronger position than were its shareholders. CIC had \$300 to \$400 million in deposits in Continental and a similar amount of commercial paper obligations. As CIC's debt matured, its deposits in Continental were drawn down to pay off the obligations. In that sense, the long-term debtholders and other holding company creditors were fully covered, because the interim assistance agreement specified that all deposits in Continental would be fully protected.

In July 1984, the FDIC, along with Continental officials, the U.S. Treasury, the OCC, and the Federal Reserve, developed a plan to provide permanent assistance to CIC to resolve the institution. The required approval of the shareholders of Continental's holding company was received at a special meeting in September, and the permanent assistance was put into place on September 26, 1984.

The permanent assistance program required changes in the bank's senior management. A new chairman of the board and a new chief executive officer were named. The program, which also called for substantial financial aid that flowed through CIC to the bank, included the following components:²¹

- The FDIC assumed \$3.5 billion in debt from Continental to the Federal Reserve Bank of Chicago.
- In exchange for the FDIC's assumption of the Federal Reserve debt, Continental transferred assets with an adjusted book value of \$3.5 billion (transferred loans) to the FDIC. On Continental's books, those assets had a book value of \$4.5 billion and an unpaid legal principal balance of \$5.2 billion. The assets were transferred to the FDIC in two parts, as follows:
 - The FDIC received a package of nonperforming, classified, or otherwise poor-quality loans with a book value of \$3 billion. The unpaid legal principal value was \$3.7 million, because \$700 million in assets already had been charged off by the bank. For transaction purposes, those assets were valued at \$2 billion (their adjusted book value). The \$1 billion difference between the \$3 billion book value and the \$2 billion adjusted book value required the bank to take a charge of \$1 billion against its capital.
 - Continental also gave the FDIC a note for \$1.5 billion. The note was to be repaid at any time within three years by giving the FDIC additional loans of Continental's choice with a book value of \$1.5 billion, which would increase the adjusted book value of the assets transferred to the FDIC to \$3.5 billion.
 - To offset the \$1 billion charge to capital required by the loan sale, the FDIC infused \$1 billion in capital into the bank by purchasing two separate preferred stock issues in CIC, which was then required to downstream the \$1 billion to Continental as equity. The two components of the FDIC's \$1 billion capital infusion were as follows:

21. Terms of the permanent assistance agreement are taken from FDIC, *1984 Annual Report*, 28-29.

- The FDIC purchased a \$720 million issue of permanent, nonvoting, junior perpetual preferred stock (32 million shares at \$22.50 per share). The preferred stock was convertible upon sale to a third party into 160 million shares of common stock of CIC, giving the FDIC effective control over 80 percent of the common stock.²² No preferred dividends would be paid unless dividends were declared on the common stock. If the holding company declared a dividend on its common stock, it also would be required to pay the FDIC dividends on the 160 million shares underlying the convertible preferred stock.
- The FDIC also purchased a \$280 million issue of permanent, adjustable-rate, cumulative preferred stock (11.2 million shares at \$25 per share) of the parent holding company, CIC, callable at CIC's option. Dividends were to be indexed to the interest rates of U.S. Treasury notes. During the first three years, the dividends could be paid in cash or in additional adjustable-rate preferred stock.
- Under the terms of a restructuring plan approved by CIC shareholders, Continental Illinois Holding (CIH) was formed for the purpose of subjecting the equity interests of existing CIC shareholders to an option granted to the FDIC under the plan. The FDIC option, as it was called, was designed to compensate the FDIC for losses incurred on transferred loans. The 40.3 million outstanding shares of CIC were acquired by CIH through a merger in which each CIC common share was converted into one share of CIH, subject to the FDIC option. The stock was to remain in the holding company for five years. At the end of five years, a determination would be made to assess the FDIC's loss under the loan purchase arrangement. If the FDIC suffered loss under the loan purchase agreement, or in the carrying costs and cost of collection, the FDIC could exercise its option rights in proportional amounts according to the amount of that loss. The purchase price was to be calculated on the basis of one share of stock for every \$20 of the FDIC's loss. If the losses exceeded \$800 million, the FDIC would have the option rights to acquire 100 percent of the 40.3 million shares for a nominal price (\$0.00001 per share). That provision was commonly referred to as the "make whole" arrangement. If the FDIC did not incur losses under the loan purchase agreement, any remaining loans and other assets acquired under the loan purchase arrangement would be transferred back to the bank.²³
- All holders of CIC's other securities (debt and preferred stock) remained in their positions as holders of CIC (and not CIH) securities.
- The FDIC received certain protections under the assistance plan safeguarding its

22. The FDIC would have preferred dealing strictly at the bank level, but the holding company had outstanding indenture agreements that precluded a direct capital contribution into the bank.

23. FDIC, *1985 Annual Report*, 44.

ownership interest against potential dilution and its veto power over the nomination of any board member.

- The \$2 billion subordinated note to Continental from the FDIC and a group of commercial banks was repaid.
- The FDIC reaffirmed its guarantee that all depositors and other general creditors of Continental would be fully protected and service to bank customers would be uninterrupted.
- The FDIC was assigned any claims against present and former directors and officers, employees, and bonding companies and accounting firms for acts or omissions that occurred before the permanent aid package was implemented. Any recoveries on such claims would be credited to the loan purchase arrangement. The FDIC committed to provide additional capital or other forms of assistance if the permanent aid package proved insufficient for Continental.
- The assets purchased by the FDIC continued to be serviced by Continental employees with FDIC oversight. (See “The Liquidation,” below.) Repayment of the Federal Reserve debt by the FDIC was scheduled through quarterly remittances funded by the net collections on the purchased loans. Any shortfall at the end of five years was to be paid from the FDIC’s funds.

The FDIC’s assistance transaction with Continental was in many ways similar to the assistance it provided First Penn. Both transactions (1) required commercial banks to provide at least a part of the funds; (2) granted the FDIC some form of stock, warrants, or a combination to purchase stock; (3) were effective for a term of five years; (4) involved commitments for lines of credit from the Federal Reserve; (5) required the approval of holding company shareholders; and (6) required the bank to submit to FDIC oversight during the term of the assistance.

The primary difference in the transactions was that the FDIC acquired none of First Penn’s assets. All of First Penn’s assets remained with the bank. Another difference was in the cost to the FDIC. The assistance to First Penn was fully repaid, and the total cost to the FDIC was zero. The eventual cost of the Continental transaction was notably higher at \$1.1 billion, which was 3.28 percent of Continental’s total assets, a relatively low ratio considering the size of Continental.

The Liquidation

The size of the portfolio of troubled loans and other assets acquired from Continental (an adjusted book value of \$3.5 billion, with an unpaid legal balance of \$5.2 billion) was greater than the FDIC’s total inventory of assets for liquidation at year-end 1983 (\$4.3 billion book value). The FDIC had neither the staff nor the facilities to manage the

liquidation of such a large volume of assets. Many of the loans were international loans or were related to specialized businesses, such as energy and shipping. Servicing such loans required expertise that the FDIC liquidation staff did not have.

On September 26, 1984, the FDIC and Continental entered into a service agreement, under which Continental would liquidate the unpaid principal balance of \$5.2 billion that was transferred to the FDIC. The mix of assets was approximately 50 percent energy loans; 20 percent international shipping loans; 20 percent corporate, individual, and marketable securities; and 10 percent commercial mortgages and real estate development loans.

Under the terms of the agreement, the FDIC owned the assets, and Continental set up a special unit, the FDIC Asset Administration (FAA), to manage and dispose of the assets. As the assets were liquidated, the portfolio collections (gross collections minus the asset-related expenses that the FAA was permitted to pay) were applied as follows: First, cash was applied to expenses of administering the pool, which included the salaries of FDIC and FAA staff, plus overhead expenses associated with the portfolio; second, interest on the Federal Reserve debt was paid; and third, funds were applied to principal owed on the Federal Reserve debt.

The goal of the service agreement was to administer the transferred loans and maximize their net present value. Both the FAA staff and FDIC oversight staff were located in the offices of Continental. At its peak, the FAA had more than 250 employees. The FDIC oversight staff included specialists hired to oversee oil and gas loans, real estate loans, international lending, and other types of loans, plus accountants and attorneys to monitor the agreement.

The authority to approve asset disposition decisions was delegated to certain individuals within the FAA and to various levels of authority within the FDIC organization. The FAA had unlimited restructure, settlement, and sales authority, but limits were placed on its capital expenditures. The FAA had no authority to approve indemnifications, and the FDIC's oversight staff reviewed the FAA's asset disposition decisions to ensure that the FAA complied with the FDIC's policies and procedures, managed the FDIC's assets in an appropriate manner, and had accurate accounting systems and budgeting processes.

The FDIC paid for all asset-related expenses and overhead of the FAA, as well as for incentive compensation, which was based on a tiered scale.²⁴ Incentive fees were paid on the net recovery only, *after* interest was paid on the Federal Reserve debt. Continental paid bonuses to FAA professional staff; that expense was billed to the FDIC. Over the

24. The FAA was paid incentive compensation based on a tiered scale ranging from 0.6 percent to 2.25 percent of net collections. Compensation for the first tier was determined by 0.6 percent multiplied by the aggregate net collections between \$250 million and \$1 billion. The percentage increased incrementally through a total of four tiers to 2.25 percent of net collections between \$3 billion and \$4.5 billion. Effectively, the more money the FAA collected, the more incentive fees they earned, which increased their motivation and tended to align the interests of the servicer with those of the FDIC.

life of the contract, the FDIC paid \$8 million in incentive compensation to the FAA, or 0.35 percent of recoveries net of asset-related expenses and 0.62 percent of recoveries net of asset-related expenses and interest paid on the Federal Reserve debt.

Although the original servicing contract was for a five-year period, in the summer of 1988, Continental wanted to transfer FAA employees to other duties in the bank. Accordingly, the service agreement between the FDIC and Continental was terminated, and in October 1988, the FDIC assumed responsibility for the management and disposition of the remaining assets for the last 11 months of the five-year period of the permanent assistance plan.

The permanent assistance agreement with Continental expired on September 26, 1989, and collection proceeds during the term of the agreement totaled \$2.3 billion net of asset-related expenses. Approximately \$1 billion were applied to interest expense, and a \$1.3 billion payment was made on principal owed under the FDIC–Federal Reserve agreement. The collections were on \$4.3 billion of the \$5.2 billion unpaid legal balance of assets to be liquidated. The FDIC made the final payment for the indebtedness at the Federal Reserve of \$2.2 billion and later liquidated the remaining assets.

The service agreement with Continental was, in effect, the FDIC’s first asset management contract. Because the results of the agreement were considered favorable, the FDIC entered into other contracts with private-sector servicers for the management and disposition of FDIC assets in connection with future resolutions. The contracts generally were cost-plus contracts, with the FDIC also paying incentive fees based on net collections.²⁵

The Stock Transactions

The FDIC provided \$1 billion in capital to Continental by purchasing two separate preferred stock issues in CIC: (1) \$720 million of permanent, convertible, nonvoting, junior preferred stock (32 million shares at \$22.50 per share) and (2) \$280 million of permanent, adjustable rate, cumulative preferred stock (11.2 million shares at \$25 per share). Later, because of losses incurred on the transferred loans, the FDIC exercised its option and obtained an additional 10,080,089 shares of Continental Bank Corporation (CBC)—the former shareholders’ portion—for a nominal price of \$0.00001 per share of common stock.²⁶

Expressed interest in the banking community, and certainly at Continental itself, indicated that the FDIC should sell its equity position as soon as possible. Within the broader banking community was concern about potential competitive disadvantages in competing against “nationalized” banks. Within Continental, concern eventually developed about the

25. For additional information, see Part I, Resolution and Asset Disposition Practices, Chapter 14, Asset Management Contracting.

26. In 1988, the name of Continental’s holding company was changed from Continental Illinois Corporation (CIC) to Continental Bank Corporation (CBC).

potential competitive disadvantages of operating as a “nationalized” bank. A public policy question concerned the extent to which FDIC ownership positions were a desirable part of bank failure resolution transactions. The FDIC was interested in selling its ownership position, but not at just any price or necessarily immediately. The first sale of a portion of the FDIC’s stock position did not occur until two years after the original transaction. The FDIC did not divest itself entirely of its ownership position until mid-1991, seven years after the original assistance transaction. The FDIC consulted with outside financial advisors for recommendations on the timing and size of the various sales of the Continental equity position.

By November 1985, Continental had sufficiently recovered so that the FDIC authorized the bank to upstream \$60 million in earnings to CIC. The dividends paid on December 31, 1985, included \$14.6 million to the publicly held preferred stock and \$40.9 million to the FDIC-owned preferred stock. The private holders received cash; the FDIC received additional adjustable rate preferred shares in lieu of cash.²⁷ In March 1986, Moody’s Investor’s Services, Inc., upgraded the debt ratings of Continental.²⁸

In December 1986, the FDIC sold 10.5 million shares, or roughly one-third of its junior perpetual convertible preferred stock, for \$259.4 million.²⁹ Two years later, in December 1988, the FDIC sold approximately another third of its interest for \$277.2 million.³⁰ In August 1989, the FDIC sold 7.2 million shares of the junior perpetual convertible preferred stock for an additional \$216.9 million, leaving 3.3 million shares.³¹ On each sale of the convertible stock, the stock was converted to common stock at the time of sale. Also, in August 1989, the FDIC sold all 12.8 million of its adjustable rate preferred stock for \$272.8 million.³²

On October 24, 1989, because of the losses under the loan purchase agreement, the FDIC exercised its option and purchased from CIH all of its rights to 10.1 million shares of common stock in CBC (formerly CIC) at a price of \$0.00001 per share, a total of \$403, which eliminated any investment the CIH shareholders had in Continental’s holding company.³³ Those shareholders thus received no benefit from the FDIC’s assistance to Continental.³⁴

27. FDIC, *1985 Annual Report*, 45.

28. Sprague, *Bailout*, 211-212.

29. FDIC, *1986 Annual Report*, 44.

30. FDIC, *1988 Annual Report*, 51.

31. FDIC, *1989 Annual Report*, 92.

32. FDIC, *Equity Investment Portfolio, Bank Insurance Fund* (December 31, 1993), 13-14.

33. Although there were originally 40.3 million shares in CIC, there was a 4-for-1 reverse stock split on December 12, 1988, which resulted in the total outstanding shares held by CIH being reduced to 10.1 million.

34. At the time of the permanent assistance transaction, the current shareholders of CIC were issued a transferable right to acquire, on a pro rata basis, approximately 40 million shares of CIC at the benchmark market price of \$4.50 per share if they exercised that right within 60 days of the effective date of the transaction, or at \$6 per share if they exercised that right during the subsequent 22 months. The rights and shares issued under this offering were not subject to the “make whole” provisions of the loan purchase agreement.

On June 6, 1991, the FDIC's remaining 3.3 million shares of the junior perpetual convertible preferred stock were also converted to CBC common stock, bringing the FDIC's total shares in CBC to 14.2 million.³⁵ On the same day, the FDIC then sold all its shares of CBC common stock in two transactions for \$173.9 million. Approximately \$50.1 million of the proceeds can be attributed to the converted junior perpetual convertible preferred stock.³⁶

The June 1991 sale completed the return of Continental to private ownership and produced a net gain to the FDIC of \$200 million in excess of the \$1 billion capital investment originally provided to Continental. Dividend income on the stock amounted to an additional \$202.2 million.³⁷ A summary of the stock transactions is included in table II.4-1.

FDIC Resolution Costs

The FDIC's maximum financial commitment in Continental's open bank assistance transaction was \$4.5 billion. The commitment consisted of two parts: (1) \$3.5 billion in debt that the FDIC assumed from Continental to be repaid to the Federal Reserve and (2) a \$1 billion capital contribution. In return for that financial commitment, the FDIC received the following: (1) \$3.5 billion (adjusted book value) in assets, (2) \$1 billion in preferred stock, and (3) the option to purchase all the former shareholders' common stock in the holding company at a nominal price should the FDIC suffer sufficient losses.

The FDIC did not realize the full \$3.5 billion adjusted book value from the assets in liquidation. After paying interest of \$1 billion on the Federal Reserve debt and collection expenses on the service agreement of \$176 million, about \$1.3 billion in proceeds during the term of the service agreement were used to pay down the principal on the Federal Reserve debt. After paying the remaining \$2.2 billion in debt with its own funds and then partially reimbursing itself from collections on the remaining assets, the FDIC was left with a \$1.5 billion net deficit position.

From an accounting perspective, the sale of the FDIC's equity positions reduced the deficit from \$1.5 billion to \$1.3 billion. A \$1 billion preferred stock original investment was sold for about \$1.2 billion. The loss on the FDIC's books was further reduced from \$1.3 billion to the final \$1.1 billion figure by factoring in approximately \$200 million in dividends received by the FDIC. The \$1.1 billion loss figure represents 3.28 percent of Continental's assets at the time of resolution. Although in a present value context the loss is somewhat higher, in the period of time over which the various stock proceeds

35. FDIC, *Equity Investment Portfolio, Bank Insurance Fund*, 13-14.

36. FDIC, *Equity Investment Portfolio, Bank Insurance Fund*, 13-14.

37. FDIC, *Equity Investment Portfolio, Bank Insurance Fund*, 13-14.

Table II.4-1

Summary of the FDIC's Stock Transactions in the Continental Permanent Assistance Plan

Date	Transaction	Beginning Number of Shares	Shares Sold, Written Down, Converted	FDIC Stock/Equity Investment	FDIC Proceeds from Sales	FDIC Book Value of Transaction	Gain or Loss on Transaction	FDIC Dividend Income
Junior Perpetual Convertible Preferred								
09/26/84	Original purchase	32,000,000		\$720,000,000				
12/01/86	Sale		(10,000,000)		\$247,000,000	\$225,000,000	\$22,000,000	
12/12/86	Sale		(500,000)		12,350,000	11,250,000	1,100,000	
12/09/88	Sale		(1,036,190)		27,199,988	23,314,275	3,885,713	
12/16/88	Sale		(10,000,000)		250,000,000	225,000,000	25,000,000	
08/15/89	Sale		(7,200,000)		216,900,000	162,000,000	54,900,000	
01/01/91	Prior dividends through 1990							\$173,434,472
01/31/91	Dividends							1,019,941
03/31/91	Dividends							1,019,941
06/06/91	Converted to CBC common stock		(3,263,810)	(73,435,725)				
Totals		32,000,000	(32,000,000)	\$646,564,275	\$753,449,988	\$646,564,275	\$106,885,713	\$175,474,354
Adjustable Rate Preferred								
09/26/84	Original purchase	11,200,000		\$280,000,000				
12/15/85	Shares dividend	1,637,922						
08/15/89	Sale		(12,837,922)		\$272,805,843	\$280,000,000	(\$7,194,158)	
Totals		12,837,922	(12,837,922)	\$280,000,000	\$272,805,843	\$280,000,000	(\$7,194,158)	\$ 0
CBC Common Stock								
10/24/89	Purchase option	10,080,809		\$403				
10/24/89	Dividends from option							\$14,151,152
01/01/91	Prior dividends through 1990							7,560,607
01/31/91	Dividends							2,520,202
03/31/91	Dividends							2,520,202
06/06/91	Conversion of Jr. Perpetual (3,263,810 x 1.25)	4,079,763		73,435,725				
06/06/91	Sale to ESOP		(500,000)		\$6,375,000	\$9,000,000	(2,625,000)	
06/06/91	Sale to public		(13,660,572)		167,478,606	64,436,128	103,042,478	
Totals		14,160,572	(14,160,572)	\$73,436,128	\$173,853,606	\$73,436,128	\$100,417,478	\$26,752,163
Grand Total, All Stock		58,998,494	(58,998,494)	\$1,000,000,403	\$1,200,109,437	\$1,000,000,403	\$200,109,033	\$202,226,517

Source: FDIC, *Equity Investment Portfolio, Bank Insurance Fund* (December 31, 1993).

were received, the FDIC's overall cost on the Continental transaction was modest, given the size of the bank and when comparing it to most other large bank transactions.

Table II.4-2 provides a more detailed account of the cost to the FDIC for the Continental resolution.

Issues

There were two primary concerns that arose from the Continental transaction. The first was whether some banks were "too big to fail," creating inequities in the resolution process. The second was whether the FDIC's protection of creditors other than insured

Table II.4-2

Continental Resolution Costs as of December 31, 1995

(\$ in Thousands)

FDIC's Expenses	
Federal Reserve debt assumed by the FDIC	\$3,500,000
Purchase of 32 million shares junior perpetual convertible preferred stock	720,000
Purchase of 11.2 million shares adjustable rate preferred stock	280,000
FDIC's Total Expenses	\$4,500,000
FDIC's Recoveries	
FDIC net recoveries on assets (principal)*	\$1,992,566
Sale of junior perpetual convertible preferred stock	753,450
Sale of adjustable rate preferred stock	272,806
Sale of CBC common stock	173,854
Dividends received on junior perpetual convertible preferred stock	175,474
Dividends received on CBC common stock	26,752
Federal and state tax refunds	1,125
FDIC's Total Recoveries **	\$3,396,027
FDIC's Total Resolution Cost	\$1,103,973

*Net recoveries is after payment of all liquidation expenses and the interest on the debt to the Federal Reserve.

**Stock transactions not discounted to reflect present value.

Sources: FDIC, *The Cost of Large Resolution Transactions* (March 12, 1996), FDIC Division of Finance, and FDIC Division of Research and Statistics.

depositors eroded market discipline in a way that intensified banking problems in later years.

Regarding the issue of inequitable treatment, it is clear that failing banks of different sizes were not always treated in the same manner. Failures of large banks were generally resolved through P&A transactions or open bank assistance transactions, both of which usually provided full protection for uninsured depositors and other general creditors. Failures of small banks, however, were more likely to result in insured deposit payoffs that afforded no protection for other failed bank creditors. The difference existed because healthy institutions generally bid acceptable prices to acquire larger failing banks, but did not always do so for smaller banks. Continental was one of the few, and therefore significant, large failing banks for which the FDIC did not receive an acceptable bid. Although Continental received open bank assistance, most of the institutions considered “too big to fail” were actually closed. The inequity was a result of the size of the banks, not their resolution methods.

Concerning the market discipline issue, however, the answer is less clear. The effect on creditors would have been very different if the FDIC had arranged a P&A transaction. Historically, in a P&A transaction, the FDIC had protected all depositors against loss, just as they were protected in the resolution of Continental. Typically, P&A transactions also eliminated the investment of a failed bank's shareholders. Continental's open bank assistance transaction had the same result for the holding company's common stock shareholders. They lost their investments as a result of the “make whole” arrangement. The only other significant group of Continental's creditors was the holders of the holding company debt. In closed bank transactions, holding company creditors and debtholders are not protected against any loss. Even in the Continental resolution, however, the net result of a P&A transaction likely would have had the same result as the open bank assistance. The holding company had sufficient deposits in the bank to pay its debts, and it drew down those deposits as debts came due. As a depositor in the failed bank, the holding company was protected in the open bank assistance. Because a P&A transaction also would have protected all depositors, the effect on the holding company would have been the same.

Critics of open bank assistance argue that the FDIC should have conducted a transaction that protected only insured depositors and caused a loss to Continental's uninsured depositors and general creditors. Such a transaction may have been less costly to the insurance fund, but probably not in an amount large enough to make cost savings the critical factor in determining the appropriate resolution strategy for the bank. In a payoff, the FDIC's only cash outlay would have been the \$3 billion in insured deposits. The FDIC's recovery would have come from its pro rata share with uninsured depositors and general creditors of more than \$33 billion (book value) in assets. The liquidation of \$33 billion in assets, however, certainly would have resulted in losses, perhaps substantial losses, and the FDIC would have shared in those losses. The FDIC's total costs may have been less than the \$1.1 billion that resulted from the open bank assistance transaction, but probably not in any significant amount.

Paying off Continental's insured deposits and liquidating its \$33 billion in assets would have caused serious disruption in the financial markets, but it might have had a significant impact on market discipline. The dilemma facing the regulators was whether that disruption was worth the potential long-term benefits provided from enhanced market discipline. The prevailing view at the FDIC and the other regulatory agencies at the time was that ensuring financial stability in the U.S. banking industry was far more critical than enhancing market discipline, and the decision was made to provide protection for all depositors and general creditors.

In reviewing the Continental resolution it is easy to question whether a payoff of insured depositors at Continental might have prevented greater problems in the future. A payoff of insured depositors at Continental may not have had any serious influence on the problems growing in the savings and loan industry crisis. There are two types of market discipline: (1) shareholder discipline, meaning responsible behavior by financial institution investors, and (2) depositor discipline, meaning the selection of sound, well-managed institutions by depositors looking for a place to invest their savings. Concerning shareholder discipline, many savings and loan institutions had become critically undercapitalized, and investors in those institutions saw no way to recover their investments. Those shareholders saw no lessening of their investment risk as a result of the Continental transaction, because Continental's shareholders lost their investments. Shareholders in thrifts with adequate capital, however, had every incentive to provide market discipline and install competent management in the savings and loan institutions to protect their interests. By the time the thrift crisis occurred, though, shareholders of many savings and loan institutions essentially had no risk at all because the capital of the institutions was already at or near zero. Shareholder investments were gone, so the incentive was for them to continue and, in fact, expand on their high-risk activities. Concerning depositor discipline, the question is whether a payoff of insured deposits at Continental would have reduced the tendency for depositors to chase the highest interest rates at savings and loans institutions. Because deposit brokers had the ability to keep deposits insured, a payoff at Continental probably would not have changed depositors' behavior in seeking higher interest rates.

The FDIC made a statement of assurance, at the time of the interim assistance, that provided protection to all depositors and general creditors. That statement also was criticized, because such a public statement before a final resolution was a departure from standard FDIC practice. Continental had a very high percentage of uninsured depositors, and the FDIC reasoned that, in the absence of such a statement, the bank run was likely to continue. The run was causing a liquidity problem that likely would have forced some form of interim solution such as open bank assistance, and all depositors would have been protected anyway.

The FDIC believed that there was enough ambiguity in its failure resolution actions that, as a rule, uninsured depositors and other general creditors were left with some level of risk because they could never be certain of complete protection. Deposit runs that

later occurred at some of the larger Texas banks seem to support the view that depositor discipline was still a factor in the public's behavior.

Shareholder discipline was enhanced as a result of the Continental resolution, because the shareholders of Continental's holding company were not protected. Under the permanent assistance plan, the FDIC purchased \$1 billion of preferred stock in CIC, which resulted in an immediate 80 percent dilution of shareholder value, and the FDIC also received certain protections under the assistance plan safeguarding its ownership interest against potential dilution. The FDIC received an option on all remaining shares in the holding company and had the right to purchase the shares of common stock at a nominal price if it suffered a certain level of loss under the loss purchase agreement. Because of the FDIC's option, the original shareholders' stake in the assisted institution was heavily dependent on the collections from the loan purchase program. The FDIC did suffer a loss and exercised its option to purchase the remaining shares of common stock in the holding company. The interests of Continental's former shareholders were eliminated. Therefore, while all depositors and creditors of Continental were made whole financially, the holding company shareholders were not, and shareholder discipline was enhanced.

There also was a belief at the FDIC that, while market discipline for investors and shareholders was desirable, depositor discipline was more of a mixed blessing. In practice, depositor discipline generally affected only unsophisticated depositors. Sophisticated depositors, who really should have provided depositor discipline, generally were already out of a failing institution by the time it was closed. This situation continued to be true long after the resolution of Continental. As a result of all of Continental's deposits being fully protected, the potential cost savings and potentially enhanced market discipline that might have resulted from a more consistent pattern of imposing losses on uninsured deposits were not viewed as overwhelming.

Effect on Future Resolutions

The methods used in the Continental transaction for handling the problem assets appear to have worked out reasonably well. The servicing agreement between the FDIC and Continental, under which Continental worked the FDIC's assets with FDIC oversight, was viewed as an effective way of handling large volumes of assets that had to be liquidated. The servicing costs were relatively low, and the FDIC needed only a relatively small staff to provide oversight. That agreement became the basis for many subsequent transactions in which an assisted or acquiring bank's employees worked FDIC receivership assets under FDIC oversight.

The problems with Continental highlighted some of the difficulties faced by the FDIC in its resolution of large institutions. The problem of resolving a large institution in just a few days was highlighted in 1984 testimony before Congress by then-FDIC

Chairman William M. Isaac, who was questioned about the explicit guarantee given to Continental's depositors and creditors:

Arranging a merger in a few days' time would likely have been impossible. Even if it had been possible, prospective purchasers would not have had an opportunity to evaluate the bank and thus, would have required substantial FDIC financial involvement to protect against the uncertainties. In short, it would have been a buyer's market and extremely expensive to the FDIC. At the same time, a merger would have had the same effect as a capital infusion in that all depositors and other general creditors of the bank would have been protected, while shareholders would have been exposed to the risk of loss.

Granting permanent direct assistance was rejected for several reasons. First, not enough was known about the bank and its true needs. Second, sufficient time was needed to resolve all of the legal and accounting complexities and to arrange for new management. Finally, we believed we should exhaust every reasonable avenue for a private sector resolution before resorting to permanent direct assistance.³⁸

Finding a merger partner for Continental was hampered in large part by interstate banking restrictions. Those problems may have influenced provisions of the Competitive Equality Banking Act (CEBA) of 1987, which amended the Federal Deposit Insurance Act (FDI Act) of 1950. CEBA permitted out-of-state holding companies to (1) acquire large stock or mutual banks before the bank's failure, (2) acquire all or parts of holding companies with large banks in danger of closing, and (3) have expansion rights in the states of acquisition through the bank holding company structure.

CEBA also provided the FDIC with another important tool for resolving large troubled institutions: the bridge bank. A bridge bank is a newly chartered, full service national bank controlled by the FDIC. When a bank is closed by its chartering authority and placed in receivership, the FDIC may establish a bridge bank to provide the time needed to arrange a permanent transaction.³⁹ By establishing a bridge bank, the FDIC avoids the problems cited by FDIC Chairman Isaac of immediately evaluating the failing institution and finding a merger partner or liquidating the institution. A bridge bank provides prospective purchasers the time necessary to assess the bank's condition before submitting their offers. Absent systemic risk, the decision to "bridge" an institu-

38. Inquiry into Continental Illinois Corp. and Continental Illinois National Bank: Hearings before the Subcommittee on Financial Institutions Supervision, Regulation and Insurance of the Committee on Banking, Finance and Urban Affairs, House of Representatives, 98th Cong., 2d Sess. (September 18, 19, and October 4, 1984), 1.

39. The FDIC, in either its corporate or receivership capacity, may establish a bridge bank when an insured bank is or may be closed. However, the FDIC does not have the authority to bridge a thrift institution; in that instance, the FDIC would have to use a conservatorship instead of a bridge bank. A bridge bank can be operated for two years, with three one-year extensions, after which time it must be sold or otherwise resolved. See Part I, Resolution and Asset Disposition Practices, Chapter 6, Bridge Banks, for greater detail.

tion must be based on whether a bridge bank resolution will result in the least costly resolution of the failing institution.⁴⁰

The Continental resolution experience was the key to how the FDIC would deal with the coming banking crisis. On July 14, 1986, the First National Bank and Trust Company of Oklahoma City (FNB&T), Oklahoma City, Oklahoma, with \$1.6 billion in total assets, failed and was assumed by First Interstate Bank of Oklahoma City, N.A. (First Interstate), a newly chartered bank subsidiary of First Interstate Bancorp, Los Angeles, California. The FDIC had been trying for several weeks to work out an open bank assistance transaction, but FNB&T was never able to satisfy the necessary requirements. Finally, the FDIC agreed to a negative premium of \$72 million to recapitalize the bank in Oklahoma City, which meant that the FDIC actually paid First Interstate to take over the deposit liability of FNB&T. The resolution of FNB&T was the first time the FDIC accepted a negative premium bid.

The resolution of FNB&T was similar to that of Continental in two ways: first, the FDIC took an equity position in the bank in the form of special preferred stock, with the provision that the FDIC would share half of any profits if the bank earned more than an 80 basis point return on assets; and second, the assuming bank agreed to work the FDIC's \$300 million in assets under a servicing arrangement. The agreement further provided full protection to all depositors.⁴¹

Over time, open bank assistance became regarded as an acceptable way to resolve large troubled institutions. On July 17, 1987, the FDIC and BancTexas Group, Inc., Dallas, Texas, entered into an agreement under which the FDIC made a one-time contribution of \$150 million in conjunction with an infusion of additional private capital obtained from a rights offering. Again, the similarities to the open bank assistance at Continental were that the FDIC received warrants, exercisable over 20 years, to purchase common stock in BancTexas Group, Inc., equal to 10 percent of the holding company's common equity. In addition, the FDIC acquired no assets from any of the \$1.3 billion holding company's 11 banks.⁴²

On September 9, 1987, the FDIC agreed in principle to an open bank assistance agreement with First City Bancorporation of Texas, Inc. (First City), Houston, Texas. A full description of the First City transaction is provided in the next chapter, First City Bancorporation of Texas, Inc.

40. For further information about bridge banks, see Part I, Resolution and Asset Disposition Practices, Chapter 6, Bridge Banks.

41. James E. Heath, FDIC Division of Research and Statistics, *Bank Failures (Texas)*, working paper (1997), 63-70.

42. Heath, *Bank Failures (Texas)*, 1-3.

**Then-Acting Chairman Hove
conducts the press conference
at FDIC headquarters on
October 30, 1992, announcing
the closing of 20 bank
subsidiaries of First City
Bancorporation of Texas, Inc.,
Houston, Texas.**





CHAPTER 5

First City Bancorporation of Texas, Inc.

Name of Institution:	First City Bancorporation of Texas, Inc.
Headquarters Location:	Houston, Texas
Date of Resolution:	April 20, 1988
Resolution Method:	Open Bank Assistance Transaction
Date of Resolution:	October 30, 1992
Resolution Method:	Purchase and Assumption Transaction; FDIC created 20 bridge banks
Date of Resolution:	January 27, 1993
Resolution Method:	Purchase and Assumption Transaction—Various Acquirers

Introduction

In 1988, 279 banks failed or received assistance from the Federal Deposit Insurance Corporation (FDIC), the highest number in recent U.S. history. Of that total, 214, or 76.7 percent, were in the Southwest, with 174 in Texas alone.¹ Included in the 174 banks were the 60 subsidiary banks of First City Bancorporation of Texas, Inc. (First City), Houston, Texas. First City was a major Texas-based bank holding company; 59 of its 60 subsidiary banks were given open bank assistance (OBA) on April 20, 1988, to prevent their failure. The other affiliated bank failed one day earlier. The assistance to 59 individual banks represented the most banks ever resolved in one transaction by the FDIC. However, aspects other than the sheer volume of the First City transaction are noteworthy.

First, the negotiations for OBA were unusually lengthy and difficult, extending for more than seven months. Second, First City was unable to survive for long after the 1988 assistance. After an unsuccessful effort to save itself in 1991 by selling off some of its more profitable banks, the 20 remaining banks in the holding company failed in

1. There were 174 bank failures in Texas, 25 in Oklahoma, 13 in Louisiana, 1 in Arkansas, and 1 in New Mexico. FDIC, *Failed Bank Cost Analysis 1985–1990* (Washington, D.C.: Federal Deposit Insurance Corporation, 1991), 16-3, 16-6, 16-7.

1992. Third, when First City's two lead banks in Dallas and Houston became insolvent and were closed on October 30, 1992, the FDIC used its cross guarantee authority under the provisions of the Financial Institutions Reform, Recovery, and Enforcement Act (FIRREA) of 1989. The cross guarantee authority allowed the FDIC to assess insured depository institutions for the cost of the failures of other banks within the same holding company. When the FDIC invoked its cross guarantee authority for the projected losses of the two lead banks, the remaining 18 banks in the holding company became insolvent and were closed. Fourth, the FDIC again used its bridge bank authority and created 20 bridge banks, rather than creating only one bridge bank for all the First City banks.²

General Description of the Institution

In 1987, First City, headquartered in Houston, Texas, was an \$11.2 billion organization with 60 banking subsidiaries. Of the 60 subsidiary banks, all were located in Texas except for one that was located in South Dakota. First City was an established banking firm that counted many industrial giants among its clients. In 1988, it was the fourth largest bank holding company in Texas.

Background

First City fell victim in the early 1980s to the downturns in the agriculture and energy markets, which were followed by a similar decline in real estate. First City was one of many Southwestern banking entities that had grown rapidly during the years of the oil boom. When the oil industry began to decline after 1981, First City, like many other banks, turned to real estate lending. That was happening at about the same time as savings and loan (S&L) institutions were permitted to enter into commercial real estate lending, and market prices skyrocketed upward.

2. The Competitive Equality Banking Act of 1987, as amended by FIRREA, provided the FDIC with the authority to establish a bridge bank to handle a failing institution. A bridge bank is a newly chartered, full-service national bank controlled by the FDIC. The original failed bank is closed by its chartering authority and placed in receivership. When appropriate, the FDIC establishes a bridge bank to provide the time needed to arrange a sale of the failed bank's assets and deposit liabilities. The bridge bank provides prospective purchasers the time necessary to assess the bank's condition in order to submit their offers. If no systemic risk (as described in section 13(c)(4)(G) of the Federal Deposit Insurance Act [FDI Act] of 1950) exists, the decision to "bridge" an institution must be based on whether a bridge bank structure will result in the least costly resolution for the failing institution. Under section 11(n) of the FDI Act, the FDIC may organize a bridge bank when one or more insured banks are "in default" or when the FDIC "anticipates" that one or more insured banks "may become in default." (Under section 3(x) of the FDI Act, "default" refers to the condition of an insured depository institution in which a judicial or an administrative decision has been reached pursuant to which a conservator, receiver, or other legal custodian is appointed for that institution.)

In 1982, First City's real estate lending accounted for less than 20 percent of its loan portfolio. However, by 1987, its total real estate portfolio was \$3.2 billion, or more than 35 percent of all its loans. Much of the lending was in the riskier areas of construction and development loans.

Although 1987 was a fairly stable year for the country, with low inflation and declining interest rates, the Southwest was still having economic troubles. The Southwest's bank failures continued to rise, reaching 110 in the region in 1987.³ About 39 percent of the surviving banks in the region had negative asset growth rates, causing the regional average asset growth rate to be negative for the second consecutive year. Nonperforming assets peaked at 4.2 percent of assets, and nonperforming loans constituted more than 10 percent of total loans and leases. Commercial office market vacancy rates in major Texas cities soared, reaching 40 percent in Austin, 31 percent in Houston, and 31 percent in Dallas. Those outside economic factors led to the deterioration of the quality of commercial loans, construction loans, and consumer loans in the various First City banks, causing large loan losses as well as a shortage of qualified borrowers.

The FDIC had been aware of First City's situation for some time and knew that some sort of intervention would be necessary. It was no surprise, then, when First City approached the FDIC for OBA. An outside investor group, headed by A. Robert Abboud, the former chief executive officer of First National Bank of Chicago, proposed the plan. The plan involved an injection of \$500 million in new capital to be raised through a stock offering with the help of an investment banking firm. Control of First City would be assumed by a newly formed holding company. The injection of that much additional capital meant that the ownership of First City's common shareholders would be reduced to less than 2 percent of the total equity in the holding company.⁴ Each shareholder would have received 1 share of stock in the new company for every 100 shares that they held in First City.⁵ Bondholders were asked to exchange their claims for 35 cents to 45 cents on the dollar.⁶ On September 9, 1987, the FDIC Board of Directors approved, in principle, an OBA agreement proposed by the Abboud group.

The Abboud investment group ran into several difficulties in raising the money, and the final assistance plan took months longer to finalize than expected. One of the initial problems was the stock market "crash" of October 19, 1987, when the Dow Jones industrial average dropped 508 points in a single day. That was the largest one-day decline in history, and the situation made potential investors anxious.

3. There were 62 bank failures in Texas, 33 in Oklahoma, and 15 in Louisiana. FDIC, *Failed Bank Cost Analysis 1985-1990*, 16-3, 16-6, 16-7.

4. FDIC News Release, "FDIC Grants Final Approval to Assistance Plan for Subsidiaries of First City Bancorporation, Houston, Texas," PR-82-88 (April 20, 1988).

5. "First City Takeover Concludes Next Week," *Reuters Financial Service* (April 8, 1988), Financial Report Section.

6. Barbara A. Rehm, "First City Deal May Be in Peril, Regulators Fear, But Company Confident It Will Complete Rescue," *American Banker* (April 18, 1988), 1.

Another problem encountered by the Abboud group was that their proposal for OBA, a part of which included the creation of a new holding company, required the approval of First City's shareholders and bondholders. The approval was no small item because the shareholders were being asked to reduce their holdings to less than 2 percent of First City's total equity, and bondholders were being asked to exchange their claims for 35 cents to 45 cents on the dollar. Then-FDIC Chairman L. William Seidman (who served from 1985 to 1991) stated,

Requiring bondholders in the bank holding company to reduce their debt holding became the most difficult part of the deal. In Continental Illinois' [Continental Illinois National Bank and Trust Company, Chicago, Illinois] failure the bondholders had been protected, even though they were not insured. Most of First City's bonds had been dumped as its troubles became public, and they had been purchased for a few cents on the dollar by Wall Street arbitrageurs. . . . They reckoned that the Continental Illinois precedent would force us to cover all company debtors, including them, because we had no other way to handle such a large institution and would recoil from closing it down and risking the panic and huge losses that might occur in the weakened Texas economy.⁷

During the period when Abboud and his investor group were trying to raise money to rescue First City, another Texas bank holding company was in serious trouble. First Republic Bank Corporation (First Republic), Dallas, Texas, was the largest bank holding company in Texas, and it had reported major losses for 1987, along with a large percentage of nonperforming loans and liquidity difficulties.⁸ First Republic was on the verge of failure and, because of interbank funding, a substantial number of affiliate banks were also at risk. The FDIC granted First Republic interim assistance on March 17, 1988, pending a final solution. Thus, the largest and the fourth largest banking institutions in Texas were both depending on FDIC assistance. First Republic's announcement on April 12, 1988, that it expected a \$1.5 billion loss for the first quarter of 1988 further reinforced the perception of some investors that Texas was a "black hole" in terms of banking.⁹

Because the First City investor group had not been able to raise the money necessary to recapitalize, on March 29, 1988, the FDIC Board of Directors again extended the closing date for First City's proposal to April 20, 1988. On April 13, 1988, after a lengthy discussion of other options, the FDIC Board of Directors authorized final approval of Abboud's proposal to acquire First City. Things once again looked bleak,

7. L. William Seidman, *Full Faith and Credit: The Great S&L Debacle and Other Washington Sagas* (New York: Times Books, 1993), 144.

8. See Chapter 6, First Republic Bank Corporation, for a full discussion of that transaction.

9. Rehm, "First City Deal May Be in Peril," 1.

though, when the Dow Jones industrial average dropped 101 points on April 14, 1988. Finally, the Abboud group raised the necessary funds by increasing the yield it was offering on a class of preferred stock in the new holding company.¹⁰

The proposal had included a provision for exchanging 90 percent of the holding company's outstanding bonds for 35 cents to 45 cents on the dollar. The FDIC eventually agreed to lower the 90 percent requirement in the original proposal to 70 percent. As late as April 18, 1988, two days before the FDIC's deadline, only 66.1 percent of the bondholders had agreed to the terms of the OBA. The original proposal from the investor group was to have been completed before the end of 1987. The transaction took more than seven months to complete after the Abboud group requested and received a total of five extensions.¹¹

One final problem that had to be solved was that of the McAllen State Bank, McAllen, Texas, which had \$590.7 million in assets and a negative \$9 million in equity in April 1988. First City had acquired the McAllen bank in 1982 but had not changed the name. The condition of the bank, the largest in the Rio Grande Valley of south Texas, had deteriorated significantly in the preceding months. Rising losses in the McAllen bank had threatened to increase the cost of the pending bailout plan. Texas Banking Commissioner Kenneth W. Littlefield closed the bank on April 19, 1988. All deposit liabilities, including uninsured deposits, were transferred to First City, Texas-Houston, N.A. (First City Houston), Houston, Texas, in a purchase and assumption (P&A) transaction. All assets were also transferred to First City Houston, except for \$50,000 retained by the FDIC for expected liquidation expenses. All customer services at the McAllen facility were provided without interruption, and the McAllen office began to function as a branch of First City Houston, the flagship bank of First City. After the bank in McAllen was closed, the FDIC and First City were able to proceed with the OBA transaction.¹²

The Resolution—April 20, 1988

On April 20, 1988, one day after the closing of the bank in McAllen, the FDIC's Board of Directors announced final approval of an assistance plan to recapitalize and to restore financial health to the remaining 59 subsidiary banks of First City.¹³ At the time of the assistance, First City held \$9.2 billion in deposits, or 6.4 percent of all deposits in Texas. Terms of the assistance included the following:

10. David LaGessee, "Drexel Stake Seals Rescue of First City," *American Banker* (April 20, 1988), 1.

11. Rehm, "First City Deal May Be in Peril," 1.

12. FDIC News Release, "FDIC Approves Acquisition of Deposits and Liabilities of McAllen State Bank, McAllen, Texas," PR-83-88 (April 19, 1988).

13. FDIC News Release "FDIC Grants Final Approval to Assistance Plan for Subsidiaries of First City Bancorporation, Houston, Texas," PR-82-88 (April 20, 1988).

- \$500 million in new capital was raised through a stock offering. The new private investors assumed control of the First City banks through a newly formed holding company, First City Acquisition Corporation (FCAC). The ownership of First City's common stock shareholders was reduced to less than 2 percent of the total equity.
- The FDIC received warrants, exercisable for five years, to purchase 5 percent (1,030,636 shares) of the common stock of FCAC at \$20.94 per share, which was the initial offering price of the stock.¹⁴ In addition, the FDIC purchased \$43 million (2,059,456 shares) of junior convertible preferred stock in FCAC. That stock could be converted into a 10 percent interest in the common stock of FCAC.
- Management and policy direction of the company was to be provided by a new management team and board of directors headed by Abboud.
- Assistance to the First City subsidiary banks took the form of \$970 million in "Senior Subordinated Interest Notes" (the FDIC Notes) from the FDIC. The FDIC Notes bore interest at the U.S. Treasury bill rate plus one-half of 1 percent, with principal payable in 10 equal semiannual installments. In exchange for the FDIC Notes, the FDIC received 97 million shares of preferred stock in the Collecting Bank (described later in this chapter). First City guaranteed the repurchase of the preferred stock for a minimum of \$100 million in 1998.
- The FDIC did not purchase any assets held by the assisted banks. Approximately \$1.7 billion in nonperforming and troubled assets were transferred to a separate entity (the Collecting Bank or bad bank) created to service such assets. Notes from the First City subsidiary banks funded the entity. Collections were to go first to repay the subsidiary banks, then \$100 million to the FDIC to repurchase the preferred stock, and finally to the previous shareholders of First City.

First City was able to exchange stock for approximately 68 percent (\$153.4 million) of about \$225 million in publicly held long-term debt for 35 cents to 45 cents on the dollar. The remaining bondholders who held out and caused the delay were rewarded because the price of the bonds on the secondary market rose after the assistance agreement was finalized. Chairman Seidman was quoted as saying that the FDIC would change the terms of future assistance agreements to avoid the potential of similar pressure from debtholders. "I wouldn't say they made a lot of friends, but that's the marketplace at work," he said of the Wall Street brokerages that bought and held the First City bonds.¹⁵

14. FDIC, *Equity Investment Portfolio: Bank Insurance Fund* (December 31, 1993), 18.

15. Thomas C. Hayes, "Bailout Plan for First City Clears Hurdle," *The New York Times* (April 20, 1988), sec. D, 1.

The assistance agreement resulted in \$1.751 billion in loans being transferred to the Collecting Bank. However, a sizable amount of questionable-value loans (approximately \$1 billion) still remained on the books of the subsidiary banks.¹⁶

First City's Problems Continue

In the beginning, the new First City was profitable. By August 1, 1989, a little more than a year after the assistance agreement was finalized, First City repurchased the FDIC's entire block of junior convertible preferred stock for \$69.1 million and purchased the FDIC's common stock warrants for \$39.4 million.¹⁷

By 1990, bank failures in the Southwest dropped to 120, though they still accounted for more than 70 percent of all bank failures in the country. In that same year, 2.9 percent of all commercial banking assets were classified as troubled loans, which was the highest level seen since 1982.¹⁸

In 1990, First City Houston had to honor a \$140 million letter of credit to Citibank, Spain. The letter of credit had as collateral a note secured by real estate in Spain valued at \$200 million. First City Houston had expected to earn a substantial fee on a transaction that it had analyzed as having minimal risk. However, it later learned that Spanish law made it difficult for lenders to seize collateral. Upon paying the letter of credit, First City Houston had to subsequently sell participations in the problem loan to 20 of the First City subsidiary banks to avoid exceeding its lending limits. By the fourth quarter of 1990, the loan was placed in nonperforming status.

In the third quarter of 1990, First City reported its first loss since the assistance. The loss, which amounted to \$102 million, included a \$77 million write-off on notes owed by the Collecting Bank to the subsidiary banks. In the fourth quarter of 1990, losses continued at First City, as it reported a loss of \$166 million.¹⁹ For all of 1990, First City reported a loss of \$180 million.

In March 1991, the First City board of directors, recognizing that the institution might be failing again, voted to remove Abboud as chief executive officer and replace him with C. Ivan Wilson, a long-time First City banker. Abboud, however, did remain a member of the board. The bank then developed a plan to raise needed capital. The plan involved selling off profitable subsidiaries, negotiating less expensive leases, and raising

16. David LaGessee, "Abboud Sets Lofty Goals for First City: Investor Plans Growth in Consumer and Energy Market," *American Banker* (April 21, 1988), 2; James E. Heath, FDIC Division of Research and Statistics, *Bank Failures (Texas)*, working paper (1997), 10.

17. FDIC, *Equity Investment Portfolio: Bank Insurance Fund*, 18.

18. Troubled loans are loans that are 90 days or more past due, nonaccrual loans, and owned real estate.

19. John W. Milligan, "Who Shot First City," *Institutional Investor*, vol. 26, no. 3 (March 1992), 43; Heath, *Bank Failures (Texas)*, 20.

\$100 million by selling stock.²⁰ On July 30, 1991, First City requested prepayment from the FDIC of the remaining \$485 million of assistance notes to increase First City's liquidity. The FDIC Board of Directors approved the request. On October 31, 1991, the FDIC wrote off its investment of \$970 million in the 97 million preferred shares of First City.²¹ The Office of the Comptroller of the Currency (OCC) classified \$270 million of Collecting Bank notes as nonaccrual assets as of December 31, 1991.²² For 1991, First City reported a loss of \$252 million; over its last six quarters its aggregated losses amounted to more than \$480 million.

The Collecting Bank

The FDIC OBA to First City had required First City to create a "Collecting Bank"²³ to dispose of certain troubled assets held by the subsidiary banks. First City's income from the Collecting Bank nearly equaled First City's net income during 1988 and 1989, which were First City's only profitable years after the OBA. A study completed by the General Accounting Office (GAO) in 1994 found that, if it had not been for the \$73 million in interest and fee income paid to First City by the Collecting Bank in 1988, First City would have lost about \$7 million that year. Although First City's 1989 net income did not depend completely on the Collecting Bank's interest and fees, the GAO found that such income accounted for nearly \$100 million of the \$112 million in net income earned by First City during 1989.²⁴

The anticipated success of the recapitalized First City had been partially based on the assumption that First City, including the loans in the Collecting Bank, would experience no further deterioration. That assumption proved to be incorrect. Problems with both precapitalization and postcapitalization loan portfolios resulted in significant loan charge-offs and depletion of bank equity. The GAO study found that about \$270 million in assets that originated before the 1988 recapitalization at the First City subsidiary banks in Houston and Dallas resulted in nearly \$75 million in losses. Those problems

20. Stephanie Anderson Forest, "First City Goes Down for the Second Time," *Business Week*, no. 3293 (November 16, 1992), 100; Milligan, "Who Shot First City," 43; Heath, *Bank Failures (Texas)*, 11.

21. FDIC, *Equity Investment Portfolio: Bank Insurance Fund*, 18.

22. Harrison Young, Director, FDIC Division of Resolutions, and Stephen Willard, Assistant Director, FDIC Division of Resolutions, Memorandum to the FDIC Board of Directors, "Early Resolution of the Insured Banks of First City Bancorporation of Texas, Inc." (January 10, 1992).

23. The Collecting Bank was a nationally chartered bank whose sole purpose was to liquidate almost \$2 billion in troubled assets it received from the First City banks as a part of the 1988 recapitalization. The Collecting Bank did not accept insured deposits and, as a general rule, did not extend credit. "Failing Banks: Lessons Learned from Resolving First City Bancorporation of Texas," *Report to the Chairman and Ranking Minority Member, Committee on Banking, Housing, and Urban Affairs, U.S. Senate* (Washington, D.C.: General Accounting Office, March 1995), 4.

24. "Failing Banks: Lessons Learned from Resolving First City Bancorporation of Texas," 33-34.

forced First City to charge off nearly \$200 million of Collecting Bank notes by October 1992, at which time all First City banks failed.²⁵

When the Collecting Bank was formed, First City's other subsidiary banks transferred to it \$1.751 billion in problem assets. In exchange for the problem assets, the Collecting Bank gave the subsidiary banks "Senior Notes" of \$781 million and \$970 million in preferred stock in the Collecting Bank. In a simultaneous transaction, the subsidiary banks transferred the \$970 million in preferred stock to the FDIC, and the FDIC gave the subsidiary banks \$970 million in FDIC Notes to recapitalize the banks. The FDIC was to amortize the FDIC Notes semiannually at \$97 million (plus interest), resulting in a five-year payoff.²⁶ The terms of the transaction required that the Senior Notes and the FDIC Notes be paid off completely before any dividends could be paid on the preferred stock. Redemption of the preferred stock was to begin after April 19, 1993, and could not be accomplished as long as any Senior Notes or FDIC Notes were outstanding. First City was required to purchase the FDIC's preferred stock in the Collecting Bank in 1998 for a minimum of \$100 million and, as of April 12, 1991, had escrowed \$44 million for that purpose.

By March 1991, the subsidiary banks had transferred additional problem assets and paid expenses of the Collecting Bank in the amount of \$285 million, and the Collecting Bank had issued an additional \$285 million in Senior Notes, bringing the total of the Senior Notes issued to \$1.066 billion. The Collecting Bank had paid \$610.6 million in principal payment on the notes, resulting in the reduction of the April 1991 Senior Note balance to \$455 million. Payment of the remaining notes in full was doubtful, however, because the Collecting Bank had only \$462 million in assets remaining and almost half of its loans were illiquid.²⁷

Even though the FDIC was not an owner of the Senior Notes, the assistance agreement required the FDIC's approval to modify them. The FDIC agreed to the modification of the Senior Notes as follows:²⁸

- The subsidiary banks had established a \$100 million loan loss reserve against the Senior Notes as a result of an OCC examination. The subsidiary banks were allowed to eliminate the reserve by forgiving \$100 million on the Collecting Bank's debt, resulting in the reduction of the April 1991 Senior Note balance to \$355 million. The Collecting Bank issued a new note (the 1991 Senior Note) for \$355 million, which resulted in its paying interest on a lower amount. The pur-

25. "Failing Banks: Lessons Learned from Resolving First City Bancorporation of Texas," 33-34.

26. In July 1991, at First City's request, the FDIC agreed to prepay the remaining \$485,000 balance of the notes.

27. John W. Stone, Director, FDIC Division of Supervision, through Paul G. Fritts, Executive Director, FDIC Divisions of Supervision and Resolutions, Memorandum to the FDIC Board of Directors, "First City Bancorporation of Texas, Inc., Houston, Texas (First City), Recommendation to Approve the Modification of the Senior Notes Issued by the Collecting Bank, N.A., (Collecting Bank)" (April 12, 1991).

28. Stone, "First City Bancorporation of Texas, Inc., Houston Texas (First City), Recommendation to Approve the Modification of the Senior Notes Issued by the Collecting Bank, N.A. (Collecting Bank)."

pose was to improve the Collecting Bank's cash flow and avoid placing the 1991 Senior Note on nonaccrual.

- The Collecting Bank had been required to apply net collections in the following priority. First, it paid its management incentive fee. Second, it paid the subsidiary banks on a pro rata basis their accrued interest from the Senior Notes. Third, it paid the subsidiary banks on a pro rata basis the remaining available cash to reduce the principal of the Senior Notes. The FDIC agreed to the modification, which allowed for the repayment of all the interest and principal on the Senior Notes before any management service fees were paid. However, the unpaid fees would continue to earn interest.

More Problems Arise

In January 1992, the FDIC Board of Directors was advised that First City could be expected to fail in late 1992. The advice was based on the projected insolvency of its lead bank, First City Houston, and on the FDIC's cross guarantee authority.²⁹ Other problems at First City included its overexpansion in real estate, both in and out of Texas; an overvaluation of First City loan portfolios; and an overly optimistic, serious miscalculation on the recovery of the Texas economy. In addition, First City's lending practices and policies were progressively deteriorating. Finally, dwindling collections impaired cash flow, and the FDIC started to develop a resolution plan for First City.³⁰

By March 31, 1992, four of First City's subsidiary banks failed to meet minimum regulatory capital guidelines. Those banks—First City, Texas-Austin, N.A. (First City Austin), Austin, Texas; First City, Texas-Dallas (First City Dallas), Dallas, Texas; First City, Texas-Houston, N.A. (First City Houston), Houston, Texas; and First City, Texas-San Antonio, N.A. (First City San Antonio), San Antonio, Texas—represented approximately 60 percent of the combined First City assets.

By June 1992, the holding company had approximately \$22 million in outstanding debt due on September 15, 1992. In addition, the FDIC held a \$23 million fully secured note due on February 28, 1993, that was the result of an agreement First City had previously reached with the FDIC in settling potential claims by the FDIC against a

29. The cross guarantee authority allows the FDIC to recover all or part of the losses incurred in liquidating or aiding a troubled institution from other institutions that have the same ownership as the failing institution. Institutions with this type of ownership arrangement are called "commonly controlled" institutions. Assessment of cross guarantees may create a liquidity strain that results in failure of the affiliate or, in some cases, immediate insolvency of the affiliate.

30. Harrison Young, Director, FDIC Division of Resolutions, Robert H. Hartheimer, Associate Director, FDIC Division of Resolutions, and Stephen Willard, Assistant Director, FDIC Division of Resolutions, through Paul G. Fritts, Executive Director, FDIC Divisions of Supervision and Resolutions, Memorandum to the FDIC Board of Directors, "Early Resolution of the Insured Banks of First City Bancorporation of Texas, Inc." (June 19, 1992).

number of past and present directors and officers of the holding company.³¹ First City doubted that it would be able to pay the debt obligations due in September and indicated that the holding company might become the subject of voluntary or involuntary bankruptcy proceedings.

The FDIC Board of Directors was briefed on First City's deteriorating condition and on various options of resolution on June 23, 1992. First City proposed another OBA transaction to the FDIC that would have been a whole bank transaction in which an acquiring holding company (New First City) acquired First City by merger or equivalent transaction. Although the FDIC would have acquired no assets, it was asked to agree to share in the losses on a \$1.8 billion pool of assets. The proposal was rejected, and the FDIC advised First City on July 21, 1992, not to give the impression in public disclosures that the FDIC was likely to provide OBA. Other financial entities expressed interest in First City only on a closed bank basis.

By August, First City had given up on its search for a merger partner. It announced a plan to raise new capital to meet regulatory standards without FDIC assistance.³² The plan projected that it would take until December 1992 at the earliest to raise the capital. Regulators doubted that the bank could raise enough capital by that time to meet regulatory standards.³³

The Resolution—October 30, 1992

An annual OCC bank examination initiated in September 1992 confirmed that loan losses were mounting at First City Houston. In response, on October 30, 1992, Acting Comptroller of the Currency Stephen R. Steinbrink closed First City Houston, a nationally chartered bank. Texas Commissioner of Banking Catherine A. Ghiglieri closed First City Dallas, a state chartered bank. The FDIC then exercised the cross guarantee authority granted by FIRREA to assess the other 18 subsidiary banks for losses on First City Houston and First City Dallas. The use of the cross guarantee authority rendered those 18 banks insolvent, and they were closed by their respective chartering authorities, that is, the OCC closed the nationally chartered banks, and the Texas Commissioner of Banking closed the state chartered banks.

The FDIC established 20 separate bridge banks to assume deposits and certain other liabilities and assets of the failed banks.³⁴ Edward G. Harshfield, former chairman of Federal Capital Bank, N.A., Washington, D.C., and chairman of EH Thrift Manage-

31. Young, Hartheimer, and Willard, through Fritts, "Early Resolution of the Insured Banks of First City Bancorporation of Texas, Inc."

32. Steven Greenhouse, "U.S. Closes First City Bancorp," *The New York Times* (October 31, 1992).

33. Forest, "First City Goes Down for the Second Time," 100; Heath, *Bank Failures (Texas)*, 13.

34. See Part I, Resolution and Asset Disposition Practices, Chapter 6, Bridge Banks, for a discussion of bridge banks.

ment, Inc., Chicago, Illinois, was appointed chief executive officer of the bridge banks. The FDIC announced that it planned to seek proposals for the acquisition of the 20 new bridge banks and return them to the private sector in approximately three months.³⁵

In the resolution of First Republic in 1988, all failed subsidiary banks had been placed in one bridge bank and marketed as one institution. The First City resolution was handled differently, and each of the 20 banks was marketed separately. For the 16 better capitalized bank subsidiaries of First City (all those except First City Austin, First City Dallas, First City Houston, and First City San Antonio), the FDIC did not expect to incur any losses, so all deposits, including about \$140 million in 5,700 accounts exceeding the \$100,000 insurance limit, were transferred to the new bridge banks. The FDIC expected that there would be losses to the FDIC from the other four First City banks—First City Austin, First City Dallas, First City Houston, and First City San Antonio. The FDIC Board of Directors therefore determined that having the FDIC absorb the uninsured depositors' share of the losses in the four banks would not result in the least costly resolution, as required by the Federal Deposit Insurance Corporation Improvement Act (FDICIA) of 1991.

For the Austin, Dallas, Houston, and San Antonio bank subsidiaries, all deposits under the \$100,000 deposit insurance limit were fully protected and were transferred to the new bridge banks. Deposits exceeding the insurance limit totaling \$260 million in 5,000 accounts were not transferred to the new banks. Owners of those deposits received checks equal to 80 percent of their claims, an amount based on the estimated recovery of the assets in those banks. Provisions were made so that, if collections on the sale of the four failed banks' assets exceeded the 80 percent recovery estimate, those owners of uninsured deposits might receive additional payments on their claims.³⁶

On November 23, 1992, one month after the failure of its 20 subsidiary banks, the First City holding company filed for bankruptcy protection from its creditors.

Sale of the Bridge Banks—February 13, 1993

Even before First City failed in October 1992, six banking entities had notified the FDIC of their interest in purchasing all or part of the First City banks.³⁷ In all, after marketing the bridge banks, the FDIC received 111 bids for the 20 banks from 32 potential purchasers. On January 27, 1993, the FDIC announced the sale of the 20 bridge banks, with more than \$9 billion in total assets, to 12 different financial

35. FDIC News Release, "FDIC Establishes 20 New Bridge Banks to Assume Subsidiaries of First City Bancorporation of Texas, Inc., Houston, Texas," PR-150-92 (October 30, 1992).

36. FDIC News Release, PR-150-92.

37. Young, Hartheimer, and Willard, through Fritts, "Early Resolution of the Insured Banks of First City Bancorporation of Texas, Inc."

institutions through P&A transactions effective February 13, 1993. Texas Commerce Bancshares (Texas Commerce), Houston, Texas, a wholly owned subsidiary of Chemical Banking Corporation, acquired the largest share of the First City franchise. Texas Commerce acquired five bridge banks and approximately 73 percent of the total assets of all the bridge banks. The five banks acquired by Texas Commerce were the two largest banks (Houston and Dallas) and the banks in Beaumont, El Paso, and Midland.³⁸

The basic provisions of the sale transactions were as follows:

- The acquiring institutions assumed all bridge bank deposits and nearly all other bridge bank liabilities.
- The acquiring institutions paid or received cash equal to the difference between assets purchased and liabilities, plus or minus the amount of their respective bids.³⁹
- The acquiring institutions purchased securities at market value, and they purchased all other assets except owned real estate and in-substance foreclosed loans at book value. The acquirers were given an option to purchase the banking premises at fair market value.

The aggregate premium received for the 20 banks was \$434 million.⁴⁰ In 17 of the failed banks, the acquiring institutions agreed to absorb all losses on assets acquired. In the other three banks, which were in Austin, Dallas, and Houston, the franchises were sold with five-year “loss sharing” arrangements on approximately \$1.8 billion of loans.⁴¹ Those assets are referred to as the loss sharing assets. During the five-year period, the FDIC reimbursed the relevant acquiring institution for 80 percent of verified net charge-offs on the loss sharing assets. The acquiring institution absorbed the remaining 20 percent of loss. Some provisions were made for increased payments from the FDIC if acquiring bank losses reached certain designated levels.⁴²

The premiums paid for the banks exceeded the original estimate of bid amounts expected.⁴³ After the bidding, the FDIC announced on January 23, 1993, that it would advance an additional 10 cents for every dollar of uninsured claims for depositors (but not

38. FDIC News Release, “FDIC Announces Sale of 20 Bridge Banks Established in October to Resolve Closed Bank Subsidiaries of First City Bancorporation of Texas, Houston; Agency Also Adds to Previous Payment to Certain Uninsured Depositors,” PR-7-93 (January 27, 1993).

39. FDIC News Release, PR-7-93.

40. FDIC News Release, PR-7-93.

41. Loss sharing is a provision of certain purchase and assumption transactions the FDIC introduced in 1991. Loss sharing is designed to sell as many assets as possible to the acquiring bank and have it manage and collect the non-performing assets in a manner that aligns the interests and incentives of the acquiring bank with those of the FDIC. In a loss sharing agreement, the FDIC agrees to absorb a significant portion of the loss, typically 80 percent, on a specified pool of assets, while the acquiring bank absorbs the rest of the loss. See Part I, Resolution and Asset Disposition Practices, Chapter 7, Loss Sharing, for a full discussion of this subject.

42. FDIC News Release, PR-7-93.

43. FDIC News Release, PR-7-93.

other creditors) of the closed bank in Dallas and for the uninsured depositors and other unsecured creditors of the Austin and San Antonio banks. The FDIC did not authorize an additional advance dividend for uninsured depositors and creditors of the Houston bank.⁴⁴

The FDIC had a reason for the disparate treatment of failed bank depositors and creditors. Sixteen of the failed banks had had higher amounts of capital when they were closed, and the FDIC expected no loss, so depositors and general creditors in those banks were all paid in full. However, the failed banks in Austin, Dallas, Houston, and San Antonio were initially expected to cause losses to the Bank Insurance Fund (BIF). In those four institutions, only insured deposits had been protected at the time the banks failed. The failed banks in Austin, Houston, and San Antonio all had been national banks, but the failed bank in Dallas had been a state chartered bank. Because of the Texas depositor preference law, which stated that all depositors must be paid before general creditors could be paid, the FDIC was unable to pay advance dividends to general creditors of the Dallas bank the way it could to general creditors of the banks with national charters.⁴⁵ On March 30, 1994, the FDIC announced that all creditors with valid claims against the First City receiverships would receive the full principal amount of their claims along with interest as provided by Texas state law.⁴⁶

Shareholder Litigation

After receiving bids for First City's assets, the FDIC announced it expected to net a surplus of \$60 million. Any surplus was to be returned to the holding company. Harrison Young, then FDIC's director of the Division of Resolutions, said, "I was astonished by how good a deal we'd gotten. By offering the [First City] banks separately, we got better premiums."⁴⁷ At the time the banks were closed, the FDIC expected the BIF to take a sizeable loss. The FDIC's original estimate of the loss was \$500 million. However, the

44. FDIC News Release, PR-7-93.

45. At the time the First City banks failed, Texas had a law known as "depositor preference," which required that all depositors of a failed bank be paid in full before any general creditors could be paid. (See *Texas Banking Code*, section 36.312.) Such was not the case for national banks, in which uninsured depositors and general creditors were treated ratably. The Texas Commissioner of Banking had reservations about closing the Dallas bank, which was a state chartered bank. She knew that banks that had sold federal funds to the Dallas bank would be considered general creditors and would not receive the full amount of their federal fund loans until all depositors had been paid in full. Banks that had sold federal funds to one of First City's national banks would have received payment on the same pro rata basis as uninsured depositors. The commissioner was concerned that this disparate treatment might lead to banks' giving priority to the national banks when selling their federal funds, resulting in an advantage for national banks over state chartered banks. The disparity that gave the commissioner cause for concern was eliminated when Congress enacted a national depositor preference statute on August 10, 1993 (*U.S. Code*, volume 12, section 1821[d][11]) that eliminated the inconsistent treatment of depositors in the various states.

46. FDIC News Release, "FDIC Reports Projected Losses for Receiverships," PR-20-94, (March 30, 1994).

47. Kelly Holland, "The Feds May Have Bolted the Door Too Quickly," *Business Week*, no. 730 (February 8, 1993), 158; Heath, *Bank Failures (Texas)*, 30.

FDIC was able to sell the failed bank franchises to other institutions for a premium of \$434 million and was also able to minimize some of its projected losses through the three loss sharing agreements, although the FDIC did take ownership of some loans.⁴⁸

However, First City holding company officials believed that a surplus close to \$400 million to \$600 million could be projected. On September 24, 1993, First City filed suit against the OCC, Texas Commissioner of Banking Catherine A. Ghiglieri, and the FDIC, in both its corporate and receivership capacities, alleging improper closure of First City Dallas and First City Houston, improper assessment of the cross guarantees, and mishandling of receivership responsibilities. The lawsuit sought \$1 billion in compensatory damages and \$2 billion in punitive damages.

In January 1994, the FDIC board of directors and First City announced a tentative settlement of the pending litigation, subject to the approval of the bankruptcy court. Under the terms of the proposed agreement, the settlement would resolve all claims and was to be funded in at least two stages: (1) an initial payment in cash and other assets from surplus funds, and (2) one or more additional payments of the total remaining surplus after the FDIC could ascertain that its insurance fund and all other creditors would be repaid in full.⁴⁹

In May 1995 the bankruptcy court approved the previously announced settlement with the FDIC. Under the settlement, it was estimated that the FDIC would return to First City \$125 million in cash and \$55 million in loans and real estate. The FDIC would also return—at face value—\$75 million from a reserve against a pool of distressed loans held by Texas Commerce and Frost National Bank, San Antonio, Texas. In addition, the FDIC would provide funds to allow restitution to those depositors in the First City banks in Austin, Dallas, Houston, and San Antonio whose deposits were not fully insured and who were required to take approximately 80 cents to 90 cents on the dollar on the amounts over the \$100,000 insurance limit. All other creditors were to be paid in full. Senior preferred shareholders would be paid over two years, and junior preferred shareholders would receive between \$100 million and \$150 million, depending on the liquidation value of the returned assets, as well as 35 percent of the new company's common stock. Common shareholders would get 15 percent of the new company's stock, with the remaining 50 percent going to shareholders of J-Hawk Corporation, Waco, Texas, whose merger with First City had been approved by the bankruptcy court at the same time it approved the settlement with the FDIC. The total value of the settlement was about \$350 million.⁵⁰

48. "FDIC Plans Settlement with First City in Litigation over 1992 Bank Closures," *BNA's Banking Report*, vol. 62 (January 3, 1994), 37.

49. "Receivership Challenge: FDIC Agrees to Rules in First City Settlement," *Litigation Reporting Service* (January 1994), 5938.

50. Joseph M. Grant, *The Great Texas Banking Crash: An Insider's Account* (Austin, Texas: University of Texas Press, 1996), 248.

The Stock Transactions

In the First City OBA transaction, the FDIC purchased \$43 million (2,059,456 shares) of junior convertible preferred stock in FCAC. That stock could be converted into a 10 percent interest in the common stock of FCAC. Dividends of \$2.1 million were received on the stock before sale. The stock was sold to First City in August 1989 for \$69.1 million, which represented a gain to the FDIC of \$26 million.

The FDIC also received warrants, exercisable for five years, to purchase 5 percent (1,030,636 shares) of the common stock of FCAC at the initial offering price of the stock of \$20.94 per share. The FDIC exercised the warrants at \$20.94 per share and sold them the same day in August 1989 to First City at \$38 per share for a total of \$39.4 million, which represented a gain to the FDIC of \$17.8 million.

Finally, the FDIC provided \$970 million in FDIC Notes to the First City subsidiary banks. In exchange for the notes, the FDIC received 97 million shares of preferred stock in the Collecting Bank. When it became apparent that the Collecting Bank would be unable to pay back the Senior Notes, the FDIC wrote off the value of its shares in 1991. A summary of the stock transactions is shown in table II.5-1.

FDIC Resolution Costs

The 1988 resolution of First City is the fourth most costly resolution in FDIC's history. The total cost of the transaction was approximately \$1.1 billion, or about 10 percent of the failed banks' assets. See table II.5-2 below for a breakdown of the resolution costs.

As in the First Republic and MCorp resolutions, the acquirer, in this case the new owners of First City, took on ownership of and responsibility for administering and collecting the problem assets. However, the FDIC did not retain any ongoing mark-to-market responsibility for those assets nor did it enter into an asset management contract with the acquirer. The FDIC did provide \$970 million in FDIC Notes to the First City subsidiary banks, who in turn funded the Collecting Bank that was responsible for administering and collecting the problem assets. In return, the FDIC received 97 million shares of preferred stock. Unfortunately, the Texas economy continued to deteriorate and the problem assets continued to deteriorate, resulting in higher losses than were originally expected. As a result, the FDIC wrote off its \$970 million preferred stock investment in late 1991. Therefore, the significant costs to the FDIC in this transaction were the \$970 million it provided in up-front assistance and the \$193 million in interest expense on the notes provided to First City. Partially offsetting those expenses was about \$35 million that the FDIC recovered from settlement of the directors and officers' claim, \$13 million that the FDIC received as part of the 1995 settlement with the holding company, and approximately \$46 million it received from dividends and gains on the sale of the junior convertible preferred stock and warrants to First City in 1989.

Table II.5-1

A Summary of the FDIC's Stock Transactions in the First City Open Bank Assistance Transaction

Date	Trans- action	Beginning Number of Shares	Shares Sold, Written Down, Converted	FDIC Stock/ Equity Investment	FDIC Proceeds from Sales	FDIC Book Value of Transaction	Gain or Loss on Transaction	FDIC Dividend Income
Convertible Junior Preferred Stock, Series D								
04/19/88	Original purchase	2,059,456		\$43,125,009				
08/23/89	Dividends prior to sale							\$2,059,456
08/23/89	Sale		(2,059,456)		\$69,146,235	\$43,125,009	\$26,021,227	
	Totals	2,059,456	(2,059,456)	\$43,125,009	\$69,146,235	\$43,125,009	\$26,021,227	\$2,059,456
Common Stock Warrants								
08/23/89	Stock Warrants traded at \$20.94 per share	1,030,636		\$21,581,518				
08/23/89	Sale		(1,039,636)		\$39,380,295	\$21,581,518	\$17,798,777	
	Totals	1,030,636	(1,039,636)	\$21,581,518	\$39,380,295	\$21,581,518	\$17,798,777	\$ 0
Preferred Stock								
04/19/88	Purchase with a note payable	97,000,000		\$970,000,000				
10/31/91	Write off of worthless stock		(97,000,000)		\$ 0	\$970,000,000	(\$970,000,000)	
	Totals	97,000,000	(97,000,000)	\$970,000,000	\$ 0	\$970,000,000	(\$970,000,000)	\$ 0
Grand Total, All Stock		100,090,092	(100,099,092)	\$1,034,706,527	\$108,526,530	\$1,034,706,527	(\$926,179,996)	\$2,059,456

Source: FDIC, *Equity Investment Portfolio, Bank Insurance Fund* (December 31, 1993).

Table II.5-2

**FDIC Resolution Costs for the 1988 First City
Open Bank Assistance Transaction as of December 31, 1995**
(*\$ in Thousands*)

FDIC's Expenses	
Purchase of preferred stock in the Collecting Bank	\$970,000
Interest expense on note	193,132
Purchase of 2.1 million shares convertible junior preferred stock in FCAC	43,125
Exercise of common stock warrants	21,582
Nonrecoverable insurance expense	854
Expenses on bond claim	25
FDIC's Total Expenses	\$1,228,718
FDIC's Recoveries	
Dividends on convertible junior preferred stock	\$2,059
Sale of convertible junior preferred stock	69,146
Sale of common stock	39,380
Settlement of directors and officers' claim*	35,066
Interest income on directors and officers' note	898
Recovery on preferred stock*	13,062
FDIC's Total Recoveries	\$159,611
FDIC's Total Resolution Cost	\$1,069,107

*Per the Amended Settlement Agreement with First City Bancorporation in June 1995, the FDIC received \$31 million related to outstanding issues on the directors' and officers' settlement and the Collecting Bank. Of that amount, \$19 million was applied to the directors' and officers' settlement and \$13 million was applied as recovery on the preferred stock. The amounts are reflected in the above figures.

Source: FDIC Division of Finance.

The second resolution of First City in 1992 resulted in no cost to the FDIC and in an aggregate surplus for the 20 First City receiverships. As part of the 1995 settlement with the holding company, the remaining surplus was ultimately used to pay in full the remaining uninsured depositors and creditors and then was paid to the holding company.

The second resolution resulted in a surplus for several reasons. First, the Texas economy, especially the real estate markets, was on an upswing and improved significantly after the resolution, thus increasing the value of the assets retained by the FDIC as well as the assets held by the acquirers. In addition, the structure of the transaction allowed for a highly competitive bidding process. Bidders were allowed to bid on each of the 20 banks individually as well as any combination thereof. This increased competition and allowed bidders to bid only on those banks they really wanted. Some banks would be worth more to some acquirers than to other acquirers. As a result, the FDIC received a \$434 million premium, which was much higher than was expected.

In addition, the structure of the transaction allowed the FDIC to sell a significant portion of the assets with no ongoing exposure to the FDIC. The FDIC was able to sell 17 of the 20 First City banks on a “whole bank” basis without any ongoing assistance from the FDIC. In the other three First City banks, the FDIC offered loss sharing on a total of about \$1.8 billion in assets, which was about one-third of the assets at the three banks at the time of resolution. In total, the FDIC was able to pass more than \$8.5 billion, or more than 90 percent, of the First City assets to the acquirers of the 20 First City banks. Of those assets, only 20 percent had any FDIC commitment for ongoing assistance.

Another reason for the surplus was that the loss sharing agreement on the three First City banks was an extremely cost-effective method of asset disposition for the FDIC. Over the life of the agreement, approximately \$2.5 billion in assets, including \$1.8 billion initially and \$0.7 billion in subsequent advances and additions, were covered by the loss sharing agreement. On the \$2.5 billion in assets, the FDIC’s total loss sharing payments totaled \$82 million, which was only about 3 percent of the total book value of the assets. Finally, the FDIC’s ability to assess the 18 affiliated banks for the projected losses of the 2 insolvent lead banks in Houston and Dallas provided the FDIC with a mechanism to recover the value of the other First City banks, which were generally in better financial shape.

Lessons Learned

The FDIC learned many lessons with the resolution of First City.

Open Bank Assistance—1988

When First City initially approached the FDIC in 1987 for OBA, the FDIC’s standard practice in the resolution of failing banks was to arrange a P&A transaction with a healthy institution and to protect all depositors, but not shareholders and bondholders, against loss. Any OBA granted by the FDIC was expected to achieve similar results. The proposal from

the Abboud group met those requirements, as the proposal indicated that the former shareholders' investments in the new holding company would be reduced to a nominal amount, and the bondholders would accept 35 percent to 45 percent of the balance due them. However, because of the manner in which Continental Illinois had been resolved three years earlier, the bondholders may have had little fear that the First City banks actually would be closed (which would cause them to lose their entire investments). Therefore, it was difficult for the Abboud group to complete a transaction that would substantially reduce the expected return of the bondholders and shareholders and still get their approval. Consequently, the negotiations for the First City resolution were unusually long and difficult.

As of 1997, First City was the largest banking institution ever to receive OBA and subsequently fail.⁵¹ The FDIC's experience with First City can be viewed almost as the "last straw" for OBA. The number of OBA transactions decreased significantly after 1988. Of the 679 failed or failing banks the FDIC handled from 1989 through 1994, only 7 were resolved by open bank assistance. The last OBA occurred in 1992. Two options, bridge bank authority and cross guarantee authority, that gave the FDIC additional flexibility in resolving large failures were not available to the FDIC when First City made its request for OBA. By the time the FDIC approved First City's OBA in principle on September 9, 1987, it had just received authority to create bridge banks on August 10, 1987, with the passage of the Competitive Equality Banking Act. The FDIC did not believe it would be appropriate to test the new authority and new procedures with such a large and complex institution.⁵² Furthermore, the FDIC did not receive its cross guarantee authority until 1989, with the passage of FIRREA. If the FDIC had possessed cross guarantee authority in 1987, the OBA might not have been the least costly transaction, because the solvent banks could have supported the losses of the insolvent ones.⁵³

Another reason for providing OBA was concern that if two of the holding company's banks were closed, bank runs might be generated in the other First City banks, thus creating liquidity problems. Any First City banks that survived would have been a benefit to the holding company's shareholders, and any banks not strong enough to endure the liquidity pressures might have continued to deteriorate until they, too, had to be closed, thereby eventually increasing the costs to the FDIC.⁵⁴

51. Others include the BancTexas Group, Dallas, Texas, which received assistance on July 17, 1987, but whose lead bank failed on January 26, 1990. The same group of investors that put together the BancTexas transaction received OBA for two banks in Alaska on January 28, 1988, but those two banks failed in April 1989.

52. The FDIC used its bridge bank authority for the first time when Capital Bank & Trust Company, Baton Rouge, Louisiana, was closed on October 30, 1987. The bank had \$386.3 million in total assets. FDIC, *1987 Annual Report*, 6. See Part I, Resolution and Asset Disposition Practices, Chapter 6, Bridge Banks, for a full discussion of this subject.

53. McAllen State Bank, McAllen, Texas, with assets of approximately \$590.7 million, was closed April 19, 1988. The only other First City banks that were insolvent and eligible to be closed in 1987 were First City Dallas and First City Houston, with \$510 million and \$3.8 billion in assets, respectively.

54. Stone, letter to James L. Bothwell, Director, Financial Institutions and Market Issues, General Accounting Office (October 24, 1994); "Failing Banks: Lessons Learned from Resolving First City Bancorporation of Texas," 36.

Some banking analysts thought the assistance provided to First City was inadequate to recapitalize the organization, but the key to the FDIC's granting the OBA in 1988 was A. Robert Abboud and his desire to complete the transaction. Abboud had indicated that he and his investment group could raise \$500 million from the private sector and that, with the assistance of the FDIC, First City could be recapitalized. Former FDIC Chairman William L. Isaac was quoted later as believing that the original assistance was insufficient. "There's no question the deal was too thin," he reported. "I thought there was about a 25 percent chance [that Abboud's] deal would not work. Those odds are too high."⁵⁵ In his book, published in 1993, former FDIC Chairman Seidman said, "... [W]e probably drove too tough a deal with Abboud, which did not leave him enough money to save the bank. Others were bidding, and we took the best bid. It turned out that the bid that gave the most money to the government was too good, because the bank failed again late in 1992. . . ."⁵⁶

A big question the FDIC faced concerning the First City transaction was, "Why did First City fail the second time?" A report from the GAO cited the continued decline in the Texas economy, weak loan portfolios in the First City banks, questionable lending activity, and high bank operating expenses.⁵⁷ After First City was recapitalized, its management was under pressure to produce returns for the new investors. The First City banks embarked on a short-lived aggressive growth policy that resulted in portfolios including loans to finance highly leveraged transactions, international loans, and out-of-territory loans. During the first two years after receiving its assistance, First City reported \$183 million in profits and paid \$122 million in cash dividends. However, the earnings used to justify the dividends were profits that depended on income from non-traditional and one-time sources, including the sale of First City's credit card operations in the first quarter of 1990. That sale enabled the holding company to turn a \$49 million loss from operations into a \$90 million profit in that quarter. In addition, the holding company was not able to achieve the operational cost-cutting it had projected and, in 1990 and 1991, operating costs increased while net income, gross profits, and total assets decreased.⁵⁸

Bridge Bank and Purchase and Assumption—1992

In 1992, the FDIC was able to use effectively both the cross guarantee authority and the bridge bank authority in the resolution of the First City failures. The FDIC thus had more resolution options than it had when First City was originally given assistance in 1988. The cross guarantee assessment resulted in the reduction of the costs of the fail-

55. Milligan, "Who Shot First City," 43; Heath, *Bank Failures (Texas)*, 17.

56. Seidman, *Full Faith and Credit*, 146.

57. "Failing Banks: Lessons Learned from Resolving First City Bancorporation of Texas," 5.

58. "Failing Banks: Lessons Learned from Resolving First City Bancorporation of Texas," 4-5, 12, 34.

Table II.5-3

**Summary of Loss Sharing Agreements for Failed First City Banks
As of March 31, 1997 (Agreements Fully Terminated)**

(\$ in Millions)

	Failed Bank	Total Loss Sharing Assets	Total FDIC Loss Sharing Payments	Payments as % of Covered Assets*
1	First City Texas-Austin**	\$ 89	\$ 0	0.56
2	First City Texas-Dallas	602	3	0.50
3	First City Texas-Houston	1,824	79	4.33
	Totals	\$2,515	\$82	3.26

*Percentages are not reflective of rounding.

**Total FDIC payments for the First City Texas-Austin loss sharing agreement are less than \$500,000.

Source: FDIC, *Summary of Loss Sharing Assistance Agreements Through March 31, 1997* (June 26, 1997).

ures, because the solvent banks lowered the insurance fund's losses. The FDIC believed that bridging the failed banks provided investors with the opportunity to find the time and resources necessary to produce the unusually high premiums for the First City franchises. The marketing that allowed for 42 institutions to perform due diligence over a seven-week period and resulted in bids from 30 potential acquirers would not have been possible had the banks been open and not under FDIC control.⁵⁹

The process of allowing separate bids for each of the First City banks allowed more competitive bidding and higher premiums than had been expected. The total premium received for all bridge banks was \$434 million. The 20 bridge banks were sold to 12 separate acquirers, consisting of 8 independent banks or holding companies located primarily in Texas, 1 thrift institution located primarily in Texas, and 3 bank holding companies located or controlled primarily out of that state.⁶⁰ Six of the acquirers were part of bank groups or holding companies with less than \$1 billion in total assets. With the exception of Texas Commerce, each acquiring institution had aggregate bank and affiliate assets of less than \$5 billion.⁶¹

The loss sharing agreements with purchasers of three First City banks (Austin, Dallas, and Houston) were also viewed as successful. The FDIC's total loss sharing pay-

59. "Failing Banks: Lessons Learned from Resolving First City Bancorporation of Texas," 38.

60. FDIC News Release, PR-7-93.

61. Holland, 158; Heath, *Bank Failures (Texas)*, 29-30.

ments were \$82 million, or 3.26 percent of total covered assets of \$2.5 billion. A summary of the loss sharing transactions is shown in table II.5-3.

Effect on Future Resolutions

The original OBA for First City took more than seven months to complete. The FDIC, which had negotiated many OBA transactions in the past, grew dissatisfied with the unusual difficulties involved in completing First City's assistance transaction. When the FDIC was asked to work with First Republic, the First City transaction was not yet complete. Because of the FDIC's experience in working with First City's shareholders and holding company debtholders, structuring a bridge bank resolution for First Republic, even without cross guarantee authority, was a simpler method of dealing with First Republic's problems. See chapter 6 of part II for a complete description of the First Republic transaction.

Tables II.5-4 and II.5-5 show the First City banks involved with each transaction.

Table II.5-4

First City Bancorporation Subsidiary Banks, April 20, 1988

(\$ in Thousands)

Bank Name, City, State	Resolution Assets	Resolution Deposits	Resolution Cost	Assets Passed	FDIC Assets	Res. Cost (%)
1 First City, Texas-Richardson, Richardson, TX	\$202,202	\$208,656	\$1,779	\$202,202	\$0	0.88
2 First City, Texas-Dallas, Dallas, TX	509,653	483,968	81,461	509,653	0	15.98
3 First City, Texas-Beaumont, Beaumont, TX	386,313	395,218	12,670	386,313	0	3.28
4 First City, Texas-Bryan, Bryan, TX	205,855	204,568	1,583	205,855	0	0.77
5 First City, Texas-Graham, Graham, TX	115,841	123,260	563	115,841	0	0.49
6 First City, Texas-Lufkin, Lufkin, TX	135,181	138,029	534	135,181	0	0.39
7 First City, Texas-Madisonville, Madisonville, TX	77,414	80,968	146	77,414	0	0.19
8 First City, Texas-Midland, Midland, TX	311,822	309,816	17,247	311,822	0	5.53
9 First City, Texas-Orange, Orange, TX	103,312	108,481	452	103,312	0	0.44
10 First City, Texas-Richmond, Richmond, TX	64,454	69,979	357	64,454	0	0.55
11 First City, Texas-San Angelo, San Angelo, TX	120,374	129,306	1,115	120,374	0	0.93
12 First City, Texas-Tyler, Tyler, TX	226,004	230,044	23,311	226,004	0	10.31
13 First City, Texas-Lewisville, Lewisville, TX	113,217	120,675	2,489	113,217	0	2.20

Table II.5-4

First City Bancorporation Subsidiary Banks, April 20, 1988

(\$ in Thousands)

Continued

Bank Name, City, State	Resolution Assets	Resolution Deposits	Resolution Cost	Assets Passed	FDIC Assets	Res. Cost (%)
14 First City, Texas-Humble, Humble, TX	\$67,660	\$75,791	\$5,565	\$67,660	\$0	8.22
15 First City, Texas-Sour Lake, Sour Lake, TX	39,524	41,804	17	39,524	0	0.04
16 First City, Texas-Houston, N.A., Houston, TX	3,819,064	2,160,951	742,348	3,819,064	0	19.44
17 First City, Texas-Austin, Austin, TX	613,430	594,778	79,626	613,430	0	12.98
18 First City, Texas-Lake Jackson, Lake Jackson, TX	74,087	77,911	186	74,087	0	0.25
19 First City, Texas-Grand Prairie, Grand Prairie, TX	68,464	73,491	145	68,464	0	0.21
20 First City, Texas-El Paso, El Paso, TX	338,309	335,465	931	338,309	0	0.28
21 First City, Texas-Arlington, Arlington, TX	207,888	215,043	19,446	207,888	0	9.35
22 First City, Texas-Kountze, Kountze, TX	29,871	31,855	28	29,871	0	0.09
23 First City, Texas-Alice, Alice, TX	91,446	94,459	570	91,446	0	0.62
24 First City, Texas-East Dallas, Dallas, TX	91,366	95,508	754	91,366	0	0.82
25 First City, Texas-Gateway, Beaumont, TX	66,030	70,722	50	66,030	0	0.07
26 First City, Texas-Central, Beaumont, TX	60,016	64,139	335	60,016	0	0.56
27 First City, Texas-Farmers Branch, Farmers Branch, TX	139,828	147,861	4,296	139,828	0	3.07
28 First City, Texas-Windsor Park, San Antonio, TX	109,502	117,314	8,804	109,502	0	8.04
29 First City, Texas-Garland, Garland, TX	112,070	118,849	1,656	112,070	0	1.48
30 First City, Texas-Market Center, Dallas, TX	58,716	63,382	5,857	58,716	0	9.98
31 First City, Texas-Northline, Houston, TX	53,071	60,370	6,071	53,071	0	11.44
32 First City, Texas-Central Park, San Antonio, TX	153,102	168,399	26,739	153,102	0	17.46
33 First City, Texas-Lancaster, Lancaster, TX	70,251	75,313	522	70,251	0	0.74
34 First City, Texas-Aransas Pass, Aransas Pass, TX	42,204	44,373	209	42,204	0	0.50
35 First City, Texas-Almeda Genoa, Houston, TX	67,291	70,712	207	67,291	0	0.31
36 First City, Texas-Valley View, Dallas, TX	123,139	131,368	4,777	123,139	0	3.88
37 First City, Texas-Gulfgate, Houston, TX	145,171	152,769	271	145,171	0	0.19
38 First City, Texas-Colleyville, Colleyville, TX	\$47,521	\$48,181	\$207	\$47,521	0	0.43

Table II.5-4

First City Bancorporation Subsidiary Banks, April 20, 1988

(\$ in Thousands)

Continued

	Bank Name, City, State	Resolution Assets	Resolution Deposits	Resolution Cost	Assets Passed	FDIC Assets	Res. Cost (%)
39	First City, Texas-Clear Lake, Houston, TX	\$68,882	\$73,856	\$1,406	\$68,882	\$0	2.04
40	First City, Texas-Highland Village, Houston, TX	127,326	136,717	3,682	127,326	0	2.89
41	First City, Texas-Bellaire, Bellaire, TX	44,128	48,064	1,465	44,128	0	3.32
42	First City, Texas-Inwood Forest, Houston, TX	65,818	70,911	1,694	65,818	0	2.57
43	First City, Texas-Corpus Christi, Corpus Christi, TX	381,259	308,890	6,272	381,259	0	1.65
44	First City, Texas-Forest Hill, Forest Hill, TX	38,703	41,348	173	38,703	0	0.45
45	First City, Texas-Medical Center, Houston, TX	45,273	48,660	159	45,273	0	0.35
46	First City, Texas-Fondren South, Houston, TX	53,939	59,232	3,064	53,939	0	5.68
47	First City, Texas-Central Arlington, Arlington, TX	78,909	82,145	3,065	78,909	0	3.88
48	First City, Texas-Northeast, Houston, TX	61,350	66,393	642	61,350	0	1.05
49	First City, Texas-Bear Creek, Harris County, TX	39,719	43,450	1,192	39,719	0	3.00
50	First City, Texas-Westheimer, Houston, TX	57,870	62,969	2,217	57,870	0	3.83
51	First City, Texas-North Belt, Houston, TX	48,942	52,757	620	48,942	0	1.27
52	First City, Texas-Plano, Plano, TX	51,352	57,748	2,042	51,352	0	3.98
53	First City, Texas-Fort Worth, Fort Worth, TX	50,738	56,603	4,965	50,738	0	9.78
54	First City, Texas-Northchase, Houston, TX	46,241	50,036	1,606	46,241	0	3.47
55	First City, Texas-Westheimer Park, Houston, TX	54,051	60,359	5,431	54,051	0	10.05
56	First City, Texas-Westwood, Houston, TX	22,122	25,358	2,758	22,122	0	12.47
57	First City, Texas-San Antonio, San Antonio, TX	41,196	44,944	3,258	41,196	0	7.91
58	First City, Texas-Northwest Highland, Austin, TX	45,485	50,513	1,784	45,485	0	3.92
59	First City, Sioux Falls, N.A., Sioux Falls, SD	516,036	225,270	0	516,036	0	0.00
	Totals	\$11,200,002	\$9,399,999	\$1,100,819	\$11,200,002	\$ 0	10.29

Source: Division of Research and Statistics.

Table II.5-5

First City Bancorporation Subsidiary Banks, February 13, 1993

(\$ in Thousands)

	Bank Name, City, State	Resolution Assets	Resolution Deposits	Resolution Cost	Assets Passed	FDIC Assets	Res. Cost (%)
1	New First City, Texas-Tyler, Tyler, TX	\$254,063	\$225,916	\$0	\$244,573	\$9,490	0.00
2	New First City, Texas-San Angelo, San Angelo, TX	138,948	127,802	0	133,994	4,954	0.00
3	New First City, Texas-Midland, Midland, TX	312,987	289,021	0	302,502	10,485	0.00
4	New First City, Texas-Orange, Orange, TX	128,799	119,544	0	127,918	881	0.00
5	New First City, Texas-Houston, NA, Houston, NA	3,575,886	2,240,292	0	3,115,360	460,525	0.00
6	New First City, Texas-Madisonville, Madisonville, TX	119,821	111,783	0	119,132	689	0.00
7	New First City, Texas-Sour Lake, Sour Lake, TX	54,145	49,701	0	53,280	865	0.00
8	New First City, Texas-Lake Jackson, Lake Jackson, TX	102,875	95,416	0	100,729	2,147	0.00
9	New First City, Texas-Austin, Austin, TX	346,981	318,608	0	289,561	57,420	0.00
10	New First City, Texas-Graham, Graham, TX	94,446	85,667	0	93,505	941	0.00
11	New First City, Texas-El Paso, El Paso, TX	397,859	367,305	0	380,741	17,118	0.00
12	New First City, Texas-Kountze, Kountze, TX	50,706	46,481	0	50,584	122	0.00
13	New First City, Texas-Alice, Alice, TX	127,990	119,187	0	122,784	5,206	0.00
14	New First City, Texas-Aransas Pass, Aransas Pass, TX	54,406	49,806	0	52,495	1,910	0.00
15	New First City, Texas-Corpus Christi, Corpus Christi, TX	475,869	390,311	0	420,950	54,919	0.00
16	New First City, Texas-San Antonio, San Antonio, TX	262,538	244,960	0	235,164	27,374	0.00
17	New First City, Texas-Lufkin, Lufkin, TX	156,766	146,314	0	154,705	2,061	0.00

Table II.5-5

First City Bancorporation Subsidiary Banks, February 13, 1993

(\$ in Thousands)

Continued

	Bank Name, City, State	Resolution Assets	Resolution Deposits	Resolution Cost	Assets Passed	FDIC Assets	Res. Cost (%)
18	New First City, Texas-Beaumont, Beaumont, TX	\$531,489	\$489,891	0	\$514,907	\$16,582	0.00
19	New First City, Texas-Bryan, Bryan, TX	340,398	315,788	0	334,031	6,367	0.00
20	New First City, Texas-Dallas, Dallas, TX	1,324,843	1,224,135	0	1,171,946	152,897	0.00
Totals		\$8,851,815	\$7,057,928	\$0	\$8,018,861	\$832,953	0.00

Source: Division of Research and Statistics.



Potential acquirers of the failed First National Bank of Midland, Midland, Texas, meet with FDIC officials in Washington, D.C., to make their bids to assume the deposit liabilities of the closed bank. The successful bidder was RepublicBank First National Midland.



CHAPTER 6

First RepublicBank Corporation

Name of Institution:	First RepublicBank Corporation
Headquarters Location:	Dallas, Texas
Date of Resolution:	March 17, 1988
Resolution Method:	Open Bank Assistance Transaction
Date of Resolution:	July 29, 1988
Resolution Method:	Bridge Bank
Date of Resolution:	November 22, 1988
Resolution Method:	Stock Purchase Transaction

Introduction

First RepublicBank Corporation (First Republic), with \$33.4 billion in assets at the time of its resolution in July 1988, holds the dubious distinction of being the largest FDIC insured banking organization ever to fail.¹ First Republic, at an estimated cost to the FDIC of \$3.9 billion, was also the most costly resolution the FDIC has ever completed.

First Republic's resolution was notable in other respects. First, the FDIC granted interim assistance in the form of a six-month note for \$1 billion to First Republic's two lead banks in Dallas and Houston. The note was backed by the stock of all the solvent subsidiaries of First Republic, which was a condition of the interim assistance. The condition effectively functioned as a cross guarantee provision, allowing the FDIC to use value in the solvent banks in the holding company to offset some of the losses in the insolvent subsidiaries.

Second, for the first time since the FDIC assisted Continental Illinois National Bank and Trust Company (Continental), Chicago, Illinois, the FDIC explicitly assured all depositors and other general creditors of First Republic's banks that they would be fully protected against any loss.

Third, a bridge bank was formed for only the second time since the FDIC had obtained this authority.²

1. Continental Illinois National Bank and Trust Company (Continental), Chicago, Illinois, was slightly larger, but technically it did not fail. Refer to Chapter 4, Continental Illinois National Bank and Trust Company, for an explanation of the Continental case.

2. The FDIC used its bridge bank authority for the first time when Capital Bank & Trust Company, Baton Rouge, Louisiana, was closed on October 30, 1987. FDIC, *1987 Annual Report*, 6. See Part I, Resolution and Asset Disposition Practices, Chapter 6, Bridge Banks, for a full discussion of this subject.

Fourth, troubled loans and real estate properties from the failed banks were placed in a special asset pool that was owned and administered by the assuming bank; all costs of operation and all losses on assets were paid by the FDIC.

Fifth, the FDIC used special powers obtained in the Garn–St Germain Depository Institutions Act (Garn–St Germain) of 1982, which allowed an out-of-state bank holding company to be selected as the acquiring institution.

Finally, the bid submitted by the acquiring bank was high enough to be least costly to the FDIC because of two special letter rulings the bidder had received from the U.S. Internal Revenue Service (IRS); the other potential acquirers were not aware of those IRS rulings. The letter rulings allowed the acquirer to treat the acquisition as a tax-free reorganization and to carry forward losses from the failed banks to offset future income. The letter rulings were controversial after the fact and led to changes in the way the FDIC evaluates bids from potential acquirers.

General Description of the Corporation

On March 31, 1988, First Republic was the 14th largest bank holding company in the United States, with 40 subsidiary banks and more than 160 banking offices throughout Texas.³ It was the largest banking organization headquartered in Texas and in the Southwest. First Republic also owned a credit card bank in Delaware. Most of the subsidiary banks had federal charters and were regulated by the Office of the Comptroller of the Currency (OCC). First Republic's subsidiary banks had a strong presence in the market areas of Austin, Dallas, Fort Worth, Houston, and San Antonio. The approximate share of bank deposits held by the First Republic banks on a city-wide basis, as of March 31, 1988, was as follows: Dallas, 34 percent; Austin, 29 percent; Fort Worth, 19 percent; San Antonio, 10 percent; and Houston, 8 percent. In total, the First Republic system had deposit accounts numbering approximately 2.2 million, of which 780,000 accounts were in the Dallas area banks.

The First Republic banks maintained major correspondent relationships with almost 1,100 banks across the United States, primarily in the Southwest. In its correspondent relationships, the First Republic banks acted as depositories for their correspondents and provided check clearing; wire transfers of funds; loan participations; and custodial, clearance, and investment advisory services.

In addition to maintaining deposit relationships, the First Republic system, as a whole, held 20 percent of the loans made by commercial banks in Texas. It also had approximately 125,000 loan customers and unfunded loan commitments of more than

3. House Committee on the Budget, *Report on FDIC Bailouts of First Republic and Mcorp Banks*, 99th Cong., 1st sess. (January 1991), 8.

\$9.1 billion. The trust departments represented the largest trust operation in the Southwest, managing more than \$50 billion in assets for more than 25,000 customers.

Background

First Republic was the result of a merger between two large bank holding companies, RepublicBank Corporation (RepublicBank), Dallas, Texas, with \$20.9 billion in assets, and InterFirst Corporation (InterFirst), Dallas, Texas, with \$18 billion in assets. At the time of the merger on June 6, 1987, RepublicBank and InterFirst were the second and third largest bank holding companies, respectively, in Texas. The merger that created First Republic, the largest bank holding company in the Southwest and the 11th largest banking group in the United States, was completed only nine months before First Republic obtained interim open bank assistance from the FDIC.⁴

RepublicBank began having difficulties in the mid-1980s because of the failing economy in the Southwest. The energy market declined, followed by the real estate and agriculture markets. The market declines severely affected the financial industry in Texas and the rest of the Southwest. During the mid-1980s, commercial real estate and the related construction industry were two of the weakest sectors of the Texas economy. At the end of 1987, Dallas and Houston had commercial office real estate vacancy rates of approximately 30 percent and, combined, had more than 87 million square feet in unoccupied office space. Real estate experts indicated that it would take four to five years to absorb the inventory of vacant office space. The residential real estate market in Texas was also weak.

The merger of the two bank holding companies was aimed primarily at assisting InterFirst, which had reported a net loss of \$326.5 million for 1986. After the merger, however, it was discovered that RepublicBank's subsidiary banks were suffering, too, as a result of (1) poor management and inadequate supervision from their respective boards of directors, (2) inadequate accounting systems, (3) poor asset quality, (4) continuing deterioration of assets, (5) an inadequate internal problem loan identification process, (6) escalating loan losses, and (7) an inability to attract sufficient funding. Both RepublicBank and InterFirst had high concentrations of real estate loans; InterFirst had problem energy loans, as well. At year-end 1986, both institutions had more than 36 percent of their loan portfolios in real estate.

Not only was RepublicBank's subsidiary banks' management slow to recognize its problems and write off nonperforming loans, it also used a variety of techniques to prop up the value of its real estate loan portfolio. For example, it did not keep its appraisals current, even though real estate values were falling 10 percent to 15 percent a year. That meant that the file appraisals did not reflect any loss in value. In addition, the banks'

4. James R. Kraus, "The First Republic Rescue," *American Banker* (August 2, 1998), 3.

management used above-market rents, below-average vacancy rates, and low discount rates to generate false future cash flow projections. Both InterFirst and RepublicBank's subsidiary banks advanced additional funds to troubled borrowers to pay interest and keep loans current.

By the end of 1987, barely six months after the merger, regulators required the First Republic banks to recognize their troubled loans. In late January 1988, First Republic disclosed that the company would suffer a net loss of \$657 million in 1987, primarily as a result of deterioration in the Texas real estate market and the establishment of significant reserves on loans to less developed countries. The company announced that \$3.9 billion, or 16 percent of the loans in the First Republic system, were nonperforming as of year-end 1987. Nonperforming real estate loans totaled \$2.08 billion.⁵

The bad news significantly affected the company's funding. First Republic's overseas sources of funds evaporated. The lead banks in Dallas and Houston encountered significant funding problems and were forced to receive funds from other banks in the First Republic system to continue operating. Also, the First Republic banks were experiencing a decline in depositor confidence, and the banks suffered heavy losses of both demand deposit and correspondent business.

From December 1987 through early March 1988, the First Republic banks lost more than \$1.8 billion in deposits, thus creating a liquidity crisis. By March 15, 1988, First RepublicBank–Dallas, N.A. was forced to borrow \$2.6 billion from the Federal Reserve Bank of Dallas (Federal Reserve) and was on the verge of failure. Even worse, more than \$6 billion of affiliated bank funds were at risk in the Dallas bank; the failure of the Dallas bank would have forced a failure of a substantial number of affiliate banks. Any discontinuation of services for that many First Republic banks had the potential of seriously disrupting the Texas and Southwest financial market.

On March 16, 1988, because it was on the verge of failure, First Republic formally sought the FDIC's assistance. Customers were withdrawing funds, compounding a liquidity crisis for the bank. The withdrawals created an "electronic run" on First Republic.⁶

The Resolution—March 17, 1988

On March 17, 1988, the FDIC announced an interim assistance plan for First Republic.⁷ The plan had two components. First, the FDIC issued a statement worded almost exactly like the statement issued for Continental, announcing that the FDIC assured

5. Kraus, "The First Republic Rescue," 3.

6. The term "electronic run" refers to heavy customer withdrawals of funds by means other than going to the bank in person for the money. Wire transfers and withdrawals at automatic teller machines are two ways this can happen.

7. FDIC News Release, "FDIC Approves Assistance for Subsidiary Banks of First RepublicBank Corp., Dallas, Texas," PR-57-88 (March 17, 1988).

that “all depositors and other general creditors of First Republic’s banks [would be] fully protected and service to the banks’ customers [would] not be interrupted.”⁸ The statement specifically provided no assurance to creditors of the holding company and made no guarantee of interbank funding.⁹

Second, the FDIC provided a \$1 billion six-month loan to the Dallas and Houston banks in the First Republic system. The loan was subordinated to the claims of depositors and general creditors of the banks and bore interest at the six-month Treasury bill rate plus 50 basis points. The note was guaranteed by First RepublicBank Corporation and by the other First Republic banks. The loan was further collateralized by a pledge of First Republic Bancorporation’s shares of stock in 30 of its bank subsidiaries.¹⁰ The Federal Reserve Board also pledged to provide interim liquidity support as the resolution process developed.

Then-FDIC Chairman William L. Seidman later explained in his book *Full Faith and Credit* why the loan was given to the First Republic banks and not to the holding company, as had been done when the FDIC assisted Continental in 1984. “This difference was of great significance,” he wrote. “It removed the safety net from the billions of dollars of holding company debt. It reduced our insurance losses, disciplined the creditors of the holding company for their bad investment, and stabilized the banking system.”¹¹

After the assistance agreement, Albert V. Casey became the new chairman and chief executive of First RepublicBank Corporation. Casey had extensive experience as a newspaper executive, chairman of American Airlines, and U.S. Postmaster General. He had also served as a director of Republic Bank^{12,13}

The assistance plan slowed the withdrawal rate on deposit accounts, but the condition of the First Republic banks continued to deteriorate. In the first two quarters of 1988, the company reported a total loss of \$2.3 billion; common stockholders’ equity decreased from \$1.2 billion at year-end 1987 to a negative \$1.1 billion at June 30, 1988.¹⁴

After providing the interim assistance, the FDIC began contacting financial entities and individuals regarding their interest in an assisted transaction or restructuring of First Republic, on either an open bank or closed bank basis.¹⁵ Several of the entities the

8. FDIC News Release, PR-57-88.

9. The statement issued by the FDIC in the Continental transaction did not protect the creditors of the holding company. They were protected indirectly because of the structure of the assistance transaction.

10. FDIC, *1988 Annual Report*, 9-10.

11. L. William Seidman, *Full Faith and Credit: The Great S&L Debacle and Other Washington Sagas* (New York: Times Books, 1993), 150.

12. Seidman, *Full Faith and Credit: The Great S&L Debacle and Other Washington Sagas*, 151.

13. Albert V. Casey became the first President of the Resolution Trust Corporation (RTC) in October 1991, and was named the RTC’s Chief Executive Officer on February 1, 1992.

14. Kraus, “The First Republic Rescue,” 3.

15. Refer to Part I, Resolution and Asset Disposition Practices, Chapter 3, Evolution of the FDIC, for a discussion of the various closed bank and open bank transactions.

FDIC approached were major bank holding companies. Some potential bidders contacted the FDIC on their own. The FDIC never issued a formal solicitation for potentially interested bidders.¹⁶ The publicity generated by the assistance agreement, however, made it clear to all banking entities that the FDIC would be accepting bids.¹⁷ Among the bidders were Citicorp, New York, New York; Wells Fargo & Co., San Francisco, California; and NCNB Corporation (NCNB), Charlotte, North Carolina.

In April 1988, the FDIC received a proposal from NCNB for the restructuring and acquisition of First Republic's bank subsidiaries. The proposal suggested that the FDIC establish a bridge bank for all the First Republic subsidiary banks, and then engage NCNB to manage the bridge bank. NCNB's proposal also included a capital injection for the banks from NCNB, along with other funds to be provided by the FDIC. Although the FDIC Board of Directors rejected NCNB's proposal, they continued negotiations with the company.

At about the same time, the FDIC was notified that First Republic was developing its own recapitalization plan, with the assistance of Drexel Burnham Lambert, Inc. The First Republic proposal would have allowed First Republic to operate as an independent, Texas-owned institution, supported with an advance from the FDIC. The plan was to rescue the entire First Republic holding company, plus the banks, by raising new capital from outside investors.¹⁸ On July 20, 1988, Casey, First Republic's new chairman, told a reporter from *The Dallas Morning News*, "We had hoped for a favorable decision on our plan by now, but the FDIC has required additional time to study all available options. We remain confident that the First RepublicBank plan is the most viable of these options and will ultimately be accepted."¹⁹

After receiving several bids, the FDIC went through a two-step process to evaluate the bids. First, it determined which bids were viable. Second, each viable bid was analyzed by determining and evaluating its effect on the banking system, its cost to the FDIC insurance fund, and the capabilities of the bidding institution's management. In July 1988, the FDIC Board of Directors reviewed details of bids submitted to date. The FDIC selected July 25, 1988, as the date for submission of final bids.

During the bid submission period, NCNB requested and received two private letter rulings from the IRS. The rulings would result in NCNB's receiving an estimated \$1 billion in tax benefits if it acquired the First Republic banks. The first ruling was applied for on May 30, 1988, and issued June 10, 1988. After the first ruling was issued, NCNB applied for a supplemental ruling that was issued on July 28, 1988, the eve of the FDIC's selection of NCNB as the acquirer of the First Republic banks. The two tax rul-

16. House Committee on the Budget, *Report on FDIC Bailouts of First Republic and MCorp Banks*, 99th Cong., 1st sess. (1991); James E. Heath, FDIC Division of Research and Statistics, *Bank Failures (Texas)*, working paper (1997), 35.

17. David LaGesse, "First Republic Decision Awaited," *The Dallas Morning News* (July 18, 1988), 1D.

18. Seidman, *Full Faith and Credit: The Great S&L Debacle and Other Washington Sagas*, 152.

19. Jim Mitchell, "Losses Plague Bank," *The Dallas Morning News* (July 20, 1988), 1D.

ings indicated that, should NCNB acquire the First Republic banks, it would be able to treat the transaction as a tax-free reorganization and carry forward the losses from the failed First Republic banks to offset future income.²⁰ The rulings allowed NCNB to offer the FDIC a higher premium for the First Republic banks because the tax savings represented an “asset” that the other bidders had not recognized. On July 27, 1988, FDIC staff reported to the board of directors that an analysis of the NCNB bid estimated costs of \$1.4 billion to \$2.6 billion to the FDIC. The FDIC selected NCNB’s bid because it was the least costly to the deposit insurance fund of all the proposals received.

The rulings issued to NCNB by the IRS were known to the FDIC, but not to the other bidders. A discussion emerged at the FDIC about whether to treat the NCNB letter rulings as proprietary information or to disclose them to other bidders. It was decided not to disclose them, because the FDIC keeps all bidders’ information confidential.²¹

The FDIC also did not discount the value of the tax benefits in weighing the competing bids. The tax savings to NCNB represented money foregone by the U.S. Treasury, and were, therefore, a cost to the government. That was a significant issue, especially in light of what was taking place in the Federal Savings and Loan Insurance Corporation (FSLIC) in 1988. Because the FSLIC’s deposit insurance fund was insolvent, all costs in its transactions for resolving the failed savings and loans came from the government. Under provisions of the Federal Deposit Insurance Act, the FDIC was not obligated to estimate the cost of its options from a taxpayer’s perspective. Instead, the FDIC was required only to consider costs to the insurance fund. On that basis, the FDIC evaluated the NCNB offer as the least costly to its insurance fund.²² Therefore, the potential tax benefit to NCNB permitted NCNB to be the high bidder; the letter rulings played a significant, if not critical, role in NCNB’s successful bid for the First Republic banks.²³

Out-of-state bank holding companies normally would not have been eligible to acquire Texas banks because of then existing state statutory restrictions on interstate branching. The federal Garn–St Germain Act, however, provided the FDIC with the authority to permit out-of-state bidders to be eligible to purchase First Republic, which the FDIC Board of Directors approved on July 29, 1988.²⁴

20. *Report on FDIC Bailouts of First Republic and MCorp Banks*, 13-14, 21-24, 51-52; Heath, *Bank Failures (Texas)*, 35-36.

21. *Report on FDIC Bailouts of First Republic and MCorp Banks*, 23.

22. *Report on FDIC Bailouts of First Republic and MCorp Banks*, 16.

23. *Report on FDIC Bailouts of First Republic and MCorp Banks*, 54; Heath, *Bank Failures (Texas)*, 37.

24. To qualify under the Emergency Interstate Acquisition provisions, a bank had to be a closed bank (with the FDIC as receiver) with total assets of \$500 million or more; or it had to be a bridge bank that had assumed deposits in one or more closed banks that had total assets aggregating \$500 million or more.

The Resolution—July 29, 1988

On July 29, 1988, the FDIC notified the OCC that its \$1 billion loan to two of the First Republic banks would not be renewed. The OCC notified the Federal Reserve Bank that First RepublicBank-Dallas, N.A., was no longer viable, and the Federal Reserve then requested repayment of the Dallas bank's borrowings. When the bank was unable to pay, it was declared insolvent and closed by the OCC. The closing of the Dallas bank was an event of default under the open bank assistance terms, and the FDIC demanded immediate repayment of its \$1 billion interim loan that had been made in March and had been guaranteed by the other First Republic banks. The amount of the banks' guarantee was charged against their capital accounts. That charge, along with losses on interbank funding, rendered the other banks in the First Republic system insolvent, and they, too, were ordered closed.²⁵ Only First Republic's credit card subsidiary bank, First RepublicBank Delaware, remained open and under the control of the holding company.²⁶

The FDIC approved the assisted acquisition by NCNB of the First Republic banks. It announced NCNB's bid as the most effective, most viable, and least costly approach for preserving existing banking services in the affected communities and as for providing stability to the Texas banking system.²⁷ The FDIC and NCNB entered into an agreement in principle on July 29, 1988, for the purchase of the First Republic banks by NCNB. The FDIC decided to use authority granted to it by the Competitive Equality Banking Act (CEBA) of 1987 to create a bridge bank, called NCNB Texas National Bank (NCNB-TNB), which NCNB agreed to manage until the transaction could be finalized.²⁸ The bridge bank purchased all assets and assumed all deposits and certain other nondeposit liabilities from the failed banks. The FDIC agreed that the assurances given in March—that the depositors and other general creditors of the First Republic banks would be fully protected—would remain in force.

First Republic Chairman and Chief Executive Casey expressed his feelings about the FDIC's rejection of First Republic's open bank assistance proposal: "We are extremely disappointed that our plan was not accepted, ...but we wish NCNB every success and pledge our complete cooperation."²⁹

Two aspects of the First Republic transaction deserve mention. First, the closing of the 40 First Republic banks comprised the largest number of banks ever closed in one

25. "Regulators Spell Out Terms of the Recapitalization," *American Banker* (August 2, 1988), 16.

26. The Delaware bank was closed on August 2, 1988, and the FDIC placed it in a separate bridge bank.

27. FDIC, OCC, and FRS Joint News Release, "Regulators Announce Approval of Acquisition of Subsidiary Banks of First RepublicBank Corporation, Dallas, Texas, by NCNB Corporation, Charlotte, North Carolina," PR-148-88 (July 29, 1988), 1.

28. For a complete description of this subject, see Part I, Resolution and Asset Disposition Practices, Chapter 6, Bridge Banks.

29. David LaGesse, "NCNB Acquiring First Republic," *The Dallas Morning News* (July 30, 1988), 1A.

day. Second, because each bank was an individual institution, the FDIC had to prepare closing and sale (bridge bank) documents for all 40 institutions. Organizing the 40 closings represented an enormous task, and the FDIC staff numbered in the hundreds.

The actions of declaring the First Republic banks insolvent and forming a bridge bank meant that the stockholders and bondholders of First Republic were essentially “wiped out.”³⁰ The FDIC’s newly acquired bridge bank authority allowed it to avoid the undesirable features of open bank assistance including the time-consuming process of accepting proposed rescue plans that would require resolving large banks by obtaining the approval of stockholders and bondholders. The bridge bank authority was important because “[t]he FDIC wrestled with those parties at length in securing the \$1.5 billion rescue of First City Bancorporation of Texas, Inc. . . .” the previous April.³¹

Joseph M. “Jody” Grant, then the chairman and chief executive officer of Texas American Bancshares, Inc., recalls speaking with former FDIC Chairman William M. Isaac in March 1988, when the FDIC had given its \$1 billion loan to the First Republic banks. (Mr. Isaac had left the FDIC before that date.)

Bill Isaac had told the . . . working group at the meeting on March 14 that he had urged the First Republic management not to accept the FDIC’s \$1 billion loan and not to pledge the stock of all the solvent subsidiary banks as security for the loan. The disastrous consequence of their failure to follow his advice was now evident. Demanding payment of the \$1 billion note, which was guaranteed by the solvent subsidiaries, was a critical element in the sequence of steps in the takeover by the FDIC, as it triggered the insolvency of all the subsidiaries.³²

The July 29, 1988, agreement in principle was finalized on November 22, 1988, in a stock purchase transaction. Before final resolution, the bridge bank was converted to stock ownership form, and the capital stock of the bridge bank was “issued” under the terms of the assistance agreement dated November 22, 1988. The new holding company, NCNB Texas Bancorporation, purchased 2 million shares of common stock, and the FDIC purchased 8 million shares of Class B nonvoting common stock. At the same time, the FDIC and NCNB entered into a shareholders agreement that, among other things, granted NCNB the exclusive right for a period of five years to purchase any or all of the FDIC’s shares.

Because the transaction was completed within the bridge bank structure, the bridge bank continued to exist until NCNB purchased the FDIC’s equity position. The bridge

30. LaGessee, “NCNB Acquiring First Republic,” 1A.

31. LaGessee, “First Republic Decision Awaited,” 1D

32. Joseph M. Grant, *The Great Texas Banking Crash: An Insider’s Account* (Austin: University of Texas Press, 1996), 145.

bank, operating under the control of NCNB, lasted for a little more than a year, from July 29, 1988, to August 9, 1989.

On November 22, 1988, the FDIC, NCNB, NCNB Texas Bancorporation, and NCNB-TNB entered into a financial assistance agreement designed to capitalize and stabilize the new bank. Major elements of the transaction were as follows:³³

- Approximately \$24.7 billion in assets and \$19.5 billion in liabilities were acquired by the new bank, NCNB-TNB.³⁴
- As part of the initial capitalization, the FDIC purchased 100 percent (8 million shares) of NCNB-TNB nonvoting common stock for \$840 million. NCNB Texas Bancorporation (100 percent owned by NCNB) purchased 100 percent (2 million shares) of NCNB-TNB voting common stock for \$210 million. Thus, the FDIC retained an 80 percent equity, 100 percent nonvoting interest in the bank. The total equity infusion of \$1.05 billion provided the new bank a minimum of 6 percent primary capital.
- NCNB Texas Bancorporation received an exclusive, nontransferable option, exercisable at any time during the first five years, to purchase the FDIC's 80 percent equity interest. NCNB Texas Bancorporation agreed to pay the FDIC a premium over the book value of the bank's stock when purchased. During the first three years, the exercise price per share was the amount of the FDIC's original investment per share plus 115 percent of the net increase in book value per share. The premium increased to 120 percent in the fourth year of the option and to 125 percent in the fifth year.
- NCNB-TNB took on the ownership of and responsibility for administering and collecting the problem assets; it segregated into a separate asset pool approximately \$9.2 billion of troubled loans, real estate properties, and other distressed assets. The segregated pool's assets were written down to market value. NCNB-TNB assigned a full-time, dedicated management team to collect and liquidate the assets in the special asset pool.
- The FDIC funded the negative equity that resulted from the writedown to market value of assumed assets and liabilities. To accomplish that funding, the FDIC assumed \$1 billion of the bridge bank's debt to the Federal Reserve. The FDIC also forgave \$131.8 million of the bridge bank's \$300 million debt to the FDIC under a revolving credit agreement. NCNB-TNB paid the balance of that debt on January 11, 1990. The FDIC's initial outlay as of November 22, 1988, was \$2.1 billion, including the \$1 billion loaned to First Republic in March of that same year.

33. Major elements of the financial assistance agreement are taken from FDIC, *1988 Annual Report*, 48-50.

34. The name of the bridge bank, NCNB Texas National Bank, was not changed until August 1989, when NCNB completed the purchase of the FDIC's stock.

After implementation of the final agreement and while NCNB was still a minority owner, it managed the bridge bank substantially as if it were an NCNB subsidiary. Under the agreement, however, NCNB was required to consult with the FDIC regarding decisions on business operations and strategies and provide certain reports to the FDIC. The overall transaction was very profitable for NCNB. Although other banking entities had equal opportunity to bid on the First Republic banks and to purchase them, critics have called the FDIC's agreement with NCNB the "deal of the century."³⁵ NCNB's chairman, Hugh L. McColl, Jr., apparently considered the terms of its agreement with the FDIC so generous that he reportedly boasted, "Candidly, I think we paid zero for First Republic."³⁶

The transaction created enormous profitability for NCNB-TNB. It was estimated that NCNB would receive tax savings of \$700 million. For year-end 1989, NCNB-TNB reported net income of \$308.8 million, or 50 percent of NCNB's total earnings. On the day the First Republic transaction was announced, NCNB's stock was trading at \$23.375 per share; one year later, the stock had more than doubled to \$53 per share. Those profits propped up NCNB at a time when the performance of NCNB as a whole was slumping.

The First Republic transaction and its resulting profits for NCNB had a tremendous impact on the Texas banking industry. Because NCNB's profits were largely shielded from taxes, NCNB could afford to pay higher interest rates on deposits and charge lower rates for loans. NCNB's market dominance in Texas grew considerably, at the expense of other struggling banks in Texas. "The government has created a monster," said Chris Williston, then the president of the Texas Independent Bankers Association. He further stated that the "tax breaks allow NCNB to engage in predatory pricing, and it is having anticompetitive effects in Texas."³⁷

NCNB did not assume any obligations of the failed banks' holding company. The obligations of the failed banks' parent companies, First Republic and 1FRB Corporation (the parent of InterFirst), included approximately \$1.2 billion in debt and preferred stock. Use of the bridge bank structure separated the obligations of the failed banks' holding company from the debts of the banks. Because the First Republic banks were closed and placed in receiverships, no claims could be presented against the bridge bank. Had the FDIC provided open bank assistance to First Republic, as its management team had requested, it might have been necessary to pass any operating profits to the parent companies to service the parent companies' debt.

First Republic and 1FRB Corporation filed Chapter 11 bankruptcy on July 31, 1988, seeking to shield the companies' remaining assets from creditors, including their bondholders. First Republic indicated that it might emerge with a plan to repay its

35. *Report on FDIC Bailouts of First Republic and MCorp Banks*, 2.

36. *Report on FDIC Bailouts of First Republic and MCorp Banks*, 2; Heath, *Bank Failures (Texas)*, 40.

37. Steve Klinkerman, "Tax Breaks Seen Giving NCNB an Unfair Edge in Texas Market," *American Banker* (July 24, 1990), 16; Heath, *Bank Failures (Texas)*, 43-44.

debts, but First Republic chairman and chief executive Casey downplayed the probability of that: “There will be so many claims against the company, I just can’t say if there’ll be anything left.”³⁸ At the time of the bankruptcy filing, First Republic still retained First RepublicBank Delaware, which had not been closed by the state of Delaware. That institution subsequently was closed by the state on August 2, 1988, and placed in a bridge bank by the FDIC. The Delaware bridge bank was sold to Citibank (Delaware), New Castle, Delaware, on September 9, 1988, and not to NCNB because First Republic had arranged the sale to Citibank before the failure of the banks.³⁹

The tax breaks resulting from the IRS letter rulings created an incentive for investment in NCNB; those investments then attracted additional investors. The increased investment enabled NCNB to buy out the FDIC’s ownership interest during the first year of its five-year exclusive option. In April 1989, NCNB purchased 29 percent of the FDIC’s nonvoting stock in NCNB-TNB, which increased NCNB’s ownership interest to 49 percent. On August 9, 1989, NCNB purchased the remaining 51 percent interest in NCNB-TNB from the FDIC. In the end, NCNB paid the FDIC a total of \$1.1 billion for all the stock, which resulted in a gain of \$275 million for the FDIC.⁴⁰

Before NCNB’s acquisition of the First Republic banks, NCNB was ranked as the 18th largest banking organization in the nation, with \$26.8 billion in assets.⁴¹ With the completion of the Texas acquisition, NCNB Corporation nearly doubled in size to become the nation’s 10th largest bank holding company, with total assets of \$55 billion.⁴²

The Liquidation

The amount of adversely classified assets initially included in the special asset pool had an estimated market value of \$6.1 billion, which was reflective of a 33 percent markdown from the 1988 year-end book value of \$9.1 billion.⁴³ In addition, the agreement allowed NCNB-TNB to return an unlimited amount of the failed banks’ assets during 1989 and a maximum of \$750 million in 1990.⁴⁴ The additional assets transferred into the pool over the two-year “put” period had a total book value of \$1.9 billion and an estimated market value of \$1.6 billion. Together with the original transfer of \$9.1 billion in book value, that \$11 billion in assets represented approximately one-third of the

38. David LaGessee, “First Republic Announces Chapter 11 Filing,” *The Dallas Morning News* (August 2, 1988), 1D.

39. FDIC, *1988 Annual Report*, 10.

40. FDIC, *1989 Annual Report*, 90.

41. David LaGessee, “Fate of First Republic to Be Decided,” *The Dallas Morning News* (July 29, 1988), 1A.

42. LaGessee, “NCNB Acquiring First Republic,” 1A.

43. FDIC, *The Cost of Large Resolution Transactions* (March 12, 1996).

44. *Report on FDIC Bailouts of First Republic and MCorp Banks*, 27.

First Republic banks' assets before failure and, at that time, was equal to nearly 40 percent of the total liquidation assets owned by the FDIC.

NCNB-TNB owned the assets in the pool and retained management and administrative responsibility for the pool. Management and employees of NCNB-TNB's Special Asset Division worked those loans exclusively and had no other bank-related duties.⁴⁵ The FDIC retained responsibility for market value declines and for NCNB-TNB's servicing expenses, incurring a significant financial stake in the operations of the asset pool. Termination of the asset pool settlement was set to occur after five years, on November 22, 1993. The FDIC had agreed to purchase the remaining unliquidated assets in the pool at fair market value and settle with NCNB for asset pool administration costs.

The servicing agreement was administered and monitored under the guidance of an on-site FDIC oversight committee, which consisted of two senior representatives of the FDIC and one senior member of NCNB-TNB. The committee had unlimited asset disposition authority, and although the Special Asset Division had been delegated the authority to resolve assets of less than \$5 million in book value, the oversight committee still retained the authority over approximately 75 percent of the dollar volume of all asset disposition decisions. The FDIC conducted financial compliance reviews on the servicer to ensure its compliance with the FDIC's policies and procedures.

The expenses covered by the FDIC included the costs of managing and administering the special asset pool, allocated overhead expenses of NCNB-TNB, and the cost of funding the assets, according to NCNB-TNB's average cost of interest-bearing funds. Those asset funding costs alone during the 21-month period from January 1, 1989, through September 30, 1990, were \$660.8 million. In addition, during 1989, the FDIC paid approximately \$248 million in overhead expenses for the servicing of those assets.⁴⁶ The servicing agreement proved to be a major source of income for NCNB-TNB, which created an incentive for the bank to hold the assets in anticipation of a market upturn rather than liquidate them. In October 1989, the FDIC's independent auditor reviewed the expenses associated with the pool. The auditor concluded that the arrangement provided no incentive for NCNB-TNB to control its expenses because it was fully reimbursed for them.⁴⁷

NCNB-TNB's management incentive fee was tied to gross collections on the pool and limited to \$48 million for the five-year term of the contract; that cap was achieved after only two years. The servicing contract that the FDIC renegotiated in July 1990 included provisions to align the interests of the bank more closely with those of the FDIC. The new formula for the incentive fees was based on net, rather than gross, collections, with net collections defined as gross collections less allowable expenses. Under the new formula, NCNB-TNB received one-half of 1 percent of gross collections, plus a sliding

45. *Report on FDIC Bailouts of First Republic and MCorp Banks*, 27, 29.

46. *Report on FDIC Bailouts of First Republic and MCorp Banks*, 3, 29.

47. *Report on FDIC Bailouts of First Republic and MCorp Banks*, 3-4; Heath, *Bank Failures (Texas)*, 41-42.

fee of 3 percent to 7 percent of net collections, which discouraged speculative holding of the assets and minimized expenses.⁴⁸ Because of the nature of the assets remaining in the pool, the termination date was moved up by two years to November 22, 1991.

In November 1991, NCNB exercised its option for the FDIC to repurchase the remaining assets in the pool for \$2.5 billion. The assets consisted of an adjusted pool value of \$1.9 billion for the assets, and a deferred settlement account of \$600 million for expenses and compensation. Over the life of the contract, gross collections were \$8.6 billion, and net collections were \$7.1 billion. As of December 31, 1996, the FDIC had terminated 33 of First Republic's 41 receiverships.

Shareholder Litigation

After the banks failed, First Republic's bondholders immediately filed court challenges against the FDIC. The suit alleged that both the March 1988 interim assistance transaction and the July 1988 bridge bank transaction exceeded the FDIC's statutory authority. The suit sought, among other things, to prevent the FDIC from pursuing, in First Republic's bankruptcy, its claim for the \$1 billion loan; to void guarantees of the loan by the holding company; and to recover the value of the First Republic subsidiary banks whose assets were transferred to NCNB-TNB.⁴⁹

The litigation further challenged the FDIC's ability to fully protect third-party creditors of a failed bank without treating affiliated creditors equally. In the case of First Republic, the FDIC arranged a resolution transaction whereby all depositors and third-party creditors received all their funds; however, the recovery on the loans from the affiliated banks to the failed lead bank was limited to their pro rata interests in the failed bank's receivership estate. The FDIC estimated that interest to be about 78 percent of the full amount those banks were owed.

Similar suits subsequently were filed against the FDIC by creditors of MCorp and Texas American Bancshares, Inc. (TAB).⁵⁰ The court in the MCorp and TAB suits initially ruled against the FDIC, but the court in the First Republic case did not rule on the claims. It merely noted that, notwithstanding the decisions in the other two cases, the FDIC's arguments had "considerable force."⁵¹

The issue was directly appealed by the FDIC to the Fifth Circuit Court, which reversed the ruling of the lower court. The court expressly held that the FDIC is obligated to pay creditors only the amount realized in liquidation, and that additional pay-

48. *Report on FDIC Bailouts of First Republic and MCorp Banks*, 32.

49. FDIC, *1988 Annual Report*, 22.

50. MCorp, Dallas, Texas, failed on March 28, 1989. Texas American Bancshares, Inc., Fort Worth, Texas, failed on July 20, 1989.

51. FDIC, *1990 Annual Report*, 28-29.

ments from the insurance fund can be preferred among creditors at the FDIC's discretion. Congress subsequently enacted the intent of that ruling into the Financial Institutions Reform, Recovery, and Enforcement Act (FIRREA) of 1989.

The First Republic bankruptcy was resolved in late 1990. The FDIC recovered approximately \$158.7 million, plus interest, for its claims on the \$1 billion loan and the guarantees of the other banks in the First Republic system.⁵²

The Stock Transactions

On November 22, 1988, to help capitalize the new institution, the FDIC purchased 8 million shares (100 percent) of NCNB-TNB nonvoting common stock for \$840 million (about \$105 per share). In April 1989, NCNB purchased 2.9 million shares of the FDIC's nonvoting stock in NCNB-TNB, at approximately \$107 per share, for a total of \$309.7 million, which represented a gain to the FDIC of \$5.1 million. In August 1989, NCNB purchased the remaining 5.1 million shares of the FDIC's stock for \$800 million, or about \$157 per share, which represented a gain to the FDIC of \$264.5 million. NCNB paid the FDIC \$480 million in cash and gave a note in the amount of \$320 million for the balance. The note was paid in full in January 1990. On January 31, 1991, the FDIC received prior years' dividends of \$4.7 million for the period during which it held the stock. In all, NCNB paid the FDIC a total of \$1.115 billion for all the stock, producing (with the dividends) a total gain of \$275 million for the FDIC. A summary of the stock transactions is shown in table II.6-1.

FDIC Resolution Costs

The First RepublicBank transaction was the most costly bank failure ever handled by the FDIC. As of December 31, 1995, the total cost of that transaction was approximately \$3.86 billion. Much of that cost was due to the poor condition of the bank's assets and the ongoing weakness in the Texas economy. Of the \$33.4 billion in total assets at failure, approximately \$12 billion in problem assets were assigned to the pool and managed by NCNB-TNB.

In total, more than \$2.2 billion of the total resolution cost were spent to reimburse NCNB-TNB for the initial and subsequent writedowns to market value. Another \$1.9 billion were spent on expenses and compensation pertaining to the asset management contract. Finally, approximately \$113 million in additional losses on the assets from the special asset pool subsequently were purchased by the FDIC, and about \$40 million were expensed for litigation, interest, indemnification, and other expenses. In all, those

52. FDIC, *1990 Annual Report*, 28-29.

Table II.6-1

A Summary of the FDIC's Stock Transactions in the Resolution of the First Republic Subsidiary Banks

(\$ in Thousands)

Date	Trans action	Beginning Number of Shares	Shares Sold, Written Down, Converted	FDIC Stock/Equity Investment	FDIC Proceeds from Sales	FDIC Book Value of Transaction	Gain or Loss on Transaction	FDIC Dividend Income
Nonvoting Common Stock								
11/22/88	Original purchase	8,000,000		\$840,000				
04/29/89	Sale to NCNB		(2,900,000)		\$309,682	\$304,500	\$5,182	
08/09/89	Sale to NCNB		(5,100,000)		800,000	535,500	264,500	
01/31/91	Prior years' dividends through 1990							\$4,736
	Totals	8,000,000	(8,000,000)	\$840,000	\$1,109,682	\$840,000	\$269,682	\$4,736

Source: FDIC, *Equity Investment Portfolio, Bank Insurance Fund*, December 31, 1993.

expenses totaled approximately \$4.3 billion. Offsetting the expenses were recoveries to the FDIC of approximately \$420 million, including \$275 million in gains from the sale of the FDIC's equity in NCNB-TNB. While that gain was a significant return on the FDIC's equity position, it was still a relatively small return when compared to the FDIC's overall expenses on the transaction. The total cost to the FDIC for the First Republic resolution is shown in table II.6-2.

The federal government also incurred other costs over and above those incurred by the FDIC. Those costs resulted from the favorable tax treatment that NCNB-TNB received, which resulted in sizeable tax savings. The tax savings represented money foregone by the U.S. Treasury and were, therefore, a cost to the federal government.

Issues and Lessons Learned

The FDIC learned several positive lessons from the First Republic resolution. First, the FDIC's relatively new bridge bank authority proved to be extremely helpful in providing a mechanism for dealing with a large failing institution. The formation of a bridge bank for First Republic enabled the FDIC to proceed to resolution quickly. The FDIC had

Table II.6-2**First RepublicBank Corporation Resolution Costs**

(\$ in Millions)

FDIC's Expenses	
Funding for mark-to-market valuations	\$2,232
Special asset pool costs and deferred settlement costs	1,887
Loss on corporate purchase of special asset pool assets	113
Indemnification, litigation, and other costs	42
Total Expense	\$4,274
FDIC's Recoveries	
Stock purchase gains	\$275
Delaware claim recovery	143
Total FDIC Recovery	\$418
FDIC's Total Resolution Costs	\$3,856

Sources: FDIC, *The Cost of Large Resolution Transactions* (March 12, 1996);
FDIC Division of Finance; FDIC Division of Research and Statistics.

struggled for more than seven months to put together an open bank assistance transaction for the subsidiaries of First City Bancorporation of Texas, Inc., and did not want to go through negotiations of that type again.⁵³

Second, the interstate acquisition provisions allowed by the Garn–St Germain legislation once again proved their value. Few banks in Texas had the ability to acquire banks the size of First Republic. Nationwide competition was needed to ensure the presence of multiple bidders.

Third, the financial benefit associated with taking an equity position was shown when the FDIC realized a \$275 million gain on its NCNB-TNB stock. That point should not be overstated, though, because the overall resolution, of which this was just one part, was the costliest in the FDIC's history.

Fourth, some evidence indicated that market discipline still existed in the post-Continental banking industry. When First Republic's losses began to grow, deposits began a rapid exodus from the banks. That suggests that, although the typical failed bank resolution involved full protection of all depositors and other general creditors, there was not enough certainty of that result for complacency to exist among those who were uninsured.

53. See Chapter 5, First City Bancorporation of Texas, Inc.

Fifth, the structure of the earlier interim assistance resulted in all the banks in the holding company providing support to the insolvent banks. The failure of the lead bank in Dallas was an event of default under the terms of the interim assistance, and the FDIC called the guarantees, but the banks were unable to pay. Those banks were, in turn, declared insolvent and closed. Because all the banks in the holding company became insolvent when the guarantee was called, it was doubtful that solvent affiliated institutions would sign such a guarantee in the future. Therefore, the cross guarantee authority granted by FIRREA in 1989 was a critical provision for the FDIC to recover some of its costs for failing banks from other banks in the same holding company.

Some of the other results from the First Republic transaction were not as favorable. First, the transaction was extremely costly for the FDIC. Much of the cost was inherent in the banks' poor condition and ongoing economic weakness in Texas. Some parts of the transaction, however, could have been structured better. For example, because of the FDIC's liquidity concerns, NCNB funded the bad assets with reimbursement from the FDIC. The problem was that NCNB had a higher cost of funds than did the FDIC. The difference raised the overall cost of the transaction. While the FDIC's liquidity concerns perhaps necessitated the structure as originally designed, the result provides support for the view that a deposit insurance fund needs adequate sources of liquidity to enable it to focus on minimizing costs. Also, the asset management contract proved to have some room for improvement. The asset manager did not have sufficient incentives built into the contract to control costs or to liquidate the assets. Eventually, that contract was restructured to address those issues, and subsequent contracts were designed to better align the interests of the servicers with the interests of the FDIC.

Second, substantial additional costs to the federal government exceeded those incurred by the FDIC. Those costs came from the favorable tax treatment received by NCNB. Under then existing law, the FDIC was required only to consider costs to the deposit insurance fund. That policy was changed with the passage of FIRREA in 1989. The FDIC is now required to offset taxes foregone by the U.S. Treasury in determining the least costly resolution.

Third, the FDIC's authority to treat creditors in like classes differently was unclear, leading to costly litigation. In the First Republic transaction, the FDIC provided full protection to all depositors and other third-party general creditors, but did not provide similar protection to the affiliated banks that lent funds within the holding company. The FDIC's position was that affiliated banks that lent funds to the failed lead bank should receive at least, but not more than, their pro rata shares of receivership proceeds.

Litigation on that issue in the First Republic transaction was resolved favorably for the FDIC, and unfavorable rulings in the litigation arising from the MCorp and the TAB resolutions were overturned on appeal. In 1989, FIRREA included a provision ratifying the FDIC's position by stating that an unsecured creditor was entitled to receive no more than its pro rata share of receivership proceeds, and that the FDIC had the discretion to pay more to some creditors from the FDIC's own funds. Table II.6-3 lists all the banks in First Republic's chain.

Table II.6-3

**First RepublicBank Corporation Subsidiary Banks
as of July 29, 1988**
(\$ in Thousands)

	Bank Name, City, State	Resolution Assets	Resolution Deposits	Resolution Cost	Assets Passed	FDIC Assets	Resolution Cost / Resolution Assets (%)
1	First RepublicBank- Clifton, Clifton, TX	\$77,693	\$77,698	\$22,321	\$77,693	\$0	28.73
2	First RepublicBank- Forney, Forney, TX	50,994	51,424	15,944	50,994	0	31.27
3	First RepublicBank- Temple, N.A., Temple, TX	163,400	152,221	13,552	163,400	0	8.29
4	First RepublicBank- Abilene, N.A., Abilene, TX	214,305	204,343	50,820	214,305	0	23.71
5	First RepublicBank- Austin, N.A., Austin, TX	1,734,407	1,275,677	44,642	1,734,407	0	2.57
6	First RepublicBank- Brownwood, N.A., Brownwood, TX	124,218	120,821	27,702	124,218	0	22.30
7	First RepublicBank- Conroe, N.A., Conroe, TX	206,393	203,730	47,432	206,393	0	22.98
8	First RepublicBank- Corsicana, N.A., Corsicana, TX	198,593	189,533	15,545	198,593	0	7.83
9	First RepublicBank- Dallas, N.A., Dallas, TX	18,162,609	6,899,561	1,962,069	18,162,609	0	10.80
10	First RepublicBank- Denison, N.A., Denison, TX	141,514	138,942	28,300	141,514	0	20.00
11	First RepublicBank- Ennis, N.A., Ennis, TX	96,137	90,650	20,727	96,137	0	21.56
12	First RepublicBank- Ft. Worth, N.A., Ft. Worth, TX	1,905,148	1,513,693	150,867	1,905,148	0	7.92
13	First RepublicBank- Galveston, N.A., Galveston, TX	261,089	248,605	13,552	261,089	0	5.19
14	First RepublicBank- Greenville, N.A., Greenville, TX	82,781	81,012	15,744	82,781	0	19.02
15	First RepublicBank- Harlingen, N.A., Harlingen, TX	208,383	196,990	46,037	208,383	0	22.09

Table II.6-3

**First RepublicBank Corporation Subsidiary Banks
as of July 29, 1988**

(\$ in Thousands)

Continued

	Bank Name, City, State	Resolution Assets	Resolution Deposits	Resolution Cost	Assets Passed	FDIC Assets	Resolution Cost / Resolution Assets (%)
16	First RepublicBank- Henderson, N.A., Henderson, TX	\$120,083	\$119,496	\$35,873	\$120,083	\$0	29.87
17	First RepublicBank- Houston, N.A., Houston, TX	2,886,126	2,236,058	536,306	2,886,126	0	18.58
18	First RepublicBank- Lubbock, N.A., Lubbock, TX	496,207	448,420	1,594	496,207	0	0.32
19	First RepublicBank- Mineral Wells, N.A., Mineral Wells, TX	167,841	169,986	51,618	167,841	0	30.75
20	First RepublicBank- Mt. Pleasant, N.A., Mt. Pleasant, TX	142,692	140,471	31,887	142,692	0	22.35
21	First RepublicBank- Odessa, N.A., Odessa, TX	167,958	163,573	37,069	167,958	0	22.07
22	First RepublicBank- Plano, N.A., Plano, TX	183,784	179,170	36,471	183,784	0	19.84
23	First RepublicBank- Richmond, N.A., Richmond, TX	94,945	91,504	28,499	94,945	0	30.02
24	National Bank of Ft. Sam Houston, Ft. Sam Houston, TX	614,155	510,064	94,267	614,155	0	15.35
25	First RepublicBank- Stephenville, N.A., Stephenville, TX	119,699	117,390	19,132	119,699	0	15.98
26	First RepublicBank- Tyler, N.A., Tyler, TX	600,406	549,262	65,768	600,406	0	10.95
27	First RepublicBank- Waco, N.A., Waco, TX	703,104	615,344	57,397	703,104	0	8.16
28	First RepublicBank- Wichita Falls, N.A., Wichita Falls, TX	287,558	271,546	41,254	287,558	0	14.35
29	First RepublicBank- Lufkin, Lufkin, TX	218,720	193,869	20,926	218,720	0	9.57
30	First RepublicBank- Cleburne, N.A., Cleburne, TX	114,816	111,062	14,150	114,816	0	12.32

Table II.6-3

**First RepublicBank Corporation Subsidiary Banks
as of July 29, 1988**

(\$ in Thousands)

Continued

	Bank Name, City, State	Resolution Assets	Resolution Deposits	Resolution Cost	Assets Passed	FDIC Assets	Resolution Cost/ Resolution Assets (%)
31	First RepublicBank- San Antonio, N.A., San Antonio, TX	\$743,428	\$680,155	\$55,803	\$743,428	\$0	7.51
32	First RepublicBank- Hillsboro, Hillsboro, TX	63,530	63,356	20,328	63,530	0	32.00
33	First RepublicBank- Malakoff, Malakoff, TX	47,978	48,912	16,143	47,978	0	33.65
34	First RepublicBank- Jefferson County, Beaumont, TX	221,573	217,100	45,639	221,573	0	20.60
35	First RepublicBank- Victoria, Victoria, TX	173,057	163,551	20,926	173,057	0	12.09
36	First RepublicBank- A&M, College Station, TX	92,090	88,599	11,360	92,090	0	12.34
37	First RepublicBank- Paris, Paris, TX	77,906	77,504	19,930	77,906	0	25.58
38	First RepublicBank- El Paso, N.A., El Paso, TX	212,114	206,932	34,080	212,114	0	16.07
39	First RepublicBank- Williamson County, N.A., Austin, TX	41,681	42,431	14,150	41,681	0	33.95
40	First RepublicBank- Midland, N.A., Midland, TX	616,165	577,549	70,750	616,165	0	11.48
41	First RepublicBank- Delaware, Newark, DE	612,745	211,500	249	0	612,745	0.04
Totals		\$33,448,025	\$19,739,704	\$3,856,826	\$32,835,279	\$612,746	11.53

Source: FDIC, 1988 Annual Report.



CHAPTER 7

MCorp

Name of Institution:	MCorp
Headquarters Location:	Dallas, Texas
Date of Resolution:	March 28, 1989
Resolution Method:	Bridge Bank
Date of Resolution:	June 28, 1989
Resolution Method:	Purchase and Assumption Transaction

Introduction

MCorp is the third largest and the second most costly resolution in the Federal Deposit Insurance Corporation's (FDIC) history to date. At the time of its resolution, it was also the second largest banking entity in the state of Texas, surpassed only by the First RepublicBank Corporation (First Republic), Dallas, Texas. MCorp's situation provided a vivid illustration of the tremendous economic difficulties experienced in the southwestern United States as a result of the faltering oil, agriculture, and real estate markets in the late 1980s. The failure of the MCorp banks came only eight months after First Republic's banks were closed, and just eleven months after the FDIC provided open bank assistance to First City Bancorporation of Texas, Inc. (First City), Houston, Texas.

The MCorp resolution had a number of noteworthy features. First, the FDIC rejected MCorp's open bank assistance proposal, and 20 of its subsidiary banks with \$15.7 billion in assets were declared insolvent shortly after certain holding company creditors moved to force MCorp into bankruptcy.

Second, while all depositors were protected against any losses, affiliated banks that had made federal funds loans to the lead banks of MCorp were not paid in full but were issued receivership certificates for their pro rata shares of receivership assets. The projected losses on those interbank funds led to 14 of the MCorp subsidiary banks being declared insolvent by the Office of the Comptroller of the Currency (OCC). Then, in turn, the holding company sued the FDIC, claiming that the FDIC did not have the authority to treat like classes of creditors differently. After losing the initial lawsuit, and losing a similar suit filed by Texas American Bancshares (TAB), Fort Worth, Texas, the FDIC won the TAB case on appeal, and the ruling applied, by derivation, to MCorp.

Third, not all MCorp subsidiary banks were closed; five banks with \$3.2 billion in assets remained open.

Fourth, the Federal Reserve Bank of Dallas (Federal Reserve) and the FDIC sought, unsuccessfully, approximately \$400 million in proceeds that MCorp held after selling two of its nonbank subsidiaries. The holding company refused to downstream the money to support its insolvent banks and kept the funds in the holding company pending approval of the open bank assistance proposal. MCorp's creditors wanted the money also and forced the holding company into bankruptcy. The United States Supreme Court held that those funds could be used to satisfy holding company debt obligations.

Two court decisions, along with a lawsuit over the same issue filed by First Republic bondholders, helped the FDIC garner support for two provisions that were included in the Financial Institutions Reform, Recovery, and Enforcement Act (FIRREA) of 1989. First, the FDIC as receiver was permitted to treat like classes of creditors differently as long as every creditor received at least its pro rata share of receivership proceeds. Second, the FDIC was granted "cross guarantee" authority requiring solvent affiliated banks to support insolvent affiliated banks within a holding company.

General Description of the Institution

In March 1989, when MCorp failed, it was the 36th largest banking entity in the United States.¹ As the second largest banking entity in Texas, MCorp consisted of 25 banks, 86 banking offices, and 1 trust company, all located in Texas. The company had assets of \$18 billion, and its common stock was listed on the New York Stock Exchange under the symbol M.² MCorp had a reputation as one of the most progressive banking entities, in terms of both technology and personnel.³

Background

MCorp suffered two straight years of quarterly operating losses beginning with the fourth quarter of 1986. At the end of 1986, MCorp, which at that time had \$29.1 billion in assets, reported a net loss of \$82.1 million after adding \$534.5 million to its loan loss reserve. Losses continued the following year, starting with a first quarter loss of \$102 million. Second quarter losses accelerated to \$114.9 million, and for the 1987 fiscal year MCorp reported total losses of \$258.3 million.⁴

1. Nathaniel C. Nash, "U.S. Takes Over 20 Texas Banks; High Costs Seen," *New York Times* (March 30, 1989), sec. A, p. 1.

2. David LaGesse, "MCorp to Seek Bankruptcy Protection," *The Dallas Morning News* (March 28, 1989), sec. A, p. 1.

3. L. William Seidman, *Full Faith and Credit: The Great S&L Debacle and Other Washington Sagas* (New York: Times Books, 1993), 155.

4. "MCorp's Rocky Road," *The Dallas Morning News* (March 28, 1989), sec. D, p. 24.

The losses stemmed primarily from an increasing amount of nonperforming assets and loan charge-offs.⁵ The oil industry in Texas and the Southwest had collapsed, with declining oil prices and an excess of oil drilling equipment. The real estate and construction markets were also declining, and MCorp had concentrated lending in both energy and real estate. Still, as late as August 1987, MCorp was actively reviewing the subsidiary banks of First City in response to the FDIC's request for proposals to acquire First City.⁶ By November 1987, it was apparent that the financial situation of MCorp had deteriorated well beyond the point where it could merge with other banks.

In April 1988, MCorp sold its MTech subsidiary to Electronic Data Systems Corporation (EDS) for \$281 million. This enabled MCorp to report a second quarter profit of \$46.2 million. Second quarter figures included an operating loss of \$169 million, the largest share of which was a \$124.6 million provision for loan losses and a \$26 million jump in noninterest expenses.⁷ MCorp also sold MNet, its consumer lending operation. These two sales enabled the holding company to accumulate huge cash reserves of approximately \$400 million.

During 1988, MCorp submitted several informal proposals to the FDIC for open bank assistance. The FDIC viewed none of the proposals favorably, primarily because the offers proposed that MCorp retain its existing management and the FDIC provide full protection from any adverse action to the holding company, its management, and its shareholders and creditors. Also, the FDIC wanted MCorp to downstream its cash reserves of \$400 million to support its failing subsidiary banks. MCorp was reluctant to do so, and held onto the funds pending acceptance of its open bank assistance proposal.

In his book, *Full Faith and Credit: The Great S&L Debacle and Other Washington Sagas*, written five years later, then-FDIC Chairman L. William Seidman, a longtime critic of the holding company structure, wrote that the MCorp case "illustrated a basic defect in the organization of the American banking system."⁸ The MCorp case demonstrated clearly the conflict of interest that occurred when directors of the holding company were directors of some or all the subsidiary banks, too. Bank directors were required by law to maintain the safety and soundness of the bank. If they served also as directors of the holding company, they could be sued by shareholders and bondholders of the holding company for putting money into a failing bank instead of paying holding company debt or dividends and interest. If the directors did not put money into the banks, they were liable to be sued by bank regulators for failing to support the banks. The First Republic situation provided an example of this dichotomy. The FDIC sued the directors of the First Republic banks for declaring dividends to the holding company when the banks were undercapitalized. However, the directors of the holding company,

5. House of Representatives, *Report on FDIC Bailouts of First Republic and MCorp Banks* (1991), 38; James E. Heath, FDIC Division of Research and Statistics, *Bank Failures (Texas)*, working paper (1997), 48-49.

6. See Chapter 5, First City Bancorporation of Texas, Inc.

7. "MCorp's Rocky Road," sec. D, p. 24.

8. Seidman, *Full Faith and Credit: The Great S&L Debacle and Other Washington Sagas*, 155.

which owned the banks, had ordered that the dividends be paid. The holding company directors were not sued, because they had acted properly in carrying out their duties.⁹

In October 1988, the Federal Reserve, which regulates holding companies, issued a temporary cease and desist order directing MCorp to support its failing banks. MCorp did not comply. That same month, MCorp submitted a formal proposal to the FDIC for open bank assistance.¹⁰ The proposal involved \$400 million in private capital (the holding company's \$400 million in cash reserves) and substantial FDIC assistance. After the OCC completed an examination, MCorp reported a loss of \$500 million for the third quarter of 1988. Later in October, MCorp announced that it would suspend interest payments on approximately \$470 million in holding company debt and indicated it might be forced to declare bankruptcy.¹¹ Almost immediately, MCorp banks began to experience a runoff of deposits, which caused them to increase their borrowings from the Federal Reserve.¹² However, the run on deposits was not serious enough to require immediate action.

MCorp's announcement of their suspension of interest payments on the \$470 million of holding company debt created the conditions under which the creditors could force the holding company into bankruptcy. Debt terms allowed MCorp 30 days after default before creditors could make an accelerated demand for payment of principal. Once creditors demanded and failed to receive payment, they would have a right to file a petition to place MCorp into involuntary bankruptcy. Some banking analysts viewed MCorp's suspension of interest payments on its debt as a way to prompt the FDIC into accepting the formal open bank assistance proposal quickly and avoid a bankruptcy, which would increase the FDIC's costs. Holding company creditors most likely preferred a bankruptcy because they might retain more holding company assets in that scenario. The Federal Reserve withdrew its efforts to enforce its "source of strength" policy. The policy, which states that a holding company should use available assets to support insolvent bank subsidiaries, had never been tested in court or enforced to the detriment of a bankrupt entity's creditors.¹³

On November 6, 1988, MCorp and the FDIC entered into a "standstill" agreement under which the FDIC would consider MCorp's request for assistance along with proposals from other interested parties.¹⁴ MCorp agreed to allow potential interested buyers to review records, meet with MCorp officials, and conduct due diligence reviews. As part of the agreement, the OCC and the Federal Reserve agreed to not pursue enforce-

9. Seidman, *Full Faith and Credit: The Great S&L Debacle and Other Washington Sagas*, 155-156.

10. Refer to Part I, Resolution and Asset Disposition Practices, Chapter 5, Open Bank Assistance.

11. "MCorp Bankruptcy Seen As Possible," *New York Times* (October 28, 1988); Joseph M. Grant, *The Great Texas Banking Crash: An Insider's Account* (Austin: University of Texas Press, 1996), 157.

12. "Emergency Fed Loans Rise Dramatically," *The Dallas Morning News* (November 15, 1988).

13. The Federal Reserve required that all assets of a bank holding company were to be used as necessary to support its banks. However, the rule had never been tested in court or backed by explicit legislation. The Federal Reserve was unwilling to have the matter decided in a bankruptcy court and withdrew its demand that MCorp recapitalize its insolvent banks.

14. *Report on FDIC Bailouts of First Republic and MCorp Banks*, 38; Heath, *Bank Failures (Texas)*, 49.

ment actions against certain MCorp banks and the holding company while the FDIC considered the proposals by MCorp and other parties. The Federal Reserve also agreed to withdraw the temporary cease and desist order. Concurrently, losses continued at MCorp as it reported a 1988 fourth quarter loss of more than \$200 million.¹⁵

MCorp's institutional creditors had decided to hold off on demands for payment pending the results of the open bank assistance request. But three small creditors, together holding only about \$2 million of debt, submitted a petition on Friday, March 24, 1989, to the U.S. Bankruptcy Court in New York for a Chapter 7 involuntary liquidation of MCorp.¹⁶ S.N. Phelps & Co., a securities firm based in Greenwich, Connecticut, initiated the filing on behalf of itself and two entities that held MCorp bonds.¹⁷ The creditors wanted priority claim on the assets remaining in the holding company instead of having those assets used as part of the assistance plan.

The deadline for submitting MCorp restructuring proposals was April 2, 1989. However, on Monday, March 27, 1989, MCorp announced its intent to file a petition that would convert the bondholders' petition for Chapter 7 filing into a Chapter 11 bankruptcy. MCorp's bankruptcy petition would have resulted in a suspension of all claims against MCorp and would have placed the holding company's assets under the control of the bankruptcy court.¹⁸

Depositors began major withdrawals of funds from MCorp banks; between \$50 million and \$100 million was withdrawn in the two days after MCorp announced its intention to file bankruptcy.¹⁹ "If regulators perceive any kind of a deposit run, they will move quickly to declare the banks insolvent," said Richard Fitzgerald, a Washington lawyer and former chief counsel with the OCC.²⁰ FDIC Chairman Seidman said in a press conference, "The planned bankruptcy definitely accelerated the outflow of funds."²¹

The Resolution—March 28, 1989

The FDIC and the OCC agreed that the holding company's bankruptcy would create a situation where it would be very difficult to resolve the insolvent subsidiary banks.

15. "MCorp's Rocky Road," sec. D, p. 24.

16. Under Title 11, Section 303, of the United States Code, an involuntary case may be commenced under Chapter 7 or 11 of the bankruptcy code by three or more entities, each of which is either a holder of a claim against a debtor or is an indenture trustee representing such a holder, if the claim is not contingent as to liability or the subject of a bona fide dispute and if such claims aggregate at least \$10,000 more than the value of any lien on property of the debtor securing such claims held by the holders of such claims. Under Title 11, Section 109, of the United States Code, the debtor may not be an insured bank as defined in section 3(h) of the Federal Deposit Insurance Act. Therefore, although the holding company could be placed in involuntary bankruptcy, the subsidiary banks could not.

17. LaGessee, "MCorp to Seek Bankruptcy Protection," sec. A, p. 1.

18. Anatole Kaletsky, "Bondholders' Move Forces MCorp Into Chapter 11," *Financial Times* (March 28, 1989), 32.

19. Nash, "U.S. Takes Over 20 Texas Banks; High Costs Seen," sec. A, p. 1.

20. LaGessee, "MCorp to Seek Bankruptcy Protection," sec. A, p. 1.

21. Nash, "U.S. Takes Over 20 Texas Banks; High Costs Seen," sec. A, p. 1.

Because of the heavy withdrawals at MBank Dallas, the OCC determined that the Dallas bank was no longer a viable concern. The Federal Reserve decided to call the loans (demand payment in full) it had made to MBank Dallas and five other MCorp banks. The banks could not pay, and on Tuesday, March 28, 1989, about 7:00 p.m., the OCC declared those six banks insolvent and closed them immediately, one by one. After MBank Dallas was closed, the OCC determined that another 14 banks could not count on getting back funds that they had lent to MBank Dallas. Those 14 banks then became insolvent and were closed. The last bank was closed about 1:00 a.m. on March 29, 1989.²² The 20 closed banks had gross assets of \$15.7 billion. Five MCorp banks, with assets of \$3.2 billion, were not considered insolvent and were left open.²³ The trust company also stayed open and remained with the holding company.

MCorp management opposed the closings and went to court Tuesday night to try to stop the actions. U.S. District Court Judge Barefoot Sanders declined to intervene. Judge Sanders essentially told the MCorp officials that the process had advanced too far, and that MCorp could come back and sue for damages later.²⁴ Counsel for MCorp contended that, "The FDIC purposely created a domino effect to seize control of as many assets as it could."²⁵

Unsubordinated general creditors and depositors, including those with funds in excess of the \$100,000 insurance limit, were fully protected at 19 of the institutions. Because of the large number of judgments filed against MBank Abilene, N.A. (MBank Abilene) only insured deposits were transferred to a new bridge bank. Uninsured depositors and general creditors at MBank Abilene, along with holders of contingent or off-balance sheet claims at all the banks, were not protected. Those claimants were to share, on a pro rata basis with the FDIC, in the liquidation of the failed bank's assets. The holding company's deposits and claims and any affiliated banks' deposits and claims against any of the failed 20 banks were also to share on the same pro rata basis for each failed bank.²⁶ First Republic's affiliated banks were treated in a similar manner. Uninsured depositors and general creditors of MBank Abilene were treated differently from similarly situated creditors of the other banks. That was because MBank Abilene, as successor to the former Abilene National Bank, had approximately \$60 million in outstanding judgments filed against it, but few accounts with uninsured deposits remained at the bank.²⁷ By mid-morning Wednesday, examiners found only \$1,000 in uninsured deposits.²⁸

22. David LaGessee, "Deposit Run Blamed for MBank Seizures," *The Dallas Morning News* (March 30, 1989), sec. A, p. 1.

23. Nash, "U.S. Takes Over 20 Texas Banks; High Costs Seen," sec. A, p. 1.

24. LaGessee, "Deposit Run Blamed for MBank Seizures," sec. A, p. 1.

25. Nash, "U.S. Takes Over 20 Texas Banks; High Costs Seen," sec. A, p. 1.

26. FDIC and OCC Joint News Release, "New FDIC Bank to Assume Deposits of 20 Insolvent MCorp Banks," PR-71-89 (March 29, 1989).

27. LaGessee, "Deposit Run Blamed for MBank Seizures," sec. A, p. 1.

28. LaGessee, "Deposit Run Blamed for MBank Seizures," sec. A, p. 1.

To facilitate the MCorp resolution, the FDIC used its bridge bank authority (as had been done in the failure of the First Republic banks) and established the Deposit Insurance Bridge Bank, National Association (DIBB). James B. Gardner, an MCorp group chairman, was named to head the \$15.4 billion bridge bank.

The FDIC soon began the process of soliciting bids for the bridge bank. On May 30, 1989, the FDIC notified the Texas Banking Commissioner of options being considered for the resolution of the bridge bank, specifically the FDIC's intent to use the interstate emergency acquisition powers granted by the Garn–St Germain Depository Institutions Act of 1982. May 31, 1989, was set as the date for the submission of closed bank proposals.

The Sale of the Bridge Bank—June 28, 1989

There were six bidders for the bridge bank: NCNB; Banc One Corporation (Banc One); First City; Bank of Scotland; Texas Commerce Bancshares (TCB); and Kohlberg, Kravis & Roberts & Co. (KKR). On the basis of resolution cost, the bidding was close. Two of the bidders, NCNB and First City, posed potential conflict of interest issues: the FDIC had large ownership positions in each institution from the earlier resolutions of First City and First Republic.²⁹ The FDIC was sensitive to the issue that those two banking entities should not be leveraging their federal aid to pursue more acquisitions.³⁰ The bids by those banking entities and by TCB also raised the antitrust issue of a large concentration of Texas banking assets in the hands of a small number of firms. Banc One, KKR, and Bank of Scotland were not from Texas, and their bids did not raise the same issue.

On June 28, 1989, the FDIC agreed in principle to the acquisition of the bridge bank by Banc One, Columbus, Ohio. The bridge bank's name was changed to Banc One Texas, N.A. (BOC Texas). A Banc One subsidiary managed the bridge bank under contract with the FDIC until the transaction was consummated on January 30, 1990.³¹ "The selection of Banc One resulted from a highly competitive process in which both banking organizations and non-bank investors participated," FDIC Chairman Seidman said in a prepared statement. "We welcomed the interest from all of these qualified bidders."³²

Banc One agreed to buy 100 percent of the resulting institution's voting common stock for approximately \$34 million. The FDIC agreed to purchase approximately \$416 million of BOC Texas nonvoting common stock, which was to be redeemed by Banc One within five years. The FDIC acquired 3,375,000 shares of Class B nonvoting convertible common stock for \$303.8 million and 1,250,000 shares of Class C nonvoting

29. Refer to Chapter 5, First City Bancorporation of Texas, Inc. and Chapter 6, First Republic Bank Corporation.

30. Robert Trigaux, Jim McTague, Robert M. Garsson, Jay Rosentstein, and Steve Klinkerman, "Seidman Says 2 Bidders Were Hurt by Ties to FDIC," *American Banker* (June 30, 1989).

31. FDIC, *1989 Annual Report*, 13.

32. Michael Weiss, "Ohio Firm Will Buy Former MCorp Banks, New Institution to be Bank One Texas," *The Dallas Morning News* (June 29, 1989), sec. A, p. 1.

common stock for \$112.5 million. In exchange, Banc One gave the FDIC a note payable in the amount of \$416.3 million.

The FDIC funded the operating losses of the bridge bank during its operation (March 29, 1989, to December 31, 1989) as well as the negative equity that resulted from a mark-to-market for assets and liabilities as of the date of Banc One's acquisition, January 1, 1990. The initial financial obligations totaled \$2.6 billion and had three components. First, the FDIC assumed Federal Reserve indebtedness, including principal and interest totaling \$1.5 billion. Second, the FDIC forgave a \$300 million subordinated note advanced to the bridge bank. Third, the FDIC gave BOC Texas a nonnegotiable promissory note for \$737 million, due on or before March 1, 1995.

Unlike NCNB's acquisition of First Republic, Banc One did not receive lucrative tax breaks, because the holding company retained its tax-loss advantages. Banc One's stock, however, still rose $4\frac{7}{8}$ that day to $32\frac{7}{8}$.³³

The Liquidation

The bridge bank continued to hold the title to the troubled and nonperforming assets and agreed to service the assets. A separate asset pool was set up, which started with \$2.5 billion of troubled assets and owned real estate of the insolvent MCorp banks. BOC Texas retained the right to transfer additional loans to the separate asset pool during its first two years of operations. All administrative and funding costs of the separate asset pool were borne by the FDIC during its five-year tenure, even though the assets were owned by BOC Texas.³⁴ The asset management contract was similar to the one used at First Republic, in that an oversight committee was formed to protect the interest of the FDIC. The incentive fee was tied to net, rather than gross, collections, however; this modification led to better performance.

During the life of the agreement, assets with a book value of \$4.2 billion (\$3.2 billion after mark-to-market reductions) were placed in the pool. BOC Texas collected \$3.6 billion on this pool. Total expenses were \$591 million, or 16.6 percent, of gross collections. Net collections were \$3.0 billion, or 71.3 percent, of the total book value of the pool assets, and 93.8 percent of the mark-to-market asset value.³⁵ The asset management agreement was terminated as of December 31, 1994, and, in accordance with the agreement, the FDIC purchased the remaining \$83.7 million in assets.

33. Dennis Cauchon, "Investors Cash in on Banc One Prize," *USA Today* (June 30, 1989).

34. FDIC, *1989 Annual Report*, 90-91.

35. Refer to Part I, Resolution and Asset Disposition Practices, Chapter 14, Asset Management Contracting.

The Stock Transactions

To effect the transaction, Banc One initially capitalized BOC Texas with \$34 million and owned 100 percent of the voting common stock. To further capitalize the new bank, the FDIC purchased 3.4 million shares of Class B nonvoting convertible common stock for \$303.8 million (\$90 per share) and 1.3 million shares of Class C nonvoting common stock for \$112.5 million (\$90 per share). In exchange for the FDIC's total investment of \$416.3 million, Banc One provided the FDIC with a note payable for the same amount. Banc One retained the right to repurchase the FDIC's stock interest for its initial investment amount of \$416.3 million plus the FDIC's cost of funds and a \$10 million premium. The stock could be repurchased in increments.

On March 1, 1991, Banc One purchased 375,000 shares of the FDIC's Class B nonvoting convertible common stock for \$37.3 million, or \$100 per share, which represented a gain for the FDIC of \$3.5 million on that stock. Banc One also purchased 577,242 shares of the FDIC's Class C nonvoting common stock for \$57.4 million, or \$100 per share, which represented a gain of \$5.5 million on that stock. Banc One reduced its note payable to the FDIC to a new balance of \$321.5 million.³⁶

On October 28, 1991, Banc One redeemed the remaining 3 million shares of the FDIC's Class B nonvoting convertible common stock for \$316.1 million, or \$105 per share, which represented a gain of \$46.1 million on that stock. Banc One also redeemed the remaining 672,758 shares of the FDIC's Class C nonvoting common stock for \$70.9 million, or \$105 per share, which represented a gain for the FDIC of \$10.3 million on that stock. Banc One's note to the FDIC was reduced to zero. A summary of the stock transactions is shown in table II.7-1.³⁷

Shareholder Litigation

On March 31, 1989, MCorp (the holding company) sued the OCC and the FDIC in both its corporate and receivership capacities, alleging that the agencies did not have the authority to declare 14 MCorp banks insolvent and that the forced recognition of losses on interbank "federal funds" loans was improper. MCorp indicated in its suit that "The solvent banks then were made to appear insolvent, and their assets were unlawfully confiscated without compensation, as a result of a (government) scheme." Without adjusting for the loss of the intercompany deposits, each MCorp bank had from \$2 million to \$12 million in capital. MCorp sought to recover that capital, which it said totaled more than \$70 million; the claim was later amended to well over \$200 million.³⁸ The litigation challenged the FDIC's ability to fully protect third-party creditors of a failed bank, including the ability to treat affiliated and third-party creditors equally.

36. FDIC, *1990 Annual Report*, 58; FDIC, *Equity Investment Portfolio, Bank Insurance Fund* (December 31, 1993), 21.

37. FDIC, *Equity Investment Portfolio, Bank Insurance Fund*, 21.

38. David LaGessee, "MCorp Files Suit, Chapter 11 Motion," *The Dallas Morning News* (April 1, 1989), sec. F, p. 4.

Table II.7-1

Summary of the FDIC's Stock Transactions in the MCorp Resolution

Date	Transaction	Beginning Number of Shares	Shares Sold, Written Down, Converted	FDIC Stock/Equity Investment	FDIC Proceeds from Sales	FDIC Book Value of Transaction	Gain or Loss On Transaction
Class B Nonvoting Convertible Common Stock							
01/31/90	Original investment	3,375,000		\$303,750,000			
03/01/91	Redemption – offset against Banc One's note payable to the FDIC		(375,000)		\$37,312,518	\$33,750,000	\$3,562,518
10/28/91	Redemption of stock		(3,000,000)		316,101,177	270,000,000	46,101,177
	Totals	3,375,000	(3,375,000)	\$303,750,000	\$353,413,695	\$303,750,000	\$49,663,695
Class C Nonvoting Common Stock							
01/31/90	Original investment	1,250,000		\$112,500,000			
03/01/91	Redemption – offset against Banc One's note payable to the FDIC		(577,242)		\$57,435,607	\$51,951,780	\$5,483,827
10/28/91	Redemption of stock		(672,758)		70,886,532	60,548,220	10,338,312
	Totals	1,250,000	(1,250,000)	\$112,500,000	\$128,332,139	\$112,500,000	\$15,822,139
Grand Total, All Stock		4,625,000	(4,625,000)	\$416,250,000	\$481,735,834	\$416,250,000	\$65,485,834

Source: FDIC, *Equity Investment Portfolio, Bank Insurance Fund*.

The purchase and assumption transaction completed with Banc One resulted in no loss to third-party creditors. However, the affiliated banks' recovery on their loans to the failed lead bank was limited to their pro rata interest in the failed bank's estate. The FDIC had estimated this interest to be about 72 percent of the amount those banks were owed at the time of the lead bank's failure.

In the MCorp case, the FDIC asked the court to reject the challenge, but the U.S. District court in Dallas held that the FDIC's treatment of affiliated creditors in MCorp was improper.³⁹ Judge Robert Porter stated that the FDIC acted illegally, because federal banking law required the FDIC to treat like classes of creditors equally when a bank failed.⁴⁰ In a similar suit, that of Texas American Bancshares, the FDIC received an adverse ruling on June 25, 1990, and appealed the decision. The Fifth Circuit ruled in the FDIC's favor on the TAB suit and reversed the ruling of the lower court. The court held that the FDIC is obligated to pay only the amount realized in liquidation, and that additional payments from the insurance fund can be preferred among creditors at the FDIC's discretion. Congress later enacted this limitation in FIRREA.⁴¹

MCorp Bankruptcy

MCorp had retained about \$400 million in assets, including \$250 million in cash and marketable securities. The liquid assets came from the sale of nonbank subsidiaries such as MTech, its data-processing firm. The Federal Reserve sought that money as a source of funds to use to offset the losses of the subsidiary banks. MCorp creditors, who were to be repaid out of the holding company assets, also wanted to obtain these funds.

The bankruptcy continued a struggle between the bankrupt holding company and the Federal Reserve over MCorp assets. The Federal Reserve tried to collect on claims it had made against the holding company, which would have forced MCorp to turn over cash to the former MBank Dallas. The Federal Reserve claimed the holding company owed approximately \$65 million to the bridge bank, DIBB (because MBank Dallas was closed already), since MCorp had withheld the cash from the former MBank Dallas when it sold its subsidiaries. The Federal Reserve had filed an administrative procedure regarding its "source of strength" policy to try to get MCorp to downstream funds to support its insolvent banks. The Federal Reserve argued its administrative procedure should remain independent and outside the control of the bankruptcy court.⁴²

39. FDIC, 1989 Annual Report, 29, 38.

40. David LaGessee, "Seizures May Be Illegal: Judge's Ruling Focuses on MCorp," *The Dallas Morning News* (September 8, 1989), sec. D, p. 1.

41. FDIC, 1990 Annual Report, 28.

42. David LaGessee, "MCorp Battling in New Territory, Case Could Set Legal Precedent," *The Dallas Morning News* (May 20, 1989), sec. F, p. 1.

On June 5, 1989, U.S. District Court Judge Lynn N. Hughes issued a preliminary injunction, ruling that federal banking law does not take priority over bankruptcy law. In a strongly worded order, Judge Hughes told the Federal Reserve that it must join other creditors in the bankruptcy court to pursue its claims, and that the Federal Reserve must halt an administrative proceeding it had started against MCorp. Judge Hughes cited “the waste and confusion” that would result if he allowed the Federal Reserve to pursue independently its administrative actions against MCorp.

The judge further said the Federal Reserve was “...enjoined from using its authority ...to effect, directly or indirectly, a reorganization of the MCorp group....”⁴³ This ruling was also appealed, first to the Fifth Circuit, which affirmed Judge Hughes’ decision, then to the Supreme Court. The Supreme Court avoided the “source of strength” issue, and decided the case in favor of MCorp on procedural grounds. This allowed MCorp to sell the remaining five solvent banks along with its other assets under the protection of the bankruptcy system.

FDIC Resolution Costs

The MCorp resolution is the second most costly resolution in FDIC’s history to date. The total cost of the transaction was approximately \$2.8 billion. This was 18 percent of the failed banks’ assets, a relatively high portion. The high cost reflects the poor condition of the bank’s assets and the ongoing weakness in the Texas economy.

Of the \$15.7 billion in total assets at failure, approximately \$4.2 billion (\$3.2 billion after mark-to-market reductions) in problem assets were assigned to a pool and managed by BOC Texas. Over the life of the agreement, gross collections totaled \$3.6 billion, which resulted in a gross recovery of approximately \$400 million on the mark-to-market adjustment. Offsetting this recovery, however, were approximately \$165 million in additional charge-offs and losses. This resulted in a settlement payment of \$235 million to the FDIC after termination of the contract. On the assets not transferred to the pool, there was an initial mark-to-market cost of more than \$1 billion.

The FDIC’s initial expenses to resolve this institution were approximately \$3 billion. This consisted of \$556 million in operating losses during the bridge bank period, approximately \$2 billion in mark-to-market losses on the bank’s assets (as described above), and \$416 million for the purchase of equity in BOC Texas. Over time, the FDIC paid approximately \$600 million in additional expenses, including more than \$500 million for administering the pool of problem assets. Against those expenses of approximately \$3.6 billion, the FDIC recovered almost \$800 million, including \$482 million in proceeds from the redemption of the BOC Texas stock, and approximately \$300 million in asset recoveries (\$72 million from a settlement immediate after failure and the \$235 million recovery after termination of the asset servicing contract).

43. David LaGesse, “Regulators Rebuffed at MCorp,” *The Dallas Morning News* (June 6, 1989), sec. D, p. 1.

Table II.7-2

MCorp Resolution Costs

(\$ in Thousands)

FDIC's Expenses	
Purchase of preferred stock	\$416,250
Bridge bank operating losses	556,000
Mark-to-market adjustment—special asset pool assets	1,065,000
Mark-to-market adjustment—nonspecial asset pool assets	1,013,000
Separate asset pool costs	545,000
Dividends to MBank creditors	33,000
Total FDIC Expense	\$3,628,250
FDIC's Recoveries	
Deferred settlement	\$235,000
Post-commencement settlement	72,000
Sale of preferred stock	481,736
Total FDIC Recovery	\$788,736
FDIC's Total Resolution Costs	\$2,839,514

Sources: FDIC, *The Cost of Large Resolution Transactions*, March 12, 1996; FDIC Division of Finance; and FDIC Division of Research and Statistics.

In a present value context the loss is somewhat higher, considering the period of time over which the various stock proceeds were received. However, the effect would be relatively minor given that the total stock proceeds were a small part of the overall transaction. See table II.7-2 for a summary of resolution costs.

Lessons Learned

As a result of the MCorp experience, the FDIC pushed for cross guarantee legislation. Unlike the situation in First Republic, where the subsidiary banks had guaranteed the interim assistance notes, the FDIC was unable to obtain any of the value of the solvent MCorp banks to offset its losses. In 1989, FIRREA granted the FDIC cross guarantee authority. The FDIC could assess its financial costs for handling failed banks against other insured institutions controlled by the same holding company.⁴⁴

FIRREA also provided the FDIC with the authority “in its discretion” to use its own funds to make additional payments to any creditor or category of creditors without having to do so for all similarly situated creditors.⁴⁵ The MCorp transactions provided further evidence of the usefulness of the FDIC’s bridge bank authority and its ability to allow interstate acquisitions. Between the time of the First Republic and the MCorp resolutions, the FDIC modified the incentive fee structure of its asset management contract to obtain better performance by the asset servicer.

Effect on Future Resolutions

The MCorp resolution was the last of the major Texas bank failures. When all was said and done, only one of the nine largest banking entities in the state survived in its previous form; the other eight were taken over by out-of-state organizations or investors, generally with financial assistance from the FDIC. Altogether, 599, or 37 percent, of all the federally insured banks that failed or required assistance from 1980 through 1994, were located in Texas. Those banks held 31 percent of all failed bank assets during that 15-year period, but nevertheless still accounted for \$13.6 billion, or 38 percent, of the FDIC’s total bank failure costs. The First Republic and MCorp transactions were far and away the most costly of the resolutions. Their combined \$6.7 billion cost was half of what the FDIC spent for all 599 Texas bank failures and more than one-sixth of the FDIC’s nationwide total of \$36.3 billion in bank failure resolution costs. The MCorp difficulties led to the section of FIRREA that added provisions related to cross guarantees. The cross guarantee provision would be used most notably in the Bank of New England resolution, as described later in Chapter 8.

44. *U.S. Code*, volume 12, section 1815(e) states in part that any insured depository institution will be liable for any loss incurred or anticipated by the FDIC in connection with the failure of or assistance provided to a commonly controlled insured depository institution that has failed. The FDIC will make a good faith estimate of the loss and advise each such commonly controlled depository institution in writing of its share of the loss and, after consultation, other regulators will either require immediate payment or establish a schedule for payment. Such liability will be superior to any obligation to shareholders and any obligation owed to any affiliate, unless the obligation to the affiliate was secured as of May 1, 1989. The liability shall be subordinate to (1) deposit liabilities in general, (2) secured obligations other than obligations to affiliates secured after May 1, 1989, (3) any other unsecured general or senior liability, and (4) any obligation subordinated to depositors or other general creditors. If the payment to the FDIC is greater than actual loss, the FDIC will refund the overpayment. If the payment to the FDIC is less than actual loss, the FDIC will require additional payment. Depository institutions are defined as “commonly controlled” for this purpose if they are controlled by the same holding company or if one depository institution is controlled by another insured depository institution.

45. *U.S. Code*, volume 12, section 1821(i) states in part that the maximum liability of the FDIC as receiver to any claimant is equal to the amount the claimant would have received if the FDIC had carried out a straight liquidation of the assets and liabilities of the failed institution. The FDIC may, in its discretion and in the interest of minimizing losses, use its own funds to make additional payments to any claimants, but will not be obligated to make additional payments to any other claimants. The FDIC may make such payments directly to the claimants or may make such payments to an open insured depository institution to induce such institution to accept liability for such claims.

Table II.7-3

Closed MCorp Subsidiary Banks as of March 28, 1989

(\$ in Thousands)

Bank Name, City, State	Total Assets	Total Deposits	FDIC's Resolution Cost	Assets Passed to BOC Texas at Closing	FDIC Assets Retained at Closing	Resolution Cost (%)
1 MBank Abilene, N.A., Abilene, TX	\$189,363	\$195,463	\$73,229	\$156,192	\$33,171	38.67
2 MBank Brenham, N.A., Brenham, TX	143,838	135,951	5,164	131,803	12,035	3.59
3 MBank Dallas, N.A., Dallas, TX	6,973,816	3,070,111	1,610,251	6,069,568	904,248	23.09
4 MBank Houston, N.A., Houston, TX	3,098,989	2,241,548	731,303	2,749,518	349,470	23.60
5 MBank Odessa, N.A., Odessa, TX	322,582	304,357	7,056	286,263	36,319	2.19
6 MBank Round Rock, N.A., Round Rock, TX	159,912	156,272	17,891	141,401	18,511	11.19
7 MBank Austin, N.A., Austin, TX	591,009	508,900	87,126	524,991	66,018	14.74
8 MBank Ft. Worth, N.A., Fort Worth, TX	766,273	676,628	153,239	673,837	92,436	20.00
9 MBank Jefferson County, N.A., Port Arthur, TX	325,646	301,603	16,199	286,109	39,537	4.97
10 MBank Longview, N.A., Longview, TX	261,253	251,380	11,288	233,069	28,184	4.32
11 MBank Marshall, N.A., Marshall, TX	217,748	206,562	4,996	190,498	27,250	2.29
12 MBank Corsicana, N.A., Corsicana, TX	190,909	178,394	900	166,264	24,645	0.47
13 MBank Denton County, N.A., Lewisville, TX	230,149	219,689	1,286	210,828	19,321	0.56
14 MBank Greenville, N.A., Greenville, TX	166,244	155,264	4,855	143,689	22,555	2.92
15 MBank Midcities, N.A., Arlington, TX	369,280	344,874	6,652	351,584	17,696	1.80
16 MBank Orange, N.A., Orange, TX	158,888	149,198	4,167	141,281	17,606	2.62
17 MBank Sherman, N.A., Sherman, TX	274,782	260,554	3,351	244,072	30,711	1.22
18 MBank Wichita Falls, N.A., Wichita Falls, TX	455,147	418,715	15,692	397,337	57,810	3.45
19 MBank The Woodlands, N.A., Woodlands, TX	165,063	154,186	6,907	143,053	22,010	4.18
20 MBank Alamo, N.A., San Antonio, TX	687,646	648,489	82,449	621,067	66,579	11.99
Totals	\$15,748,537	\$10,578,138	\$2,844,001	\$13,862,424	\$1,886,112	18.06

Sources: FDIC, 1989 Annual Report, and FDIC Division of Research and Statistics.

Table II.7-4**Remaining MCorp Subsidiary Banks as of March 31, 1989***(\$ in Thousands)*

	Bank Name, City, State	Total Assets	Total Deposits	Total Liabilities	Equity
1	MBank Brownsville, N.A., Brownsville, TX	\$431,326	\$403,193	\$411,320	\$20,006
2	MBank Corpus Christi, N.A., Corpus Christi, TX	717,039	622,082	712,582	4,457
3	MBank El Paso, N.A., El Paso, TX	1,194,060	1,104,454	1,152,617	41,443
4	MBank New Braunfels, N.A., New Braunfels, TX	139,784	131,792	135,079	4,705
5	MBank Waco, N.A., Waco, TX	471,755	460,845	470,707	1,048
	Totals	\$2,953,964	\$2,722,366	\$2,882,305	\$71,659

Source: FDIC Division of Research and Statistics.



CHAPTER 8

Bank of New England Corporation

Name of Institution:	Bank of New England Corporation
Subsidiary Banks:	Bank of New England, N.A., Boston, Massachusetts Connecticut Bank & Trust Company, N.A., Hartford, Connecticut Maine National Bank, Portland, Maine
Date of Resolution:	January 6, 1991
Resolution Method:	Formation of Bridge Banks
Date of Resolution:	July 12, 1991
Resolution Method:	Sale of Bridge Banks by Dissolution and Purchase and Assumption Transaction

Introduction

The January 6, 1991, failure of the Bank of New England (BNE), Boston, Massachusetts, and its two sister banks, Connecticut Bank & Trust Company (CB&T), Hartford, Connecticut, and Maine National Bank (MNB), Portland, Maine, was the largest since the 1989 collapse of MCorp and the 1988 collapse of the First Republic Bank Corporation, both of Dallas, Texas. All three banks were owned by Bank of New England Corporation (BNE Corp.). The failures received a lot of news media attention because 45 credit unions without federal deposit insurance had been closed in nearby Rhode Island on New Year's Day.¹

In addition to being very large, the resolution of the BNE Corp. banks is notable because the FDIC, considering the region's financial conditions, decided to protect all depositors (except those affiliated with BNE Corp.), including those whose total deposits exceeded the \$100,000 insurance limit. Of the approximately \$19.1 billion on deposit in the three banks, more than \$2 billion were in accounts larger than \$100,000. Then-FDIC Chairman L. William Seidman stated, "It was clear to us that to protect the stability of the system, we should protect all depositors."²

1. L. William Seidman, *Full Faith and Credit: The Great S&L Debacle and Other Washington Sagas* (New York: Times Books, 1993), 165.

2. Stephen Labaton, "U.S. Is Taking Over a Group of Banks to Head Off a Run," *The New York Times* (January 7, 1991), A1.

The FDIC again used its bridge bank powers in the resolution of Bank of New England, Connecticut Bank & Trust Company, and Maine National Bank, and the FDIC used its cross guarantee assessment authority to assess MNB for the FDIC's costs associated with the BNE failure. As part of the transaction, the FDIC injected \$750 million of capital into the bridge banks. A small trust company, BNE Trust Company, West Palm Beach, Florida, that was also owned by the holding company, BNE Corp., did not fail.

General Description of the Bank

BNE, based in Boston, was one of the largest banks in the commonwealth of Massachusetts and at the time of its failure was the 33rd largest bank in the United States. CB&T, based in Hartford, was the second largest bank in the state of Connecticut. These two banks, along with a sister bank, MNB, had \$21.8 billion in total assets and 117 branch locations throughout New England. They also held more than \$19 billion in deposits at the time of their failure.

Background

For many years, BNE profited from the booming economy in the Northeast and from a series of acquisitions that greatly increased its size. The lending problems emerged in early 1990 when, after a bank examination, BNE announced a \$1.23 billion loss for the fourth quarter of 1989. As bad loans mounted, the bank set aside reserves for loan losses that amounted to about \$650 million in 1990.

Economic Conditions

While the southwestern portion of the United States in the 1980s was suffering from problems with oil and gas loans, as well as huge real estate losses, the Northeast had continued to grow. Real estate prices, and the economy in general, grew by nearly 20 percent annually for several years. But, by 1990, real estate values in the Northeast were falling. Vacancy rates for both residential and commercial properties were rising.³ The condominium market, particularly Connecticut's, was overflowing, with some areas having more than a two-year supply of vacant units.⁴ The state of the real estate market was felt by the banking industry in the region.

3. National Association of Realtors, "Home Sales," vol. 5, no. 11 (November 1991), 10, 13, 19; CB Commercial Torto/Wheaton Research, "The Office Outlook Report," vol. 1 (September 1993).

4. Katherine Morrall, "Weakening Northeast Real Estate Market Raises Concerns," *Savings Institutions*, vol. 111, no. 4 (April 1990), 11-14, as provided in extract available from ProQuest.

During 1990, the number of FDIC insured problem banks declined from 1,109 to 1,046, but the volume of assets in those institutions increased dramatically. The problem banks had \$408.8 billion in assets in 1990, nearly double the \$235.5 billion in assets in 1989. By the end of 1990, 2.9 percent of all commercial banking assets were classified as troubled.⁵ For all FDIC insured banks, troubled assets increased by \$23.5 billion in 1990, or nearly three times the previous year's increase of \$8.2 billion. Net charge-offs for banks nationwide rose to a record \$29 billion, compared with the previous high of \$23 billion in 1989.⁶

BNE was not the only bank in the region with problems. Forty percent of all banks in the Northeast reported negative income for 1990. Nonperforming assets at Northeast banks peaked at 5 percent of total assets, and nonperforming loans accounted for more than 8 percent of all loans.

Problems at Bank of New England

A new management team, headed by Lawrence K. Fish, was installed in BNE early in 1990. In February and April 1990, BNE, CB&T, and MNB all consented to cease and desist orders with the Office of the Comptroller of the Currency (OCC) that required them to, among other things, improve their real estate lending procedures and tracking systems and to increase capital. BNE Corp. presented a recapitalization plan to the Federal Reserve Bank of Boston (Federal Reserve) that proposed the sale of its Maine and Rhode Island subsidiaries for \$189 million and would have allowed the banking subsidiaries to repurchase \$344 million of their debt at a substantial discount. Overall, the plan would have increased equity by \$185 million. The Federal Reserve did not approve the plan as presented.⁷

By September 1990, almost half the loans BNE had made for construction projects, and nearly 20 percent of its mortgage loans for commercial projects, were delinquent.⁸ It was thought, however, that the solid consumer branch networks of BNE and CB&T would be enough to pull BNE Corp. through the problems.⁹ The press indicated that proposals by BNE Corp. bondholders to exchange their bonds for stock were actively discussed in late December 1990, but no transactions were completed.¹⁰ On Friday, January 4, 1991, BNE Corp. indicated that it had lost up to \$450 million in the fourth quarter of 1990, mostly as a result of losses on its delinquent real estate loans.¹¹ (See table II.8-1.)

5. Troubled assets were defined as loans that were 90 days or more past due, loans no longer earning interest, and owned real estate.

6. FDIC, *1991 Annual Report*, 15.

7. Thomas E. Cimeno, Jr., Senior Vice President, Federal Reserve Bank of Boston, letter addressed to Edward Lane-Retticker, Secretary, Bank of New England Corporation (June 20, 1990).

8. Cimeno, letter, June 20, 1990.

9. Comptroller of the Currency, News Release (January 6, 1991).

10. Michael Quint, "A Success Story Turns Sour in New England," *The New York Times* (January 7, 1991), D8.

11. "BNEC Projects Fourth Quarter Results," *PR Newswire Association, Inc.* (January 4, 1991), Financial News Section.

Table II.8-1

**Bank of New England Corporation Institutions
Information as of September 30, 1990**

(\$ in Millions)

	Assets	Liabilities	Equity	Income
BNE	\$13,172	\$13,062	\$110	-\$174
CB&T	7,711	7,477	234	-5
MNB	1,050	983	66	4
BNE Corp. *	\$23,042	\$22,787	\$255	-\$203

* Bank subsidiary figures will not equal the holding company's totals because of other holding company assets that are not reflected in these figures.

Source: Comptroller of the Currency, News Release (January 6, 1991).

Preparation for Resolution

BNE and BNE Corp. bondholders who owned more than \$700 million in BNE securities had proposed a rescue plan for the bank in December 1990. On January 3, 1991, bank management offered a revision to that plan under which the bondholders would swap all of their debt securities for about 95 percent of new BNE common stock. The transaction would have erased about \$700 million of debt from the books of BNE Corp., and its offsetting equity would have been an increase in the capital of the bank. The plan also proposed raising an additional \$100 million through a shareholder rights offer, but it depended on the FDIC's contribution of at least \$200 million.¹² Bank executives worked on the plan throughout the following weekend, but were unable to complete it before the bank failed.

On Saturday, January 5, 1991, the FDIC Board of Directors met to discuss BNE's financial condition. The governor of nearby Rhode Island had recently closed 45 credit unions and, because of the insolvency of that state's deposit insurance fund, the insured depositors in those credit unions were unable to retrieve their money. Publicity surrounding that event, coupled with BNE Corp.'s announcement of loss, was contributing to public fears for the safety and soundness of BNE and its affiliates. As Comptroller of the Currency Robert L. Clarke stated later, "Clearly, we were thinking about Rhode Island." Even though the problems with the credit unions were unrelated to BNE, Clarke said, "... it makes people real nervous. People who are not familiar with these things don't always make distinctions. All they know is they can't get their money."¹³

12. Peter G. Gosselin and Doug Bailey, "Last Ditch Rescue Plan Fell Short," *The Boston Globe* (January 7, 1991), 1.

13. Peter G. Gosselin and Doug Bailey, "US Takes Over the Bank of N.E.; \$750M To Be Pumped into Broke Institution," *The Boston Globe* (January 7, 1991), 1.

Essentiality Test of Deposits In Excess of the Insurance Limit

The FDIC identified the major categories of customers with deposits in excess of the insurance limit in the event that only insured deposits were passed to an acquirer and determined that the effect of that action on the community at large outweighed the benefits of paying insured deposits only. Both the Federal Reserve and the Treasury Department supported the idea that all depositors be protected. “It was clear to us that to protect the stability of the system, we should protect all depositors,” said Chairman Seidman.¹⁴

The Resolution—January 6, 1991

The OCC closed both BNE and CB&T on Sunday, January 6, 1991, and appointed the FDIC as receiver. The FDIC exercised its cross guarantee authority and ordered the payment of \$1,015,000 by the affiliated MNB. The OCC then declared MNB insolvent and closed that bank as well.¹⁵

The FDIC created three bridge banks: New Bank of New England, N.A. (New BNE), Boston, Massachusetts, with assets of approximately \$8 billion; New Connecticut Bank & Trust Company, N.A. (New CB&T), Hartford, Connecticut, with assets of approximately \$6.4 billion; and New Maine National Bank (New MNB), Portland, Maine, with assets of approximately \$800 million.¹⁶

All three bridge banks were opened for business on Monday, January 7, 1991. The Federal Reserve announced that it was prepared, in accordance with customary arrangements, to meet any unusual liquidity needs of the banks.^{17, 18}

The FDIC fully protected all deposits of all three failed banks, including those deposits exceeding the \$100,000 insurance limit. All deposits were transferred to the new banks. Liabilities to trade creditors, employees, and qualified financial contracts such as foreign exchange contracts and interest rate swaps, also were transferred to the bridge banks.¹⁹ Not all creditors were offered full protection. Instead, the FDIC

14. Labaton, “U.S. Is Taking Over a Group of Banks to Head Off a Run,” A1.

15. The cross guarantee authority discourages multi-bank holding companies from transferring losses that occurred at their better-capitalized institutions into troubled sister institutions. Without the cross guarantee authority, losses might be transferred to weak banks that are then allowed to fail, and the deposit insurance fund would have to bear the losses, rather than the holding companies.

16. FDIC News Release, PR-61-91, “FDIC to Sell Bank of New England Franchise to Fleet/Norstar” (April 22, 1991).

17. A Federal Reserve Bank customarily makes loans that are “secured to the satisfaction of such Federal Reserve Bank.” Irvine H. Sprague, *Bailout* (New York: Basic Books, 1986), 213.

18. FDIC News Release, PR-3-91, “FDIC Establishes Three New Banks to Assume Deposits of Bank of New England, N.A., Boston, Massachusetts, Connecticut Bank & Trust Company, N.A., Hartford, Connecticut, and Maine National Bank, Portland, Maine” (January 6, 1991).

19. FDIC News Release, PR-3-91.

Table II.8-2

Bridge Banks

	Total Assets
New BNE	\$13.9 billion
New CB&T	7.1 billion
New MNB	1.0 billion

Source: FDIC News Release, PR-61-91, "FDIC to Sell Bank of New England Franchise to Fleet/Norstar" (April 22, 1991).

announced that other nonsubordinated creditors (those affiliated with BNE Corp.) would share pro rata with the FDIC in the receivership estates of the failed banks. Neither did the new banks assume any of the liabilities of the parent holding company, BNE Corp., or its creditors.²⁰

The bridge banks were set up with \$750 million in capital to continue operating the bridge banks.²¹ The capital was distributed as follows: \$450 million to New BNE and \$250 million to New CB&T and \$50 million to New MNB.²² Lawrence K. Fish was named chairman of the three bridge banks.

Selection of the Winning Bidder

The three bridge banks were marketed and, on April 22, 1991, the FDIC Board of Directors approved the bid of Fleet/Norstar Financial Group (Fleet), Providence, Rhode Island, for all three of the bridge banks.²³ The FDIC entered into an interim management agreement with Fleet to manage the bridge banks until the purchase and assumption (P&A) transaction could be consummated. The FDIC also entered into a service agreement with Fleet for the servicing of the former banks' problem assets.

The FDIC Board of Directors selected the acquirer by using the "essentiality" exemption from the cost test as provided in the Federal Deposit Insurance Act (FDI Act). The exemption was specifically contained in Section 13(c)(4)(A) of the FDI Act:

No assistance shall be provided under this subsection in an amount in excess of that amount, which the Corporation determines to be reasonably necessary to

20. FDIC News Release, PR-3-91.
21. FDIC News Release, PR-3-91.
22. FDIC, *Equity Investment Portfolio, Bank Insurance Funds* (December 31, 1993), 22-24.
23. FDIC News Release, PR-61-91.

save the cost of liquidating, including paying the insured accounts of, such insured depository institution, except that such restriction shall not apply in any case in which the Corporation determines that the continued operation of such insured depository institution is essential to provide adequate depository services to its community.²⁴

This exemption permitted the FDIC to provide assistance without performing an analysis of the cost because it had determined that “the continued operation of [the banks was] essential to provide adequate depository services” in their respective communities. This type of exemption to the cost test was eliminated by the Federal Deposit Insurance Corporation Improvement Act (FDICIA) of 1991, passed later in the year. FDICIA requires the FDIC to always use the least costly resolution method except in the case of systemic risk.

Fleet’s existing Connecticut and Maine banking entities acquired the assets and liabilities of New CB&T and New MNB; Fleet established a new bank named Fleet Bank of Massachusetts, N.A. (Fleet Boston) to absorb the New BNE assets and liabilities.²⁵

Fleet’s bid had originally requested capital assistance from the FDIC, but it was able to raise \$683 million of new capital with the assistance of Kohlberg, Kravis Roberts & Co. (KKR), Merrill Lynch, and Salomon Brothers. Fleet also put \$67 million of its own money into the transaction;²⁶ KKR provided an additional \$283 million. Chairman Seidman said, “We are delighted to see this new money coming into the banking system.”²⁷

The partnership between Fleet and KKR had mutual benefits. Fleet needed the capital provided by KKR to qualify for the right to bid. KKR, however, was unable to bid for a banking entity on its own, because of the provisions of the Bank Holding Company Act that limited ownership of a bank by nonbank institutions to less than 25 percent.²⁸ In the bid for the bridge banks, KKR assumed a passive role in the transaction. The bid for the bridge banks also marked the first time since the Great Depression that a nonbank investor participated in the acquisition of a failed commercial bank.²⁹ Chairman Seidman was reported as saying that the Fleet bid had been chosen over the other bidders for one reason: Its bid represented the lowest-cost alternative for the deposit insurance fund.³⁰

BNE and CB&T had agreed to sell their corporate trust business to State Street Bank and Trust Company (State Street), Boston, Massachusetts, prior to their failure. After the

24. See *U.S. Code*, volume 12, section 1823(c)(4)(A).

25. Fleet had acquired the failed Maine Savings Bank, Portland, Maine, which failed on February 1, 1991.

26. Doug Bailey and Peter G. Gosselin, “Fleet, Partner To Buy Bank of N.E.; With \$875M Offer, R.I. Bank and N.Y. Firm Win Bidding War,” *The Boston Globe* (April 23, 1991), 1.

27. FDIC News Release, PR-61-91.

28. Geoffrey Smith, “Right Time, Right Place, Right Price,” *Business Week*, No. 3212 (May 6, 1991), Top of the News Section, 28.

29. Bailey and Gosselin, “Fleet, Partner To Buy Bank of N.E.; With \$875M Offer, R.I. Bank and N.Y. Firm Win Bidding War,” 1.

30. Bailey and Gosselin, “Fleet, Partner To Buy Bank of N.E.; With \$875M Offer, R.I. Bank and N.Y. Firm Win Bidding War,” 1.

Table II.8-3**Discounts Taken by the FDIC in Calculating the Purchase Price of Assets Put Back**

Period after Commencement Date	Discount Percentage
0-365 days	0
13-24 months	2
25-36 months	4

Source: Assistance Agreement among the FDIC, in its corporate capacity; Fleet/Norstar Financial Group, Inc.; Fleet/Norstar Holding Company, Inc.; and the FDIC as receiver of New Bank of New England, N.A.; New Connecticut Bank and Trust Company, N.A.; and New Maine National Bank (July 12, 1991), 111-112.

failure of those banks, the FDIC, as receiver, transferred the trust business to the bridge banks and disaffirmed the Sale Agreement with State Street. Notwithstanding the disaffirmance, the FDIC, Fleet, and State Street jointly agreed that the sale should proceed. The FDIC completed that transaction on September 3, 1991, with an effective date of July 14, 1991.³¹

Structure of the Transaction

Three of the characteristics of the purchase and assumption transaction involved shared equity, put back provisions, and a servicing agreement.³²

- **Shared Equity:** The FDIC received as a premium an issue of preferred stock worth approximately \$100 million, plus a cash premium of \$25 million. The FDIC purchased class I and class II preferred stock from Fleet for both the New BNE and the New CB&T transactions.³³ The proceeds were used as capital to provide Fleet with the capital ratios required for the transaction.
- **Put Options:** Fleet purchased all nonclassified commercial, industrial, and commercial real estate loans. The FDIC provided Fleet with a three-year option to put back to the FDIC any commercial asset that became classified after the date it was acquired by Fleet. The price the FDIC was required to pay for assets put back was discounted over time; in general, the longer the period that Fleet held and managed the assets prior to the put back, the larger the discount taken by the FDIC. All 1-4 family real estate loans with a book value of less than \$191,250 and all other consumer loans with a book value of less than \$100,000 were acquired without any put back provision. Table II.8-3 represents the discounted amount over time.

31. Fleet/Norstar Financial Group, Inc., and Fleet Bank of Massachusetts, N.A., to the FDIC, Letter re: Instrument of Appointment effective as of July 14, 1991, by the FDIC as Receiver of New Bank of New England, N.A., and the New Connecticut Bank and Trust Company, N.A., to State Street Bank and Trust Company (September 13, 1991) and attached Instrument of Appointment (September 3, 1991).

32. FDIC, "Revised Instructions to Bidders" regarding structure of transaction governing assisted acquisitions of New Bank of New England, N.A., New Connecticut Bank & Trust Company, N.A., and New Maine National Bank (March 14, 1991).

33. Refer to the section of this chapter entitled "The Stock Transactions."

- **Service Agreement:** All classified loans and owned real estate of the three banks were owned by the FDIC and placed in a special asset pool. The FDIC and Fleet entered into a five-year service agreement under which Fleet would service and collect loans on behalf of the FDIC. In general, the FDIC reimbursed Fleet for eligible costs actually incurred in servicing the pool of assets. In addition, incentive fees were given based on a percentage of cumulative net collections to gross book value. The graduated incentives are shown in Table II.8-4.

Table II.8-4

Incentive Fee Structure for Servicing Agreement

Cumulative Net Collections as a Percentage of Gross Pool Value	Incentive Fees as a Percentage of the Cumulative Net Collections
Over 0% to and including 20%	1.5
Over 20% to and including 31%	4.0
Over 31% to and including 39%	7.5
Over 39% to and including 46%	11.0
Over 46% to and including 50%	18.5
Over 50%	27.5

Source: Service Agreement by and among Fleet/Norstar Financial Group, Inc.; RECOLL Management Corporation; New Bank of New England, N.A.; New Connecticut Bank and Trust Company, N.A.; New Maine National Bank; and the FDIC (June 1, 1991), 18.

As part of the bridge bank resolution, the 108-branch Fleet Bank of Maine would have acquired the 40 branches of New MNB. Even before the purchase, Fleet Bank of Maine was that state's largest financial institution, with \$2.9 billion in deposits or nearly 22 percent of the state's total deposits. The purchase of New MNB by Fleet added another \$1 billion in deposits, or 7.2 percent of the state's deposits. The U.S. Department of Justice viewed this situation as anti-competitive, and on July 5, 1991, Fleet agreed to re-sell six of the Maine branches it was acquiring to settle the antitrust concerns of the U.S. Department of Justice before it could file suit. A spokesman for Fleet stated that Fleet did not consider the sale of the six branches to reduce the value of the New MNB franchise. The six branches sold had a total of \$85 million in deposits.³⁴

The Liquidation

While Fleet had been managing the bridge banks on an interim basis since April 29, 1991, the servicing agreement with Fleet to manage and dispose of all classified and charged-off assets of the failed banks began on June 1, 1991. Fleet established a wholly owned subsidiary, RECOLL Management Corporation (RECOLL), to manage the

34. Mitchell Zuckoff, "Fleet/Norstar to Sell 6 Branches in Maine to Settle Suit By US," *The Boston Globe* (July 6, 1991, 31).

FDIC's assets. The assets were placed in a separate asset pool that initially consisted of more than 17,000 substandard loans and 500 owned real estate properties with a total book value of \$5.8 billion. Fleet had the right to put back to the FDIC, within a three-year period, any loan from the failed banks that was later classified by Fleet's internal staff and the FDIC's examination staff. Such put backs also were added to the pool serviced by RECOLL.

RECOLL was given limited delegations and was supervised by an oversight committee consisting of two employees from the FDIC and one officer of Fleet. The oversight committee had unlimited delegations except for the authority to grant indemnifications. While RECOLL had operational responsibility for the management and disposition of the pool, it needed the committee's approval on the larger transactions. The oversight committee approved 75 percent (based on the total dollar amount of the pool) of all asset disposition decisions; other decisions were made by lower-level RECOLL committees.

RECOLL's initial assignment was massive, with numerous start-up challenges. RECOLL inherited approximately 360 account officers from BNE's collections and real estate sales departments. In only six months, RECOLL's staff had grown to nearly 1,000 and eventually reached 1,200. The former banks had operated collection offices from five different cities in three different states, and RECOLL merged two of these sites into the remaining offices by the end of 1991. Additionally, the former banks had approximately 30 different data processing systems that had to be converted into one system before adequate management reports could be obtained.

Another problem for RECOLL was the lack of available refinancing opportunities for borrowers with loans in the asset pool. Only six banks had failed in New England during the 1980s, but 88 banks failed in the region from 1990 through 1993. The remaining banks became increasingly conservative, and a "credit crunch" ensued. Small businesses were severely limited in their ability to refinance their debts serviced by RECOLL. A sizable number of loans in the asset pool that required the payment of interest only until the final due date (referred to as interest-only balloon loans) became known as "performing nonperforming" loans. The value of real estate in New England was declining and, even though borrowers were making required payments (performing), some of the balloon loans became classified because the underlying real estate collateral had insufficient value to support the debt amount or had passed their contractual maturity dates (nonperforming). The public perceived that RECOLL, on behalf of the FDIC, was foreclosing and litigating against borrowers whose loans were past maturity and technically delinquent, but whose only real fault was being in an economic environment where third-party refinancing was not available.

Some borrowers complained that RECOLL's account officers were being too aggressive in their collection tactics, and elected officials in the New England states took an active role in investigating RECOLL's practices. In response, RECOLL and the FDIC began holding town meetings in September 1991 to better communicate their mission to the public and to attempt to resolve individual borrower issues. RECOLL set up a

Borrower Review Office in October 1991 to investigate borrower complaints. In October 1991, the FDIC and Fleet began negotiating the repurchase of these borderline credits by Fleet, subject to a full buy-back guarantee by the FDIC. By the end of January 1992, Congressional hearings were scheduled in both Portland, Maine (February 1, 1992), and Boston, Massachusetts (February 3, 1992), to hear testimony from RECOLL borrowers, to review RECOLL's loan collection procedures, and to discuss the larger issue of the New England credit crunch.

The FDIC worked with officials of Fleet and RECOLL to address the complaints of borrowers and elected officials. Loan foreclosures were temporarily halted to put in place steps to review all loans in foreclosure or litigation, and the authority within RECOLL to initiate litigation was restricted. The FDIC conducted a site visitation to review litigation, and RECOLL subsequently revised its policies and procedures regarding the initiation of legal action. RECOLL staff received additional training in their policies and procedures.

In January 1992, Fleet announced that it would repurchase a package of approximately \$500 million of performing nonperforming loans from the special asset pool. Purchased loans had to have the following characteristics:

- Less than 30 days past due under original note terms or an existing workout or restructure agreement,
- Loan-to-value ratio of 125 percent or less,
- No related credit in the special asset pool,
- No pending litigation, and
- Cooperative borrower and optimistic recovery.

The sale contained two unusual provisions. First, the FDIC agreed that Fleet would have the right to return any of the loans for any reason until July 1994, allowing time for borrowers to establish a business relationship with the operating bank. Second, the FDIC also protected additional extensions of credit by Fleet to the affected borrowers up to a maximum of 10 percent of the amount of the loan purchased. Loans not purchased by Fleet would be offered to other financial institutions with the same terms and conditions.

After the public hearings, the FDIC issued a press release on February 13, 1992, clarifying its national liquidation and supervision policies.³⁵ In short, the FDIC stated the following:

- Borrowers current on their payments could continue according to the terms of their loans, and the FDIC would not foreclose or initiate litigation with current borrowers.
- When a current loan matured and the borrower was unable to refinance at another institution, the FDIC would work with the borrower to restructure the loan so that it could be sold to another financial institution.

35. FDIC News Release, PR-21-92, "FDIC Clarifies Liquidation and Supervision Policies" (February 13, 1992).

- Bank examiners would not adversely classify loans (sold to another financial institution) that had loss protection by the FDIC.
- The press release also referenced the recently announced sale of loans to Fleet and indicated that borrowers with current loans managed by RECOLL who believed their loans should have been included in the package of loans purchased by Fleet were to write to the FDIC for a review of their situation.

The sale generated positive reviews from some of those who previously had been critical of the FDIC's handling of loans in New England. Massachusetts Representative Joseph P. Kennedy was quoted as saying, "The FDIC is not only recognizing that the credit crunch exists, but alleviating some of the lack of liquidity that banks have felt with regard to these troubled loans."³⁶ John Kyte, vice president of legislative affairs of the New England Council, a consortium of 500 businesses, said, "This is the first significant ray of hope I've seen. It offers the businessperson with temporary cash flow problems and capital shortages something to get over the hump."³⁷ But at the time of the sale there were still critics. "It reminds me of the strategy the big banks took in Latin America in the early 1980s," said Karen Shaw, president of the Institute for Strategy Development. "It seems like they're solving a different problem than the one they say they have."³⁸

The FDIC viewed the loan sale as having achieved its goal. As the economy improved, more than two-thirds of the loans purchased were worked out in an open bank environment, which gave borrowers an opportunity to establish a financial relationship with an open institution instead of being liquidated. Fleet purchased 2,667 loans valued at approximately \$1.1 billion under the sale. As loans deteriorated, or as borrowers defaulted, Fleet would return the loans to the FDIC, which would repurchase them as required under the terms of the sale agreement. During the course of the contract, the FDIC repurchased 1,054 loans (40 percent of the loans sold) valued at approximately \$314 million (27 percent of value sold).

In addition, several years later, there remained \$834 million in loans still eligible for the July 1994 repurchase by the FDIC. These were loans in which the borrowers were able to continue making their interest payments but were still unable to obtain refinancing at other banks. Rather than return the loans, in 1994, the FDIC and Fleet negotiated an amendment to the loan purchase agreement that released the FDIC from its repurchase obligation in exchange for a percentage of the maximum repurchase price. Because of this agreement, the FDIC and Fleet were able to terminate the five-year servicing agreement approximately six months early.

36. Debra Cope and Jim McTague, "Loan Gambit By FDIC Gets Cheers, Jeers," *American Banker* (February 7, 1992), 1.

37. Cope and McTague, "Loan Gambit By FDIC Gets Cheers, Jeers," 1

38. Cope and McTague, "Loan Gambit By FDIC Gets Cheers, Jeers," 1

Despite early problems, RECOLL effectively disposed of one of the largest and most complex asset pools of the FDIC. For the four and one-half year contract, RECOLL achieved book value reductions of \$6.5 billion, gross collections of \$4.2 billion, and net collections of \$3.6 billion, for an overall recovery rate (net collections to book value reductions ratio) of 55 percent. The collections were achieved within the four and one-half year period. The original contract term was shortened by six months to December 1995, and the FDIC absorbed the remaining assets into its other Northeast offices.

The Stock Transactions³⁹

New BNE

On January 6, 1991, the FDIC acquired 4,500,000 shares of class I preferred stock in the bridge bank through the note purchase agreement for an investment of \$450 million. The bridge bank stock was redeemed on July 12, 1991, for \$450 million to record the assistance agreement with Fleet.

Class I Preferred Stock—Fleet Boston. On July 16, 1991, as part of the premium for the bridge banks, Fleet gave the FDIC 560,000 shares of class I preferred stock in Fleet Boston; the stock had a value of \$56 million. No dividends were ever received on the class I preferred stock. In March 1992, Fleet Boston redeemed 140,435 shares of the class I preferred stock for \$14.5 million, which represented a gain to the FDIC of \$0.5 million. On March 31, 1993, Fleet redeemed the remaining shares of class I preferred stock for \$45.3 million, which represented a gain to the FDIC of \$3.3 million. In all, the total gain to the FDIC on the class I preferred stock was \$3.8 million.

Class II Preferred Stock—Fleet Boston. In December 1991, the FDIC purchased 280,000 shares of class II preferred stock in Fleet Boston for \$28 million. Dividends were received on the class II preferred stock as follows: \$0.4 million in September 1992; \$0.7 million on December 30, 1992; \$0.7 million on March 9, 1993; and \$0.5 million on May 12, 1993. Total dividends were \$2.3 million. On May 12, 1993, Fleet redeemed the 280,000 shares of class II preferred stock for \$29.8 million, which represented a gain to the FDIC of \$1.8 million. Dividends plus gain on redemption totaled \$4.1 million.

For all Fleet Boston stock, the FDIC received \$2.3 million in dividends and \$5.6 million in gains at redemption, for a total to the FDIC of \$7.9 million.

39. All information relating to the stock transactions is taken from FDIC, *Equity Investment Portfolio, Bank Insurance Fund* (December 31, 1993), 22-24.

New CB&T

On January 6, 1991, the FDIC acquired 2,500,000 shares of class I preferred stock in the bridge bank through the note purchase agreement for an investment of \$250 million. The bridge bank stock was redeemed on July 12, 1991, for \$250 million to record the assistance agreement with Fleet.

Class I Preferred Stock—Fleet Hartford. On July 12, 1991, as part of the premium for the bridge banks, Fleet gave the FDIC 440,000 shares of class I preferred stock in Fleet Hartford; the stock had a value of \$44 million. No dividends were ever received on the class I preferred stock. On March 31, 1993, Fleet redeemed all 440,000 shares of class I preferred stock for \$47.5 million, which represented a gain to the FDIC of \$3.5 million.

Class II Preferred Stock—Fleet Hartford. In December 1991, the FDIC purchased 220,000 shares of class II preferred stock in Fleet Hartford for \$22 million. Dividends were received on the class II preferred stock as follows: \$0.3 million in September 1992; \$0.6 million on December 30, 1992; \$0.5 million on March 9, 1993; and \$0.4 million on May 12, 1993. Total dividends were \$1.8 million. On May 12, 1993, Fleet redeemed the 220,000 shares of class II preferred stock for \$23.4 million, which represented a gain to the FDIC of \$1.4 million. Dividends plus gain on redemption totaled \$3.2 million.

For all Fleet Hartford stock, the FDIC received \$1.8 million in dividends and \$4.9 million in gains at redemption, for a total to the FDIC of \$6.7 million.

New MNB

On January 6, 1991, the FDIC acquired 500,000 shares of class I preferred stock in the bridge bank through the note purchase agreement for an investment of \$50 million. The bridge bank stock was redeemed on July 12, 1991, for \$50 million to record the assistance agreement with Fleet. The FDIC never received stock in Fleet Portland.

On the sale of the three banks, the FDIC recovered \$14.6 million plus the \$100 million value of the original stock obtained as a part of Fleet's premium for the bridge banks.

FDIC Resolution Costs

The FDIC infused capital into the bridge banks and purchased stock in Fleet Boston and Fleet Hartford. The FDIC also absorbed approximately \$270.7 million in bridge bank operating losses.

In early termination of the servicing agreement, RECOLL returned the MNB assets with a book value of \$5 million to the FDIC in April 1995, and the CB&T assets with a book value of \$28 million were returned to the FDIC at the end of August that same

year. The remaining BNE assets of approximately \$250 million were returned to the FDIC in December 1995.

Total resolution costs for Bank of New England, Connecticut Bank & Trust, and Maine National Bank were approximately \$889 million as of December 31, 1995, or about 4.1 percent of the total assets. See table II.8-5 for a summary of resolution costs.

Lessons Learned

Because the FDIC protected all depositors in the BNE Corp. banks, the failures resulted in little disruption among the banks' depositors. In contrast to the situation in Rhode Island, where 45 credit unions without federal deposit insurance had failed only days earlier, depositors in the BNE Corp. banks were fully protected. Public confidence in the banking system and in the FDIC remained high.

Table II.8-5

BNE Corp. Banks Resolution Costs

(\$ in Thousands)

	BNE	CB&T	MNB	Total
Expenses				
Stock purchase	\$28,000	\$22,000	\$0	\$50,000
Bridge bank losses	103,010	103,001	2,137	208,148
Losses on qualified financial contracts	62,506	0	0	62,506
Allowance for receivership losses	580,810	152,497	0	733,307
Total FDIC expenses	\$774,326	\$277,498	\$2,137	\$1,053,961
Recoveries				
Sale of stock received as premium	\$56,000	\$44,000	\$0	\$100,000
Gain on sale of stock received as premium	3,757	3,436	0	7,193
Sale of stock purchased	28,000	22,000	0	50,000
Gain on sale of stock purchased	1,820	1,430	0	3,250
Dividends on stock	2,318	1,821	0	4,139
Total FDIC Recoveries	\$91,895	\$72,687	\$0	\$164,582
Total Resolution Cost	\$682,431	\$204,811	\$2,137	\$889,379

Source: FDIC Division of Finance, *The Cost of Large Resolution Transactions* (March 12, 1996).

Some of the borrowers of the failed banks were not as happy with the resolution. The FDIC learned from its experience with RECOLL that contracted asset management firms can sometimes be overly aggressive in their attempts to collect loans for the FDIC, resulting in complaints from borrowers and elected officials in the area. That issue, along with the costs associated with the FDIC's ownership of failed bank assets, resulted in the FDIC's overall review of asset management contracting. At the same time, the FDIC analyzed the January 1992 sale of performing nonperforming loans to Fleet, in which the FDIC protected Fleet against loss. Nearly 70 percent of the loans sold to Fleet were worked out either by Fleet or by an outside source, and the borrowers were able to establish new, ongoing financial relationships that they could use in future dealings.

The FDIC used its cross guarantee authority to assess MNB for the FDIC's estimated costs of resolving BNE. The cross guarantee authority was granted to the FDIC in 1989 when Congress passed the Financial Institutions Reform, Recovery, and Enforcement Act (FIRREA). Cross guarantee authority allows the FDIC to assess other banks within a holding company for losses incurred or expected to be incurred in resolving troubled banks within the same holding company. This authority discourages multi-bank holding companies from transferring losses at any of their institutions into troubled sister institutions and then allowing them to fail so that the deposit insurance fund would have to bear the losses rather than the holding companies. The cross guarantee authority was also significant in the later resolutions of First City Bancorporation of Texas, Inc., and Southeast Banking Corp. and has been a factor in reducing costs of resolving financial institutions.⁴⁰

Effect on Future Resolutions

In the 1980s, the most famous example of "too big to fail" was the resolution of Continental Illinois National Bank and Trust Company (Continental), Chicago, Illinois.⁴¹ On occasion, BNE and its affiliates were also referred to (inaccurately) as "too big to fail." The BNE Corp. banks did fail and were actually closed.

"Too big to fail" is, however, occasionally used to refer to the disparate treatment afforded to uninsured depositors in very large banks. It is true that from Continental's assistance through the resolution of the BNE Corp. banks, the average asset size of institutions resolved by straight deposit payoff and liquidation was approximately \$65 million. This compared unfavorably to those banks resolved through either open bank assistance or purchase and assumption transactions in which uninsured depositors were protected, the average size of which was about \$200 million.⁴² Those resolutions include

40. Refer to Chapter 5, First City Bancorporation of Texas, Inc., and Chapter 9, Southeast Banking Corp.

41. Refer to Chapter 4, Continental Illinois National Bank and Trust Company.

42. FDIC, *Failed Bank Cost Analysis 1986-1995* (1996), 11; FDIC, *History of the Eighties—Lessons for the Future: An Examination of the Banking Crisis of the 1980s and Early 1990s* (Washington, D.C.: FDIC, 1997), 248.

First City Bancorporation of Texas, Inc., with total assets of \$11.8 billion; First RepublicBank Corporation with total assets of \$33.4 billion; and MCorp with total assets of \$15.8 billion.⁴³

The perception of unfairness to depositors in small banks undoubtedly had an impact on the provisions of FDICIA, passed by Congress later in the year after the BNE Corp. banks failed. Some members of Congress wanted to prohibit the protection of uninsured depositors, but others argued to retain the FDIC's flexibility in dealing with unusual situations. In some large banks, all depositors would need to be protected, said Federal Reserve Board Chairman Alan Greenspan, "in the interests of macroeconomic stability," but there would "also be circumstances in which large banks fail with losses to uninsured depositors but without undue disruption to financial markets."⁴⁴

FDICIA placed some limits on the FDIC, but still left it the ability to protect all depositors in certain instances. The FDIC was required to evaluate all resolutions on the basis of which alternative caused the least cost to the deposit insurance fund, and the FDIC was prohibited from protecting any uninsured deposits or nondeposit bank debts whenever that protection would increase losses to the deposit insurance fund. The FDIC could not provide open bank assistance to any institution unless it was the least expensive method of resolution. The only exception to the requirement of least cost resolution was in the event of systemic risk. Such cases require the approval of the secretary of the Treasury after consultation with the president of the United States and at least a two-thirds vote of both the FDIC Board of Directors and the Board of Governors of the Federal Reserve.⁴⁵

43. Refer to Chapters 5, 6, and 7, First City Bancorporation of Texas, Inc., First RepublicBank Corporation, and MCorp, respectively.

44. *Congressional Quarterly* (May 11, 1991).

45. See *U.S. Code*, volume 12, section 1823(c)(4)(G) for further information and a description of the systemic risk exception.



CHAPTER 9

Southeast Banking Corp.

Name of Institution:	Southeast Banking Corporation
Subsidiary Banks:	Southeast Bank, N.A., Miami, Florida Southeast Bank of West Florida, Pensacola, Florida
Date of Resolution:	September 19, 1991
Resolution Method:	Purchase and Assumption Transaction

Introduction

Southeast Banking Corporation (Southeast) was a two-bank holding company located in Miami, Florida. Although the resolution of Southeast's two banks is notable for several reasons, the primary reason is that it was one of the first times the Federal Deposit Insurance Corporation (FDIC) used a transaction known as loss sharing.¹ The loss sharing agreement for the two Southeast banks was a part of a purchase and assumption (P&A) transaction in which the acquiring institution, First Union National Bank of Florida (First Union), Jacksonville, Florida, a subsidiary of First Union Corporation (First Union Corp.), Charlotte, North Carolina, purchased \$10.1 billion of the failed banks' assets. First Union then managed and liquidated the assets under a loss sharing agreement that required the FDIC as receiver to reimburse First Union for a substantial portion of its losses on purchased assets² for a period of five years.³ The program was successful, and the FDIC recovered all of its principal expenditure for the resolution of the two banks.

The lead bank in the holding company, Southeast Bank, N.A. (Southeast Miami), Miami, Florida, was closed on September 19, 1991, when it was unable to repay a loan from the Federal Reserve Bank of Atlanta (Federal Reserve). The other bank in the holding company, Southeast Bank of West Florida (Southeast Pensacola), Pensacola, Florida,

1. See Part I, Resolution and Asset Disposition Practices, Chapter 7, Loss Sharing.

2. The FDIC agreed to reimburse First Union for a period of five years for 85 percent of net charge-offs on all assets other than certain consumer debts. The credit card debts and home equity loans loss reimbursement percentage declined in 5 percent increments from 85 percent in the first year to 65 percent in the fifth year. See the section of this chapter titled "A New Transaction Structure" for further information.

3. FDIC, *1991 Annual Report*, 20-21.

failed when the FDIC exercised its cross guarantee authority and demanded payment for expected losses incurred in the resolution of Southeast Miami.

General Description of the Institution

Southeast Miami and Southeast Pensacola had total assets of \$10.5 billion and total deposits of \$7.6 billion at the time of their failure. Most of the assets were with Southeast Miami; Southeast Pensacola had less than \$100 million in assets. Southeast Miami had 218 offices and Southeast Pensacola had 6, for a total of 224 offices. Together, they had approximately 6,200 employees. The parent corporation, Southeast, operated exclusively in Florida.

Background

The First National Bank of Miami was founded on December 1, 1902, and was the largest bank in Florida in 1946. It was one of only two banks in Florida to survive the Great Depression of the 1930s.⁴ The bank changed its name to Southeast Bank in 1969, under the leadership of Charles Zwick, former U.S. budget director during the Lyndon B. Johnson administration.

In the 1960s and 1970s, Southeast Miami was the biggest bank in Florida. It had a good reputation and was occasionally referred to as “the Morgan of the South.”⁵ Although some regional economic problems started weakening Southeast Miami in the early 1980s, it was still highly regarded in the Florida banking industry. In 1982, a hostile shareholder attempt to take control of the bank was rebuffed at a cost of \$148 million. Southeast Miami watched Barnett Banks, Inc. (Barnett), Jacksonville, Florida, pass it by as the largest bank in Florida in 1983. In 1987, Southeast Miami lost \$87 million on loans to lesser developed countries, and in 1988 Southeast Miami bought First Federal Savings and Loan, Jacksonville, Florida, an acquisition that turned out to be unprofitable.

Also during 1988, Southeast Miami began losing its deposit base to competitors. By June 30, 1990, it had fewer offices in Florida (246) than either First Union (390) or SunTrust Bank, (SunTrust) Atlanta, Georgia (369), and far fewer than Barnett (548). Although Florida was a banking market driven by consumer accounts and its economy was powered by small businesses, Southeast Miami was viewed as a bank that wanted to do business only with large companies.⁶ Southeast Miami had developed a large Latin

4. Robert Trigaux, David Dahl, John Craddock, and Helen Huntley, “Southeast Bank Sold to First Union,” *St. Petersburg Times* (September 20, 1991), 1A.

5. Gregg Fields, “Government Takeover of Miami’s Southeast Bank May Not Have Been Necessary,” *The Miami Herald* (October 6, 1997).

6. Gregg Fields, “Government Takeover of Miami’s Southeast Bank May Not Have Been Necessary.”

American private banking business, and the number of its uninsured deposits was high for a bank of its size. Uninsured deposits made up about 13 percent of all deposits at the end of 1990, and about \$760 million, or 10 percent of all deposits, at the time of failure.

Between July 1990 and January 1991, Southeast Miami replaced its president and entered into a formal agreement with the Office of the Comptroller of the Currency (OCC), in which it agreed, among other things, to improve its real estate lending and credit administration procedures. The bank failed to comply with parts of the enforcement action, however, and continued to experience substantial losses. For 1990, Southeast Miami reported losses of \$172 million.⁷

Southeast Miami had also experienced significant problems as a result of concentrated lending in commercial real estate and weak underwriting and credit administration practices. As of August 31, 1991, real estate loans at Southeast Miami totaled \$3.5 billion, or 45 percent of the bank's total loan and lease portfolio, and nonperforming assets equaled 10 percent of loans.⁸ Southeast Miami reported a loss of \$116.6 million for the first quarter of 1991 and \$139 million for the second quarter of 1991.

The announcement of the huge 1991 losses caused more depositors to withdraw their funds, and the bank's liquidity problems grew worse. Total deposits declined from \$11.2 billion at year-end 1990 to \$8 billion at the end of August 1991; deposits fell more than \$1 billion in July and August alone. In September 1991, Southeast Miami started offering above-market-rate certificates of deposit in an effort to generate liquidity.⁹ The Federal Reserve had agreed with Congress only a few months earlier that it would limit its lending to undercapitalized banks to a period of 60 days out of any 120-day period, and the bank was unable to obtain private funding to meet its daily cash needs.¹⁰

From June through early September 1991, Southeast Miami struggled to put together a proposal for open bank assistance (OBA) from the FDIC. Southeast Miami officials worked closely with the FDIC in arranging for due diligence teams from Barnett; First Union; NCNB Corporation (NCNB), Charlotte, North Carolina; SunTrust; and a private investor group. Southeast Miami's President Douglas Ebert reported, however, that hopes "really dimmed" when a New York investment firm that could have provided additional capital broke off negotiations on September 13, 1991.¹¹

7. "OCC [Office of the Comptroller of the Currency] Declares Southeast Bank Insolvent," *PR Newswire* (September 19, 1991), Financial News section.

8. "OCC Declares Southeast Bank Insolvent," Financial News section.

9. Robert Trigaux and Helen Huntley, "Banking's Changing of the Guard," *St. Petersburg Times* (September 21, 1991), 1B.

10. Barbara A. Rehm and Kenneth Cline, "First Union Bid Wins Ailing Bank in Miami," *American Banker*, (September 20, 1991), 1.

11. Kenneth Cline, "First Union Deal Breaks New Ground; Stock Market Signals That It Likes Pact," *American Banker* (September 23, 1991), Special Report section, "The Rescue in Miami," 1.

A New Transaction Structure

Because Southeast Miami was located in Florida, which was having fewer economic troubles than the Northeast, the bank attracted the interest of several potential acquirers. The FDIC believed the resolution presented an opportunity to experiment with a new type of transaction it had developed known as “loss sharing.” Rather than placing troubled assets into a special pool, as had been done in Texas and the Northeast, the FDIC asked bidders to purchase all of the failing banks’ assets other than its real estate owned. In exchange, the FDIC proposed to reimburse the acquirer for 85 percent of all net losses it might have on that portfolio for a period of five years.¹²

By placing all of the failed banks’ assets (except for real estate owned) with the acquirer, the FDIC was no longer responsible for 100 percent of losses, as it was when troubled assets were placed in a special asset pool. The acquirer accepted 15 percent of the risk and had a strong incentive to diligently manage the acquired assets. However, the risk of loss was viewed as low enough not to negatively affect the bidding process. Potential acquirers could adjust their bids downward for those projected losses but had to keep their bids competitive to win the franchise. Borrowers benefited from the new process, because they were more readily serviced by a standing financial institution, and the acquirer benefited by being able to retain more credit customers. The loss share agreement was also flexible enough to enable the acquirer to advance funds and restructure credits if it wanted to do so.

To introduce the new type of transaction structure, the FDIC made two accommodations to potential acquirers. First, the FDIC agreed to buffer the cost of carrying nonaccrual assets by accepting a note (the Nonaccrual Assets [NAA] note), rather than cash, from the acquirer in exchange for the nonaccrual assets. The NAA note was to bear interest at the nominal rate of 1/8 of 1 percent per year, and the amount of the note could be increased or decreased on a revolving basis as nonaccrual assets rose or fell over the course of five years.

Second, the FDIC recognized that retaining ownership of troubled assets imposed an additional capital burden on the acquirer, whether or not the assets were earning interest. To ease that situation for the acquirer, the FDIC agreed to purchase \$150 million of fixed-rate perpetual preferred stock in the acquiring institution’s holding company. The purchase of the stock in the parent corporation, rather than in the acquiring bank, provided the stock with increased marketability if the FDIC needed to sell it.

The FDIC developed a bid structure with four stipulations:

- The acquirer would provide the FDIC with the NAA note in the amount of \$639 million at closing;

12. Losses are defined as charge-offs or write-downs of the value of shared loss assets recorded in accordance with criteria used by bank examiners. Recoveries are defined as collections of (1) charge-offs of shared loss assets or (2) assets charged off by the failed bank. Net charge-offs or net losses are charge-offs less recoveries. For credit card debts and home equity loans, the FDIC proposed to reimburse the acquirer a declining percentage of loss over five years; the amount declined in 5 percent increments from 85 percent in the first year to 65 percent in the fifth year.

- The acquirer would pay the FDIC \$55.1 million in cash for the amount of earning assets that exceeded the liabilities assumed;
- After taking into consideration the potential loan losses, bidders could either offer premiums for the franchise or submit bids that would require the FDIC to pay them to take over the bank; and
- The FDIC would retain all real estate owned of the failed banks.

The Resolution

On September 19, 1991, the OCC notified the Federal Reserve that Southeast Miami was no longer a viable entity, and the Federal Reserve demanded payment of its \$568 million loan. Southeast Miami, with \$10.4 billion in assets, was unable to make payment and was closed by the OCC. Southeast Pensacola, with \$92.3 million in assets, was closed by the Florida state comptroller after the FDIC asserted its cross guarantee authority and assessed Southeast Pensacola \$143 million, the estimated cost of the FDIC's projected loss on Southeast Miami. At the time of its closing, Southeast Miami had approximately \$409 million in equity capital and \$430 million in loan loss reserves.¹³ Loan losses were expected to exceed \$1 billion, an amount that was more than twice the \$430 million in loan loss reserves and higher than equity capital and loan loss reserves combined.

Barnett, First Union, and SunTrust all submitted bids for the failed banks, and the bid from First Union was determined to be the least costly to the Bank Insurance Fund (BIF). The FDIC Board of Directors approved two purchase and assumption transactions with First Union, which paid a premium of \$81 million to take over the failed banks' franchises. All depositors were protected because the FDIC determined that transferring all deposits to First Union resulted in the lowest cost transaction for the BIF. The transaction made First Union the second largest banking entity in Florida, behind Barnett,¹⁴ and the 16th largest banking company in the United States.¹⁵

The two P&A agreements had the following basic parameters:

- First Union agreed to assume all deposit accounts, both insured and uninsured, totaling about \$7.6 billion in 1.1 million deposit accounts at Southeast Miami and \$85 million in 13,000 deposit accounts at Southeast Pensacola. First Union paid a net premium of \$81 million.
- First Union also agreed to purchase all of the failed banks' assets except their premises, real estate owned, subsidiaries, and other assets. The FDIC agreed that First

13. "OCC Declares Southeast Bank Insolvent," Financial News Section.

14. Rehm and Cline, "First Union Bid Wins Ailing Bank in Miami," 1.

15. Trigaux, Dahl, Craddock, and Huntley, "Southeast Bank Sold to First Union." 1A.

Union could occupy and pay rent on any of the premises and gave First Union a 120-day option to purchase banking property at fair market value. Total assets purchased were approximately \$10.1 billion, composed of \$7.1 billion in performing assets (including \$435 million in cash and equivalents and \$1.7 billion in securities and other obligations), \$1.6 billion in performing problem loans, \$800 million in credit card loans, and \$639 million in nonperforming loans.

- The FDIC agreed to buffer the cost of carrying nonaccruing loans by accepting from First Union the NAA note in lieu of cash. The FDIC earned nominal interest on the note of 1/8 of 1 percent per year. The amount of the note could have been increased or decreased as the amount of nonaccruing assets rose or fell during the five-year period, but after six months First Union elected to “cap” the note at \$639 million. At maturity, First Union paid the principal of the note to the FDIC.
- The FDIC retained approximately \$205 million in real estate owned, \$151 million in bank subsidiaries, \$232 million in bank premises, and other assets, for a total of \$624 million. The FDIC also paid off the Federal Reserve debt of \$568 million.

On September 20, 1991, one day after the failure of its two banks, Southeast Miami's holding company, Southeast, filed for liquidation under Chapter 7 of the U.S. bankruptcy code.¹⁶

The Loss Sharing Agreement

The Southeast transaction was the FDIC's first large resolution involving the use of loss sharing. First Union purchased the failed banks' problem loans, but not real estate owned, and no fee was paid to First Union for managing the loans. First Union also purchased Southeast Miami's large credit card operation, which had \$800 million in book value as of June 30, 1991. For those loans, the loss sharing payments were paid on a declining scale. Borrowers' cards were not canceled, which meant that “new” advances to credit card customers could increase the FDIC's liability. In the past, the FDIC had normally tried to sell credit card portfolios outright, either at the closing or immediately thereafter, to eliminate potential increased liabilities. In the Southeast transaction, the FDIC accepted the additional liability because it believed that cutting off credit and attempting to collect outstanding balances in a liquidation mode would result in greater gross losses than would allowing the acquirer to manage the credits.

Under the loss sharing structure, First Union had the flexibility to affirm previous loan commitments, restructure problem loans, and even extend limited amounts of additional credit as part of loan workouts. Then-FDIC Chairman L. William Seidman

16. George Graham, “Southeast Reopened by New Owner,” *Financial Times* (September 21, 1991), International Companies and Finance section, 10.

said the loss sharing arrangement “should help reduce the insurance fund’s losses significantly and greatly reduce the typical hardships suffered by loan customers at failed banks.”¹⁷ Banking analysts were not immediately convinced. “It’ll be interesting to see what the loss really is on the FDIC side for this deal,” said Cynthia Mahoney, a bank analyst with Duff & Phelps in New York.¹⁸

The loss sharing arrangement was designed to reduce costs to the BIF because (1) a forced liquidation of the problem loans would be avoided, (2) the FDIC’s administrative expenses would be lower than under a servicing agreement, and (3) the failed banks’ franchise value would be better preserved.¹⁹ However, the FDIC took on additional risk in a loss sharing agreement. It had no oversight of the acquirer’s activities, and the FDIC’s savings depended on an acquirer’s doing a good job of managing bad assets, which was a job in which “good” banks might not have had as much experience or expertise as would an outside asset management company. If an acquirer failed in its collection efforts or if the economy worsened, the FDIC losses could have been higher than they would have been if the loans had been assigned to an asset management company for liquidation.

The original package of assets eligible for loss sharing in the Southeast transaction was \$7.9 billion.²⁰ At the time of the agreement, the FDIC estimated that total loss sharing payments would be \$854 million. Because the payments would be made over time, FDIC staff calculated the present value of the payments to compare them to other resolution alternatives and determined that the present value of the payments at the time of the banks’ closings was \$647 million. The FDIC’s actual payments over the five-year term of the agreement were \$450 million net of recovery payments, or 52.7 percent of the original estimate of \$854 million.

The Stock Transactions

The \$150 million in preferred stock contained an 11 percent dividend rate and was redeemable at par within one year.²¹ The stock was redeemed quickly, with two million of the shares being redeemed within two months and the remaining shares redeemed in less than seven months, at no gain or loss to the FDIC. During the one-year period, the FDIC received \$6.8 million in dividends.²² A summary of the stock transactions is included in table II.9-1.

17. Graham, “Southeast Reopened by New Owner.”

18. Trigaux and Huntley, “Banking’s Changing of the Guard,” 1B.

19. FDIC News Release, “FDIC Approves Assumption of Deposits of Southeast Bank, N.A., Miami, and Southeast Bank of West Florida, Pensacola,” PR-137-91 (September 19, 1991).

20. FDIC, *Summary of Loss Sharing Assistance Agreements Through March 31, 1997* (June 26, 1997).

21. FDIC, *1991 Annual Report*, 20-21.

22. FDIC, *Equity Investment Portfolio: Bank Insurance Fund* (December 31, 1993), 25.

Table II.9-1

**Transaction with First Union National Bank of Florida
A Summary of the FDIC's Stock Transactions in the
Southeast Miami/Southeast Pensacola Purchase and Assumption**
(*\$ in Thousands*)

Date	Transaction	Beginning Number of Shares	Shares Sold, Written Down, Converted	FDIC Stock/ Equity Investment	FDIC Proceeds from Sales	FDIC Book Value of Transaction	Gain or Loss on Trans- action	FDIC Dividend Income
Series A Cumulative Perpetual Class A Preferred Stock								
09/27/91	Original purchase	6,000,000		\$150,000				
11/21/81	Dividends							\$856
11/21/91	Redemption		(2,000,000)		\$50,000	\$50,000	\$0	
12/ /91	Dividends							2,903
03/31/92	Dividends							2,750
04/10/92	Redemption		(4,000,000)		100,000	100,000	0	
04/10/92	Dividends							275
06/25/92	Dividends							61
	Totals	6,000,000	(6,000,000)	\$150,000	\$150,000	\$150,000	\$0	\$6,845

Source: FDIC, *Equity Investment Portfolio, Bank Insurance Fund*.

FDIC Resolution Costs

When the two Southeast banks were closed, the FDIC entered into an assistance agreement with First Union, under which First Union agreed to assume the liabilities, including \$7.6 billion of deposits, of the two banks. The FDIC in its corporate capacity funded First Union's assumption of the deposits by borrowing or using the Southeast banks' assets to satisfy its funding obligation.

First Union purchased all \$10.1 billion of the failed banks' assets other than bank premises, real estate owned, subsidiaries, and other assets, and the FDIC afforded First Union loss protection on all loans. Over the life of the agreement the FDIC's total loss sharing payments totaled approximately \$450 million. By retaining 85 percent of the risk on the bank assets being sold to the acquirer, the FDIC received an \$81 million premium for the bank franchises.

The FDIC had other costs as well. To facilitate the assistance transaction with First Union, the FDIC accepted a \$639 million note with a nominal interest rate to offset the acquirer's loss of interest on the nonaccruing assets. The FDIC also purchased \$150 million of preferred stock in First Union. The FDIC paid off the Federal Reserve debt of \$568 million, and it directly managed and sold \$624 million in real estate owned, bank premises, subsidiaries, and other assets.

The Southeast receiverships recovered more than the total of principal claims against them, largely because the losses in the loss share agreement were not as great as had been expected. As it became apparent that the FDIC's costs would not be as great as had been anticipated, the FDIC on March 30, 1994, officially announced that all creditors with valid claims against the receiverships would receive the full principal amount of their claims. The FDIC also projected a surplus of \$27 million that would be used to pay a portion of interest on the claims. The surplus was primarily the result of the significant improvement in the Florida economy, especially the real estate markets. That improvement increased the value of the assets retained by the FDIC as well as the assets held by the acquirer and covered by loss sharing.

In November 1996, the Southeast Miami receivership declared a 72.21 percent dividend on allowed claims for postinsolvency interest, and Southeast Pensacola declared a 100 percent dividend on allowed claims for postinsolvency interest. Ultimately, the Southeast Pensacola receivership was terminated, and a final dividend of cash and assets totaling \$8.1 million was returned to the bankruptcy trustee. The FDIC's liability for the loss share portion of the assistance agreement ended after five years, on June 30, 1997. After taking into consideration contingent and unpaid claims against the receiverships, it was estimated that the receiverships had \$31.8 million in funds available for distribution.

Settlement of Litigation

The holding company for the failed banks had filed for liquidation under Chapter 7 of the U.S. bankruptcy code on September 20, 1991. In March 1993, the trustee for the holding company's estate, William A. Brandt, Jr., filed suit in the southern district of Florida against the FDIC as receiver of the Southeast banks. The suit alleged fraudulent and preferential transfers because in 1990 the OCC had required the holding company to assign a mortgage subsidiary, Southeast Mortgage Company (SEMCO), to Southeast, because the bank needed to increase its equity. That suit was amended in March 1994, alleging that the FDIC's issuance of a cross guarantee assessment against Southeast Pensacola after the failure of Southeast Miami was unconstitutional because it was a taking of property that violated Southeast Pensacola's right to due process. In November 1996, the suit was amended a second time to add a count challenging the FDIC's entitlement to recover postinsolvency interest on its subrogated deposit claim against the Southeast receivership estates because such a recovery violated the National Bank Act of

1864. The FDIC's \$7.6 billion deposit claim against the Southeast receiverships accrued more than \$304 million in postinsolvency interest between September 1991 and March 1994. During roughly the same period, the FDIC in its corporate capacity also paid more than \$183 million in interest to the Southeast receiverships on its "borrowing" of receivership assets used to fund First Union's assumption of the failed banks' deposits.

The bankruptcy trustee filed a second lawsuit in November 1995, while he and the FDIC were in the middle of negotiations. The suit challenged the FDIC's overall administration of the Southeast receiverships, including the decision not to pursue litigation against Southeast's former directors and officers, failure to allocate portions of professional liability settlements to the Southeast receiverships, and payment of indirect liquidation expenses to the FDIC in its corporate capacity from the receivership estates.

The issues raised by the bankruptcy trustee were similar to those raised in the litigation filed against the FDIC by First City Bancorporation of Texas, Inc. (First City). The 1992 resolution of 20 First City failed banks also involved the issuance of cross guarantee assessments and a surplus in the receiverships. The FDIC had settled the First City claims in 1995, and the FDIC's experience in that matter helped guide the FDIC's actions in settling the Southeast litigation.

In August 1997, the FDIC reached a tentative settlement with the Southeast bankruptcy trustee. The basic terms of the settlement were as follows:

- The settlement of all pending litigation at a discount, including the challenge to the FDIC's cross guarantee statute;
- The settlement of the FDIC's claim against the Southeast receiverships for approximately \$221.4 million in postinsolvency interest;
- The retention by the FDIC of approximately \$47 million in indirect receivership expenses;
- A transfer of the remainder of the Southeast receivership estate to the Southeast bankruptcy trustee; and
- The indemnification of the FDIC in its corporate capacity by the Southeast bankruptcy estate for claims submitted by First Union under the indemnification provisions of First Union's agreement with the FDIC.

Ultimately, all creditors received 100 percent of principal plus interest. The FDIC received 100 percent of the principal it expended, including its liquidation costs, plus \$221.4 million in postinsolvency interest in the settlement with the trustee in the Southeast bankruptcy. The litigation settlement was based on the recognition that the FDIC in its corporate capacity was legally obligated either to pay insured depositors or to arrange for the assumption of the failed banks' deposits by a third party.

Overall, the settlement agreement provided an appropriate conclusion to the resolution of the failed institutions. The settlement allowed the FDIC to settle all pending litigation at a discount, with no further expenditures from the BIF. All receivership claims were

paid and/or settled with the payment of the appropriate interest, and the FDIC returned approximately \$120 million in receivership assets to the Southeast bankruptcy estate.

Lessons Learned

The resolution of the Southeast banks was viewed as successful, and the lessons learned center on (1) the loss sharing agreement between the FDIC and First Union and (2) the cross guarantee assessed against Southeast Pensacola. The FDIC was able to pay all receivership claims in full and still receive \$221.4 million in postinsolvency interest. The shareholders also received approximately \$120 million in assets from the estate.

By placing all of the Southeast assets (except for real estate owned, bank premises, subsidiaries, and other assets) with First Union, the FDIC was no longer responsible for 100 percent of losses, as it was when troubled assets were placed with an asset management contractor. First Union accepted 15 percent of the risk and had a stronger incentive to diligently manage the acquired assets.

Since the Southeast transaction through 1997, loss sharing has been successful for the FDIC in 15 instances. The primary benefits include keeping the FDIC's inventory of assets at a minimum level, keeping failed bank assets in the private sector to maintain their value, and allowing borrowers of failed banks to continue doing business with open financial institutions. As the FDIC gained experience with loss share transactions, later agreements were modified to focus on the commercial loans of the failing institution. The FDIC determined that tracking small assets was more costly than taking them into inventory for liquidation and that a ready secondary market existed in which they could be quickly sold. The performing loans, such as consumer and single-family mortgages, generally could be sold at par to the acquirer without the FDIC's having to accept liability for losses for a five-year period.

The loss sharing agreement with First Union was also successful in a nonmonetary sense. The FDIC's experience with asset management contractors' working the assets of failed banks in the Northeast was not altogether favorable. Although collections were satisfactory, borrowers experienced some problems in the region. Because real estate values had decreased quickly, large numbers of loans were classified and placed in asset pools because of diminishing collateral values. Many borrowers complained that being placed in the bad asset pools unjustly labeled them as poor credit risks and caused them to be shut out from other lenders that may have been able to assist them. Without credit, many smaller businesses failed that otherwise might have been able to survive. Also, since the FDIC retained ownership of the assets, mistakes made by its asset management firms reflected poorly on the FDIC as a government agency. With the Southeast transaction, however, by having the assuming bank retain the ownership, borrowers were treated fairly to protect the reputation of the new acquirer. The loss share agreement also made it easier for the acquirer to continue advances on lines of credit, which kept a lot of businesses from having cash flow problems.

Effect on Future Resolutions

The resolution of the two Southeast banks, especially the introduction of loss sharing, led to changes in the way the FDIC handles failing institutions. Including the two Southeast banks and throughout all of 1992 and 1993, the FDIC resolved 203 banks. Of that number, 24 were resolved in 16 loss sharing arrangements. This practice has resulted in the FDIC's keeping in the private sector \$18.5 billion in assets that otherwise might have been placed in the FDIC's inventory of assets for liquidation.



CHAPTER 10

Seven Banks in New Hampshire

Names of Institutions:	Dartmouth Bank, Manchester, New Hampshire New Hampshire Savings Bank, Concord, New Hampshire Numerica Savings Bank, F.S.B., Manchester, New Hampshire Amoskeag Bank, Manchester, New Hampshire Nashua Trust Company, Nashua, New Hampshire Bank Meridian, N.A., Hampton, New Hampshire BankEast, Manchester, New Hampshire
Date of Resolution:	October 10, 1991
Resolution Method:	Two Purchase and Assumption Transactions

Introduction¹

On October 10, 1991, seven banks failed in New Hampshire. Although at \$4.4 billion, the combined size of the banks was small in comparison to other notable failed banks, the seven banks represented approximately 25 percent of all banking assets in the state. Also, the closing of seven banks in one day was a significant economic event for the citizens of New Hampshire. The resolutions of the New Hampshire banks were notable for several reasons. First, the Federal Deposit Insurance Corporation (FDIC) packaged the seven unaffiliated failed banks into two franchises for sale to potential purchasers rather than marketing the banks individually, as was usually done. Second, a separate asset pool, owned by the FDIC, was established for the classified assets, repossessed real estate, all real estate subsidiaries, and unwanted bank premises of the seven banks. Bids for the management of the asset pool were solicited from acquiring institutions and banking and nonbanking outside management firms. Third, for the first time, the FDIC awarded the asset management contract to a firm other than one of the acquiring banks. Fourth, to reduce the number of bank assets that the FDIC would own, it provided loss sharing agreements on both resolution contracts for all the consumer loans

1. Unless otherwise noted, much of the material in this chapter concerning the background and the BONHAM contract was taken from Robert W. Schwarzlose, "FDIC Solutions to the Banking Crisis in New Hampshire," (November 8, 1996).

and the smaller balance residential mortgage loans.² Finally, the FDIC agreed to purchase preferred stock of the acquiring institutions through a “shared equity” feature designed to help the acquirers obtain the capital needed for the transactions on terms favorable enough to the FDIC that the acquiring banks would be encouraged to redeem the stock relatively quickly.³

General Description of the Institutions

In early 1991, seven banks in New Hampshire with aggregate assets of approximately \$5.3 billion were failing. These banks included five of the largest banks in the state and represented approximately 25 percent of all banking assets in New Hampshire. On October 10, 1991, the FDIC grouped these banks into two franchises for resolution. See table II.10-1 for Franchises One and Two in what was called the New Hampshire Plan—the name given to the resolutions.

Each institution experienced rapid asset growth during the boom of the early to mid-1980s through increased real estate lending, especially lending for commercial real estate. This asset growth peaked in 1988 but began to reverse during 1989 as the banks started to write off loans and shrink their portfolios to try to meet capital requirements. For example, Amoskeag Bank Shares, the largest of the holding companies, grew from \$1.2 billion in total assets in 1984 to \$2.3 billion in 1988, which was almost a 100 percent increase over four years, before falling to \$1.5 billion by March 31, 1991.

All three institutions in Franchise One were savings banks that had operated under separate, unrelated holding companies:

- Dartmouth Bank, Manchester, New Hampshire, had total assets of \$847 million and operated 20 branches. Dartmouth Bank was owned by the Dartmouth Bank Corporation, a one-bank holding company.
- New Hampshire Savings Bank, headquartered in Concord, New Hampshire, had total assets of \$935 million and operated 23 branches. New Hampshire Savings Bank was the result of a merger of the three banks owned by New Hampshire Savings Bank Corporation that were merged into one bank before their resolution.
- Numerica Savings Bank, F.S.B. (Numerica), headquartered in Manchester, New Hampshire, had total assets of \$486 million and operated 11 branches. Numerica and Home Bank, F.S.B., were owned by Numerica Financial Corporation. Home Bank, F.S.B., was a Savings Association Insurance Fund (SAIF) insured

2. For a full explanation of this subject, see Part I, Resolution and Asset Disposition Practices, Chapter 7, Loss Sharing.

3. FDIC, *1991 Annual Report*, 22.

Table II.10-1**Banks in the New Hampshire Plan
Information as of October 10, 1991***(\$ in Thousands)*

Failed Institution	Total Assets	Total Deposits
Franchise One		
Dartmouth Bank	\$847,325	\$776,816
New Hampshire Savings Bank	934,810	878,890
Numerica Savings Bank, F.S.B.	486,402	430,568
Subtotal for Franchise One	\$2,268,537	\$2,086,274
Franchise Two		
Amoskeag Bank	\$855,747	707,513
Nashua Trust Company	405,372	354,194
Bank Meridian, N.A.	110,054	102,370
BankEast	737,642	583,701
Subtotal for Franchise Two	\$2,108,815	\$1,747,778
Grand Total	\$4,377,352	\$3,834,052

Source: FDIC Division of Research and Statistics.

institution and was placed into conservatorship by the Resolution Trust Corporation (RTC) simultaneously with the resolution of Numerica.

Franchise Two consisted of four commercial banks, three of which were owned by one holding company:

- Amoskeag Bank Shares owned Amoskeag Bank, Manchester, New Hampshire; Nashua Trust Company, Nashua, New Hampshire; and Bank Meridian, N.A., Hampton, New Hampshire. The three banks combined had total assets of approximately \$1.37 billion and operated 28 branches.
- BankEast, owned by BankEast Corporation, was headquartered in Manchester, New Hampshire. BankEast had total assets of \$738 million and operated 28 branches. BankEast Corporation was in bankruptcy.

Background

In the early and mid-1980s, New Hampshire was a leader in New England's economy. The state's close proximity to Boston and low tax rates helped make New Hampshire the fourth fastest growing state in the nation. The impetus for this growth was the creation of well-paying jobs in the high technology and defense industries. Companies such as Digital Equipment, Raytheon, and Lockheed Sanders had base operations in Massachusetts; all had decided to expand into southern New Hampshire because of its proximity to Massachusetts, attractive land prices for development, and lower cost of living for their employees. As a result, the population in the state grew by more than 20 percent from 920,475 in 1980 to 1,109,117 in 1990. The housing market benefited greatly from this increased demand, and the price of real estate skyrocketed. For the 10-year period from 1980 to 1990, the average price of a residential home soared by 179 percent.

In 1981, revisions in New Hampshire's state banking laws allowed banks to convert from mutual ownership to publicly traded stock ownership. In September 1982, the first savings bank in New Hampshire converted under this new regulation; 19 banks converted over the next five years. As a result of the conversions, the banks were flush with capital and had established aggressive lending practices. At the end of 1984, New Hampshire had a total of 69 banks; by 1989, that number had grown to 93.

Most of the lending officers who worked for these savings banks had expertise in residential and small commercial loans. However, many of them began making large commercial loans, an area in which they had little experience. This market hit its peak by 1987. Widespread optimism about New Hampshire's long-term growth prospects led to significant real estate development projects, including condominiums, retail malls, and commercial properties.

By 1989, after years of economic expansion, New Hampshire's economy experienced a contraction that also was occurring throughout New England. Contributing to the recession was a decline in the region's three primary industries: real estate development, high technology, and defense contracting.

A downturn in employment decreased local buying power and ended the rapid immigration of people. Many real estate properties were under construction already or had been completed recently in anticipation of a continuation of the rapid population growth. This created an oversupply of all types of real estate, with many single-family homes, condominium units, and commercial real estate properties remaining unsold or unleased.

New Hampshire's housing starts in 1989 were off by more than 63 percent from the high point experienced in 1986. This resulted in a substantial decline in real estate values, as well as a sharp increase in the level of nonperforming bank loans. Foreclosures on real estate properties, which had been almost nonexistent in the 1980s, increased dramatically, forcing the legal sections of the newspapers to expand to accommodate the foreclosure notices. Over the next two years, many of the largest loans were restructured in the hope that the economy would not continue its downward slide toward a recession.

On September 30, 1990, nonperforming assets for all banks in New Hampshire totaled more than \$1.2 billion, or about 7 percent of all assets, up significantly from \$83 million, or 0.5 percent of all assets, at the end of 1987. By the end of 1990, nonperforming bank assets in New Hampshire amounted to about 90 percent of primary capital. The deterioration in loan quality resulted in losses to banks throughout New Hampshire of \$62 million in 1989 and more than \$250 million in 1990. Those losses reduced tangible bank equity in the state from approximately 7 percent of assets in 1988 to 5.5 percent by the end of the third quarter of 1990. By early 1991, it was clear that, with the poor capital positions and the continued earnings deterioration of the New Hampshire banks, the FDIC would have a major role to play in the state's banking industry.

The decline in the state's cumulative bank capital ratio, however, understates the severity of the problems experienced by New Hampshire's larger banks, which historically had supplied the majority of the in-state commercial real estate loans. The state's large banks had collective tangible equity of 3.9 percent of total assets by the end of the third quarter of 1990, and 9.5 percent of their assets were nonperforming.

The bleak condition of New Hampshire's banking industry can be brought into perspective by comparing it to the condition of banking in other states. For example, the level of nonperforming assets in New Hampshire banks in 1991 was higher than it was for Texas banks in 1987, the peak year of nonperforming assets in Texas.

The real estate market's decline and the harshness of the recession in New Hampshire were the primary factors leading to the banking crisis in New Hampshire. All seven banks of the New Hampshire Plan experienced adverse effects as a result of their excessive growth of the early to mid-1980s and inadequate or lax underwriting and administration of loans. This led to an increase in the level of nonperforming assets at those institutions. On average, nonperforming assets as a percentage of total assets rose from 1.1 percent in 1986 to more than 11 percent by the end of 1990, which led to significant losses at each bank. In 1989, the seven banks lost nearly \$200 million, and in 1990 they lost approximately \$306 million. In the first quarter of 1991, the banks had losses totaling \$75.6 million.

The first bank failure in New Hampshire occurred on July 27, 1990; three more banks were closed over the next 13 months. All the banks were small, each with assets of less than \$125 million and together having only \$219 million in total assets.⁴ The FDIC acquired relatively few assets, so the impact of the bank closings was not significant. The FDIC assets to be liquidated from these failed banks were transferred to the existing FDIC offices in Franklin, Massachusetts, and Hartford, Connecticut.

4. The four banks, with their total assets, were U.S. Savings Bank of America, Seabrook, New Hampshire, \$12.3 million; City Bank and Trust, Claremont, New Hampshire, \$119.6 million; Hillsborough Bank and Trust Company, Milford, New Hampshire, \$46.2 million; and The Family Bank and Trust, Allentown, New Hampshire, \$40.5 million.

Because of the seriousness and size of the banking problems in New Hampshire, newspapers began to report the possible failures in November 1990. Regulators worried about a possible liquidity crisis in the state because of the publicity and the relatively large number of uninsured depositors in all the banks. As of January 1991, New Hampshire had 10 major banks with assets of more than \$200 million each; 7 of those banks were experiencing serious financial difficulties. In February 1991, the Federal Reserve Bank of Boston (Federal Reserve) began to monitor the liquidity of the banks on a daily basis. In addition, the FDIC began working with New Hampshire state banking officials and other regulatory agencies to try to revive the banking industry in New Hampshire and to assist in stabilizing the economy.

Between February and April 1991, then-FDIC Chairman L. William Seidman received letters from New Hampshire's senators, congressmen, governor, and state banking commissioner regarding the banking and credit crisis in the state. They emphasized the importance of restructuring existing loans to keep them on a performing basis, instead of foreclosing and adding to an already deteriorating real estate market. In early 1991, New Hampshire Governor Judd Gregg hosted meetings with representatives of the failing banks, the four federal regulatory agencies, and the state banking department. In the meetings, the FDIC stressed the importance of bringing in new private capital, which would be facilitated by consolidating the failing banks. The group worked to determine the most economically advantageous way to package the failing banks for sale. Communications between New Hampshire's elected officials and the FDIC continued throughout 1991.

Resolution Structure

In May 1991, the decision was made to market the failing New Hampshire banks in two franchises. The three savings banks were combined into one package and the four commercial banks into another. The three savings banks in Franchise One were unrelated entities; however, there had been discussions between Numerica and both Dartmouth Bank and New Hampshire Savings Bank about the possibility of a merger. The FDIC considered these discussions between the banks in deciding to package them together and believed that combining the banks made sense because of their similarities. Franchise Two included the three banks from the same holding company. (BankEast was originally not a resolution candidate, but was later added to Franchise Two.) The grouping of the banks was intended to provide economies of scale, making the two packages more attractive to potential buyers. The banks were marketed nationwide and to Canadian financial institutions to ensure the exposure of the banks to the greatest possible number of bidders. Ultimately, most of the interested parties were local, and no Canadian bank submitted a bid.

The Federal Deposit Insurance Act (FDI Act) of 1950 required the FDIC not to approve a transaction that would significantly diminish competition in banking, unless

public needs and convenience would override the effect of such an impact. The U.S. Justice Department expressed some concerns over the grouping of the banks into two franchises and stated that if in-state banks were interested in the franchises, antitrust issues could surface. The FDIC concluded, however, that the franchise groupings were close enough to other markets that anticompetitive issues were not a serious problem.

The FDIC structured the purchase and assumption (P&A) transactions to attract bidders, especially bidders with new but limited levels of capital, to a depressed economy. At the same time, the transactions were designed not to be too generous. The FDIC lowered the risk to purchasers by removing the nonperforming assets and offering loss sharing or put options on the remaining loan portfolios. The FDIC also offered to provide up to two-thirds of the necessary equity through the purchase of preferred stock from the acquirers.

In structuring the transactions, the FDIC agreed to put all real estate owned, subsidiaries holding real estate owned, classified assets, and unwanted bank premises into a separate asset pool. This pool was to be owned by the FDIC and managed by a third party under the FDIC's supervision. The acquirers were to have the option to place commercial loans into the FDIC asset pool for three years after acquisition if the assets were later classified as substandard by bank examiners. The initial size of the asset pool for all the banks was estimated at \$800 million, and another \$400 million was estimated for the additional assets.⁵

To attract potential purchasers with new capital, the transactions included a shared equity feature through which the FDIC temporarily infused cash into the acquiring institutions in return for a preferred stock position. The FDIC determined that providing short-term equity for three years was preferable to establishing a three-year bridge bank. Further, terms favorable to the FDIC, such as rising call prices, were built into the equity to motivate the acquirers to redeem the stock quickly.

Data processing services for the banks in Franchise Two were provided by subsidiaries of their holding companies. That could have been a major problem, however, because those data processing subsidiaries could have refused to continue providing services after the failures of the banks, and bidders had stipulated that bids would be contingent upon assurances from the FDIC that data processing services would continue without disruption. To resolve this issue, the FDIC worked with the failing banks' management to purchase the data processing subsidiaries from the holding companies before the resolution of the banks.

5. Actually, \$515 million in assets were added to the pool over the three-year put period.

The Resolution

When the seven banks failed in October 1991, the two P&A transactions protected all depositors, not just those with insured accounts. The FDIC was authorized to protect all depositors of the failed banks through P&A agreements, because it determined that it would be less costly to the insurance fund than a payoff of only insured deposits.⁶ In 1991, FDIC Chairman Seidman said,

In February of this year, I came to New Hampshire to participate in a summit with hundreds of the region's government officials and business leaders to address problems facing New England's banks and borrowers. Because of the severity of the recession in New Hampshire in particular, and the much-publicized problems facing several of the largest banks in the state, I vowed then that the FDIC would do everything we could to find the most innovative, least costly and least disruptive alternatives to the area's banking crisis. Today, we are announcing an infusion of public and private sector funds that will result in a New Hampshire banking system better positioned to meet the credit needs of the area's businesses and consumers, and better able to weather future economic storms.⁷

Franchise One

Franchise One was acquired by the New Dartmouth Bank Group (New Dartmouth), an investor group that established a de novo banking charter for the transaction and paid a premium of approximately \$55 million. Fortunately, that bid, the only offer made for Franchise One, met the FDIC's cost test. The FDIC estimated the cost of the transaction to be approximately \$624 million, a total savings of approximately \$140 million to \$175 million more than the estimated cost of conducting a payoff.

To capitalize the new institution, New Dartmouth raised \$38.8 million from 30 investors. The FDIC contributed \$61 million to ensure the bank had sufficient capital. In addition to the \$61 million contribution, the FDIC also purchased \$31.1 million in preferred stock. The FDIC's investment was in the form of 347,073 shares of nonvoting, noncumulative, perpetual preferred stock that had the same par value as the common stock. The FDIC's stock represented 45 percent of the new bank's initial capital. The stock carried no cash dividend, but the redemption price was to increase each year until the stock was redeemed. The preferred stock was redeemable at any time and was convertible into common stock on a one-to-one basis after three years. Those features were designed to give the acquirer incentives to redeem the FDIC's stock as soon as possible and to give the FDIC an equity return if the transaction worked out well for the acquirer.

6. FDIC News Release, "FDIC Approves Assumption of Deposits of Seven New Hampshire Banks by First NH Bank, Concord, and New Dartmouth Bank, Manchester," PR-150-91 (October 10, 1991).

7. FDIC News Release, PR-150-91.

Franchise Two

Franchise Two was acquired by First NH Bank (First NH), a four-rated bank at the time of acquisition and the U.S. subsidiary of the Bank of Ireland.⁸ Two other bids were received for Franchise Two—from Fleet-Norstar Financial Group, Providence, Rhode Island, and KeyCorp, Albany, New York. Also, two nonconforming bids were submitted for Bank Meridian, N.A., only. First NH's bid was estimated to cost \$342 million, which was estimated to be \$72 million less costly than the next best bid and represented a lower cost than the estimated cost of conducting a payoff of the banks.

As part of the acquisition, First NH agreed to pay the FDIC a premium of \$23.3 million, and the FDIC purchased \$50 million in preferred stock. In addition, Bank of Ireland, First NH's parent company, made a \$27 million capital contribution to First NH and agreed to maintain ongoing support for the bank.

The FDIC's stock carried a 10.25 percent dividend rate and was redeemable by the issuer after seven years. After three years, the FDIC had the ability to require First NH to purchase the stock anytime at a price that increased each year.

The Liquidation

Separate Asset Pool

A separate asset pool was established for the classified assets, repossessed real estate, subsidiaries, and unwanted bank premises. The pool was owned by the FDIC and managed by a third party under the FDIC's supervision. Both assuming banks had the right to require the FDIC to purchase assets to put into the pool for three years after acquisition, if the assets were identified as classifiable, that is, designated by bank examiners as having some degree of potential loss to the acquiring banks. The repurchase price of each loan was defined as the book value of the loan as of bank closing less the payments received by the assuming bank, plus any advances made by the bank.⁹

The initial size of the separate asset pool was \$800 million. Because of the amount of additional assets projected to be added to the pool, the FDIC sent out a solicitation for bids from servicers capable of managing \$2 billion in assets.¹⁰ The contract for managing the separate asset pool was also offered to the acquirers of both franchises. Only the acquirer of Franchise One submitted a bid, but it was not accepted. Because of time

8. Bank examiners rate banks using a scale of 1 to 5, with 1 being the best and 5 being the worst.

9. Purchase and Assumption Agreement, October 10, 1991.

10. "Selection of Servicer to Manage, Liquidate, and Collect the Asset Pool from the Failed Banks Involved in the New Hampshire Plan," Andrew F. Basel, Assistant Director, Assistance Transactions Branch, FDIC Division of Liquidation, to the FDIC Board of Directors, memorandum, February 10, 1992.

requirements in the bidding process, the assuming banks were responsible for servicing the FDIC assets for the first five months after the resolutions had occurred.

The FDIC received seven bids for management of the separate asset pool, and Banc One New Hampshire Asset Management (BONHAM), a subsidiary of Banc One Corporation (Banc One), was the winning bidder in the process. On March 10, 1992, the two assuming banks transferred all the FDIC assets to BONHAM. The Asset Liquidation Agreement (ALA), signed by the FDIC and BONHAM, called for a five-year term to handle assets from failed New Hampshire banks (assets from other New Hampshire banks that failed could be added to the contract) up to a total book value of \$2 billion. As described in the ALA, BONHAM's goal was to maximize the net present value of cash flows from pool assets. The ALA called for the FDIC to reimburse all of BONHAM's expenses. BONHAM's profit or "incentive fee" was based on "net collections." Initially, the incentive fee was 0.2 percent of net collections. The incentive fee gradually increased throughout the term of the contract to 2.5 percent of net collections.¹¹ An Oversight Committee of three voting members, consisting of two FDIC employees and one BONHAM employee, was established. That committee had the authority to make all decisions locally and quickly.

The economic situation in New Hampshire was similar to what the FDIC had encountered during the mid-1980s in the farm belt states, when banks were failing in small, rural communities. The FDIC mounted a strong public relations effort, including appearances at town meetings, in an attempt to inform the local citizenry about the FDIC's disposition process. The FDIC's oversight office in New Hampshire established contact with key state officials, such as the governor, senators, congressmen, mayors of the largest cities, and newspaper reporters. Management from the FDIC and BONHAM were present at meetings in various cities to explain the disposition process and to answer questions from the general public. Speeches were also given to several business groups in the state, including the New Hampshire Bar Association, the Realtors Association, and the Chamber of Commerce. These outreach efforts were designed to both communicate the FDIC's mission and reduce the level of anxiety and frustration created from the failure of so many of the state's banks.

Over the course of the four-and-a-half-year contract, BONHAM managed a total of 9,943 FDIC assets with a book value of \$1.7 billion, which equates to an average asset size of \$175 thousand. At its peak BONHAM had 280 employees. On average, 40 percent of the loans were commercial real estate and comprised 50 percent of the book value of the portfolio. BONHAM sold more than 1,700 real estate properties for an average of 86 percent of the appraised value. The separate asset pool included 21 subsidiary companies, all of which were sold or dissolved during the term of BONHAM's contract. Total collections

11. For a full explanation of ALA agreements, see Part I, Resolution and Asset Disposition Practices, Chapter 14, Asset Management Contracting.

Table II.10-2**BONHAM Key Performance Ratios**

Ratio	Percentage
Collections/Book Value	64.00
Liquidation Expense*/Collections	10.07
Total Expenses†/Collections	14.90
Incentive Fee/Collections	0.53

* Liquidation expenses are directly related to the management and disposition of assets, for example, appraisal fees, real estate taxes, and property management costs.

† Total expenses include, among other things, liquidation expenses, salaries, overhead, and incentive fees.

Source: Robert W. Schwarzlose, "FDIC Solutions to the Banking Crisis in New Hampshire" (November 8, 1996).

were \$1.1 billion. Total expenses paid by the FDIC on the BONHAM contract were \$165 million, which included the servicer's incentives of \$5.9 million.

The pool experienced higher real estate tax expense than normal because of New Hampshire's high property tax rates. The majority of the state's taxes came from real estate because it had neither a sales tax nor a state income tax. Most of the 650 properties on which BONHAM foreclosed had at least three years of back taxes owing, and these taxes had to be paid by the winning bidder. Table II.10-2 shows some of the key ratios pertaining to the performance of BONHAM.

Loss Sharing Agreements

The FDIC's three-year loss sharing agreements with First NH and New Dartmouth were the same. In general, the FDIC agreed to reimburse the banks for 90 percent of the failed banks' net loan losses on residential mortgages and other consumer loans that exceeded specified threshold levels for three years.¹² See table II.10-3 for data on the loss sharing.

Amounts paid by the FDIC represent the amount of losses the FDIC paid to the assuming banks on loss share assets, less the amount paid by the banks to the FDIC for recoveries. The recovery sharing ended on December 31, 1995. With losses on those portfolios in the 3 percent range, it appears the loss share program was successful in reducing the FDIC's ultimate cost of liquidation.

12. FDIC News Release, PR-150-91.

The structure of the loss sharing agreement in the New Hampshire Plan was a departure from the FDIC's standard practice of including only commercial and commercial real estate loans. Consumer loans, home equity loans, and residential mortgage loans were usually not covered in loss sharing agreements because such loans were typically of better quality.

The Stock Transactions

On October 11, 1991, the FDIC purchased two million shares of nonvoting preferred stock in First NH at a price of \$25 per share, for a total of \$50 million. The stock paid the FDIC a 10.25 percent noncumulative dividend. The FDIC had the ability to put the stock to the bank after three years. The put price was defined to be equal to the initial amount of capital investment, plus an increase of 10.25 percent per year for the first three years and 12.25 percent thereafter, less any dividends paid.

Table II.10-3

Loss Sharing Data

(\$ in Millions)

	New Dartmouth	First NH	Total
Beginning balance of loss share assets	\$876	\$622	\$1,498
Plus permitted advances and additions	5	183	188
Total loss share assets	\$881	\$805	\$1,686
Less principal collected, charged off, or otherwise reduced	(542)	(538)	(1,080)
Less protection forfeited, assets removed from pool, and adjustments to beginning balance	(339)	(267)	(606)
Ending balance loss share assets	\$0	\$0	\$0
FDIC's loss share payment estimate	\$65	\$59	\$124
FDIC actual loss sharing payments	27	18	45
Total payments as a percentage of estimated payments	41.54	30.51	36.29
FDIC loss sharing payments as a percentage of total loss share assets	3.06	2.24	2.67

Source: FDIC, "Summary of Loss Sharing Assistance Agreements Through March 31, 1997" (June 26, 1997).

First NH redeemed all two million shares on September 30, 1993, two years after the original transaction, for the price of \$50 million. The FDIC received total dividends during that period of \$10.1 million.¹³

In the other transaction, on October 11, 1991, the FDIC purchased 347,073 shares of nonvoting preferred stock in New Dartmouth at a price of \$89.46 per share, for a total of \$31.1 million. The stock carried no cash dividend, but the redemption price increased by 7.2 percent each year until redeemed. The preferred stock was convertible into common stock on a one-to-one ratio after October 10, 1994. The conversion feature was designed to encourage New Dartmouth to redeem the preferred stock within three years.¹⁴ The stock was redeemable at any time, which allowed the bank to minimize its financing burden in early years while giving the investor group strong incentives to redeem the FDIC's shares as soon as possible.

On March 23, 1993, New Dartmouth Bank and Shawmut National Corporation (Shawmut), Boston, Massachusetts, entered into a merger agreement. The agreement required New Dartmouth to redeem all remaining shares of the FDIC's preferred stock before the merger. The merger was projected to yield New Dartmouth common stock shareholders a gain of \$213.04 per share, or 220 percent, over the two years since the failed banks had been acquired. The merger resulted in the FDIC's stock position being redeemed one year earlier than had been originally projected.

The stock was redeemed over a 16-month period. New Dartmouth redeemed 112,000 shares on January 25, 1993, for \$96.95 per share; 25,000 shares on April 8, 1993, for \$99.28 per share; 40,000 shares on August 27, 1993, for \$102.42 per share; and 170,073 shares on May 27, 1994, for \$107.77 per share. The FDIC's gain on the investment amounted to \$4.7 million.¹⁵ Table II.10-4 summarizes the stock transactions.

FDIC Resolution Costs

The New Hampshire Plan is the sixth most costly resolution in FDIC's history. The total cost of the transaction was approximately \$891 million. This was a relatively high 20.4 percent of the failed banks' assets. The high cost reflects the poor condition of the banks' assets, the severity of the recession, and the decline in the real estate market in New Hampshire.

13. "Equity Investment Portfolio (BIF)," Steven A. Seelig, Director, FDIC Division of Finance, to Andrew C. Hove, Jr., Acting Chairman of the FDIC Board of Directors, memorandum, March 21, 1994.

14. "New Dartmouth Bank, Acquisition of New Dartmouth by Shawmut National Corporation," Harrison Young, Director, Robert H. Hartheimer, Deputy Director, and Gerald C. Widdicombe, Associate Director, FDIC Division of Resolutions, to the FDIC Board of Directors, memorandum, July 1, 1993.

15. "Equity Investment Portfolio (BIF)," Steven A. Seelig, Director, FDIC Division of Finance, to Andrew C. Hove, Jr., Acting Chairman of the FDIC Board of Directors, memorandum, March 21, 1994, updated December 31, 1994.

Of the \$4.4 billion in total assets at failure, approximately \$1.7 billion of the most troubled assets (approximately 40 percent of the total assets) were placed in a separate asset pool, which was assigned to BONHAM. The loss on these assets totaled approximately \$750 million (44 percent of serviced assets), which consisted of losses on the assets (collections less than the values stated on the banks' books) as well as the expenses paid by the FDIC on the BONHAM asset management contract.

Table II.10-4

**A Summary of the FDIC's Stock Transactions
in the New Hampshire Plan**

Date	Transaction	Beginning Number of Shares	Shares Sold, Written Down, or Converted	FDIC Stock/Equity Investment	FDIC Proceeds from Sales	FDIC Book Value of Transaction	Gain or Loss on Transaction	FDIC Dividend Income
New Dartmouth								
Class A Noncumulative Convertible Perpetual Preferred Stock								
10/11/91	Original purchase	347,043		\$31,050,000				
01/25/93	Redemption		(112,000)		\$10,858,400	\$10,019,794	\$838,606	
04/08/93	Redemption		(25,000)		2,482,000	2,236,561	245,439	
08/27/93	Redemption		(40,000)		4,096,800	3,578,498	518,302	
05/27/94	Redemption		(170,073)		18,328,767	15,215,147	3,113,620	
Totals		347,043	(347,073)	\$31,050,000	\$35,765,967	\$31,050,000	\$4,715,967	\$ 0
First NH								
Class A Noncumulative Perpetual Preferred Stock								
10/11/91	Original purchase	2,000,000		\$50,000,000				
03/31/92	Dividends							\$2,448,611
07/22/92	Dividends							1,281,250
10/30/92	Dividends							1,281,250
12/31/92	Dividends							1,281,250
03/31/93	Dividends							1,281,250
07/06/93	Dividends							1,281,250
09/30/93	Dividends							1,267,014
09/30/93	Redemption		(2,000,000)		\$50,000,000	\$50,000,000	\$0	
Totals		2,000,000	(2,000,000)	\$50,000,000	\$50,000,000	\$50,000,000	\$0	\$10,121,875
Grand Total, All Stock		2,347,043	(2,347,073)	\$81,050,000	\$85,765,967	\$81,050,000	\$4,715,967	\$10,121,875

Source: FDIC, *Equity Investment Portfolio, Bank Insurance Fund*.

Another \$1.7 billion of better quality assets were sold to the acquirer under a loss sharing agreement. Over the term of this agreement the FDIC paid approximately \$45 million in loss sharing payments (2.7 percent of covered assets) to the acquirers. The remaining \$1 billion in assets (the highest quality assets) were purchased by the acquirers with no ongoing financial commitment by the FDIC.

Some of the costs were offset by the net premium of \$38 million received from the acquirers and the \$15 million in dividends and gains on the sale of the preferred stock. Table II.10-5 shows a breakdown of the New Hampshire Plan resolution costs. In a present value context, the loss is higher because of the period of time over which the collections on the assets and the recovery of preferred stock proceeds were received.

Lessons Learned

Several issues arose in the months preceding the resolution of the banks in the New Hampshire Plan. One discussion centered on the grouping of the failed banks into two franchises. Some officials wondered whether grouping the banks constituted “social engineering” by the FDIC and whether it might be better to let market forces decide how or if the banks should be grouped. To offset these concerns, the FDIC held discussions with all parties involved, and offered a structure that incorporated the views of potential acquirers.

There was some concern among FDIC officials that shared equity might be viewed as nationalization of the banks. However, the FDIC had been taking stock in failed bank holding companies since the resolution of Continental Illinois National Bank and Trust

Table II.10-5

New Hampshire Plan Resolution Costs

(\$ in Millions)

FDIC's Expenses

Book Value Capital (deficit)	\$72
Losses on Separate Asset Pool	750
Loss Sharing Payments	45
Additional Capital Contributed on Franchise One	61
Net Premium Received on Franchise Two	(23)
Gain and Dividends on Preferred Stock	(15)
Total Resolution Cost	\$891

Source: FDIC Division of Finance.

Company, Chicago, Illinois, in 1984. The FDIC also determined that providing “bridge equity” was preferable to establishing a three-year bridge bank and that it was essential to bring in some private capital or the banks might have had to be paid off and liquidated. To ensure the FDIC’s early disposition of its stock holdings, incentives such as rising call prices were built into the structure.¹⁶

Another question was how the FDIC would respond if other states requested the same type of resolution and whether the New Hampshire Plan would be viewed as “setting a precedent.” Such requests would have been reviewed and considered on a case-by-case basis, but that never became a real issue.¹⁷

Effect on Future Resolutions

The liquidation of the \$1.7 billion in assets in less than four years was accomplished with little negative publicity. This was attributed to the communication network that was set up in New Hampshire and the priority given to listening to and working with the borrowers. Liquidation efforts were enhanced because a local office in the state handled the FDIC’s assets, and borrowers believed that the servicer’s employees had an understanding of the local economic hardship. The FDIC’s experience in New Hampshire contributed to a move toward greater communication and customer service in its asset disposition activities.

In the New Hampshire Plan, the FDIC, for the first time, solicited bids from servicers who were not acquiring institutions. That procedure, used several times since, has been a cost saving method for servicing failed bank assets. The loss sharing with the acquiring institutions also appears to be a cost saving mechanism for the FDIC.

The New Hampshire Plan was an innovative structure. Although the FDIC has not offered failing banks in that same structure since then, the New Hampshire Plan stands as a reminder of the FDIC’s readiness to consider unique resolution structures.

16. Selig, memo updated December 31, 1994.

17. Selig, memo updated December 31, 1994.



CHAPTER 11

CrossLand Savings, FSB

Name of Institution:	CrossLand Savings, FSB Brooklyn, New York
Date of Interim Resolution:	January 24, 1992
Resolution Method:	Conservatorship
Date of Final Resolution:	August 12, 1993
Resolution Method:	Public Offering of Stock to Institutional Investors

Introduction

The Office of Thrift Supervision (OTS) closed CrossLand Savings, FSB (CrossLand), Brooklyn, New York, and appointed the Federal Deposit Insurance Corporation (FDIC) as receiver on January 24, 1992. CrossLand is memorable for several reasons. First, CrossLand, with total assets of \$7.3 billion, owned 98 subsidiary corporations, including a savings and loan association and a mortgage company. Second, the FDIC placed CrossLand into a conservatorship, which was used much like a bridge bank, for approximately 18 months until the institution could be downsized, simplified, and marketed to the private sector.¹ This is the only instance in which the FDIC used a pass-through receivership and acted as a conservator in a manner similar to that of the Resolution Trust Corporation (RTC). Third, placing the institution into conservatorship generated criticism that the FDIC had not taken the least costly approach when it resolved CrossLand. Many banking analysts were of the opinion that the FDIC had taken the path of least resistance that would eventually cost the FDIC much more than a quick resolution of the bank's problems.

1. The Competitive Equality Banking Act (CEBA) of 1987 gave the FDIC in either its corporate or receivership capacity authority to establish a bridge bank. The FDIC has used this authority when an insured bank was or might be closed and timing and marketing constraints would make it more cost effective not to implement an immediate resolution. Because the FDIC does not have the authority to bridge a failing thrift institution, the FDIC can use a pass-through receivership that involves chartering a new mutual savings institution through OTS that OTS then places under FDIC conservatorship to provide the same interim resolution achieved by the use of a bridge bank.

General Description of the Institution

CrossLand was headquartered in Brooklyn, New York, had 44 branches in the New York City metropolitan area, and was the second largest savings bank on the East Coast. Included in CrossLand's nationwide operations were two large subsidiaries headquartered in Salt Lake City, Utah: CrossLand Mortgage Corporation (CrossLand Mortgage) and a savings and loan association named CrossLand Savings, FSB (CrossLand Utah), with 42 branch offices nationwide. CrossLand's New York branches averaged more than \$100 million in deposits, with some branches having deposits exceeding \$300 million. Before it was closed, the savings bank served approximately 400,000 customers with approximately \$7.3 billion in assets and total deposits of \$5.6 billion. CrossLand and CrossLand Utah together had 86 branches, with \$8.6 billion in assets and \$6.7 billion in deposits.

Background

Beginning in the mid-1980s, CrossLand began to invest heavily in the New York commercial real estate market by financing new apartment buildings, office towers, and stores. On December 21, 1990, the OTS issued a capital directive to CrossLand as a result of its deteriorating capital position over the past several years and its over-concentration (49.1 percent as of year-end 1990) of high-risk real estate investments and loans for acquisition, development, and construction (ADC) loans. The OTS directive restricted lending, investment, growth, and operating activities.

On a national level, the United States was still involved in the Persian Gulf War in 1991, and the nation's economy as a whole had negative growth. Regional problems continued to mount in the Northeast, as evidenced by the 52 bank failures in that area of the country that year. Among those failures were the Bank of New England, Boston, Massachusetts, and Goldome, Buffalo, New York. The Northeast banking industry continued to struggle with depressed real estate markets. More than 23 percent (208) of the Northeast's insured financial institutions were considered problem institutions.²

On September 30, 1991, CrossLand had a negative \$80 million in equity (negative \$306 million in tangible equity). By December 31, 1991, the bank had approximately \$1.5 billion of nonperforming assets, and \$2.2 billion of classified assets, the nine largest of which represented more than 30 percent of the total classified assets. Included in the inventory of problem loans were 80 loans with principal balances exceeding \$10 million. The bank lost \$308.5 million during 1991 alone. During that time, it obtained much-needed cash by paying significantly above-market interest rates for deposits. This reckless

2. FDIC, *History of the Eighties—Lessons for the Future: An Examination of the Banking Crisis of the 1980s and Early 1990s*, (Washington D.C.: Federal Deposit Insurance Corporation, 1997), 362.

expansion later led Representative Charles Schumer, (D-NY), to call the bank “a case study of what is wrong with our banking system, with institutions soaking up insured deposits and using them to fund high-risk, speculative loans.”³

CrossLand’s insolvency was due primarily to its large dollar volume of nonperforming assets. Asset deterioration was compounded by the decline in the New York area real estate market, especially in the commercial sector. At its closure, the bank had 21.5 percent of its assets classified as substandard or lower by regulators. It had about \$2 billion of loans that were not expected to be repaid in full or that had already been foreclosed, and another \$2.5 billion of loans that were current but were collateralized by risky real estate projects. CrossLand lost approximately \$729 million in the 21 months before it was closed by the OTS.

Marketing the Institution

In April 1991, the FDIC received notice from the OTS that CrossLand likely would fail, and began preparing for its resolution. On July 29, 1991, CrossLand signed a consent agreement with the OTS, which called for CrossLand to be placed in conservatorship or receivership status. Three days later, on August 2, 1991, the FDIC held an informational meeting for investors and bankers that might be interested in purchasing CrossLand. Although 65 investor groups had been invited, only 10 attended the meeting. This lack of interest might have been caused by the poor regional economy or by the fact that 90 percent of CrossLand’s \$310 million in time deposits had terms of one year or less, which might have made the franchise less attractive to investors seeking a strong core deposit base. The FDIC believed, however, that CrossLand still contained some franchise value as it retained good branch locations in New York and its original core business of home mortgage lending in the New York area was sound.

The FDIC promoted a wide variety of potential resolution structures, including (1) a discounted sale of the whole bank, (2) a purchase and assumption (P&A) transaction with loss sharing, (3) an asset sale with putback provisions, (4) a separation of CrossLand and CrossLand Utah, and (5) the transfer to the FDIC of all classified assets to be administered in a separate pool. However, there remained little interest in CrossLand. Only three of the 10 investor groups attending the informational meeting completed due diligence on CrossLand.

During the marketing period, it became clear that no investor group was interested in purchasing the assets of CrossLand. One of the three potential acquirers dropped out of the process because of a lack of capital, and only two buyers were interested in acquiring any or all of the deposit base. Accordingly, the FDIC developed contingency plans to deal with CrossLand’s failure.

3. Michael Quint, “CrossLand Is Seized by the U.S.,” *The New York Times* (January 25, 1992), sec. 1, 37.

First, in the event that only the bank's deposits were sold, the FDIC selected an outside asset management company that would handle the servicing of the nonperforming loans on an interim basis. The FDIC also made plans to market CrossLand's portfolio of securities (approximately \$547 million) and its performing loan portfolio (approximately \$5 billion) as soon as the bank failed, and to use the resulting sale proceeds, in part, to pay CrossLand's approximately \$2 billion in debt to the Federal Home Loan Bank. The securities and mortgages had been pledged as collateral for the debt.

Second, if no adequate bids were received for the transfer of the deposits, the FDIC planned to organize and capitalize a new institution that would operate in FDIC conservatorship, culminating in the bank's return to the private sector. This second plan included hiring a new management team that would return CrossLand to its core business of making mortgage loans in the New York area. The new management team also would develop a business plan that would include selling subsidiaries and branches outside the New York market area. The FDIC then intended to remarket the bank after 18 to 24 months, at which time it was hoped that the economy in the area would have improved.

When the bids were opened on December 30, 1991, only two parties had submitted offers. Neither bidder wished to purchase any assets from the bank. One bid was for only the deposits from 20 of the 44 New York branches, and the second bid was contingent on the FDIC's providing a long-term note, rather than cash, to fund the deposits. The FDIC's note was to be either a 5- or a 10-year note, at a yield to the acquirer that was much higher than the FDIC's cost of funds. Neither bid was determined to be least costly when compared against the conservatorship alternative and the cost of liquidation. Therefore, the FDIC Board of Directors approved the plan to create a new institution operated under FDIC conservatorship as the least costly resolution method for CrossLand.

The FDIC believed there were several benefits to correcting the savings bank's problems in a conservatorship rather than a liquidation environment. First, the FDIC believed that loans would lose less value if worked out in a banking environment. Second, FDIC staff also thought that more value could be obtained from the nonbanking subsidiaries by selling them over a longer period of time than could be achieved by either a liquidation or a quick sale of the businesses. Third, the FDIC believed that CrossLand's original core savings bank business in the New York area had a value that was not being recognized by the potential bidders at the time of its failure.

The Resolution—January 24, 1992

On January 24, 1992, the OTS closed CrossLand and appointed the FDIC receiver. The FDIC organized CrossLand Federal Savings Bank (CrossLand Federal), a new federal mutual savings bank, with the FDIC as the only member.⁴ The OTS chartered

4. A mutual savings bank is organized as a nonstock business. All depositors in a mutual institution have a share in the ownership of the institution, in proportion to the amounts of their deposits. In CrossLand Federal, the FDIC was the only member because of the assistance the FDIC had provided to capitalize the newly chartered institution.

CrossLand Federal and then appointed the FDIC as conservator. Substantially all of the assets and liabilities of CrossLand were acquired and assumed by CrossLand Federal, although certain significant assets and liabilities were retained in the receivership.⁵ The FDIC capitalized CrossLand Federal by providing a cash infusion of \$1.2 billion in the form of a noninterest-bearing account. Later, the deposit was reallocated as follows: Of the \$1.2 billion, \$675 million was used to recognize loan losses and to mark down CrossLand Federal's assets to their estimated value, \$525 million was booked as equity capital, and a minimal amount was retained in the deposit account.

In its capacity as conservator, the FDIC hired Richard Kraemer as president and chief executive officer of CrossLand Federal, with the objective of managing CrossLand Federal as a full-service institution and preparing it for return to the private sector.^{6,7} Mr. Kraemer said CrossLand Federal would concentrate on issuing new home mortgages and steer clear of the commercial real estate business—"where we have more than enough loans to work out before we even think of doing more."⁸ At a New York news conference, then-FDIC Chairman William Taylor was quoted as saying, "It is more cost-effective for us to spend on repairs for CrossLand than to rip out its wiring and sell its parts."⁹

A controversial decision made by the FDIC at the time of CrossLand's failure was to protect both the insured and the uninsured depositors. It was estimated that CrossLand held a large portion of uninsured depositors; potentially 3,300 households had an estimated \$132 million in uninsured deposits. The FDIC believed that not making all depositors whole would have a materially adverse impact on the franchise value, and that, absent full deposit coverage, the conservatorship would be unable to attract or retain large depositors that could provide liquidity to the franchise. The cost to the insurance fund for covering these uninsured depositors was originally estimated at \$18 million; FDIC staff believed that this cost was offset by the loss in potential franchise value that would result from not paying the uninsured.

Shortly after CrossLand was placed into conservatorship, Jonathan R. Macey, a professor at Cornell Law School, had a different opinion: "During the time when CrossLand [sic] was a 'zombie bank,' economically insolvent and kept alive only thanks to regulatory forbearance," he wrote, "it obtained much needed cash by paying significantly above-market interest rates for deposits, further increasing costs to the FDIC, which plans to fulfill these financial obligations. These lucky depositors are delighted

5. The FDIC, as receiver of CrossLand, retained CrossLand's subordinated debt and litigation and approximately \$68 million in nonperforming assets and owned real estate.

6. Mr. Kraemer was formerly chief executive of Bowery Savings Bank and Home Savings Bank (subsidiaries of H.F. Ahmanson & Co.).

7. FDIC, News Release, PR-8-92, "FDIC Establishes New Savings Bank as Successor to CrossLand Savings Bank, FSB, Brooklyn, N.Y." (January 24, 1992).

8. Quint, "CrossLand Is Seized by the U.S.," 37.

9. Quint, "CrossLand Is Seized by the U.S.," 37.

that the FDIC has nationalized CrossLand, since now they will continue to enjoy receiving above-market rates on certificates of deposit bought before the changeover.”¹⁰

The decision to place the institution into conservatorship and run it until it could be sold also drew fire from Professor Macey, as well as from banking analysts in the private sector. Referring to FDIC Chairman Taylor, Professor Macey wrote: “Disdaining the term ‘socialism,’ Mr. Taylor has dubbed his scheme the ‘bank hospital’ plan. The plan . . . is simply reverse-privatization. First the FDIC assumes control of an insolvent bank, then it pumps in enough FDIC funds to keep it afloat, and finally it installs its own top management to run the bank.”¹¹

Professor Macey further criticized the least cost decision of the FDIC. “The FDIC’s plan appears inconsistent with the Federal Deposit Insurance Corporation Improvement Act (FDICIA) of 1991. The inconsistency stems from the fact that, under the FDICIA, the FDIC is required to adopt the failure resolution strategy that imposes the lowest cost on the FDIC,” he wrote. “First, it apparently assumed that the real estate market in New York will rebound quickly so that the FDIC can profit from holding onto CrossLand’s assets, which are mostly in the form of real estate investments. Otherwise there is no way it could conclude that holding and ‘managing’ CrossLand’s assets is a superior strategy to limiting the FDIC’s exposure to its current level by simply liquidating the thrift.”¹²

Other analysts agreed that CrossLand simply should have been closed, and compared the takeover of CrossLand to the strategy of the Federal Savings and Loan Insurance Corporation (FSLIC). The FSLIC allowed troubled thrifts to remain open, which gave them the ability to grow, make more loans, and take on more high-rate deposits. Professor Macey and the other banking analysts did not understand that the FDIC’s intent in establishing the conservatorship was to control CrossLand and shrink it back to its core business to restore its value.

The Conservatorship

CrossLand Federal was operated as a full-service, going concern, with the goal of shrinking the savings bank to its core franchise (that is, a consumer-oriented savings bank), reducing costs, closing down unprofitable branches, and cleaning up the bad assets. In August 1993, approximately 18 months later, CrossLand Federal was returned to the private sector, with the following accomplishments:

- Operations: CrossLand Federal sold or closed 41 branches—8 in New York, 1 in Utah, and 32 in Florida. The bank also significantly reduced noninterest expense by \$50 million on an annual basis and reduced staff by approximately 1,200 employees.

10. Jonathan R. Macey, “Needless Privatization at the FDIC,” *The Wall Street Journal* (February 14, 1992), 1.

11. Macey, “Needless Privatization at the FDIC,” 1.

12. Macey, “Needless Privatization at the FDIC,” 1.

- Assets: CrossLand Federal sold two major operating subsidiaries for significant gains over their marked-to-market values (CrossLand Mortgage and an insurance premium finance subsidiary, CrossLand Premium Funding). Mortgage-backed securities were sold, reducing the balance from \$883.7 million to \$391.4 million over the same period. Net loans were reduced by \$1.5 billion, which allowed CrossLand Federal to decrease its allowance for loan losses from \$324.6 million in January 1992 to \$216.4 million in March 1993. Overall, the conservatorship (CrossLand Federal and CrossLand Utah together) was reduced from \$8.6 billion to \$5.3 billion in assets, from \$6.7 billion to \$4.2 billion in deposits, and from 86 to 45 branches.

As conservator of CrossLand Federal, the FDIC provided operating guidelines for the savings bank and established reporting requirements for approval of strategies and business transactions, such as the disposition of assets. The FDIC approved the pay of the chief executive officer and that of other CrossLand Federal executives consistent with market studies of comparable financial institutions. The FDIC required the institution's management to prepare a business plan specifying how the institution would operate profitably and how it would restructure its assets.¹³

CrossLand Federal's management was also required to submit periodic status reports and to brief the senior FDIC officials responsible for overseeing the conservatorship. These reports and briefings were related to progress in addressing the business plan and specifically in the handling of troubled loans. For example, at the time of its sale, CrossLand Mortgage had a book value of \$266 million. The conservatorship received 10 bids for the subsidiary and sold CrossLand Mortgage to the highest bidder for a sale price of \$305 million, realizing a gain of approximately \$39 million over the book value.¹⁴

The FDIC had a constant on-site presence at CrossLand Federal, including one or more staff attorneys assigned to the bank's corporate office headquarters to represent the FDIC and the conservator on legal issues. Senior FDIC officials were in daily contact with senior bank officers, paying particular attention to the major asset problems and actively advising on the marketing and disposition strategies for the major subsidiaries. As conservator, FDIC officials also attended monthly meetings with the bank executives where decisions on major asset disposition and other significant business matters were made. To provide further oversight of the CrossLand Federal conservatorship, a number of independent financial and operational audits were performed. These audits generally were concerned with the condition of the assets, but also reported that the conservatorship managers were doing a good job in following the operating guidelines and the business plan. Both the OTS and the FDIC conducted limited scope examinations in October

13. U.S. General Accounting Office, Report to the Chairman, Committee on Banking, Finance and Urban Affairs, House of Representatives, GAO/GGD-94-109, "Failed Bank: FDIC Sale of CrossLand Conservatorship Satisfied Least-Cost Test" (April 20, 1994), 9-12.

14. GAO/GGD-94-109, 9-12.

1992, and both concluded that the conservatorship was well managed but that the quality of its assets was still a concern. Two accounting firms reviewed the financial and compliance aspects of the conservatorship. One firm performed the financial audit and concluded that the bank's financial statements were fairly presented. The other firm was contracted by the FDIC's Office of the Inspector General to review the conservatorship's compliance with guidelines to ensure appropriate management and control of operations. That firm reviewed 80 to 90 of the largest transactions and a sample of the smaller ones, and found no significant shortcomings in the operations or controls of CrossLand Federal.¹⁵

Disposition of the Conservatorship

In December 1992, the FDIC began exploring its alternatives for dissolving the conservatorship of CrossLand Federal, in keeping with its charge of executing the least costly resolution for the savings bank. The FDIC identified and evaluated four possible resolution alternatives:

- Liquidation of the bank's remaining assets and liabilities;
- Piece by piece sale of the bank's assets and liabilities, with some assets retained by the receivership;
- Sale of the entire bank; and
- Sale of CrossLand Federal equity stock through a public offering.¹⁶

The FDIC evaluated the savings bank and estimated that the first alternative, a liquidation of the institution, would result in a cost of approximately \$1.2 billion to the Bank Insurance Fund (BIF).¹⁷ A financial advisor hired by the FDIC proposed a second alternative in March 1993. The advisor recommended a piecemeal sale of CrossLand Federal that would comprise the sale of some assets, including selected branches and their deposits, but would retain certain hard-to-sell assets by the FDIC for liquidation. This alternative was estimated to provide the FDIC an additional \$110 million and \$220 million in net proceeds, with a resulting cost to the BIF of between \$970 million and \$1.1 billion.¹⁸ This figure reflected the FDIC's original investment of \$1.2 billion, which would be reduced in the piecemeal sale by the \$110 to \$220 million in sale proceeds and by an estimated \$10 million that was anticipated to be recovered from assets held in the receivership estate.

15. GAO/GGD-94-109, 9-12.

16. GAO/GGD-94-109, 5-8.

17. GAO/GGD-94-109, 5-8.

18. GAO/GGD-94-109, 5-8.

Table II.11-1.

CrossLand Federal Savings Bank
Four Possible Resolution Alternatives
Potential Cost to the Bank Insurance Fund
(\$ in Millions)

Alternative	Cost
Liquidation of conservatorship assets and liabilities	\$1,175
Piece-by-piece sale of CrossLand Federal, with certain hard-to-sell assets retained in the receivership	970 to 1,080
Sale of entire CrossLand Federal per bid received (whole bank with loss sharing)	899
Sale of CrossLand Federal equity stock by private placement or public offering	889

Note: The cost of all four alternatives includes the net proceeds plus an expected return from assets held in the FDIC receivership of CrossLand. The cost to the FDIC is projected by offsetting the expected net proceeds to the FDIC, plus the return from the FDIC receivership, against the \$1.2 billion that the FDIC injected in cash.

Source: U.S. General Accounting Office, report to the chairman, Committee on Banking, Finance and Urban Affairs, House of Representatives, GAO/GGD-94-109, "Failed Bank: FDIC Sale of CrossLand Conservatorship Satisfied Least-Cost Test" (April 20, 1994).

A third alternative for resolving CrossLand Federal was its sale to another financial institution. Nine institutions showed initial interest in bidding for CrossLand Federal. The FDIC estimated that a bid would generate \$291 million in net premium for CrossLand Federal, thereby costing the BIF \$899 million, or the FDIC's original \$1.2 billion investment reduced by the \$291 million premium and by the \$10 million in anticipated recoveries from the assets in the receivership.¹⁹

At the same time the FDIC was considering these alternatives, it was also exploring a fourth alternative: resolving CrossLand Federal through a public offering or private placement of stock. In early 1993, improving market conditions for savings bank securities were helping some publicly traded savings banks recapitalize. In April 1993, the FDIC decided to investigate the option of converting CrossLand Federal to stock form and selling all or a majority of the equity ownership of CrossLand Federal through a private placement or public offering. As part of this process, the FDIC engaged two investment banking firms to pursue the equity sales strategy. In the spring of 1993, these firms concluded that the sale of CrossLand Federal would generate approximately \$300 million in proceeds.²⁰ If the estimate were correct, this alternative would be the least costly, with an estimated cost to the BIF of \$889 million. See table II.11-1.²¹

19. GAO/GGD-94-109, 5-8.

20. GAO/GGD-94-109, 5-8.

21. GAO/GGD-94-109, 5-8.

The Resolution—August 12, 1993

In early 1993, the FDIC's two investment firms prepared for a private placement or public offering of CrossLand Federal to institutional investors. The offering circular for CrossLand Federal reported that, during the conservatorship period, the institution had made progress in reducing and restructuring its franchise in the New York area and in selling or restructuring its nonperforming assets. The investment banking firms were proactive in assembling the group of investors, and the FDIC staff made itself available to the investors and had frequent interaction with them.

While the FDIC Board of Directors determined that a stock sale of the institution was likely to produce disposition proceeds greater than any other disposition alternative, it also agreed to consider traditional P&A bids for CrossLand Federal's assets and liabilities to increase competition and accommodate potential interest that might result from a due diligence process. Only one bid for a P&A transaction was received, and it was approximately \$30 million more costly than the institutional placement of the stock. On August 12, 1993, the FDIC Board of Directors approved the sale of CrossLand Federal by placing the stock with institutional investors in a registered public offering for \$332 million, plus warrants for an additional one million shares of stock in the institution. The sale was closed on August 19, 1993.

To effect the transaction, CrossLand Federal was converted from a federal mutual savings bank to a federal stock savings bank. In the conversion, the FDIC received convertible preferred stock of the bank that automatically converted into 12 million shares of common stock on the FDIC's transfer of the stock to the new owners. The common stock was sold for \$282 million, or \$23.50 a share. CrossLand Federal issued to the FDIC \$50 million of subordinated debentures that were simultaneously sold to the institutional investors, bringing the total proceeds of the transaction, net of \$11 million of advisory fees, to \$321 million. The FDIC also received warrants providing it with the right to purchase one million (about 8.3 percent) of the 12 million shares of the common stock of the bank at an exercise price of \$23.50 per share. The warrants could be exercised at any time before their expiration date of August 19, 2003; the warrants were exercised in 1996, resulting in a gain of \$18 million.

Finally, to effect the bank's sale, the FDIC provided the buyers with protection against large, unexpected losses on certain of CrossLand Federal's bad assets through a loss sharing agreement. Loss sharing was by then a familiar concept, having been used a total of 14 times, covering \$20.6 billion in initial total assets in the resolution of failing institutions. The loss sharing agreement with CrossLand Federal covered approximately \$2.8 billion in total assets, including all multi-family and commercial real estate loans (\$1.7 billion), construction loans (\$324.4 million), commercial business loans (\$96.9 million), and investments in real estate (\$560.4 million).²² The assets were primarily

22. FDIC, *The Cost of Large Resolution Transactions* (March 12, 1996).

CrossLand Federal's high-risk assets (both performing and nonperforming). Unlike previous loss sharing agreements, this loss sharing required the new bank to assume all losses up to the "threshold amount," which was \$179 million. The FDIC agreed to only reimburse the acquirer for 80 percent of net loan charge-offs and reimbursable expenses that exceeded the threshold amount during the agreement's five-year term. If the acquirer recovers any additional income from these assets, the FDIC is entitled to 80 percent of the net amounts for an additional three years (until June 30, 2001).

Many of these assets had already been partially charged off during the conservatorship so that their book value would more appropriately reflect their value. By having the new investor group agree to absorb the first \$179 million in losses, the FDIC's risk was minimal. At the time of the resolution, the FDIC estimated the cost under the loss sharing agreement to be \$28 million. The new institution reached the threshold loss figure in December 1995, and the FDIC revised its loss share estimate to \$32 million; see table II.11-2 for details on the loss sharing agreement.

The Stock Transactions

When the conservatorship was established, the FDIC had contributed \$525.2 million into the equity of CrossLand Federal. A large portion of these funds covered the negative equity that had existed on CrossLand's books. When the FDIC converted the mutual institution to stock form, it received 120,000 shares of convertible preferred stock that was converted into 12 million shares of common stock of the bank on transfer by the FDIC to the institutional investors. Institutional investors paid the FDIC \$282 million in cash, plus \$50 million in subordinated debentures and gave the FDIC warrants for the purchase of one million shares of common stock of the bank at \$23.50 per share. In 1994, the bank became a wholly owned subsidiary of Brooklyn Bancorp, Inc. (Bancorp) and, in accordance with the original sale agreement, the warrants automatically converted to warrants for Bancorp common stock with identical terms and conditions. On February 29, 1996, Republic New York Corporation (Republic) acquired Bancorp for an aggregate cash purchase price of \$529.6 million or \$41.50 per common share. As part of this transaction, the FDIC exchanged its Bancorp warrants at a price equal to the aggregate difference between their exercise price of \$23.50 per share (\$23.5 million) and Republic's cash offer of \$41.50 per share (\$41.5 million), for a net gain of \$18 per share. Bancorp was required to pay all expenses associated with the registration of the warrants.²³ See table II.11-3 for a summary of stock transactions.

23. FDIC, *The Cost of Large Resolution Transactions*.

Table II.11-2.

**CrossLand Federal Savings Bank Loss Sharing Data
as of December 31, 1997**

(\$ in Millions)

	Amount
Beginning balance loss share assets	\$2,820
Permitted advances and additions	32
Total loss share assets	2,852
Principal collected	2,234
Principal charged off	320
Protection forfeited, assets removed from pool, and adjustments to beginning balance	5
Total principal reductions	2,559
Remaining balance of loss share assets*	294
FDIC's original estimate of loss sharing payments	28
FDIC's actual loss sharing payments as of December 31, 1997	6
FDIC's remaining anticipated payments	28
FDIC's revised estimate of total loss sharing payments	34
Revised estimate of total payments as a percentage of original estimated payments	121.43%
Revised estimate of total payments as a percentage of total loss share assets	1.19%

*Total does not foot due to rounding differences.

Source: FDIC, "Summary of Loss Sharing Assistance Agreements Through December 31, 1997" (February 23, 1998).

Table II.11-3.

**A Summary of the FDIC's Stock Transactions
for CrossLand Federal Savings Bank**

(\$ in Millions)

Date	Transaction	Amount
08/19/93	Cash received	\$282
08/19/93	Debentures received	50
08/19/93	Cost of sale	(11)
02/29/96	Sale of warrants to Republic New York Corporation	18
Totals		\$339

Source: FDIC, *Equity Investment Portfolio, Bank Insurance Fund* (December 31, 1993).

FDIC Resolution Costs

The FDIC's estimate of the resolution cost of completing an insured deposit transfer in 1992 was \$1.3 billion. As shown in table II.11-4, the FDIC's decision of placing the institution into conservatorship and then selling it later through the stock sale was less expensive with a total cost of approximately \$740 million, or 10.2 percent, of failed bank assets as of December 31, 1995. This is also less than the \$889 million estimate made by the FDIC in late 1993, when it was comparing the three different available alternatives prior to the stock offering. Part of the reason for the difference after the sale was proposed is that the franchise was sold for more than predicted and the sale of the warrants later added an additional \$18 million in proceeds. Also there was approximately \$15 million in proceeds received from suits involving the directors and officers of the failed bank and a bond claim on the insurance policy of the bank. Even though the resolution costs are less than what was predicted in 1993, CrossLand still ranks as one of the most costly resolutions in FDIC history.

Table II.11-4.

CrossLand Federal Savings Bank Resolution Costs

(\$ in Millions)

FDIC's Expenses	
Initial capital infusion	\$1,200
Loss sharing payments—estimated*	34
FDIC's Total Expenses	\$1,234
FDIC's Recoveries	
Net proceeds from sale of stock	\$321
Recovery of capital investment	155
Gain on sale of stock warrants	18
FDIC's Total Recoveries	\$494
FDIC's Total Resolution Cost**	\$740

*As of December 31, 1997, actual loss share payments totaled \$6 million; however, the FDIC expects that prior to the end of the loss sharing agreement there will be additional claims of approximately \$28 million. The total expected payments of \$34 million equals about 1.2 percent of the total asset balance originally covered by loss sharing.

**Includes both receivership and FDIC corporate costs of CrossLand.

Sources: FDIC *The Cost of Large Resolution Transactions* (March 12, 1996); FDIC Division of Finance; and FDIC Division of Research and Statistics.

Lessons Learned

CrossLand was an unusual and high-profile resolution, and the FDIC learned some valuable lessons from this experience. Also, CrossLand was the first large institution to fail after passage of FDICIA. Because of this, and because of the unique way it was resolved, the failure and resolution drew a lot of attention. The United States General Accounting Office (GAO) conducted two independent investigations into the original transaction in 1992 and the resolution in 1993.

Reports from the U.S. General Accounting Office

The GAO produced two reports in connection with the failed institution. The first report, “Failed Bank: FDIC Documentation of CrossLand Savings, FSB, Decision Was Inadequate,” July 7, 1992, dealt with the FDIC’s decision to place CrossLand into conservatorship.²⁴ The second report, “Failed Bank: FDIC Sale of CrossLand Conservatorship Satisfied Least-Cost Test,” April 20, 1994, was concerned with the FDIC’s sale of CrossLand Federal.²⁵

GAO Report, July 1992. One FDICIA requirement was that the FDIC had to select the least costly method of resolving a failing bank. CrossLand was the sixth institution to fail after passage of FDICIA and was much larger than any of the other five. The FDIC’s placing of CrossLand into conservatorship was a controversial decision, and the chairmen of both the Senate and House banking committees requested that the GAO review the transaction to see if the FDIC had selected the least cost transaction.

Ultimately, the GAO could not confirm that the decision to place CrossLand into conservatorship was the least costly resolution alternative. The GAO found that FDIC staff had presented three possible resolution alternatives for CrossLand and had made various cost assumptions about each alternative.²⁶ The GAO did not find empirical evidence to support the assumptions in either its review of the presentation made to the FDIC Board of Directors or in any other FDIC files. This resulted in the GAO’s questioning the validity of the cost savings of the conservatorship resolution.

The FDIC staff had estimated that the resolution of CrossLand through the conservatorship option would cost about \$763 million. That estimate was based on the assumption that the FDIC would need to inject approximately \$1.2 billion in cash into CrossLand Federal to adjust the value of CrossLand’s loans and to bring the institution’s equity to approximately 4 percent of assets. FDIC staff further estimated that CrossLand Federal would earn about \$69 million after taxes for each of two years following

24. U.S. General Accounting Office, Report to Congressional Requesters, GAO/GGD-92-92, “Failed Bank: FDIC Documentation of CrossLand Savings, FSB, Decision Was Inadequate” (July 7, 1992).

25. GAO/GGD-94-109.

26. U.S. General Accounting Office, “Failed Bank: FDIC Documentation of CrossLand Savings, FSB, Decision Was Inadequate” (July 7, 1992), 3.

the establishment of the conservatorship, for a total of \$138 million. After two years, the institution would pay the FDIC a cash dividend of \$203 million, and the equity in the institution could be sold for roughly \$375 million, for a total return to the FDIC of \$578 million. FDIC staff discounted the \$578 million at 15 percent for the two-year period, making the return to the FDIC about \$437 million in 1992 dollars. This left a cost to the FDIC of \$763 million (\$1.2 billion, less \$437 million) at the time of the decision to place CrossLand into conservatorship in 1992. The \$763 million projected cost was about \$517 million less than the next least costly resolution method of transferring insured deposits only to a healthy institution (\$1.297 billion), and approximately \$534 million less than a resolution through an insured deposit payoff (\$1.28 billion).²⁷

Approximately \$440 million of the FDIC's projected \$517 million cost savings in 1992 was based on the FDIC's estimate that, in a conservatorship, it would realize a savings of roughly 10 percent more on CrossLand's troubled assets than it would if the FDIC assigned the assets to a contractor for management and disposition. This belief was based on three key assumptions. First, the values of assets held in a going concern are greater than the values of assets placed in a liquidation mode. Second, it would be more efficient to retain CrossLand's "collection machinery" than incur the cost and disruption associated with replacing that system. Third, CrossLand's borrowers most likely would prefer the approach taken by the "local banker" than the approach taken by the "out-of-town liquidator." The "10 percent assumption" was the biggest factor in the recommendation to proceed with a conservatorship, and the GAO believed it should have been more firmly supported.²⁸ Additionally, the GAO objected to the FDIC's use in January 1992 of CrossLand asset valuations, because they had been completed in July 1991; they were based on March 31, 1991, information; and they did not cover any of CrossLand's subsidiaries. The GAO felt that such data were obsolete and may have resulted in inaccurate asset valuations.²⁹

The FDIC received a draft copy of the GAO's report, and the FDIC disagreed with the GAO's findings that the decision was inadequately documented. The final report was produced with that disagreement noted. It should be noted that the law (FDICIA) that required the FDIC to comply with the least cost test had only been effective since December 19, 1991. This was less than a month before the FDIC's decision to place CrossLand into conservatorship. Responding to the draft of the GAO report, Chairman Taylor wrote: "Although specific policies and procedures may not have been fully implemented at the time of the CrossLand Savings resolution, the FDIC believes that the process which resulted in the decision to pursue interim ownership of CrossLand Savings represented full compliance with FDICIA."³⁰

27. GAO/GGD-92-92, 8.

28. GAO/GGD-92-92, 10-11.

29. GAO/GGD-92-92, 9-10.

30. FDIC Chairman William Taylor, letter to Richard L. Fogel, Assistant Comptroller General, U.S. General Accounting Office (June 17, 1992); GAO/GGD-92-92, 21-22.

GAO Report, April 1994. After the FDIC arranged the sale of CrossLand Federal in August 1993, the GAO was again requested to review the FDIC's actions. In its second review, the GAO was requested by the House Committee on Banking, Finance, and Urban Affairs to determine whether the FDIC had complied with the least cost requirement of FDICIA and whether the conservatorship achieved the \$517 million in savings that the FDIC had estimated in February of 1992. In its second report, the GAO found that the process used by the FDIC to approve selling CrossLand Federal in a public offering was much improved over the method used in January 1992 when the decision was made to place CrossLand into conservatorship. The GAO further reported that the documentation of the cost estimates for each alternative, as well as the underlying assumptions for those cost estimates, was also improved.³¹ The GAO reported that it believed the FDIC complied with FDICIA and selected the least costly resolution alternative.

The GAO, however, reported that the FDIC did not achieve its expected savings of \$517 million by selecting the use of the conservatorship resolution method in 1992. At the time of the GAO's investigation, the FDIC had reduced the savings estimate to \$400 million, which the GAO further adjusted to \$333 million. In establishing its original estimate, the FDIC had predicted that CrossLand Federal would, before its sale, generate income and pay dividends of \$272 million. However, the conservatorship lost \$235,000 in the 18-month period before its sale.

The GAO reported that the conservatorship did not restore CrossLand Federal to profitability, nor did it produce the improvements to franchise value that it had projected. FDIC Divisions of Supervision and Resolutions Executive Director John W. Stone advised the GAO that the bank's asset quality was lower than expected when CrossLand was closed in 1992: ". . . [I]t is our firm belief that the cost of liquidating CrossLand was underestimated in January 1992. It was only after the FDIC gained control of the institution that it became evident that the condition of CrossLand's assets was worse than believed in January of 1992."³² Regardless of the large difference in the cost estimate of the transaction, the GAO also confirmed that, while CrossLand cost more than originally projected, the selection of the conservatorship resolution method was still less expensive than any of the other resolution alternatives available in 1992.

The GAO also indicated that the conservatorship was judged to be well managed and controlled. As conservator of CrossLand Federal, the FDIC provided guidelines for operating the bank and established reporting requirements for approval of strategies and business transactions, such as the disposition of assets. The FDIC hired a chief executive officer and approved his remuneration, as well as that of other CrossLand Federal executives, consistent with market studies of executive pay in comparable financial

31. GAO/GGD-92-92, 3.

32. John W. Stone, Executive Director, FDIC Divisions of Supervision and Resolutions, letter to James L. Bothwell, Director, Financial Institutions and Markets Issues, U.S. General Accounting Office (February 25, 1994); GAO/GGD-92-92, 18

institutions. The FDIC required the bank's management to prepare a business plan specifying how the bank was going to operate profitably and restructure its assets.³³

Finally, the GAO believed that it might not have been necessary for the FDIC to protect the uninsured depositors of CrossLand or to honor the interest rates in deposit contracts on some of CrossLand's deposit accounts. The cost of protecting the uninsured did not have a major effect on the final resolution cost. The actual cost of protecting the uninsured was \$11 million, which was 1.24 percent of the \$889 million estimated cost at the time the conservatorship was sold in August 1993. The FDIC assumed that if it did not protect uninsured depositors from losses and honor deposit contracts on certain deposit accounts, there would be a large outflow of deposits during conservatorship. The FDIC believed that this would result in a reduced CrossLand Federal franchise value and would lower the expected sales proceeds when CrossLand Federal was sold to the private sector. In its 1992 report, the GAO had stated that the FDIC did not have documented support for the assumption on depositor reactions. In its 1994 report, the GAO noted that, after the January 1992 CrossLand resolution decision, other resolutions such as American Savings Bank in New York and the subsidiary banks of First City Bancorporation of Texas, Inc., in Texas showed that requiring uninsured depositors to absorb their share of losses in the resolution of a failed bank did not necessarily result in depositor runs. With the benefit of that experience, the FDIC agreed that, in hindsight, it was not necessary to protect the CrossLand uninsured depositors in the January 1992 resolution decision.³⁴

Other Lessons Learned

In addition to the points brought out in the GAO reports, the FDIC also learned valuable lessons from its operation of the CrossLand Federal conservatorship. The FDIC had previously completed several transactions that involved the FDIC's sharing of risk. Because the bank was in conservatorship, due diligence teams could determine the potential loss in the portfolio that was to be sold in the final transaction. Potential purchasers were instructed to take this into consideration when making their bids. In the transaction completed with the purchasers of CrossLand Federal, the FDIC agreed to a sales price that reflected the purchasers' estimation of the probable loss on the assets. In return, the purchasers agreed to fully absorb the first \$179 million of losses on CrossLand Federal's commercial loans and real estate owned. The FDIC would reimburse the acquirers for 80 percent of further net charge-offs on those assets for a period of five years. The FDIC believed that its costs of sharing the risk on the portfolio of commercial loans and real estate owned would be lower if the assets were worked out in

33. GAO/GGD-92-92, 9.

34. GAO/GGD-92-92, 12.

an open bank environment. Because the investors absorbed the initial losses in the portfolio, the FDIC learned that it could transfer to institutional purchasers a larger portion of its risk than had been transferred in previous transactions.

At CrossLand Federal, the FDIC used lessons that it had learned previously in its oversight of large asset management firms. Ever since the 1988 resolution of First RepublicBank Corporation, Dallas, Texas, the FDIC had used contracted asset management firms, under FDIC supervision, to collect the FDIC's assets acquired from large bank failures. In the asset management contracts, the FDIC required the contractor to develop and follow a business plan approved by the FDIC, that the contractor have policies in place to support the business plan, and that audits be performed regularly to ensure compliance with the business plan. While CrossLand Federal was operated in a conservatorship, the FDIC used many of the same management principles that it had learned in its oversight of the asset management companies.

The FDIC's hiring of an outside executive to run CrossLand Federal was not an unusual move; use of private sector expertise was successful in the operation of many of the FDIC's bridge banks in previous resolutions. Although the conservatorship of CrossLand Federal lasted longer than most of the bridge banks, the FDIC considers use of an outside executive, along with a strong and focused business plan, integral to the successful resolution of CrossLand.

Additionally, the FDIC's emphasis of working assets out of an open bank, private sector environment is viewed as being cost-effective in this instance. A "credit crunch" in the Northeast at that time was causing many lenders to become more conservative, making it more difficult for borrowers to refinance. Borrowers able to work with an ongoing financial entity were more able and more willing to service their debt obligations than if they had been placed into a liquidation mode. CrossLand Federal was able to reduce its asset base by 38 percent in the 18 months that it was in operation as a conservatorship. The remaining assets stayed in an open bank environment when the bank was sold to the new investors.

Although the FDIC agreed with the GAO's findings that, in hindsight, the uninsured depositors did not need to be protected, there were valid reasons given for the action in January 1992. The FDIC's primary interest was to protect the institution's future franchise value. The estimated \$11 million cost of protecting the uninsured was small, compared to the damage that could have occurred if core depositors had left the bank during the conservatorship period. The FDIC believed that, given the nature of the communities served by CrossLand, the remaining \$5 billion core deposit base could be considered quite fragile. The conservatorship likely would have suffered if unaffected safety conscious depositors, anxious about losses imposed on the uninsured, had reacted by withdrawing their deposit balances. If that had happened, CrossLand Federal would have found itself more dependent on rate conscious depositors, which would have increased operating costs and further reduced the value of the franchise.

FDIC staff estimated that a seven basis point increase in the average interest rate paid on deposits would have reduced CrossLand Federal's net income by approximately

\$2.5 million per annum. Richard Kraemer, whom the FDIC had hired to serve as president and chief executive officer of CrossLand Federal, estimated that imposing losses on the bank's uninsured depositors could have affected the bank's core deposit costs by as much as 25 basis points. Such an increase in deposit costs would have been very detrimental to CrossLand Federal's future franchise value.

As further support of the FDIC's action, the vast majority of all time deposits with high interest rates were set to mature within a year. The FDIC staff viewed CrossLand Federal's continuation of the relatively high interest rates as a temporary problem that could be corrected as the accounts matured. Without liquidity pressure during the conservatorship period, renewal rates on deposits could be set at market rates. Before the passage of FDICIA, the FDIC had nearly always protected all depositors in a P&A transaction and had done so in 1991 for such notable failed institutions as the Bank of New England Corporation banks, the Southeast Banking Corporation banks, and the New Hampshire Plan banks. It is difficult to predict depositor reaction and therefore it is difficult to assess what damage, if any, would have occurred if the uninsured depositors had not been covered. While it is true that the cost of protecting uninsured depositors was minimal when compared to the total cost of the entire resolution, in retrospect, the FDIC learned that its practice of protecting all depositors probably was not necessary.³⁵ Since the enactment of FDICIA, the FDIC has become more conscious of recognizing all resolution solutions and uses greater care at documenting costs of each alternative.

The lack of bidders willing to purchase the CrossLand franchise in January 1992 provided the FDIC with the opportunity to test a different source for resolving an institution. After the conservatorship, the investment firms engaged to help the FDIC market CrossLand Federal were very proactive in finding a group of investors to purchase the bank. The price received from these investors exceeded the highest bid the FDIC received under a traditional P&A transaction structure. The CrossLand experience showed that, in some instances, investors from other markets outside the standard banking community provide the FDIC with its lowest cost alternative.

Effect on Future Resolutions

CrossLand was one of the last large, complex banks to fail during the banking crisis period. After CrossLand Federal's sale in August 1993, only 22 insured banks failed through the end of 1994, and the largest of those had \$296 million in total assets. The FDIC has not had a real opportunity to test some of the lessons learned from its

35. The GAO's April 1994 report compared the FDIC's actual \$11 million cost of protecting the uninsured to the FDIC's August 1993 estimated total resolution costs of \$889 million and determined the cost of protecting the uninsured as 1.24 percent of total costs. A comparison of the \$11 million cost to the FDIC's actual total resolution costs of \$740 million results in a cost of protecting the uninsured as 1.5 percent of total costs.

CrossLand experience. The FDIC does, however, continue to share risk with failed bank purchasers through loss sharing agreements, and it is expected that loss sharing will continue to be offered as a resolution technique in the future. It is entirely possible that, in the event of another large high-profile institution failure the FDIC would hire private sector advisors from Wall Street to assist in developing potential investors groups outside the banking community.

The FDIC has refined its procedures to comply with FDICIA elements that require the FDIC to always choose the least costly resolution alternative for a failing financial institution. Other FDICIA requirements, particularly those involving prompt corrective action, have not been used enough, because of the strong economy, to determine the effect on large bank failures.³⁶

The FDIC's placing of CrossLand into a conservatorship was deemed necessary by the FDIC in 1992 because there were no acceptable bids for the institution. Although there was heavy criticism from many sides at the time, the final outcome of the sale of CrossLand Federal proved that the conservatorship option was the appropriate and least costly action for the FDIC to take. The sale was consummated 18 months after the conservatorship was started, and during that time the general economy improved and the banking environment got better. The institution was downsized to its core business, it resolved many of its problem assets, and it was operating more efficiently. The conservatorship decision was proved to be correct, and the FDIC might well make the same decision if a similar situation arises in the future.

36. Prompt corrective action requires bank regulatory agencies to take specific steps to deal with institutions that have declining levels of equity capital. Actions range from restrictions on an institution's deposit taking to closing of the institution.



CHAPTER 12

Conclusions

The previous 10 chapters have outlined some of the FDIC's most notable failing bank resolutions. Although they represent a very small number of the 1,617 bank resolutions that took place during the 15-year period, they represent some of the FDIC's most innovative resolution strategies. These case studies were designed to give the reader a feel for the challenges faced by the agency from 1980 through 1994.

This Conclusions chapter is presented in four parts: Resolutions, Assets, Liabilities, and Equity. Each of these sections will highlight some of the lessons learned by the FDIC. See table II.12-1 for a summary of the resolutions.

Resolutions

The preceding 10 case studies of significant resolutions discussed several different resolution structures such as open bank assistance and the creation of bridge banks. The case studies also discussed the FDIC's use of cross guarantee authority and its bidding procedures.

Open Bank Assistance¹

Of the 10 case studies presented, 4 involved open bank assistance (OBA).² During the early 1980s, OBA was the only resolution method used for larger banks requiring FDIC financial assistance. OBA was effective in minimizing the costs of failing banks,

1. Refer to Part I, Resolution and Asset Disposition Practices, Chapter 5, Open Bank Assistance, for a full discussion of OBA transactions.

2. Four of the chapters present case studies of open bank assistance (OBA): Chapter 2, First Pennsylvania Bank, N.A., Philadelphia, Pennsylvania; Chapter 4, Continental Illinois National Bank and Trust Company, Chicago, Illinois; Chapter 5, First City Bancorporation of Texas, Inc., Houston, Texas; and Chapter 6, First Republic Bank Corporation, Dallas, Texas.

Table II.12-1

Significant Bank Resolutions

(\$ in Millions)

Name and Location	Resolution Date	Total Assets	Resolution Cost	Resolution Type	Depositor Treatment	Creditor Treatment
First Pennsylvania Bank, N.A. (First Penn), Philadelphia, Pennsylvania	04/28/80	\$7,953	\$0	OBA	Full protection	Full protection
Penn Square Bank, N.A. (Penn Square), Oklahoma City, Oklahoma	07/05/82	517	65	Insured deposit payoff	Uninsured depositors not given 100 percent protection	No special protection; approved claims received dividends
Continental Illinois National Bank and Trust Company (Continental), Chicago, Illinois	05/17/84	33,633	1,104	OBA, with asset management contract	Full protection through explicit FDIC guarantee	Full protection through explicit FDIC guarantee
First City Bancorporation of Texas, Inc. (First City), Houston, Texas	04/20/88 and 10/30/92	11,200 and 8,852	1,069 and 0	OBA and 20 bridge banks; P&As with loss sharing	Full protection and all depositors eventually paid in full	Full protection and all creditors eventually paid in full
First Republic Bank Corporation (First Republic), Dallas, Texas	07/29/88	33,448	3,856	One bridge bank; P&A with asset management contract	Full protection through explicit FDIC guarantee	Third party creditors protected; interbank funding not protected
MCorp (MCorp), Dallas, Texas	03/28/89	15,749	2,840	One bridge bank; P&A with asset management contract	Full protection at 19 of 20 banks	Unsubordinated general creditors protected; interbank funding not protected
Bank of New England Corporation (BNE Corp.), Boston, Massachusetts	01/06/91	21,754	887	Three bridge banks; P&A with asset management contract	Full protection through explicit FDIC guarantee	Full protection except to credit-ors affiliated with holding company
Southeast Banking Bancorporation (Southeast), Miami, Florida	09/19/91	10,478	0	P&A with loss sharing	Full protection; acquiring bank assumed all deposits	Full protection
Seven Failing Banks in New Hampshire (The New Hampshire Plan), Various Cities, New Hampshire	10/10/91	4,377	891	Two P&As with loss sharing; one asset management contract	Full protection; acquiring banks assumed all deposits	Full protection
CrossLand Savings, F.S.B. (CrossLand), Brooklyn, New York	01/24/92	7,269	740	Conservatorship; stock sale	Full protection	Only subordinated debt and contingent liabilities not protected
Totals		\$155,230	\$11,452			

Source: FDIC, Division of Resolutions and Receiverships.

maintaining public confidence in the banking system, and continuing banking services in the affected communities. Initially, OBA worked well, but it became less effective over time. Open bank assistance was not used at all after 1992.

Changes in the Law and Their Effects on Open Bank Assistance. The power to complete OBA was provided to the FDIC under the Federal Deposit Insurance Act (FDI Act) of 1950. As the case studies have shown, OBA authority was important to the resolution of several of the larger troubled banks in the early to mid-1980s. The resolution of First Penn shows the difficulty that the FDIC would have had if OBA was not available as a resolution option. The restrictive branching laws made it improbable that the FDIC would have successfully located a purchase and assumption (P&A) candidate for First Penn. Because of the size of First Penn, it also would have been difficult for the FDIC to complete a payoff transaction.

The FDI Act required that a bank be considered “essential” to its community for it to receive OBA. The FDIC struggled with the concept of determining when a bank was “essential.” Nevertheless, OBA was used to facilitate the mergers of many insolvent mutual savings banks in 1981 and 1982. First Penn and the mutual savings banks pointed out the need for OBA at that time. The Garn–St Germain Depository Institutions Act (Garn–St Germain) of 1982 gave the FDIC greater latitude to provide OBA by eliminating the “essentiality” requirement in situations where OBA was determined to be less costly than paying off the bank’s insured depositors.

The lack of potential purchasers for First Penn brought to light the problem of state branching restrictions. The FDIC sought relief from Congress from those restrictions in 1982 and, with Garn–St Germain, Congress gave the FDIC limited authority to seek out-of-state bidders in certain emergency failing bank situations. That authority was of particular assistance in the resolutions of failing Texas institutions a few years later when the depressed economy limited the number of in-state institutions that were eligible to purchase the Texas banks that failed. The Competitive Equality Banking Act (CEBA) of 1987 further expanded the FDIC’s authority to seek out-of-state purchasers by allowing out-of-state holding companies to acquire large institutions under emergency circumstances.

In 1984, when the FDIC was faced with the potential failure of Continental, it used its 1982 authority under Garn–St Germain to solicit out-of-state bidders but was unable to quickly find an acquirer or merger partner for the bank. A payoff was not considered feasible because a large number of small banks and credit unions held uninsured deposits and could have failed if the FDIC paid off Continental’s insured deposits. Foreign depositors would have suffered losses, as well, negatively affecting the nation’s international banking business. Using the FDI Act, the FDIC determined that the continued operation of Continental was essential, and granted OBA.³

3. Because the FDIC believed that providing assistance might be more costly than a payoff, it could not provide open bank assistance unless the bank was deemed “essential.”

Although CEBA provided the FDIC with the ability to create bridge banks in 1987, that authority was not used when the FDIC provided OBA to the subsidiary banks of First City in 1988. In response to a proposal from a group of outside investors who had gathered \$500 million in new capital, the FDIC provided OBA to First City for two reasons. First, the transaction appeared to be beneficial to the FDIC, because the new investors were bringing new capital into First City. Second, the First City banks were large and complex, and the FDIC did not view those banks as an acceptable venue in which to try out the new bridge bank procedures. The FDIC provided OBA because the assistance provided was less than the estimated cost of resolving the banks through other means.

In 1988, the FDIC provided assistance to the two lead banks of First Republic using the essentiality criterion. The First Republic banks were experiencing a liquidity crisis, and the FDIC needed to act quickly. Convinced that the failure of First Republic's two lead banks would cause all the other First Republic banks to fail, the FDIC determined that the lead banks were essential and granted OBA.

Liquidity Issues Requiring a Quick Resolution. The large, troubled banks in need of FDIC assistance frequently had serious liquidity problems that required a quick solution making a P&A transaction difficult, if not impossible, to complete. Three of the OBA transactions examined initially had liquidity problems. First Penn was experiencing a deposit run that included withdrawals by some regional banks and even deposit brokers, and the bank had tied up its liquidity in long-term securities. Continental's liquidity crisis also threatened its ability to remain open. Because of the seriousness of Continental's deposit run, the FDIC had to act quickly to provide interim OBA to prevent Continental's failure. The FDIC wanted the bank's depositors to understand that in any OBA transaction, depositors would suffer no loss as a result of the assistance. The FDIC issued an explicit statement guaranteeing that no depositors or general creditors of Continental would suffer any losses as a result of the FDIC's actions. First Republic is another example of a financial entity that suffered liquidity problems before its resolution. First Republic's two lead banks were experiencing deposit runs. Even though the FDIC had recently gained bridge bank authority, the agency provided OBA to the First Republic banks on an interim basis to give the holding company time to search for new investors. The owners of the holding company pledged the rest of the company as security for the loans to the lead banks.

Equity and the Treatment of Shareholders. One concern regarding OBA was whether shareholders of an assisted institution would receive the same benefit from OBA that they would have received if the bank was actually closed. The 20 million warrants for stock provided to the FDIC and the commercial bank lenders in the First Penn case sufficiently diluted the existing shareholders' interests in the bank, decreasing any return to them. First Penn's shareholders did not receive benefit until after the FDIC's assistance loan had been repaid in full.

In the Continental transaction, the FDIC purchased convertible preferred stock that could be converted into 80 percent of the common stock of Continental's holding

company, effectively diluting the interests of the former stockholders to 20 percent. In addition, the FDIC received a purchase option for the former shareholders' remaining shares of stock in the holding company. The option was exercised when the FDIC suffered losses on the loans purchased from Continental, and the FDIC purchased the former shareholders' stock in the holding company for a nominal amount. That transaction effectively wiped out the equity interests of the former shareholders of Continental's holding company, just as if Continental had been closed.

The FDIC's 1988 assistance to the subsidiary banks of First City was secured by stock in the Collecting Bank. In that transaction, the original shareholders' investments were reduced to less than 2 percent of total equity in the holding company.

Although experience showed that shareholder investments were almost entirely eliminated in OBA transactions, concern over possible benefits under OBA led to legislation passed in 1993. Under the Resolution Trust Corporation Completion Act, failing bank shareholders were restricted from receiving any benefit from OBA.

Open Bank Assistance—Problems and Shortfalls. As OBA became more common, bank shareholders and bondholders began to manipulate the transactions. The First City transaction, for example, pointed out some of the problems of using OBA in dealing with sophisticated creditors. The First City bondholders believed that the FDIC would not let the First City banks fail (because Continental had not failed), and the bondholders learned that they could "use the system" to their advantage by refusing to negotiate and by holding out for better terms.

Another shortfall of OBA highlighted by the First City transaction was the limited control held by the FDIC over bank management once the agreement was completed. This had not been a problem at First Penn or at Continental. In the case of First City, however, the new management was not effective, and the banks eventually failed in spite of the assistance.

Investors who acquired failed institutions through P&A transactions had a competitive advantage over those who received OBA. P&A acquirers were relieved of contingent liabilities and from burdensome contracts such as high lease rates, standby letters of credit, and excessive fees for outside service providers. New acquirers did not have to negotiate with the shareholders or bondholders of the failing banks.

In providing OBA to large, troubled institutions, the FDIC received criticism for "nationalizing" the banks and for creating an unfair competitive advantage for large banks over smaller banks that did not receive OBA. Officers of small banks and elected officials complained that large banks received special treatment simply because of their size and, after the resolution of Continental, the term "too big to fail" was used for the first time. The general public came to think of OBA as an FDIC "bailout" of large banks.

OBA was the only feasible resolution for First Penn. The transaction is viewed as successful, partly because it gave First Penn time to work out its problems. The transaction also was beneficial to the FDIC, because First Penn eventually became profitable, repaid its assistance from the FDIC two years early, and the resolution resulted in no cost to the deposit insurance fund.

The FDIC also could view the Continental resolution (although controversial) as successful because it likely prevented the failure of a large number of small financial institutions that had deposits in Continental and possibly prevented a domino effect that could have rippled through the banking system. Foreign depositors were protected, which helped maintain international banking business for banks throughout the United States. Also, Continental's OBA was provided at a relatively low cost to the FDIC, 3.3 percent of the bank's total assets.

The First City OBA transaction in 1988 provided the FDIC a benefit by bringing \$500 million of new money into the First City enterprise. The amount of money raised by the new investors, however, proved to be inadequate, leading to a second resolution of First City in 1992.

The assistance provided to First Republic's two lead banks in 1988 was only an interim measure that gave the holding company time to look for new investors. The benefit to the FDIC was the pledge from the holding company of all its other assets. When the two lead banks failed, the asset pledge acted like a cross guarantee, allowing the FDIC to use value in the solvent banks to offset some of the losses in the insolvent banks. This was important because the FDIC did not have cross guarantee authority at the time. Cross guarantee authority was not granted until the passage of the Financial Institutions Reform, Recovery, and Enforcement Act (FIRREA) of 1989.

Initially, OBA worked very well for large, failing institutions, and it was used in many situations. As the banking crisis continued, however, OBA began to lose its effectiveness and there were fewer instances in which OBA was appropriate. The FDIC had more resolution alternatives after it received authority to create bridge banks in 1987 and the ability to assess cross guarantees in 1989. Those changes in the law, along with least cost requirements that became law in 1991 and the law restricting OBA from providing any benefit to a failing bank's shareholders, led to the decline in OBA transactions.

Bridge Banks

The bridge bank authority received by the FDIC under CEBA was an important resolution tool for a large, failing institution.⁴ In the 10 bank case studies presented, there were four instances in which bridge banks were established.⁵ Three of the other studied banks failed or were provided assistance prior to the enactment of the bridge bank legislation. Having the option to set up a bridge bank provided benefits to the FDIC in several ways.

4. Refer to Part I, Resolution and Asset Disposition Practices, Chapter 6, Bridge Banks, for a full discussion of bridge banks.

5. Four of the chapters present case studies of bridge banks: Chapter 5, First City Bancorporation of Texas, Inc., Houston, Texas; Chapter 6, First RepublicBank Corporation, Dallas, Texas; Chapter 7, MCorp, Dallas, Texas; and Chapter 8, Bank of New England Corporation, Boston, Massachusetts.

First, bridge banks eliminated the problems associated with OBA. After it received bridge bank authority, the FDIC did not have to negotiate with an institution's shareholders and bondholders to complete a transaction agreement. Second, when a bridge bank was established, a receivership was created for the former bank. Liabilities and claims that hampered the operation and profitability of the original bank, and most contingent liabilities, could be cut off and left in the receivership. Third, the FDIC controlled the bridge bank and could provide bidders with access to perform their due diligence, which improved the bidding process for the former bank. Fourth, the bridge bank remained open so that service was provided to the community and the value of the deposit franchise was protected.

The case studies show that the FDIC's process for establishing bridge banks changed over time. In the case of First Republic, which was the FDIC's first use of a bridge bank for a large banking entity, the FDIC already had a winning bidder selected to take over control of the former bank's assets. In that instance, because the FDIC had provided interim assistance to two of the First Republic banks earlier in the year, prospective bidders had access to perform due diligence on the former banks. Using the authority granted under Garn–St Germain to solicit out-of-state acquirers, the FDIC was able to have a buyer waiting when the banks failed. The FDIC formed one bridge bank for all of First Republic's 40 banks in Texas, and the buyer took over management of the bridge bank the same day. NCNB operated the bridge bank until it could purchase the FDIC's remaining interest in the bridge bank over a year later.

The MCorp transaction, which occurred shortly after the First Republic transaction, was similar to that of First Republic, in that the new entity, Banc One, operated the bridge bank until it could purchase the FDIC's interest in the bridge bank more than 18 months later. Unlike First Republic, however, the FDIC had not solicited potential purchasers before the banks' failure. In that case, the bridge bank provided the FDIC with time to solicit bidders and to allow the bidders to perform due diligence. Three months after creation of the bridge bank, the FDIC announced a winning bidder.

The 1991 failure of the BNE Corp. banks was handled a bit differently. In that case, three bridge banks were set up, one in each state where the former banks had operated. After the banks failed on January 6, 1991, prospective bidders started their due diligence and a winning bidder was selected in April of the same year. The acquirer operated the three bridge banks under an interim agreement, followed in June 1991 by a servicing agreement for the FDIC's assets and in July 1991 by the final P&A agreement. At that point, the bridge banks were dissolved.

Finally, in the case of the First City transaction in 1992, a bridge bank was set up for each of the holding company's 20 failed banks. By that time, legislation had been enacted requiring that the least cost resolution for each failed bank be used, and each of the 20 individual bridge banks was marketed separately. That structure likely resulted in the higher-than-anticipated premiums from the acquirers, which led to a no-cost transaction for the FDIC.

Use of a bridge bank allowed the FDIC to leave certain liabilities with the receiver, rather than transferring them to the bridge bank. As receiver, the FDIC could repudiate any of the former bank's contracts that might have harmed the value of the franchise. Contingent liabilities and interbank loans to affiliates could be retained in the receivership and eliminated from the bridge bank, which increased the sale value of the bridge bank.⁶ Two examples shown in the case studies bring out this point. Receivership certificates were provided for interbank loans at both the First Republic and the MCorp closings, although all other depositors and general creditors were protected.⁷ The forced recognition of loss caused the affiliated banks to fail and helped the FDIC recover some of its costs from the other banks in each holding company.

The lawsuits filed against the FDIC by First Republic's bondholders and by the MCorp holding company over the interbank loans were probably responsible for 1989 legislation that clarified the rights and responsibilities of the FDIC with regard to creditors. Specifically, the legislation provided that the FDIC, in its discretion and to minimize its costs, may make additional payments to any creditor of a failed bank as long as each creditor receives what it would have received from the liquidation of the failed bank's assets. That discretionary authority is significant to the FDIC, because it helps preserve the franchise value of a bridge bank.

Conservatorships and Bridge Banks—A Comparison. CrossLand was resolved by using a conservatorship, which functioned in a manner similar to that of a bridge bank. The failed bank was placed in receivership, providing the FDIC with the same advantages regarding contracts and liabilities as a bridge bank. The conservator could repudiate or disaffirm any of the failed bank's contracts that were considered burdensome, thus avoiding any future obligations imposed by the contract. The conservator also could void security interests in property, even if perfected, if the security interest had been taken with fraudulent intent.

The conservator, as well as a receiver, substitutes for the bank in all pending litigation, can request courts to stay litigation, has all cases resolved in federal court, and has extended periods of time to file contract claims and tort suits. The conservator can avoid fraudulent transfers of property made within five years before or after the conservator's

6. Banks are required to maintain certain levels of reserves, either in vault cash or, if they are members of the Federal Reserve System, in deposits at a Federal Reserve Bank. Banks that are not members of the Federal Reserve System may satisfy reserve requirements by keeping deposits in banks that are members of the Federal Reserve System and that pass the balances through to the Federal Reserve Bank. Because the reserve requirements fluctuate daily, one way banks can meet their requirements is by borrowing excess balances in Federal Reserve deposits, particularly from affiliated banks. In banking, excess balances borrowed are called "Fed Funds Purchased," excess balances loaned are called "Fed Funds Sold."

7. At MBank Abilene, N.A. (MBank Abilene), Abilene, Texas, only insured deposits were transferred to the new bridge bank. Uninsured depositors and general creditors of MBank Abilene were treated in a different manner from similarly situated creditors of the other MCorp banks, because MBank Abilene, as successor to the former Abilene National Bank, had approximately \$60 million in outstanding judgments filed against it.

appointment, and those avoidance rights are superior to any rights of a bankruptcy trustee competing for the same transferred property.

The conservator also had “special defenses” similar to those of a receiver. Any agreement that was not properly documented in the institution’s records, therefore, could not be enforced against the conservator either to make a claim or to defend against a claim by the conservator. Courts were prohibited from issuing injunctions or similar equitable relief to restrain the conservator from completing its resolution and liquidation activities.

After extensively marketing CrossLand, the FDIC received no acceptable bids and proceeded with the conservatorship resolution. Although the FDIC’s decision to place the failed savings bank into a conservatorship generated much public comment and criticism, the transaction proved to be cost effective. The FDIC’s experience demonstrates that, in some instances, a bridge bank or a conservatorship can be operated with a long-term goal of improving an institution’s franchise value.

Most bridge banks were temporary solutions, lasting only a few months; the conservatorship lasted longer than most of the bridge banks. The two exceptions were the First Republic bridge bank, which was operated for a little more than a year, and the MCorp bridge bank, which was operated for approximately two and a half years. Both of those bridge banks were resolved rather quickly but were not terminated, because the acquirers needed time to purchase the FDIC’s interest. The purpose behind the CrossLand conservatorship and its length of duration was to improve the institution and get it ready for sale, whereas the FDIC’s objective in a bridge bank is to gain control of an institution so that it can be sold quickly. From an operations standpoint, however, the conservatorship was little different from a bridge bank. The creation of a business plan, the hiring of an outside executive to run the conservatorship, and the working out of assets in an open bank environment also can be completed in a bridge bank.

Cross Guarantee Authority

The problems encountered by the FDIC in the closings of the First Republic and MCorp banks caused the agency to request cross guarantee authority from Congress. The cross guarantee authority granted by Congress under FIRREA in 1989, is significant to the FDIC because it helps the FDIC recover some of its costs for handling troubled banks. Cross guarantee authority was used in the 1991 resolutions of Bank of New England, Boston, Massachusetts, and Southeast Bank, N.A., Miami, Florida.

One of the most instructive examples of the FDIC’s use of its cross guarantee authority was in the 1992 First City transaction. Two of the First City banks were insolvent, which led to the FDIC assessing cross guarantees against the other 18 banks. Although losses were expected in 4 of the 20 banks, the cross guarantee allowed the FDIC to retrieve value from the 16 better-capitalized banks. That value led to no loss being incurred by the deposit insurance fund.

Bidding

In the early phases of the banking crisis, the FDIC did not offer potential purchasers many options regarding the failing institutions. The most commonly used resolution method was a P&A transaction in which the FDIC protected all depositors, both insured and uninsured. As the laws and the economy changed and the FDIC gained experience, the FDIC started offering more types of resolutions.⁸ The FDIC used those new resolution types to develop bidding alternatives designed to increase the pools of bidders and stimulate competition. When Garn–St Germain and CEBA removed many of the state laws restricting interstate banking and intrastate branching, it enabled the FDIC to attract out-of-state acquirers for large failing banks.

The FDIC frequently offered prospective purchasers of large institutions the option to bid on asset purchases with “put back” options, that is, the eventual acquirer was allowed to require the FDIC to repurchase certain assets. Depending on the size of the institution and the quality of the asset portfolio, some purchasers were allowed to put back assets that could be classified according to bank examination standards, and some purchasers were allowed to put back any assets they did not want.

Asset put backs had some advantages for the FDIC. First, acquiring institutions did not need to spend as much time on due diligence reviews before a bank’s failure, because there was no risk in acquiring the failed bank’s assets. Second, the FDIC did not have to acquire all of a failed bank’s assets at the time of its failure. Finally, FDIC management viewed the higher percentages of assets passed at resolution to the acquirers as a way to minimize disruption in the failing banks’ communities. As the FDIC’s inventory of failed institution assets continued to grow, however, the FDIC looked for better ways to pass more assets to acquiring institutions.

To further improve the bidding alternatives, the FDIC developed the concept of loss sharing. Loss sharing was primarily designed to sell as many failed bank assets as possible. The FDIC’s agreement to reimburse an acquiring institution for the bulk of its net losses on assets purchased reduces the potential risk of the acquirer to a more definable amount. Potential purchasers were more likely to submit bids when they were assured that they would not be responsible for the entire amount of loss in a failed bank’s asset pool, particularly if there had not been much time to perform due diligence on the assets to be acquired. Loss sharing essentially replaced giving an acquirer put back rights.

Capital Assistance to Acquirers. The FDIC on several occasions has encouraged interested purchasers to submit bids for failing institutions by offering to provide interim capital assistance. That capital assistance increased an acquirer’s capital and helped it take on the additional liabilities and assets of the failing institution. Capital assistance is discussed in more depth later in this chapter in the section titled “Equity Investments.”

8. Refer to Part I, Resolution and Asset Disposition Practices, Chapter 2 Overview of the Resolution Process, and Chapter 3, Evolution of the FDIC’s Resolution Practices, for a full discussion of various resolution alternatives.

Multiple Bank Bidding. When the First Republic and MCorp banks failed, the FDIC formed one bridge bank for each group. In each case, all deposits were transferred into the bridge bank. At the time, Texas had restrictions on intrastate branching and selling one bank with multiple locations was unique to the FDIC's resolution activities. Acquirers were selected either right before the banks failed, or very shortly thereafter. In 1990, the RTC began experimenting with multi-branch institutions by marketing and selling the individual branches separately. In marketing and selling the First City bridge banks in 1992, the FDIC increased bidding by offering each of the 20 bridge banks individually. The FDIC received 111 bids from 32 potential purchasers for the 20 bridge banks, resulting in a much higher than anticipated premium of \$434 million. The FDIC believes that marketing each bridge bank separately increased competition and allowed bidders the flexibility to bid only on those banks they really wanted, thereby increasing the premiums received.

Assets

Asset Management Contractors

In the early years of the banking crisis, the FDIC worked all liquidation assets in-house. With the Continental resolution, the FDIC began using the former bank's staff to manage and collect some of the FDIC's assets. Contracting with acquirers of large failed banks to service the FDIC's assets became common as the banking crisis deepened and the FDIC's volume of liquidation assets grew larger. The handling of assets from small banks continued to be worked by the FDIC in-house. Gradually, the FDIC began to contract with third-party asset managers rather than acquirers. The FDIC also searched for other methods of disposing of failed bank assets, and the concept of loss sharing was introduced, enabling the FDIC to transfer some of its credit risk to acquirers.

Assisted Bank Retains Assets. The earliest case study, First Penn, is an example of OBA in which the FDIC provided financial assistance but took back no assets. Because the assisted bank retained all the assets, it bore all the risk of loss.⁹ The success of the plan depended primarily on the management of the subject bank and economic conditions. First Penn eventually returned to health, and the resolution resulted in no cost to the FDIC. A comparison can be made to First City's OBA. In 1988, First City retained all of its assets and risk of loss, and the banks eventually failed. First City was never able to repay its OBA loans, and the FDIC had to write off its capital investment.

At the time of Continental's resolution in 1984, the FDIC had approximately \$4.3 billion in assets in liquidation from previous bank failures. Continental had approxi-

9. Actually, if the bank incurs too much loss and fails, the FDIC is faced with another resolution and must deal with the loss at that point.

mately \$5.2 billion of problem assets that, if acquired and managed by the FDIC, would have required the FDIC to more than double its staff. In addition, Continental's assets were much larger, individually, than most of the assets the FDIC was working in-house, and the FDIC did not have the expertise to handle many of the specialized maritime, commercial, and international loans.

The Continental agreement illustrates some of the advantages of contracting for the FDIC to use employees of the failed bank to collect the FDIC's loans. The contractor was already familiar with the assets and was a specialized collection group (not the lending group that had originated the loans). The contractor also had the expertise needed for Continental's specialized loans, and the FDIC did not have to hire and train new employees for that work. Part of the agreement required the FDIC to pay all of the contractor's expenses. That cost-plus option was used because the newly organized Continental retained only the good loans of the bank and did not need the special collection group, other than to collect on the problem assets retained by the FDIC.

The agreement also included an incentive plan for the contractor. The more money the contractor brought in, the more incentive fees it earned, effectively increasing the contractor's motivation and aligning its interests with those of the FDIC. The incentive fees on Continental were relatively nominal at \$8 million, or about 0.35 percent of total asset recoveries net of asset-related expenses. To ensure that the contractor worked the assets according to FDIC policies and procedures, a small group of FDIC employees were on-site to monitor the performance of the contractor. That use of a private-sector collection group worked well for the FDIC and was used at some of the largest bank failures encountered by the FDIC. In addition to Continental, in the 10 case studies presented, asset management contractors were used at First Republic, MCorp, BNE Corp., and the New Hampshire Plan banks.

Acquiring Bank as Servicer. The First Republic contract for the management of \$11 billion in assets was a learning experience for the FDIC. As part of the FDIC's agreement with the assuming bank, the bridge bank retained ownership of the assets and managed them. The resolution of the First Republic banks was the FDIC's most expensive resolution. While most of the cost can be attributed to the huge losses in the loan portfolio, the contract itself also proved to be expensive. The FDIC learned from that experience and three provisions contained in the First Republic servicing contract were improved in future agreements. First, the acquirer of the First Republic banks funded the pool assets with reimbursement from the FDIC. Although that arrangement reduced the FDIC's initial cash outlay, helping to preserve the liquidity of the deposit insurance fund, it raised the overall cost of the transaction to the FDIC because the acquirer had a higher funding cost than the FDIC. Second, the servicing agreement cap on management incentive fees was reached after only two years, leaving the servicer with little incentive to aggressively manage the assets for the remainder of the five-year term. Third, because the FDIC reimbursed the servicer for all asset-related expenditures, there was no incentive for the servicer to control costs. The FDIC renegotiated the contract after two years to include provisions that better aligned the servicer's interests with those of the FDIC.

The contract for the management of \$4.2 billion in assets from the MCorp banks was somewhat improved from the First Republic contract. Again, the acquirer, acting in its bridge bank capacity, owned and managed the assets. In the history of the FDIC, the resolution of the MCorp banks is the second largest, in terms of cost, to First Republic. Although the primary costs were associated with the losses in the asset portfolio, the FDIC's servicing contract also was expensive. The MCorp contract contained one significant change from the contract for First Republic: the management incentive fee was tied to net collections, rather than gross collections. That modification was designed to induce the servicer to control expenses.

Both the First Republic and the MCorp P&A agreements contained provisions that allowed the acquiring banks to put assets from the banks into the special asset pools. Those put back provisions were necessary because of the size of the failed banks' assets and the credit risks associated with them. No bidder was willing to purchase those assets without considerable and expensive due diligence and steep discounts in price. The FDIC found that, to complete a transaction quickly after a bank failure, it was necessary to allow the acquiring institutions the option to put risky assets back to the FDIC. The ability to return assets to the special asset pool kept the acquirers' risks at a minimum. For First Republic, the original asset pool was \$9.1 billion with a market value of \$6.1 billion; and total puts over the two-year put period were \$1.9 billion in book value with a market value of \$1.6 billion. For MCorp, the original asset pool was \$2.5 billion in book value, and during the life of the contract, assets with a total of \$4.2 billion in book value and market value of \$3.2 billion were placed in the pool.

In the contract for the three BNE Corp. banks, the FDIC retained ownership of the assets because it had a lower cost of funds, which reduced holding costs. As an inducement to control expenses, the FDIC paid the servicer incentive fees based on net collections, rather than gross collections. The contractor's treatment of borrowers from the BNE Corp. banks became a controversial issue. Although the contractor was servicing the portfolio, the FDIC, as well as the contractor, was criticized for insensitive collection practices. That criticism led to an increased emphasis on customers' rights, for the assets the FDIC worked in-house and for those assets worked by the contractors. A second part of solving the problem for borrowers at BNE was the sale of a package of those loans from the FDIC back to the acquiring bank with a guarantee against loss from the FDIC. The sale of 2,000 loans with a total book value of over \$700 million reinforced the FDIC's attitude that loans needed to be kept with the acquirer. The return of those borrowers into an open bank environment helped provide them with a way out of the "credit crunch" in the area.

Third-Party Asset Management Contractors. The contract for managing the assets from the New Hampshire Plan banks in 1991 is an example of a resolution involving a third-party asset management contractor. With that resolution, for the first time, the FDIC solicited asset management bids from outside contractors, as well as from the assuming banks. Because the FDIC knew it would also be adding assets to the contract from other failed banks, the solicitation required the contractors to be capable of servic-

ing \$2 billion in assets. The FDIC received seven bids from asset managers and the contract was awarded to a third-party asset servicer.

Contract asset managers work assets in much the same way that the FDIC works its own assets in-house. Contractors may occasionally, however, have some specialized skills for particular assets, can pay higher salaries and bonuses not tied to governmental pay scales, and thus can generally attract personnel with greater experience or specific knowledge.

Future contracts were improved on as the FDIC gained more experience with contracting. For example, the contract for the MCorp bank assets was an improvement over the contract for the First Republic bank assets. After Continental, the FDIC went on to use a total of 14 asset management contracts to liquidate more than \$33 billion of assets, or nearly half of the failed bank assets the FDIC retained for liquidation.

Loss Sharing

While asset management contracting worked well for the FDIC, by 1991 the FDIC had learned that retaining ownership of problem assets meant paying all the collection expenses and bearing all the credit risk in the loans.¹⁰ The FDIC believed that assets left in the banking sector retained more value than those placed in liquidation, primarily because of maintaining consistency in the customer-institution relationship. To overcome the reluctance of acquiring institutions to purchase certain assets from failing banks and thus to sell more assets, however, the FDIC had to address the problems of limited due diligence, poorly underwritten loans, and declining real estate markets. In the Southeast resolutions, the FDIC developed the concept of loss sharing, a variation of a P&A transaction, to limit the downside risk to acquirers.¹¹

By designing the loss sharing agreements so the FDIC absorbed a significant portion of any credit losses, the FDIC was able to attract potential acquirers willing to purchase hard-to-sell assets during the resolution process. The acquirers' risks were minimized and could be better quantified. By having the acquirer absorb a limited amount of credit loss, the FDIC attempted to ensure rational and responsible credit management behavior by the acquirer. Because of the additional administrative duties and costs for both the acquirer and the FDIC in managing the agreement, the FDIC believed that loss sharing was generally efficient when the pool of shared loss assets was more than \$100 million. The loss sharing transactions that have taken place have led to lower average costs than other resolution methods.

10. The FDIC also developed Regional Asset Liquidation Agreements, in which collection expenses were limited, for smaller banks. Refer to Part I, Resolution and Asset Disposition Practices, Chapter 14, Asset Management Contracting.

11. Refer to Part I, Resolution and Asset Disposition Practices, Chapter 7, Loss Sharing, for a full discussion of this subject.

The FDIC used loss sharing in the September 1991 resolution of Southeast, followed by the New Hampshire Plan in October 1991, the 1993 resolution of First City, and the sale of CrossLand Federal in 1993.¹²

The FDIC views the loss sharing agreement with the acquirer of the Southeast banks as a success for two reasons. First, the bank's acquirer bought all \$10.1 billion of Southeast's assets except owned real estate, bank premises, other assets, and subsidiaries, including more than \$2 billion in nonperforming assets or performing problem loans. Second, the FDIC's total loss sharing payments to the acquiring institution were less than 70 percent of the original estimated costs. The two loss sharing agreements in the New Hampshire Plan resolution involved only small residential mortgages and other consumer loans. The FDIC's total cost of loss sharing for this resolution was approximately 36 percent of the original estimated cost.

In 1992, the FDIC sold three of the 20 First City bridge banks to two different acquirers using loss sharing provisions. For those agreements, the FDIC added a provision for 95 percent reimbursement of net loss if the net loss reached a "transition amount." In that instance, the FDIC's loss sharing costs were underestimated. The FDIC's total loss sharing payments for both agreements were roughly 119 percent of the amount estimated by the FDIC in 1992 (\$82 million instead of \$69 million, a \$13 million difference). Total loss share payments were still only about 3 percent of the total book value of the assets.

The final loss sharing agreement in the bank studies is the one completed for the CrossLand resolution. The CrossLand loss sharing agreement differed from previous agreements in that the bank's purchasers had to absorb the first \$179 million in losses on the \$2.8 billion portfolio of loans and owned real estate. The loss sharing agreement was designed to protect the purchasers from large, unknown losses. The agreement required the FDIC to absorb 80 percent of the losses after the \$179 million threshold was reached. Total loss sharing payments were approximately \$34 million or 1.2 percent of assets covered.

Because it has been used generally in larger transactions, loss sharing has been very successful at keeping assets in the private banking sector and lowering costs to the FDIC. On average, losses on assets covered by loss sharing have been approximately 6 percent of the beginning balances of the assets. From September 1991 through December 1994, the FDIC used loss sharing a total of 16 times to resolve 24 failed institutions with total assets of \$41.4 billion.

Summary. The dollar volume of assets retained by the FDIC from any failed bank typically depends on the quality of the specific assets. Good assets are nearly always passed to the acquiring bank, and the FDIC typically retains marginal and poor quality assets.

12. Four of the chapters present bank studies involving loss sharing: Chapter 9, Southeast Banking Corporation, Miami, Florida; Chapter 10, The New Hampshire Plan; Chapter 5, First City Bancorporation of Texas, Inc., Houston, Texas; and Chapter 11, CrossLand Savings, F.S.B., Brooklyn, New York.

Before the Continental resolution, the FDIC always liquidated failed bank assets using in-house staff. The Continental asset management contract supplemented the in-house efforts. As asset management contracting became more common, FDIC's in-house staff still played an important role in the disposition of asset from large failed banks. The FDIC's in-house staff developed and negotiated the asset management contracts and provided oversight for the contracts. The FDIC's in-house staff absorbed assets that represented conflicts of interest for contractors or that the contractors were not servicing properly. As contracts reached their termination dates, the FDIC in-house staff also took in any remaining loans from the contracts. Studies conducted by the FDIC reveal that the costs of resolutions, whether worked in-house or by contractors, have been similar.

The use of asset management contractors and the development of loss sharing were two of the most important changes in the way the FDIC disposed of assets from large failed banks. For the 10 bank case studies presented in Part II, the FDIC's resolution cost and the handling of the failing institution's assets is shown in table II.12-2.

Liabilities¹³

The FDIC was formed in 1933 to make sure that, if a bank failed, insured depositors would be able to recover their funds quickly.¹⁴ As receiver of a failed financial institution, however, the FDIC is responsible for liquidating the institution's assets and distributing the proceeds to the failed institution's creditors. The laws concerning the order of payment preference have changed over the years.¹⁵

The case studies demonstrate how the FDIC handled liabilities in various situations. The liabilities of a failed bank or thrift include obligations to depositors, general creditors, shareholders, and holding companies. Others with claims against the failed bank may include shareholders and creditors of the holding company.

13. Refer to Part I, Resolution and Asset Disposition Practices, Chapter 8, The FDIC's Role as Receiver; Chapter 9, The Closing Process and Payment of Insured Depositors; and Chapter 10, Treatment of Uninsured Depositors and Other Creditors, for a full discussion of deposit insurance.

14. The FDIC was formed in 1933, and federal deposit insurance coverage became effective January 1, 1934.

15. Before passage of the National Depositor Preference Amendment on August 10, 1993, each state had established its own priority for the payment of creditors of failed state chartered banks. In all national and some state chartered banks, all unsecured creditors shared equally in the recoveries of the receiverships. Some states, however, had established that all depositors must be paid before any other creditors could be paid. Those were known as depositor preference states. The priority for paying allowed claims against any failed, federally insured, depository institution is now determined by federal law. The law gives payment priority to depositors, including the FDIC as subrogee, over general unsecured creditors, for all receiverships established after its enactment. Under the National Depositor Preference Amendment and related statutory provisions, claims are paid in the following order of priority: (1) administrative expenses of the receiver; (2) deposit liability claims (the claim of the FDIC as subrogee takes the position of the insured deposits); (3) other general or senior liabilities of the institution; (4) subordinated obligations; and (5) shareholder claims.

Depositors

After passage of the Federal Deposit Insurance Corporation Improvement Act (FDICIA), because of that law's least cost requirement, and after enactment of the National Depositor Preference Amendment in 1993, depositor treatment changed.

Out of the 10 notable bank resolutions studied, Penn Square was the only failed bank that was paid off. The payoff was completed through the use of a Deposit Insurance National Bank (DINB), which provided the FDIC with a method of paying the insured depositors that was easier than providing each depositor with an insurance check. In the aftermath of Penn Square, the prevailing feeling was that perhaps the

Table II.12-2

Failing Bank Resolution Cost and Asset Disposition Method

(\$ in Thousands)

Name of Bank	Assets at Resolution	Resolution Cost	Cost as a Percentage of Assets	Asset Option
First Penn	\$7,953,000	\$0	0.00	Retained by bank
Penn Square	516,799	64,970	12.57	Retained by FDIC
Continental	33,633,000	1,103,083	3.28	First asset mgmt. contract
First City—1988	11,200,002	1,069,107	9.55	Retained by bank
First City—1992	8,851,815	0	0.00	Loss share on three banks
First Republic	33,488,025	3,856,826	11.52	Asset mgmt. contract
MCorp	15,748,537	2,839,514	18.03	Asset mgmt. contract
BNE Corp. banks	21,754,001	886,988	4.08	Asset mgmt. contract
Southeast banks	10,478,311	0	0.00	First loss share
New Hampshire Plan	4,377,351	890,799	20.35	Asset mgmt. contract and loss share
CrossLand	7,269,198	739,941	10.18	Loss share

Source: FDIC Division of Finance.

FDIC would be less inclined to protect uninsured depositors and unsecured creditors at failed institutions than it had been in the past.

Penn Square also led to a debate over brokered funds. Because brokers combined depositors' funds but kept each depositor within insurance limits, bankers had access to an almost unlimited source of funds for liquidity purposes. In 1984, the FDIC and the Federal Home Loan Bank Board¹⁶ issued a joint rule that limited deposit insurance on brokered deposits according to the entire amount of the deposit, but an appeals court overturned the rule in 1985. Passage of FIRREA in 1989 restricted troubled institutions from accepting brokered deposits.

In the cases of First Penn, Continental, and First City in 1988, all depositors were protected against loss due to the nature of the OBA transaction. Furthermore, in the case of Continental, the FDIC issued an explicit statement fully protecting Continental's depositors and general creditors. The statement was designed to slow the deposit run being experienced by Continental, averting liquidity pressures. The FDIC's statement also provided assurance to the group of commercial banks that had participated in the FDIC's \$2 billion loan to Continental. The banks were concerned that all depositors would not understand that all depositors and general creditors of the institution, as a consequence of the OBA transaction, were fully protected against loss.

The assistance provided to First Republic was an interim measure that stabilized the banks until the permanent resolution could be finalized. When the FDIC promised to protect the depositors and creditors of the First Republic banks, the agency accomplished two goals beyond stemming deposit runs. First, the promise helped stabilize the 41 subsidiary banks through the period of interim assistance and soothe depositors' fears. When the FDIC reaffirmed the statement of depositor and general creditor protection on the date the banks failed and were placed in a bridge bank, the FDIC also provided the assuming bank with confidence that the franchise value of the bridge bank would remain intact.

The resolution of MCorp was different from the standard P&A agreements in which all of the depositors and general unsecured creditors were protected. Although the FDIC formed one bridge bank for all 20 failed banks, and again wished to protect the future franchise value of the bridge bank, all depositors and general creditors were fully protected in only 19 of the banks. MBank Abilene, N.A. (MBank Abilene), Abilene, Texas, had approximately \$60 million in outstanding judgments. Limiting the losses at the receivership level for MBank Abilene was the only cost-effective resolution possible for that institution and only the insured deposits were transferred to the bridge bank. Because MBank Abilene was a national bank, all creditors shared ratably in liquidation proceeds, and therefore uninsured depositors and general creditors of MBank Abilene were not protected.

16. The Federal Home Loan Bank Board was the governing board for the Federal Savings and Loan Insurance Corporation (FSLIC), the insurer of deposits in savings and loan associations. Both the Federal Home Loan Bank Board and the FSLIC were abolished in 1989.

The FDIC's third and final explicit statement of depositor and general creditor protection was in connection with the failure of the BNE Corp. banks. The statement was made on the date the banks failed and were placed in bridge banks. In the neighboring state of Rhode Island, 45 credit unions had failed only five days earlier. The credit unions had been insured by a state insurance fund that had gone broke, and the credit unions' depositors were concerned about getting their deposits back. The FDIC considered the various resolution alternatives available for the BNE Corp. banks and determined that any resolution that did not fully protect the banks' depositors would likely have a seriously adverse effect on the community. The FDIC's guarantee of depositor and general creditor protection helped calm fears surrounding the poor economic conditions in the entire region, and also helped preserve the value of the bridge bank franchise.

In the 1991 P&A transactions involving Southeast and the New Hampshire Plan banks, the FDIC determined that providing full protection for depositors resulted in the lowest possible cost to the deposit insurance fund, because the bidding for the banks was centered on the value of the deposit base. The general trade creditors were not protected in either case.

The FDIC's 1992 decision to place CrossLand in conservatorship came less than a month after passage of FDICIA. Although the resolution of CrossLand was not a P&A transaction, the FDIC determined that it was necessary to protect all depositors because failure to do so would seriously diminish the franchise value of the conservatorship. The General Accounting Office (GAO) later criticized the action, noting that, after the January 1992 conservatorship decision, resolutions in New York and Texas showed that not protecting uninsured depositors did not result in depositor runs.

First City is the only example in the case studies of banks resolved using the FDICIA least cost requirements. The remaining 20 First City banks were closed in 1992, and the FDIC evaluated each bank separately, determined its value, and decided about whether or not to transfer both insured and uninsured deposits to the bridge banks. The FDIC created a separate bridge bank for each of the 20 banks and depositor treatment varied. The FDIC expected no loss in 16 of the receiverships and all deposits, both insured and uninsured, were transferred to the 16 bridge banks. In four of the receiverships, the FDIC anticipated some loss, and only insured deposits were transferred to the four bridge banks. Of those four, one was a state chartered institution. Because Texas was a "depositor preference" state, the FDIC issued uninsured depositors an advance dividend of 80 percent. The three other failed banks had been national banks and federal law proclaimed that all depositors and other creditors shared ratably in the proceeds of the liquidation. In those banks, the FDIC paid uninsured depositors and unsecured general creditors an 80 percent advance dividend. Later, as it became apparent that the FDIC would not incur any loss in any of the First City transactions, all depositors and general creditors were paid in full.

Creditors

General creditors, sometimes referred to as general trade creditors, are typically the suppliers or service providers of a financial institution. That type of debt is not secured. Examples of general creditors include office supply stores, lawn maintenance services, and outside attorneys.

Before enactment of the National Depositor Preference Amendment, payments to failed bank creditors varied considerably. Each state had its own laws outlining the priority of payments to creditors of state chartered banks. For national banks, however, all creditors (including depositors) shared ratably in the distribution of receivership recoveries. That requirement was an important factor in the decision to pay off insured deposits when Penn Square, a national bank, failed. The FDIC was concerned over the huge amount of potential liabilities from loan participants. Those concerns were based on what is commonly called “the First Empire decision,”¹⁷ in which a court ruled that the FDIC could not prefer one class of similarly situated creditors to another in a national bank receivership. Because of existing law at the time, the FDIC could not have arranged a P&A transaction without insuring the assuming bank against losses on Penn Square’s \$2.1 billion in contingent liabilities, because all creditors, including depositors, had to be treated in the same manner. A payoff of insured deposits was, therefore, the only feasible resolution for Penn Square.

In the resolutions of the First Republic and MCorp banks, the FDIC’s decision to give receivership certificates to the affiliated banks for interbank loans forced the affiliated banks to recognize losses on their balance sheets. The losses rendered the banks insolvent, and those banks also were closed. The lawsuits generated from both resolutions probably were responsible for enactment of FIRREA, which gave the FDIC important leverage in resolutions. FIRREA provides that the FDIC may, in its discretion and to minimize its costs, pay additional amounts to some creditors of a failed depository institution without being obligated to make additional payments to other creditors in the same class.

Shareholders

Open Bank Assistance. Generally speaking, in OBA transactions, the bank’s shareholders should suffer the approximate loss that they would have incurred had the FDIC paid off the bank’s insured deposits and liquidated its assets. In the resolutions of First Penn, Continental, and First City in 1988, shareholders of each institution suffered losses. The losses accrued to the shareholders primarily through the FDIC’s taking of equity positions through stock purchases or the receipt of stock warrants. Legislation passed in 1993 prohibits the use of any deposit insurance funds from benefiting the shareholders of any failing depository institution.

17. *First Empire Bank v. FDIC*, 572 F.2d 1361 (9th Cir. 1978), cert. denied, 439 U.S. 919 (1978).

Deposit Payoffs. Shareholders of the failed Penn Square lost their investments. Under the laws in effect at the time, distributions of the receivership's recoveries were paid ratably to all failed bank creditors and to pay receivership expenses, and only funds left over could be distributed to shareholders. All approved claims were paid at approximately 65 percent of their face amounts, and there were no distributions to Penn Square's shareholders.¹⁸

Purchase and Assumption Transactions. In the cases of First Republic, MCorp, the BNE Corp. banks, and the New Hampshire Plan banks, shareholders lost their entire investments. In the resolution of Southeast, however, shareholders did obtain some value. The transaction resulted in no cost to the FDIC, and other creditors were paid in full. The remainder of the receivership estates, approximately \$120 million in assets, was returned to Southeast. This amount owed to shareholders was the subject of litigation settled in 1998.

Equity

In the majority of the bank failures, the FDIC did not purchase any stock in the newly acquired institution. As the case studies relate, however, it was not uncommon in larger transactions for the FDIC to purchase stock in the new bank or to provide a capital injection in exchange for stock in OBA transactions. There were several reasons for the FDIC to purchase stock in those larger transactions. For institutions of that size to be adequately capitalized, large infusions of funds from the private-sector purchasers would be needed. If the FDIC had limited the bidding to those that had sufficient funds on hand to capitalize the large banks, it would have severely reduced its number of bidders. That, in turn, would have reduced the competitiveness of the bidding process, which may have resulted in situations where the highest bid was not sufficient to complete the transaction. The FDIC was sensitive to the issue of a government agency owning an equity interest in the banks. Most of those transactions, however, were completed so that the FDIC would hold the stock interest for a relatively short time. Federal law also required that the FDIC's interest in the financial institution must be nonvoting, which sufficiently reduced its ability as an investor to control the operations of the new bank. An additional benefit to the FDIC was that the ownership of stock in the newly capitalized (or re-capitalized institution, in the case of OBA) institution allows the FDIC to benefit from any upside if the new bank is successful. As the case studies have shown, most of the stock purchases have been profitable; in only one case did the FDIC lose money on its equity investment.

18. In 1982, the law provided that the liquidation proceeds of any failed national bank would be paid first to each and every creditor of the bank with proven claims and to pay the expenses of the receiver. After that, payments would be made to repay amounts paid in by shareholders by reason of any assessments made upon the failed bank's stock by order of the Comptroller of the Currency. Lastly, payments would be made to pay the balance ratably among the bank's stockholders, in proportion to the number of shares held and owned by each.

OBA Capital Investments

The capital investment by the FDIC took many forms. Each transaction was unique and tailored to particular circumstances. For example, in the First Penn OBA transaction, the FDIC and the other banks that provided First Penn with a loan received warrants for 80 percent stock interest in the stock of the holding company. By placing restrictions of dividends and management action, it provided incentive to First Penn to purchase the warrants and repay its loan from the FDIC as quickly as possible.

In the Continental OBA transaction, the FDIC infused \$1 billion of capital into the bank to allow for its continuing operation. In exchange, the FDIC received two large issues of preferred stock. In addition, the FDIC retained a right to purchase the remaining shareholder interest for a nominal amount because of the large losses that the FDIC had absorbed in the nonperforming loan pool. The FDIC sold its interest over a seven-year period.

In the First City OBA transaction, the FDIC lost the majority of its investment as the bank eventually failed. In that situation, while the FDIC had small gains on the sale of the preferred stock and warrants, it lost a significant investment when it wrote off \$970 million in stock held in the First City "Collecting Bank."

P&A Capital Investments

The capital investments the FDIC made in the acquiring banks also varied widely. In First Republic, the FDIC provided the acquirer with 80 percent of the capital needed to close that large transaction. The acquirer retained the right to repurchase the stock within a five-year period; the price of the stock, however, escalated on an annual basis. The acquirer moved quickly to redeem the stock, repurchasing it in a little more than two years. With the sale of MCorp, although it was completed shortly after First Republic, the FDIC's stock investment in the acquiring institution was different in that it was offset by a corresponding note from the acquirer. The acquirer owned the stock once it paid back the loan.

The BNE transaction also was unique in that the winning bidder provided the FDIC with stock in lieu of a larger premium on the banking franchise. In the Southeast transaction, the FDIC helped capitalize the new institution by providing \$150 million in exchange for stock. That stock contained a clause that allowed its repurchase at par if redeemed within one year. The stock also provided a high dividend rate of 11 percent to induce the acquirer to redeem the stock quickly. That tactic was successful as the acquirer redeemed a portion of the stock within two months and the balance within seven months.

In New Hampshire, there were two transactions involving seven failed banks. Because the FDIC expected the sale of those banks would be difficult, it tried to increase the number of bidders by indicating it would be willing to provide up to two-thirds of the capital needed to operate the new institutions. In the first New Hampshire transac-

tion, acquired by New Dartmouth, the FDIC provided 45 percent of the capital. The stock did not require a dividend, but the redemption price increased annually at a progressive rate. In the second New Hampshire transaction, acquired by First New Hampshire, the stock owned by the FDIC contained a high dividend rate of 10.25 percent. To further induce the acquirer to repurchase the stock, it was provided with redemptive rights for a seven-year period. The stock could be repurchased at par within the first three years, and the price would escalate in each of the final four years. In both of those situations, the acquirer repurchased the FDIC's stock interest within two years.

In the final bank study, CrossLand, the FDIC received warrants as a premium from the investment group that acquired the franchise. Those warrants were sold for a gain of \$18 million in 1996.

The ability to provide acquirers with additional capital has been effective for both the FDIC and the acquirers. It provides the acquirer with the time necessary to establish its new business and to obtain cheaper sources of capital from the private sector. The FDIC has used capital injections on a limited basis, usually for its largest bank failures or OBA transactions. It sets the terms to sufficiently motivate the acquirer to purchase the FDIC's interest.

See table II.12-3 for a summary of the equity investments and their returns.

Reflections

The case studies in Part II were provided to show clear examples of how the FDIC practices its resolution responsibilities and to describe how those practices evolved over time in response to changes in the economy and the various legislative initiatives. Over time, the FDIC gained the ability to solicit out-of-state acquirers, create bridge banks, assess affiliated banks for its resolution costs, and make additional payments to some creditors of a failed institution without making any additional payments to others. The FDIC also developed advance dividend payments, asset management contracting, and loss sharing.

Each of the resolutions is distinctly different from the others, even though some of them occurred only a few months apart. It is clear from the case studies that the resolution of multi-billion-dollar banks is not a simple matter, nor is it a "canned" solution that can be duplicated from one resolution to the next. The case studies show that the FDIC approached each failing bank situation as a unique set of circumstances and developed a resolution strategy that it believed was right for that particular bank.

Table II.12-3

FDIC Failing Bank Equity Investments

(\$ in Thousands)

Bank Name	Nature of Investment	FDIC Stock/ Equity Investment	Disposition Method	FDIC Proceeds from Sales	Gain or Loss On Transaction	FDIC Dividend Income	Total Return on Investment
First Penn	13 million warrants for holding company common stock	\$0	Sold to holding company	\$43,063	\$43,063	\$0	\$43,063
Continental	Preferred stock in holding company; purchase option on former shareholders' stock	1,000,000	Sold to holding company	1,200,109	200,109	202,227	402,336
First City (1988)	Preferred stock in holding company; warrants for holding company common stock; preferred stock in Collecting Bank	1,034,707	Holding company stock and warrants sold to First City; stock in Collecting Bank written off in 1991	108,527	(926,180)	2,059	(924,121)
First Republic	Nonvoting common stock in bridge bank	840,000	Sold to acquiring bank	1,109,682	269,682	4,736	274,418
MCorp	Nonvoting common stock in bridge bank	416,250	Sold to acquiring bank	481,736	65,486	0	65,486
BNE Corp.	Preferred stock in acquiring banks	150,000	Sold to acquirer	160,444	10,444	3,948	14,392
Southeast	Preferred stock in acquiring bank	150,000	Sold to acquirer	150,000	0	6,844	6,844
The New Hampshire Plan	Preferred stock in acquiring banks	81,050	Sold to acquirers	85,766	4,716	10,122	14,838
CrossLand	1 million warrants for bank common stock	23,500	Sold to purchaser of acquiring bank	41,500	18,000	0	18,000

Source: FDIC, *Equity Investment Portfolio, Bank Insurance Fund* (December 31, 1993).



APPENDIX A

Legislation Governing the FDIC's Roles as Insurer and Receiver

Background

This appendix focuses on the Federal Deposit Insurance Corporation (FDIC) from 1980 to 1994. To provide a historical context for that period, however, the appendix begins with a brief overview of some earlier, significant legislation passed by the U.S. Congress.

Federal Reserve Act of 1913

Congress created the Federal Reserve System (Federal Reserve) when it passed into law the Federal Reserve Act of 1913. Apart from giving the Federal Reserve regulation of the money supply, the Federal Reserve Act gave state banks the option of Federal Reserve membership, and the Fed was designated the lender of last resort to member banks experiencing liquidity problems.

Glass-Steagall Act of 1932

Between 1921 and 1929, 5,711 banks failed, with approximately two banks failing each day, most of which were small banks in rural communities. Then, at the end of 1930, a large wave of bank failures triggered serious bank runs and liquidity problems that the Federal Reserve was unable to ease. Confidence in the banking system as a whole began to falter.

President Herbert Hoover's administration responded to the banking crisis by recommending two measures to improve funding for banks experiencing liquidity problems. The first measure resulted in the creation in January 1932 of a new federal lending agency, the Reconstruction Finance Corporation (RFC). One of the RFC's primary

functions was to lend money to banks. By the end of 1932, the RFC had authorized almost \$900 million in loans to assist more than 4,000 banks striving to remain open.

The second measure was the Hoover administration's support of the Glass-Steagall Act of 1932, which broadened the circumstances under which member banks could borrow from the Federal Reserve. The Glass-Steagall Act allowed member banks to borrow from a Federal Reserve Bank by pledging paper other than that ordinarily eligible for rediscount or as collateral for loans. Although individual banks were helped by this measure, the amounts borrowed were not large in the aggregate.

Federal Home Loan Bank Act of 1932

The Great Depression, which began in October 1929, served as a catalyst for passage of the Federal Home Loan Bank Act of 1932, which regulated savings and loans (S&Ls). Congress intended that the act would boost the economy by creating a pool of funds for home financing, foster home ownership through favorable treatment of home mortgages, and change savings and loans institutions from short-term housing lenders to long-term housing lenders.

The Federal Home Loan Bank Act directed that no fewer than 8 and no more than 12 Federal Home Loan Banks (FHLBs) be established as soon as practicable. The act also established the Federal Home Loan Bank Board (FHLBB) to coordinate the system of FHLBs. It gave the board the power to adopt, amend, and enforce rules and regulations, as well as remove or suspend employees and agents of an FHLB and officers or employees of a savings and loans institution. The act allowed eligible financial institutions to borrow from an FHLB by becoming members of an FHLB, or by becoming nonmember borrowers.

Emergency Banking Act of 1933

During the winter of 1932-1933 banking conditions deteriorated rapidly and liquidity pressures increased in response to general uncertainty about the economy. With the election of Franklin D. Roosevelt to the presidency in November 1932, rumors circulated that the new administration would devalue the dollar. Speculative investments and the conversion to gold and foreign currencies followed, and the resultant increases in withdrawals started a massive panic.

By March 4, 1933, approximately 4,000 banks had failed that year, and every state had declared a bank holiday. By March 6, the U.S. financial system was on the verge of collapse, and President Roosevelt proclaimed a four-day nationwide bank holiday. Congress rushed to draft a plan of action. On March 9, after only 40 minutes of debate, the House of Representatives passed a bill. Several hours later, the Senate approved the bill with no changes, and the Congress enacted the Emergency Banking Act of 1933.

The act legalized the national bank holiday and set standards for reopening banks after the holiday. It also provided for the issuance of Federal Reserve notes, which were

to be backed by U.S. government securities. In addition, the act gave the Office of the Comptroller of the Currency (OCC) the power to appoint conservators for failed banks.

Implementation of the Emergency Banking Act resided primarily with the secretary of the Treasury, who was empowered to issue licenses for all member banks, both national and state, upon the recommendation of the regional Federal Reserve Bank, the chief national bank examiner, and the OCC. State banking authorities were empowered to license nonmember banks.

Banking Act of 1933

Enacted in June 1933, the Banking Act established the FDIC as a temporary agency to restore public confidence in the banking system and to stabilize the financial system. The act required the appointment of the FDIC as receiver for all national banks and as receiver for insured state chartered banks according to state law. The legislation prohibited paying interest on demand deposits to forestall potentially harmful competition among banks and authorized the Federal Reserve Board to set a ceiling on time deposit rates offered by member banks.¹ In addition, the act began the regulation of bank holding companies by limiting their ability to vote their stock in subsidiary banks.

One element of the Banking Act of 1933 (sections 16, 20, 21 and 32) is the famous Glass-Steagall Act, which provides for the separation of banking and commerce and which is a subject of debate today. It was section 8 of the Glass-Steagall Act that created the FDIC, through an amendment to the Federal Reserve Act, and provided for a temporary plan of deposit insurance, to be initiated on January 1, 1934, and a permanent plan, to be effective on July 1, 1934. Those provisions formed the nucleus of what is today known as the Federal Deposit Insurance Act. Through the Glass-Steagall Act, the initial deposit insurance limit was set at \$2,500. It subsequently was increased to \$5,000 under the temporary plan.

The Banking Act of 1933 also included a provision that required the FDIC to organize a Deposit Insurance National Bank (DINB) to act as the instrument for paying off the insured deposits of each closed bank. The DINB, a chartered national bank with limited life and powers, could accept new deposits and could be capitalized by the local community within two years if it was in the public interest to establish a new bank in the community in which the original bank closed. The organization of DINBs was made optional by the Banking Act of 1935 and the FDIC was authorized to make payments to depositors directly or through an existing bank. From January 1, 1934, to August 23, 1935, the FDIC placed 24 insured banks into receivership and paid off their deposits through DINBs.

1. The Federal Reserve Board is the body upon which the general supervision and coordination of the Federal Reserve System rests. The Federal Reserve, which is the central banking system of the United States, was created by the Federal Reserve Act of 1913. With the Banking Act of 1935, the Federal Reserve Board came to be known as the Federal Reserve Board of Governors.

Home Owner's Loan Act of 1933

In response to the continuing Great Depression, the estimated 40 percent of home mortgages in default, and an epidemic of foreclosures by home financing institutions during 1932 and 1933, Congress passed the Home Owner's Loan Act of 1933 as an additional piece of legislation to regulate the savings and loan industry.

The primary purpose of the act was to protect small homeowners from foreclosure and to relieve them of a portion of the burden of excessive interest and principal payments incurred during a period of higher value and earning power. The act authorized the FHLBB to charter and regulate federal savings and loan associations. It also allowed state chartered savings and loans that were members of an FHLB to convert to federal charters. In addition, the act authorized the FHLBB to liquidate or appoint a receiver or conservator for any federal savings and loan.

National Housing Act of 1934

Congress passed the National Housing Act of 1934 to improve national housing and to stimulate the sluggish economy. The act sought to prevent risky new mortgages and to decrease the need for second mortgages in the home financing industry.

Congress had determined that the best method to restore confidence in the savings and loan system was through an insurance program such as that provided for banks in 1933. Thus, the act provided for insuring the deposits of savings and loans so they would have the necessary funds to make home loans. Title IV of the National Housing Act established the Federal Savings and Loan Insurance Corporation (FSLIC), which would operate under the direction of the FHLBB.

Under the act, any savings and loan seeking deposit insurance with the FSLIC would apply for and submit to examination of its financial condition. The FSLIC insured deposits at approved institutions up to \$5,000 for any one investor or depositor, who would receive an insurance payoff in the event of an institution's failure. The act empowered the FSLIC to liquidate any of its insured institutions or act as a conservator or receiver for federal savings and loans.

The Banking Act of 1935

The Banking Act of 1935 established the FDIC as a permanent agency of the federal government and inaugurated a permanent federal deposit insurance plan. The act set \$5,000 as the limit for insurance coverage and gave the FDIC the authority to pay off depositors either directly or through an existing bank instead of through a DINB.

The 1935 act set more rigorous standards for admission to the deposit insurance plan. The act required the FDIC, when acting on insurance applications from new banks, to consider (1) the adequacy of the bank's capital, (2) its future earnings prospects, (3) the quality of its management, and (4) its usefulness in serving the

convenience and needs of the community. The act also empowered the FDIC to terminate a bank's insured status if it was found to be engaging in uncorrected unsafe and unsound practices.

The 1935 act also required insured banks to pay for assessments at a rate of 1/12 of 1 percent per annum, computed on the assessment base, which was to be the average for six months of the difference at the end of each day between the total amount of the bank's liabilities for deposits and the total of uncollected items.

Moreover, the act authorized the FDIC to issue notes or other obligations in an amount not to exceed three times the amount received by the FDIC in payment of its capital stock and assessments for the year 1936. It also authorized the FDIC to prohibit the payment of interest in insured nonmember banks and to limit rates of interest paid on savings and time deposits.

Finally, the act expanded the FDIC's authority to resolve failing banks by giving it the power to make advances that would facilitate the merger or consolidation of an insured bank when such action would reduce or avert the risk of a threatened loss to the FDIC. With this new power, a receivership and payoff was no longer the only solution to a failing bank.

Federal Deposit Insurance Act of 1950

The Federal Deposit Insurance Act (FDI Act) of 1950 withdrew the FDIC's authorizing statute from the Federal Reserve Act and consolidated the basic authority for the permanent operation of the Federal Deposit Insurance Corporation into one law. The separate nature of this legislation served to reinforce the independent nature of the FDIC.

Although the FDI Act was substantively similar to the Banking Act of 1935, Congress added section 13(e), which codified the result reached by the U.S. Supreme Court in the 1942 case of *D'Oench, Duhme & Co. v. FDIC*. That case is credited with articulating the rule of law prohibiting a party who had lent himself or herself to an unrecorded scheme or arrangement that would tend to mislead banking authorities from asserting this as a defense against the FDIC. In 1989, with the enactment of the Financial Institutions Reform, Recovery, and Enforcement Act (FIRREA), Congress amended section 13(e) by providing additional protection for the FDIC receiver from unrecorded agreements that would tend to diminish or defeat the receiver's interest in an asset.

The FDI Act also made a change from the Banking Act of 1935 regarding bank examinations. The 1935 act had empowered examiners to conduct an examination of any insured state nonmember bank, any state nonmember bank applying for insurance, and any closed insured bank. In addition, it allowed examiners to examine any national bank or District of Columbia bank and any state member bank with the written consent of the OCC or the Board of Governors of the Federal Reserve System, respectively. In the FDI Act, after Congress eliminated the requirement of consent regarding such national and District of Columbia banks and state member banks, it provided that the

FDIC examiners could conduct such examinations if the FDIC Board of Directors believed them necessary to determine the bank's condition "for insurance purposes."

Fifteen years after the enactment of the Banking Act of 1935, the FDIC asked Congress to eliminate the requirement for a merger or consolidation for cases in which a potential failure could best be handled with loans or asset purchases that would restore the institution to a sound condition. Congress responded to the FDIC's request by limiting the exercise of the authority for such open bank assistance to situations in which the continued operation of the bank was essential to provide adequate banking services in the community.

Housing Act of 1954

Congress enacted the Housing Act of 1954 to amend the National Housing Act of 1934 by limiting insurance coverage on mortgages to 90 percent of total assets. In addition, Congress included new provisions and amendments in the act that relate to the FHLBB and the FSLIC, such as limitations on the authority of courts to hear claims involving FSLIC insurance payments.

The FDIC from 1980 through 1994

In the early 1980s, a banking crisis resulted from a sustained period of rising interest rates and the erosion of traditional funding sources. In an effort to respond to the crisis, Congress passed a series of laws that imposed additional regulatory controls. The remainder of this appendix presents a summary of some of the significant legislation enacted during that period and the effect that legislation had on the receivership and resolution processes.

Depository Institutions Deregulation and Monetary Control Act of 1980

In response to the situation facing banks and thrifts, Congress passed the Depository Institutions Deregulation and Monetary Control Act (DIDMCA) of 1980. That act was perhaps the most significant piece of banking legislation since the passage of the Banking Act of 1933. The DIDMCA began the gradual process of removing the restrictions imposed by Regulation Q, the Federal Reserve's regulation that had placed a ceiling on the interest rates banks could offer their depositors. It sought to deregulate banking and promote more competition to benefit consumers; it also sought to tighten monetary control by extending Federal Reserve requirements to all member and nonmember commercial banks and thrifts offering negotiable order of withdrawal (NOW) accounts (interest-bearing demand accounts on which thrifts had to keep reserves). The DIDMCA also raised the insurance limit from \$40,000 to \$100,000.

Garn–St Germain Depository Institutions Act of 1982

The financial position of thrift institutions worsened during the early 1980s. Interest rates rose sharply in 1980 and did not decrease measurably until the end of the summer of 1982. Thrifts, which traditionally had a significant portion of their portfolios invested in mortgage and other real estate lending (which are frequently long-term investments), could not rapidly adjust to the interest rate change. In response to this mismatch of assets and liabilities, Congress passed the Garn–St Germain Depository Institutions Act (Garn–St Germain) of 1982. The act, aimed at the savings and loan associations and mutual savings banks (MSBs), greatly expanded the powers of those institutions by adding commercial lending and direct investment authority. It also granted banks and other depository institutions authority to offer money market accounts, which, it was thought, would improve the institutions' chances for long-term survival and reduce exposure to risk.

In addition, to increase or maintain the capital of qualifying depository institutions, the act granted the FDIC the authority to purchase net worth certificates from those institutions. The FDIC could purchase a net worth certificate from a qualifying financial institution in exchange for an FDIC issued promissory note. The note was an asset on the bank's books, with the offsetting liability of the certificate counted toward regulatory capital. The FDIC paid interest to the bank as cash, while the bank, if it had earnings and achieved a certain level of net worth, paid part of its net income to the FDIC. In 1985, at the height of the Net Worth Certificate Program, which ultimately lasted until October 1991, the FDIC had more than \$700 million in outstanding certificates. Of the 29 savings banks that participated in the program, 22 required no further assistance and eventually extinguished their net worth certificates.

The act also expanded the FDIC's authority to provide open bank assistance by eliminating the essentially test except in instances in which the cost of open assistance would exceed the estimated cost of liquidating the subject institution.

Competitive Equality Banking Act of 1987

When Congress passed the Competitive Equality Banking Act (CEBA) of 1987, it contained several provisions that were particularly significant for the FDIC and state nonmember banks. A summary of the most important of those provisions follows:

Emergency Acquisitions. CEBA amended the FDI Act to extend and expand the FDIC's emergency interstate acquisition authority in the following ways:

- Out-of-state holding companies could acquire failing or failed qualified stock institutions and mutual savings banks before failure if the failing institutions had assets of \$500 million or more.
- A holding company could be sold, in whole or in part, to an out-of-state holding company if the in-state holding company had a failing bank or banks with aggre-

gate banking assets of \$500 million or more, and the bank or banks represented 33 percent or more of the holding company's banking assets.

- An out-of-state holding company was permitted expansion rights in the state of acquisition through the bank holding company structure. CEBA also prevented regional compact restrictions from applying to a holding company that made an acquisition under emergency authority.

Bridge Banks. CEBA permitted the FDIC to establish a bridge bank (which was chartered as a national bank and operated under the direction of a board appointed by the FDIC) to assume the deposits and certain other liabilities, and to purchase certain assets of one or more failed banks, if the FDIC's Board of Directors determined that (1) the cost of establishing a bridge bank did not exceed the cost of liquidation, (2) the continued operation of the failed bank was essential to provide adequate banking services in the local community, or (3) the continued operation of the failed bank was in the best interest of the depositors or the public. Modifications of the bridge bank authority in 1989 by FIRREA included extending the term of bridge bank operation from three years to five years and revising the provisions concerning dissolution of a bridge bank.

The FDIC found the bridge bank to be an important tool, one that it used in some of the largest bank failures. By providing the FDIC with authority to create a bridge bank contemporaneously with the closing of a failing bank and to control the bridge bank until its disposition, CEBA provided the FDIC sufficient time to evaluate the bank's situation and determine an appropriate resolution. The additional time also allowed prospective acquirers sufficient time to assess the bank's condition and make a reasonable offer for the institution.

Recapitalization of the FSLIC. Another significant provision of CEBA authorized the Financing Corporation (FICO), a newly established financing corporation funded by the FHLBs, to raise \$10.8 billion for the FSLIC by selling bonds in the capital markets. CEBA limited the FSLIC's spending to no more than \$3.75 billion per year in conjunction with failed thrift institutions. CEBA gave the FICO authority to levy assessments against savings and loan institutions. CEBA also imposed a one-year moratorium from the date of enactment, during which no insured institution could voluntarily leave the FSLIC. CEBA later extended that provision for an additional year. A grandfather provision exempted institutions that had converted into or merged with an FDIC insured institution, or that had entered into a letter of intent or memorandum of understanding to do so, before March 31, 1987.

Loan Loss Amortization. Under certain circumstances, agricultural banks could write down their losses on agricultural loans over seven years, rather than deduct the amount of loss from capital as soon as the loss was identified. Agricultural banks were defined as banks in economic areas dependent on agriculture, with assets of \$100 million or less, that had at least 25 percent of their loans in agricultural loans. During 1987, 20 state nonmember banks had applied for the program. By the end of the next year, agricultural bank failures had declined.

Financial Institutions Reform, Recovery, and Enforcement Act of 1989

When Congress passed the landmark Financial Institutions Reform, Recovery, and Enforcement Act of 1989, its primary intent was to address the financial crisis facing the thrift industry, which at the time, included some 600 seriously troubled savings associations with assets of about \$350 billion. Provisions in FIRREA also significantly changed the financial institution's regulatory structure and strengthened the authority of federal supervisors to require adequate capital, promote safe banking practices, and ensure compliance with applicable laws. Greatly expanding the powers and duties of the FDIC, FIRREA also—

- Eliminated the FSLIC and the FHLBB and created the Office of Thrift Supervision (OTS). It established the OTS as an agency under the supervision of the U.S. Department of the Treasury that would assume the examination and supervision functions of the former FHLBB.
- Established the Resolution Trust Corporation (RTC) to merge or liquidate savings associations declared insolvent during the period from January 1, 1989, through August 9, 1992, with the FDIC as the manager of the RTC. The FIRREA legislation also established the Resolution Funding Corporation (REFCORP), which funded the activities of the RTC, primarily through \$40 billion in bond sales. (The RTC's sunset was December 31, 1995.)
- Created two new insurance funds to be administered by the FDIC: the Savings Association Insurance Fund (SAIF) and the Bank Insurance Fund (BIF). The funds would provide federal deposit insurance for deposits at savings associations and banks, respectively, to replace the FSLIC and the FDIC's permanent insurance funds.
- Granted authority to the FDIC to assess insured depository institutions whose sister insured depository institutions had failed. That cross guaranty authority was designed to prevent affiliated banks from shifting assets and liabilities in anticipation of one or more of their number failing in order to retain value for shareholders. By virtue of the cross guaranty authority, in the event of the failure of an affiliated bank, FIRREA authorized the FDIC to apportion the loss among all of the banks in the affiliated group.
- Expanded the FDIC Board of Directors from three to five members: three presidential appointees (one designated as chairperson and another designated as vice chairperson), the comptroller of the currency, and the director of the OTS.
- Granted authority to the FDIC and the RTC to appoint themselves as sole conservators or receivers of any insured state depository institution, providing they met certain criteria. (The OCC got its conservatorship powers in the Emergency Banking Act of 1933, so that it could act as conservator for any national bank.)

FDIC Assessment Rate Act of 1990

In response to the FDIC's request for greater flexibility, Congress enacted the FDIC Assessment Rate Act of 1990, which gave the FDIC enhanced authority over the timing and size of increases in deposit insurance premiums. Principal provisions of the act removed annual assessment rate restrictions and allowed the FDIC board to make mid-year adjustments to the assessment rates. The act also enabled the FDIC to borrow from the Federal Financing Bank for the BIF or the SAIF. Before that act was passed, the maximum annual assessment rate was $\frac{1}{2}$ of 1 percent computed on the assessment base, which was not enough to keep the insurance fund capitalized.

Comprehensive Thrift and Bank Fraud Prosecution and Taxpayer Recovery Act of 1990

Congress enacted the Comprehensive Thrift and Bank Fraud Prosecution and Taxpayer Recovery Act of 1990 as part of the Crime Control Act of 1990. The act was designed to enhance the powers of the FDIC and other federal banking regulatory agencies to prevent and punish fraud in the banking and thrift industries. The act also—

- Gave the FDIC and the RTC the authority to ask courts to freeze the assets of persons who had defrauded depository institutions to prevent them from transferring assets out of reach of regulatory agencies.
- Prevented individuals who had defrauded financial institutions from using title 11 of the U.S. Code, the Bankruptcy Code of the United States, to discharge their debts to those institutions and from shielding their assets under the code by buying lavish homes and subsequently invoking a homestead exemption in bankruptcy.
- Gave the FDIC the power to issue administrative subpoenas in connection with its receivership and conservatorship activities, a power it already held in its supervisory capacity. In addition, the act authorized the FDIC to prohibit excessive bonuses, benefits, and certain “golden parachute” payments to departing directors, officers, or employees of troubled banks or thrifts.

Federal Deposit Insurance Corporation Improvement Act of 1991

When Congress passed the Federal Deposit Insurance Corporation Improvement Act (FDICIA) of 1991, it had a significant effect on the FDIC. Key provisions of that act include least cost resolution, FDIC borrowing authority, recapitalization, prompt corrective action, risk-based premiums, FDIC backup enforcement authority, open bank assistance, and brokered deposits.

Least Cost Resolution. The new “least cost test” requires that any assistance the FDIC provided under section 13 of the FDI Act be (1) necessary to meet the FDIC's obligation to protect the insured deposits in a failed or failing institution and (2) the least costly to the

deposit insurance fund of all possible methods of meeting that obligation. That requirement meant that any assisted transaction the FDIC implemented would have to be less costly than liquidation and less costly than all other possible assisted transactions. Under prior law, the transaction implemented had to be less costly than a liquidation, but not necessarily less costly than all other possible transactions. The least cost resolution of FDICIA ended the FDIC's preference for whole bank transactions and compelled the FDIC to consider more transaction options than it had previously.

In making its least cost determinations, the FDIC is required to evaluate the alternative structures and bids on a present-value basis, using a realistic discount rate. The statute requires the FDIC to document its evaluation and the assumption on which the evaluation is based, including any assumptions regarding interest rates, asset recovery rates, asset holding costs, and payment of contingent liabilities, and to retain that documentation for at least five years.

Under the "systemic risk" exception to the least cost test, a non-least cost assisted transaction could be implemented only if the secretary of the Treasury, acting in consultation with the president of the U.S. and on the recommendation of the boards of both the FDIC and the Federal Reserve (both boards acting by two-thirds majorities), determined that the transaction was necessary to avoid serious adverse effects on economic conditions or financial stability. That exception replaced the former essentiality exception, under which an assisted transaction that was not less costly than a liquidation could be implemented if the FDIC determined that the operation of the institution were deemed essential to provide services in its community. The essentiality exception was used numerous times over the years with the determinations ranging from the specific—a minority-owned bank serving a minority community—to the general—the number of depositors, size of the bank, and whether the bank was a significant depository of public funds.

FDIC Borrowing Authority. In 1991, for the first time in history, the BIF technically dropped below zero to negative \$7 billion. Under FDICIA, the FDIC's authority to borrow from the Treasury Department to cover BIF losses was increased from \$5 billion to \$30 billion. The insured banks were required to repay the borrowed amounts through deposit insurance premiums over a period not to exceed 15 years. In addition, the FDIC could borrow money on a short-term basis for working capital, subject to an overall cap. Working capital borrowings were not to exceed the total of cash and cash equivalents held by the insurance fund, plus 90 percent of the estimated fair market value of the assets held by the fund, plus the amount authorized to be borrowed from the Treasury to cover insurance losses.

Recapitalization. The FDIC Board of Directors was required to adopt deposit insurance premiums according to a recapitalization schedule that would cause the BIF to reach its designated reserve ratio within 15 years and the SAIF to reach its reserve ratio within a reasonable time.

Prompt Corrective Action. In general, FDICIA required federal banking regulators to take certain supervisory action (prompt corrective action) when an insured depository

institution fell within one of the three lowest of five specifically enumerated capital categories (well-capitalized, adequately capitalized, undercapitalized, significantly undercapitalized, and critically undercapitalized). Such prompt corrective actions included increased monitoring, raising additional capital, requiring acceptance of an offer to be acquired, and closure of the institution. The purpose of the new provisions was to resolve the problems of insured depository institutions at the least possible long-term loss to the deposit insurance funds. For insured depository institutions that were designated critically undercapitalized (that is, those institutions with a ratio of tangible equity to total assets equal to or less than 2 percent), FDICIA required that, not later than 90 days from designation, a conservator or receiver must be appointed.

Risk-Based Premiums. Beginning January 1, 1994, FDICIA required the FDIC to impose deposit insurance assessments according to the risks that an institution posed to the appropriate insurance fund. The act also authorized the FDIC to deny insurance to any applicant (including national banks and state chartered banks supervised by the Federal Reserve Board), based on a bank's failure to meet statutory factors.

FDIC Backup Enforcement Authority. FDICIA gave the FDIC, which had been given backup enforcement authority over insured savings associations, the same authority over national banks and state member banks. Under FIRREA, if the federal banking agency to which the FDIC recommended specific enforcement action against any insured depository institution or any affiliated institution failed to take the recommended action (or acceptable alternative action) within 60 days, the FDIC could step in. In cases of exigent circumstances, the FDIC could take immediate action.

Open Bank Assistance. Open bank assistance was the subject of two separate provisions of FDICIA. The first provision was mandatory and stated that the FDIC could provide open bank assistance only if it had determined that grounds for the appointment of a conservator or receiver existed and that the institution's capital was not likely to be increased without assistance. In addition, the FDIC would have to be able to determine that the institution's management was competent and not the cause of the institution problems.²

Brokered Deposits. FDICIA also imposed a restriction on the use of brokered deposits. Troubled institutions (that is, those that did not meet applicable minimum capital requirements) were precluded from accepting funds obtained directly or indirectly by or through any deposit broker and were similarly prohibited from offering a rate of interest significantly higher than other area banks.

Disposition of Assets. FDICIA applied to the FDIC a rule that had previously applied only to asset dispositions of the RTC and that was intended to maximize the value and reduce the costs of asset dispositions. With FDICIA, the FDIC was required to (1) maximize the net present value return from the sale or disposition of assets, (2) minimize the

2. See Part I, Resolution and Asset Disposition Practices, Chapter 5, Open Bank Assistance, for further details.

amount of any loss realized in the resolution of cases, (3) ensure adequate competition and fair and consistent treatment of bidders, (4) prohibit discrimination on the basis of race, sex, or ethnic group in the solicitation and consideration of offers, and (5) maximize the preservation of the availability and affordability of residential real property for low- and moderate-income individuals.

Resolution Trust Corporation Refinancing, Restructuring, and Improvement Act of 1991

The Resolution Trust Corporation Refinancing, Restructuring, and Improvement Act (RTCRRIA) of 1991 provided that the restructured RTC be headed by a chief executive officer (CEO), appointed by the president with the advice and consent of the Senate, instead of by the FDIC chairman and board of directors. The RTC Oversight Board, created by FIRREA, was recast into the Thrift Depositor Protection Oversight Board (TDPOB), composed of the secretary of the Treasury (who served as chairman), the chairman of the FDIC, the director of the Office of Thrift Supervision, the CEO of the RTC, the chairman of the Federal Reserve Board, and two private-sector representatives.

The RTCRRIA legislation provided the RTC with \$25 billion more in funding through April 1, 1992, and extended its ability to accept appointment as conservator or receiver from August 9, 1992, to September 30, 1993, at which time the FDIC, as manager of the SAIF, would become responsible for handling failed thrifts. The RTC would continue to handle the resolution of failed thrifts until October 1, 1993. The Treasury Department was required to make up any shortfall in any annual funding of the SAIF through the year 2000.

Omnibus Budget Reconciliation Act of 1993

Two years after passing RTCRRIA, Congress passed the Omnibus Budget Reconciliation Act of 1993. A significant provision of the act was the “national depositor preference” distribution schedule applicable to the assets of all insured depository institutions that closed on or after August 10, 1993. The following five categories of claims, with priority determined in order of payment, were specified:

1. Administrative expenses of the FDIC as receiver;
2. Any deposit liability, including the FDIC's subordinated claim;
3. Any other general or senior liabilities;
4. Any subordinated obligations, including any obligation of commonly controlled depository institutions for cross guaranty assessments; and
5. Any obligations to shareholders or members, including holding companies and their creditors.

General unsecured creditors' claims were subordinated to any deposit liability of the institution, including the FDIC's (that is, all deposit liabilities were preferred). It was expected that the depositor preference schedule would reduce the cost of resolutions to the deposit insurance funds. Previously, assets had been distributed according to the law of the jurisdiction that chartered the failed institution.

RTC Completion Act of 1993

The RTC Completion Act (Completion Act) of 1993 became the most significant banking statute of the year to affect the FDIC and RTC. From April 1, 1992, through December 17, 1993, the RTC would not have had sufficient funding to resolve additional failed savings and loan institutions. The Completion Act removed the April 1, 1992, deadline for the use of funds that had previously been established, which permitted the RTC to use up to \$18.3 billion authorized under RTCRRIA to resolve the remaining insolvent thrifts.

The Completion Act—

- Extended the September 30, 1993, deadline for appointing the RTC as conservator or receiver for savings associations to a date between January 1, 1995, and July 1, 1995, to be determined by the chairperson of the TDPOB.
- Accelerated the act of transferring the RTC operations to the FDIC by amending the termination date of the RTC from December 31, 1996, to December 31, 1995.
- Disallowed the use of BIF assessments for repaying funds borrowed from the U.S. Treasury for SAIF insurance purposes, and vice versa.
- Extended the moratorium on conversions from membership in one insurance fund to the other until August 9, 1994, or the date on which SAIF first met the designated reserve ratio of \$1.25 for every \$100 of insured deposits, whichever came later.
- Required the RTC to adopt a series of management reforms and implement provisions designed to improve the agency's record in providing business opportunities to minorities and women when issuing RTC contracts or selling assets.
- Established an affordable housing program, under which the FDIC and the RTC were required to provide tenants a right of first refusal to purchase one-to-four-family residences owned by the FDIC or the RTC, except under certain circumstances, and to give limited preference to offers from nonprofit corporations, public agencies, and other organizations that would provide for use of a property by homeless individuals and families.

Riegle-Neal Interstate Banking and Branching Efficiency Act of 1994

The Riegle-Neal Interstate Banking and Branching Efficiency Act of 1994 authorized interstate banking and branching for United States and foreign banks over a three-year period. Significant for the FDIC, the act authorized—

- Bank holding companies to acquire banks located in any state beginning September 29, 1995.
- Insured banks to merge across state lines beginning June 1, 1997, unless the affected states “opted out” (that is, enacted laws that prohibit interstate branching).
- Insured banks to establish de novo out-of-state branches if the host state permitted interstate branching through the establishment of de novo branches.

Table A-1

Legislation at a Glance 1913-1954

Legislation	Major Provisions
Federal Reserve Act of 1913	Established the Federal Reserve System, the nation's central bank, to regulate the nation's money supply; gave state banks the option of Federal Reserve membership; designated the Federal Reserve as lender of last resort to banks experiencing liquidity problems.
Glass-Steagall Act of 1932	Broadened the circumstances under which member banks could borrow from the Federal Reserve; required the separation of investment activities and commercial banking. (Part of the Banking Act of 1933—see below).
Federal Home Loan Bank Act of 1932	Established Federal Home Loan Banks; established the Federal Home Loan Bank Board to coordinate the home mortgage system; empowered the FHLBB to adopt, amend, and enforce rules and regulations, as well as remove or suspend FHLB employees and agents of S&Ls.
Emergency Banking Act of 1933	Set standards for reopening banks after the declared national bank holiday; provided for the issuance of Federal Reserve notes backed by U.S. government securities; empowered the OCC to appoint conservators for failed banks.
Banking Act of 1933	Established the FDIC as a temporary agency to restore public confidence in banking; required the FDIC's appointment as receiver for all national banks.
Home Owner's Loan Act of 1933	Authorized the Federal Home Loan Bank Board to charter and regulate federal S&Ls, and allowed conversion of state chartered S&Ls that were FHLB members to federal charters; authorized the FHLBB to liquidate or appoint a receiver or conservator for any federal S&L.
National Housing Act of 1934	Established the Federal Savings and Loan Insurance Corporation under the FHLBB's direction to monitor S&L financial conditions, insure deposits at approved institutions for up to \$5,000, and provide for insurance payoffs in the event of failure; empowered the FSLIC to liquidate any of its insured institutions or to act as conservator or receiver for federal S&Ls.
Banking Act of 1935	Established the FDIC as a permanent government agency, set up permanent insurance coverage with a \$5,000 limit, authorized the FDIC to pay off depositors directly or through an existing bank, and established rigorous standards for insurance admission; provided for assessments to be paid by insured banks, and facilitated the merger or consolidation of insured banks to reduce risk or loss to the FDIC.
Federal Deposit Insurance Act of 1950	Consolidated the basic authority for the FDIC's permanent operation into one law; codified <i>D'Oench</i> ; empowered examiners to examine all insured state nonmember banks, as well as closed insured banks, national banks, D.C. banks, or state member banks for insurance purposes, without the consent of the OCC or the Federal Reserve Board of Governors.
Housing Act of 1954	Amended the National Housing Act of 1934 by limiting insurance coverage on mortgages to 90% of total assets; limited the authority of the courts to hear claims involving FSLIC insurance payments.

Table A-2**Legislation at a Glance
1980–1994**

Legislation	Major Provisions
Depository Institutions Deregulation and Monetary Control Act of 1980	Deregulated banking and promoted competition; gave financial institutions additional lending and investment powers; increased deposit insurance coverage to \$100,000.
Garn–St Germain Act of 1982	Granted the use of money market accounts; allowed federal savings and loan institutions to offer demand deposits; authorized the FDIC net worth certificate assistance.
Competitive Equality Banking Act of 1987	Provided for emergency acquisitions; authorized bridge banks; recapitalized the FSLIC; allowed agricultural banks to amortize loan losses.
Financial Institutions Reform, Recovery, and Enforcement Act of 1989	Addressed the thrift crisis by abolishing the FSLIC and the FHLBB; creating the RTC and the OTS; and strengthening provisions of the FDI Act.
FDIC Assessment Rate Act of 1990	Removed annual assessment rate restrictions.
Comprehensive Thrift and Bank Fraud Prosecution and Taxpayer Recovery Act of 1990	Strengthened the FDIC's powers to prevent fraud.
Federal Deposit Insurance Corporation Improvement Act of 1991	Required “least cost” resolutions of failed and failing insured depository institutions, prompt corrective action, and risk-based premiums.
RTC Refinancing, Restructuring, and Improvement Act of 1991	Restructured the RTC and provided an additional \$25 billion in funding.
Omnibus Budget Reconciliation Act of 1993	Created national depositor preference amendment.
RTC Completion Act of 1993	Accelerated the RTC closing date by one year; released funds authorized under RTCRRIA.
Riegle-Neal Interstate Banking and Branching Efficiency Act of 1994	Authorized interstate banking and branching.



APPENDIX B

List of Abbreviations and Glossary of Terms

This list of abbreviations and glossary of terms is compiled from terminology that is used in this publication. An entry with an asterisk in the list of abbreviations is defined in the glossary of terms.

The definitions in the glossary are not intended to be comprehensive and complete. The reader can often obtain more information about specific terms by referring to appropriate chapters in the book. The index at the back of the book includes most of the terms that appear in the glossary.

Abbreviations

ABA	American Bankers Association
ADC	acquisition, development, and construction
AGS	Automated Grouping System
AHAB	Affordable Housing Advisory Board
AHDP	Affordable Housing Disposition Program
AHP*	Affordable Housing Program
ALA*	Asset Liquidation Agreement
AMDA*	Asset Management and Disposition Agreement
AMDM	<i>Asset Management and Disposition Manual</i>
AMDP	Asset Management and Disposition Plan
AMRESCO	Asset Management and Real Estate Sales Company
AMV*	affordable market value
APP	Accelerated Payment Program

APS	Automated Payout System
ARM*	adjustable rate mortgage
ARP*	Accelerated Resolution Program
AVR*	asset valuation review
BEY*	bond equivalent yield
BIF*	Bank Insurance Fund
BONHAM	Banc One New Hampshire Asset Management, Inc.
BONNET	Bonnet Resources Corporation, Inc.
CAP*	corrective action plan
CARC	Consolidated Asset Recovery Corporation
CBI Act*	Coastal Barrier Improvement Act of 1990
CD	certificate of deposit
CEBA*	Competitive Equality Banking Act of 1987
CEO	chief executive officer
CMBS	commercial mortgage-backed securities
CMO*	collateralized mortgage obligation
CMS	Case Management System
COMB*	Contractor Oversight and Monitoring Branch
CPPM	<i>Contract Policies and Procedures Manual</i>
CRA	Community Reinvestment Act of 1977
CSP*	Conservator's Strategic Plan
DAS	Division of Depositor and Asset Services, a former FDIC organizational unit
DIDMCA*	Depository Institutions Deregulation and Monetary Control Act of 1980
DINB*	Deposit Insurance National Bank
DIRM	Division of Information Resource Management, FDIC
DIV*	derived investment value
DOF	Division of Finance, FDIC
DOL	Division of Liquidation, a former FDIC organizational unit
DOR	Division of Resolutions, a former FDIC and RTC organizational unit
DOS	Division of Supervision, FDIC

DRR*	Division of Resolutions and Receiverships, FDIC
DRS	Division of Research and Statistics, FDIC
ECR*	estimated cash recovery
ERISA	Employee Retirement Income Security Act of 1974
ERV*	estimated recovery value
FADA*	Federal Asset Disposition Association
Fannie Mae*	Federal National Mortgage Association
FASB	Financial Accounting Standards Board
FDI Act*	Federal Deposit Insurance Act of 1950
FDIC	Federal Deposit Insurance Corporation
FDICIA*	Federal Deposit Insurance Corporation Improvement Act of 1991
FF&E	furniture, fixtures, and equipment
FFA	Federal Financial Assistance
FFB*	Federal Financing Bank
FHA*	Federal Housing Administration
FHLB*	Federal Home Loan Bank
FHLBB*	Federal Home Loan Bank Board
FIRREA*	Financial Institutions Reform, Recovery, and Enforcement Act of 1989
FIS	Financial Institution System
FmHA*	Farmers Home Administration
FOIA/PA	Freedom of Information Act (1967) and Privacy Act (1974)
Freddie Mac*	Federal Home Loan Mortgage Corporation
FRB*	Federal Reserve Bank
FRF*	FSLIC Resolution Fund
FSLIC*	Federal Savings and Loan Insurance Corporation
GAAP*	generally accepted accounting principles
GAO*	General Accounting Office
GCR*	gross cash recovery
GG*	general grade federal employee
Ginnie Mae*	Government National Mortgage Association
GL	general ledger

GSA	General Services Administration
HUD	U.S. Department of Housing and Urban Development
IBSGC*	Industrial Bank Savings Guaranty Corporation
ICA	interim capital assistance
ICC*	income capital certificate
ICR	internal control review
IDT*	insured deposit transfer
IG	inspector general
IMA*	Income Maintenance Agreement
IRR*	internal rate of return
ITCV*	initial targeted cash value
JDC*	judgments, deficiencies, and charge-offs
JERNE	J. E. Robert, Inc.
KKR	Kohlberg, Kravis Roberts & Co.
LAMIS	Liquidation Asset Management Information System
LDIMS	Legal Division Information Management System
LG*	liquidation grade federal employee
LIBOR	London InterBank Offered Rate
LOC	Letter of Credit
LSA	Legal Services Agreement
LSI	Legal Services Invoice (System)
LSO	Legal Services Office
LURA*	Land Use Restriction Agreement
MA*	managing agent
MAST	Multi-Asset Sales Transaction
MBS*	mortgage-backed security(ies)
MCR*	management control review
MIF*	Multiple Investor Fund

MIS	management information system
MSB	mutual savings bank
MWOB	minority- or women-owned business
MWOP	minority- or women-owned program
N.A.	National Association
NOW	negotiable order of withdrawal
NPV*	net present value
NTEU	National Treasury Employees Union
NWC*	Net Worth Certificate
OBA*	open bank assistance
OCATS	Outside Counsel Application Tracking System
OCC*	Office of the Comptroller of the Currency
OCIS	Outside Counsel Information System
OIG*	Office of Inspector General, FDIC and RTC
ORE*	owned real estate
OTS*	Office of Thrift Supervision
P&A*	purchase and assumption
PBGC	Pension Benefit Guaranty Corporation
PCA*	prompt corrective action
PLS	Professional Liability Section, FDIC
PMN	predominantly minority neighborhood
QFC*	qualified financial contract
RALA*	Regional Asset Liquidation Agreement
RAP	regulatory accounting principles
RECOLL	RECOLL Management Corporation
REFCORP*	Resolution Funding Corporation
REIT	real estate investment trust
REMIC*	Real Estate Mortgage Investment Conduit
REO	real estate owned

REOMS*	Real Estate Owned Management System
RFC*	Reconstruction Finance Corporation
RICO	Racketeer Influenced and Corrupt Organization
RLIS	RTC Legal Information System
RTC*	Resolution Trust Corporation
RTCCA*	Resolution Trust Corporation Completion Act of 1993 (Completion Act)
RTCRRIA*	RTC Refinancing, Restructuring, and Improvement Act of 1991
S&L	savings and loan
SAIF*	Savings Association Insurance Fund
SAMA*	Standard Asset Management Amendment
SAMDA*	Standard Asset Management And Disposition Agreement
SBA	Small Business Administration
SIMAN*	Subsidiary Information Management Network
SWAT	Settlement/Workout Assistance Team
TAA*	technical assistance advisor
TDPOB*	Thrift Depositor Protection Oversight Board (the RTC's Oversight Board, starting in 1991)
UDAA*	Unclaimed Deposits Amendment Act of 1993
VA	Veterans' Administration
WAC	weighted average coupon (rate)

*Abbreviations with an asterisk are defined in the following glossary.

Glossary of Terms¹

absolute auction: An open, outcry sale in which assets are sold to the highest bidder regardless of price, with no reserve price and no minimum bid.

accelerated dividend: A dividend paid to proven creditors of the receivership based on a projection of future funds available. Accelerated dividends are calculated based on estimates of asset collections, less projections of administrative expenses, other liabilities, and contingent liabilities.

Accelerated Resolution Program (ARP): A means of resolving a failed thrift institution in which there is an expedited transfer of the insolvent thrift's assets and deposit liabilities to a healthy institution, without first placing the failed thrift in conservatorship. This approach, initiated jointly by the OTS and the RTC in 1990, was similar to FDIC resolutions at the time. The program was designed to allow thrifts that were below FIRREA-mandated capital levels, but that otherwise were perceived as having substantial franchise value, to continue to operate throughout the resolution process.

acquiring institution: A healthy bank or thrift institution that purchases some or all of the assets and assumes some or all of the liabilities of a failed institution in a purchase and assumption transaction. The acquiring institution is also referred to as the assuming institution. (Also see *assuming institution*.)

ad valorem real property taxes: Taxes imposed on real property based on its value.

adjustable rate mortgage (ARM): A type of mortgage in which the interest rate is reset at regular intervals, typically at a spread over a stated short-term interest rate index. The most frequently used indexes have been the one-year U.S. Treasury constant maturity yield and the Eleventh District Cost of Funds Index. Because the interest rate paid by the borrower fluctuates with the general level of interest rates in the marketplace, ARMs shift most of the interest rate risk from the lender to the borrower.

advance dividend: A payment made to an uninsured depositor or creditor after a bank or thrift failure. The amount of the advance dividend represents the FDIC's conservative estimate of the ultimate value of the receivership. Cash dividends equivalent to the board-approved advance dividend percentage (of total outstanding deposit claims) are paid to uninsured depositors, thereby giving them an immediate return of a portion of their uninsured deposit.

adverse domination: A legal doctrine advanced by the FDIC and the RTC in professional liability suits against the officers and directors of a failed institution. Under the doctrine of adverse domination, in a lawsuit against corporate wrongdoers, the statute of

1. Many of the RTC-related definitions were obtained from the glossary of *A History of the Resolution Trust Corporation's Asset and Real Estate Management and Disposition Program*, by FDIC's Brian D. Lamm and James E. Heath, published August 28, 1995.

limitations does not run during the period when the defendants were in control of the board of directors of the failed institution.

Affordable Housing Program (AHP): An FDIC program that increases the stock of affordable housing through disposition of eligible residential properties to low- and moderate-income families. The RTC program was known as the Affordable Housing Disposition Program (AHDP). The affordable housing created comes from the agency's inventory of owned real estate.

affordable market value (AMV): A valuation model used to determine the sales price of multi-family residential property sold in the FDIC AHP. The affordable market value was determined by subtracting the cost to cure physical deficiencies and operating deficits from the maximum supportable loan amount, which was determined by applying a debt service coverage factor to the projected net operating income of the property.

agency swap program: A method of securitization in which single family residential mortgages conforming to agency underwriting guidelines are swapped for mortgage-backed securities issued by Fannie Mae or Freddie Mac.

agricultural bank: Banks of the Farm Credit System and certain other farm-oriented commercial banks, typically located in the farm belt states, that specialize in providing credit to the farming industry. (Also see *Loan Loss Amortization Program*.)

appraised equity capital: A regulatory capital item established by the former FHLBB that allowed a savings association to count as part of its regulatory capital the difference between the book value and the fair market value (appraised value) of fixed assets, including owner-occupied real estate.

Asset Liquidation Agreement (ALA): An asset management contract between the FDIC and a bank affiliate or private-sector contractor for the management and disposition of distressed assets of all types. The ALA contract was designed for asset pools with an aggregate book value in excess of \$1 billion.

asset management contract: A contract with a private-sector asset management contractor for managing and disposing of distressed assets.

Asset Management and Disposition Agreement (AMDA): A partnership agreement between the FDIC as manager of the FSLIC Resolution Fund (FRF) and the acquirers of certain failed savings and loan institutions, created as a result of the RTC's review and renegotiation of the FSLIC's 1988 and 1989 assistance agreements. Assets with a book value of \$3.7 billion were assigned to two partnerships under AMDA contracts.

asset manager: A term often used to describe an asset management contractor who manages and disposes of assets (for example, an ALA or SAMDA contractor). The term "asset manager" may also be used in a broad, generic sense to describe a person or entity responsible for the management of an asset or a portfolio of assets.

asset pool: A portfolio of assets, often composed of assets with similar characteristics.

asset specialist: An FDIC or RTC employee with responsibility for the management and disposition of assets, or for the oversight of asset managers employed under asset management contracts.

asset valuation review (AVR): A review of a failing institution's assets to estimate the liquidation value of the assets. An AVR estimate is used in the least cost analysis that is required by FDICIA.

assistance agreement: An agreement pertaining to a failing institution under which a deposit insurer, such as the FDIC, provides financial assistance to the failing institution or to an acquiring institution. The assistance agreement includes the terms of the purchase of assets and assumption of liabilities of the failing institution by the assuming institution; it may also include provisions regarding a reorganization of the failing institution under new management or a merger of the failing institution into a healthy institution.

assisted merger: A failing institution is absorbed into an acquiring institution that receives FDIC assistance. In 1950, the FDIC was authorized by section 13(e) of the FDI Act to implement assisted mergers. In 1982, when the FDI Act was amended, the merger authority, as amended, was written into section 13(c) of the FDI Act. Such transactions allow the FDIC to take direct action to reduce or avert a loss to the deposit insurance fund and to arrange the merger of a troubled institution with a healthy FDIC insured institution without closing the failing institution. Assisted merger was the FSLIC's preferred resolution method. (Also see *Federal Deposit Insurance Act*.)

assuming institution: A healthy bank or thrift that purchases some or all of the assets and assumes some or all of the deposits and other liabilities of a failed institution in a purchase and assumption transaction. The assuming institution is also referred to as the acquiring institution. (Also see *acquiring institution*.)

auction: An asset sales strategy in which assets are sold either individually or in pools to the highest bidder in an open-outcry auction.

Bank Insurance Fund (BIF): One of the two federal deposit insurance funds created by Congress in 1989 and placed under the FDIC's administrative control. The BIF insures deposits in most commercial banks and many savings banks. The FDIC's "permanent insurance fund," which had been in existence since 1934, was dissolved when the BIF was established. The money for a deposit insurance fund comes from the assessments contributed by member banks and also from investment income earned by the fund. (Also see *Savings Association Insurance Fund*.)

bond equivalent yield (BEY): A bond, Treasury bill, or other discount instrument's yield over its life, assuming it is purchased at the asked price and the return is annualized using a simple interest approach. The bond equivalent yield is equal to a bill's discount,

expressed as a fraction of the purchase price multiplied by 365 divided by the number of days to maturity.

$$\text{BEY} = (\text{discount/purchase price}) \times (365/\text{days to maturity})$$

book value: The dollar amount shown on the institution's accounting records or related financial statements. The "gross book value" of an asset is the value without consideration for adjustments such as valuation allowances. The "net book value" is the book value net of such adjustments. The FDIC restates amounts on the books of a failed institution to conform to the FDIC's liquidation accounting practices. Therefore, in the FDIC accounting environment, book value generally refers to the unpaid balance of loans or accounts receivable, or the recorded amount of other types of assets (for example, ORE or securities).

book value reduction: The decrease in book value of all types of assets resulting from activities such as the collection of loan principal, the sale of an asset, the forgiveness of a debt, and the write-off or donation of an asset.

branch banking: Multi-office banking. Branch banking occurs when a single bank conducts its business at a number of different offices located in the same or different cities, states, or countries. The ability to operate branches is controlled by state law; most states permit branches within city limits and a few states permit statewide banking. Federal law ties the ability of a national bank to establish and operate branches to the scope of the branching powers granted by state law to the state banks located in the state in which the national bank is situated.

branch breakup: A resolution strategy that provides bidders with the choice of bidding on the entire franchise or on individual or groups of branches of the failing institution. Marketing failing institutions on both a whole franchise and a branch breakup basis can expand the universe of potential buyers and may result in better bids in the aggregate. In branch breakup transactions, prospective acquirers are required to submit bids on both the "all deposits" and "insured deposits" options except for bids on the entire franchise. The branch breakup resolution strategy was developed by the RTC to allow smaller institutions to participate in the resolution process and to increase competition among the bidders. (Also see *core branch P&A* and *limited branch P&A*.)

bridge bank: A temporary national bank established and operated by the FDIC on an interim basis to acquire the assets and assume the liabilities of a failed institution until final resolution can be accomplished. The use of bridge banks generally is limited to situations in which more time is needed to permit the least costly resolution of a large or complex institution. (Also see *Competitive Equality Banking Act*.)

bulk sale: The sale of a large number of assets to one purchaser in a single transaction. Also known as a "portfolio sale."

capital forbearance: The temporary permission for a bank or thrift to operate with capital levels below regulatory standards if the bank or thrift has adequate plans to restore capital. For example, banks suffering because of the energy and agricultural crises in the mid-1980s were permitted to operate with capital levels below regulatory standards if they had adequate plans to restore capital. A joint policy statement issued in March 1986 by the FDIC, the OCC, and the Federal Reserve Board encouraged a capital forbearance program for agricultural banks.

capital loss coverage: A form of aid in assistance transactions that provided for a payment equal to the difference between an asset's original value (book value) and the proceeds received when the asset was sold.

charge-off: A book value amount that was expensed as a loss before receivership and that continues to be a legal obligation of the borrower to the institution. A charge-off is technically an off-book memorandum accounting item that represents the book value of an asset that the bank or thrift previously wrote off.

chartering authority: A state or federal agency that grants charters to new depository institutions. For state chartered institutions, the chartering authority is usually the state banking department; for national banks, it is the OCC; and for federal savings institutions, it is the OTS.

cherry-pick: The tendency of an asset manager to dispose of the assets in a portfolio that are relatively easy to sell before disposing of the hard-to-sell assets; a P&A variation in which no loans are transferred as of closing but the acquiring institution has an option to acquire loans from the FDIC for a designated time period.

claim: An assertion of the indebtedness of a failed institution to a depositor, general creditor, subordinated debt holder, or shareholder.

classified asset: An asset that is designated as substandard, doubtful, or subject to loss. An asset becomes classified when it is so designated by the appropriate regulatory agency.

clean bank P&A: A purchase and assumption transaction in which the acquiring institution assumes the deposit liabilities and the cash and cash equivalent assets of the failed institution. In addition, the assuming bank purchases the "good" loans of the failed institution or receives an exclusive call option to purchase designated fixed assets and assume certain contracts of the failed institution.

Coastal Barrier Improvement Act (CBI Act): Legislation enacted in 1990 that placed limitations on property transfers and required special disposition procedures for certain environmentally significant properties located in coastal areas or located adjacent to publicly managed conservation areas. The act imposed a waiting period of up to six months on FDIC and RTC sales of environmentally sensitive property located in coastal areas or adjacent to publicly managed conservation areas.

collateralized mortgage obligation (CMO): A corporate bond backed by a pool of mortgages in which the cash flows of the pool are channeled into two or more series of bonds. Interest payments generally are made to the purchasers of such securities.

Competitive Equality Banking Act (CEBA): Legislation enacted in 1987 that permitted qualifying agricultural banks to amortize losses over a seven-year period for agricultural loans, rather than having to deduct losses from capital as soon as the loss was incurred. CEBA also created the Financing Corporation, which was chartered by the FHLBB, to borrow up to \$10.8 billion over three years to finance the closure of failed S&Ls or to subsidize their takeover by healthy S&Ls. In addition, CEBA encouraged the supervisory forbearance of well-managed but undercapitalized institutions.

CEBA also expanded the FDIC's authority to permit out-of-state bank holding companies to acquire stock institutions and mutual savings banks before failure, providing those companies met certain conditions.

In addition, CEBA provided the FDIC with authority to establish a bridge bank, a new national bank that was created to purchase the assets and assume the liabilities of a failing bank until resolution could be accomplished. Under CEBA a bridge bank could be established if—

- The cost of establishing the bridge bank did not exceed the cost of liquidating the failing bank;
- The continued operation of the uninsured bank was essential to provide adequate banking services in the community; or
- The continued operation of the institution was in the best interest of its depositors and the public.

confidentiality agreement: An agreement between the FDIC and a potential acquiring financial institution that acknowledges the confidentiality of the information package pertaining to the failing institution and other documents, including the financial transaction agreements. To receive the information package and perform on-site due diligence at the institution before failure, potential acquirers must sign a confidentiality agreement.

conservator: A person or entity, including a government agency, appointed by a regulatory authority to operate a troubled financial institution in an effort to conserve, manage, and protect the troubled institution's assets until the institution has stabilized or has been closed by the chartering authority.

Conservator's Strategic Plan (CSP): A plan prepared by the managing agent of an RTC-controlled institution within 60 days of the start of the conservatorship. The CSP describes the plan of operation for the failed institution during the conservatorship stage. The CSP formerly was known as the "Conservator's Operating Plan." (Also see *managing agent*.)

conservatorship: The legal procedure provided by statute for the interim management of financial institutions used by the FDIC and RTC. Under the pass-through receivership method, after the failure of a savings institution, a new institution is chartered and

placed under agency conservatorship; the new institution assumes certain liabilities and purchases certain assets from the receiver of the failed institution. Under a straight conservatorship, the FDIC or RTC may be appointed conservator of an open, troubled institution. In each case, the conservator assumes responsibility for operating the institution on an interim basis in accordance with the applicable laws of the federal or state authority that chartered the new institution. Under a conservatorship, the institution's asset base is conserved pending the resolution of the conservatorship.

contractor: An individual or other legal entity that directly or indirectly submits offers for or receives a government contract for goods or services.

Contractor Oversight and Monitoring Branch (COMB): An organizational unit located in Dallas, Texas, within the FDIC's former Division of Liquidation and responsible for overseeing the FDIC's asset management contractors. This contractor oversight group has since been renamed but is still situated in Dallas.

core branch P&A: A component in a purchase and assumption (P&A) transaction in an RTC branch breakup resolution. Under the terms of the core branch P&A agreement, the acquiring institution assumes all of the deposit liabilities directly attributable to the failed institution's headquarters branch and other acquired branches, and certain other liabilities. In addition, the acquirer purchases the assets directly attributable to the headquarters and other acquired branches as well as assets that are not branch-specific such as the trust or credit card business. The core branch P&A incorporates the terms of the standard P&A as the standard terms and conditions of the transaction. Generally, the core branch P&A was used in branch breakup transactions for the sale of the headquarters branch or core branch clusters while individual branch offices were sold under the limited branch P&A. (Also see *branch breakup*, *limited branch P&A*, and *standard P&A*.)

core deposits: That portion of a bank's deposits that is relatively stable and has a predictable cost. Deposits fluctuate seasonally and cyclically, but even in adverse circumstances, deposits normally do not fall below some minimum level.

corrective action plan (CAP): A plan for correcting organizational or operational weaknesses. As defined in the FDIC Internal Control Review program, a CAP states the deficiency, the corrective action required to cure the deficiency, the person or persons responsible for the action, and actual or expected completion dates for the required actions.

cost-plus: The practice of establishing the selling price for a product or service by adding a fixed amount or percentage to costs. For example, the FDIC's ALA contractors received a cost-plus compensation package.

cost test: The statutory requirement before enactment of FDICIA that a P&A transaction be less costly to the relevant insurance fund than a payoff and liquidation. The "cost test" was introduced in 1982 by the Garn–St Germain Depository Institutions Act, which enhanced the power of the FDIC and FSLIC to provide aid to troubled institutions and imposed the condition that the assistance provided must be less costly than the cost of liquidation.

critically undercapitalized: One of the five capital categories of financial condition established by FDICIA and codified in section 38 of the FDI Act. The five categories are well-capitalized, adequately capitalized, undercapitalized, significantly undercapitalized, and critically undercapitalized. Section 38 requires banking supervisors to impose constraints on insured depository institutions that are determined to be in any of the latter three categories. An insured depository institution is “critically undercapitalized” if its ratio of tangible capital to total assets is equal to or less than 2 percent.

cross guarantee: A provision of the FDI Act added by FIRREA that allows the FDIC to recover part of its costs of liquidating or assisting a troubled insured institution by assessing those costs to the remaining solvent insured institutions which are commonly controlled as defined in the statute. When the FDIC acts to protect its interests under this provision, the assessment can result in a liquidity strain or, in some cases, the immediate insolvency of an affiliated bank.

deficiency: The dollar amount that is owed to a lender after foreclosure or repossession has occurred. The deficiency is normally the sum of principal debt outstanding, unpaid interest, and late charges remaining as a legal obligation, minus the net value of the foreclosed or repossessed asset.

de novo judicial review: A court’s independent review of the facts and the law with no deference to the agency’s original determination. The court makes its determination based on the facts of the case, independent of any prior decision by the agency.

Deposit Insurance National Bank (DINB): The Banking Act of 1933 authorized the FDIC to establish a “new” bank called a DINB to assume the insured deposits of a failed bank. Passage of the act permitted the FDIC to pay the depositors of a failed FDIC insured institution through a DINB, a national bank that was chartered with limited life and powers. Depositors of a DINB were given up to two years to move their insured accounts to other institutions. A DINB allowed a failed bank to be liquidated in an orderly fashion, minimizing disruption to local communities and financial markets.

deposit payoff: A resolution method for failed FDIC insured institutions that is used when liquidation of the institution is determined to be the least costly resolution or when no assuming institution can be found. Deposit payoffs generally have two forms: (1) a straight deposit payoff, in which the FDIC directly pays the insured amount of each depositor, and (2) an insured deposit transfer, in which a healthy institution is paid by the FDIC to act as its agent and pay the insured deposits to customers of the failed institution. A deposit payoff is sometimes called a payoff. (Also see *payoff* and *insured deposit transfer*.)

depositor discipline: One aspect of “market discipline.” The concern of depositors for the safety of their deposits is theorized to control the riskiness of a bank’s investment and lending portfolios. (Also see *market discipline*.)

depository: A bank or other entity responsible for holding assets in safekeeping.

Depository Institutions Deregulation and Monetary Control Act (DIDMCA): The 1980 act that began the process of phasing out Regulation Q, the regulation that had placed a ceiling on the rates of interest banks and thrifts could offer their depositors. DIDMCA sought to deregulate banking and promote more competition in the banking industry to benefit customers. It also permitted S&Ls to issue credit cards and offer checking accounts, and it increased FDIC insurance coverage on insured deposits from \$40,000 to \$100,000.

derived investment value (DIV): A valuation model that was developed for the RTC, primarily to value portfolios of real estate and nonperforming commercial mortgages. The DIV model discounts expected future cash flows, using many rules that govern holding periods, marketing periods, various discount rates by asset type, and so on. The DIV model has been widely used to value the collateral underlying commercial mortgage-backed securities.

discounted payoff: The payoff of a nonperforming loan at a price that is below the book value of the asset; for example, a 15 percent discount would equate to a price that is 85 percent of book value.

distressed asset: Owned real estate, nonperforming loan, or other troubled asset. The market value of a distressed asset is almost always less than it was projected to be when the investment was originally made and is often below the asset's current book value.

Division of Resolutions and Receiverships (DRR): An FDIC organizational unit, created in late 1996 by combining the Division of Resolutions (DOR) and the Division of Depositor and Asset Services (DAS).

D'Oench Duhme: One of the "superpower" remedies relied on extensively by the FDIC and the RTC in disposing of assets. *D'Oench Duhme* has existed since the 1940s and essentially states that side agreements that are not recorded on the books or records of a financial institution cannot be enforced.

due diligence: A potential purchaser's on-site inspection of the books and records of a failing institution. Before an institution's failure, the FDIC invites potential purchasers to the institution to review pertinent files so they can make informed decisions about the value of the failing institution's assets. All potential purchasers must sign a confidentiality agreement. In addition, contractors may be hired to perform due diligence work on assets that are earmarked for multi-asset sales initiatives. By hiring outside firms to provide and certify the due diligence, investors have the assurance that an independent source provides them with reliable investment information.

duty of care: One of the principal fiduciary duties of bank directors and trustees. The duty of care requires directors and trustees to make appropriate inquiries and acquaint themselves with all information reasonably available to them before making a business decision, and to act with requisite care after becoming so acquainted.

duty of loyalty: The fiduciary obligation of a bank director or trustee to act in the best interest of the institution and its constituents, as opposed to acting for the fiduciary's own interest or for the benefit of outsiders.

energy bank: Commercial banks, often located in the southwest, that provided credit to the energy industry during the period of the study, 1980 through 1994.

entrance fee: A fee required by statute to be paid to the Bank Insurance Fund when an insured depository institution participates in a conversion transaction wherein insured deposits are transferred from a Savings Association Insurance Fund member to a Bank Insurance Fund member. The entrance fee assessed in connection with a conversion from SAIF to BIF is the amount derived by multiplying the dollar amount of the deposits transferred from SAIF to BIF by the BIF reserve ratio. The entrance fee assessed in connection with a SAIF conversion is the amount derived by multiplying the amount of deposits transferred from BIF to SAIF by the SAIF reserve ratio or by .01 percent, whichever is greater.

equity partnerships: An RTC asset disposition program in which the RTC transferred a share of the ownership and certain rights and responsibilities regarding specific assets but retained the right to share in future profits. The program was used to dispose of nonperforming commercial mortgages, nonperforming business loans, land, and other distressed assets.

essentiality: Under section 13(c) of the FDI Act as originally enacted, the FDIC was allowed to assist an open bank to prevent its failure if the FDIC Board of Directors determined that the insured bank was in danger of failing and continued operation of such bank was "essential." Section 13(c) of the FDI Act was revised by the Garn–St Germain Depository Institutions Act; and this essentiality test was replaced by the cost test, except for cases in which the cost of providing open bank assistance was expected to exceed the cost of liquidating the failed institution. (Also see *cost test*.)

estimated cash recovery (ECR): An estimate of the amount and timing of all future cash recoveries, direct expenses, and payment of any prior liens. An ECR is a projection of expected net cash flows and often is used in the process of valuing a nonperforming loan.

estimated recovery value (ERV): A mark-to-market valuation of an asset, determined by calculating the net present value of expected net cash flows. The RTC calculated an ERV for each asset that was assigned to the original SAMDA contracts. This method of valuation was similar in concept to the FDIC's "net present value of the estimated cash recovery."

exit fee: A fee required by statute to be paid to the Savings Association Insurance Fund (or the Financing Corporation, as determined by the secretary of the Treasury) when an insured depository institution participates in a conversion transaction wherein insured

deposits are transferred from a SAIF member to a BIF member. The exit fee assessed in connection with a conversion from SAIF to BIF is the amount derived by multiplying the dollar amount of deposits transferred from SAIF to BIF by .90 percent. The exit fee assessed in connection with a conversion from BIF to SAIF is the amount derived by multiplying the dollar amount of the retained deposit base transferred from BIF to SAIF by .01 percent.

failure: The closing of a financial institution by its chartering authority, which rescinds the institution's charter and revokes its ability to conduct business because the institution is insolvent, critically undercapitalized, or unable to meet deposit outflows.

Farmers Home Administration (FmHA): A federal agency created in the 1930s in the U.S. Department of Agriculture. Its mission is to support American farmers through commodity programs, farmer operating and emergency loans, conservation, domestic and overseas food assistance, and disaster programs. In a 1994 USDA reorganization, FmHA became the Farm Service Agency (FSA).

Federal Asset Disposition Association (FADA): A corporation, chartered as a savings and loan and wholly owned by the FSLIC, created in 1985 by the FHLBB to manage and liquidate assets of failed thrifts. One of the RTC's duties was to liquidate the FADA within 180 days from the enactment of FIRREA.

Federal Deposit Insurance Act (FDI Act): A 1950 act that, among other things, (1) increased the FDIC deposit insurance limit from \$5,000 to \$10,000 and (2) granted the FDIC the authority to provide open bank assistance through loans or the purchase of assets to prevent the failure of an insured bank. Under the "essentiality doctrine" of the FDI Act, a bank was eligible for open bank assistance only if the FDIC Board of Directors decided that the continued operation of the institution was "essential."

Federal Deposit Insurance Corporation Improvement Act (FDICIA): A comprehensive package of legislation, enacted in 1991, that included (1) a "least cost" test, imposed in the resolution process, that required the FDIC to evaluate all resolution alternatives, including liquidation, and to choose the resolution method least costly to the relevant insurance fund; (2) section 131 of FDICIA, which imposed new capital requirements, effective December 19, 1992, whereby institutions were to be closed before they became insolvent, although banks with tangible capital of less than 2 percent of assets were "critically undercapitalized" and subject to immediate closure; and (3) an extension of the time period for the RTC to accept conservatorship and receivership appointments from August 31, 1992, to October 1, 1993, a date after which the FDIC would assume responsibility for failed thrifts and would pay losses from the SAIF.

Federal Financing Bank (FFB): A bank established by the Federal Financing Bank Act of 1973 with a mission to (1) assure coordination between federal borrowing programs and the overall economic and fiscal policies of the federal government and (2) reduce the cost of federal and federally assisted borrowings from the public. The FFB has become

the vehicle through which most federal agencies finance their programs involving the sale or placement of credit market instruments, including agency securities. The FFB is under the general supervision of the secretary of the Treasury, and it is managed and staffed by Treasury employees.

Federal Home Loan Bank(s) (FHLB[s]): A system of banks created in 1932 by the Federal Home Loan Bank Act, which established 12 regional FHLBs to encourage home loans by local thrifts during the Great Depression that began in 1929. The FHLBB was responsible for overseeing the FHLBs from 1932 to 1989, when FIRREA transferred this function to the Federal Housing Finance Board.

Federal Home Loan Bank Board (FHLBB): A five-member board established on July 22, 1932, by the Federal Home Loan Bank Act. The board was authorized to establish Federal Home Loan Banks with the authority to regulate and supervise S&Ls, as well as to lend money to S&Ls, which would in turn finance home loans. The FHLBB retained these basic responsibilities until the passage of FIRREA in August 1989. FIRREA created the Federal Housing Finance Board to succeed the FHLBB, and some of the FHLBB's functions were transferred to the FDIC, the RTC, and the OTS.

Federal Home Loan Mortgage Corporation (Freddie Mac): A corporate instrumentality of the United States, created by Congress on July 24, 1970. Freddie Mac is owned by its shareholders and accountable to its shareholders and a board of directors. Its primary mission is to increase the availability of money from mortgage lenders to homebuyers and investors in multi-family residential property. As one of the biggest buyers of home mortgages in the United States, Freddie Mac is a secondary market conduit between mortgage lenders and investors.

Federal Housing Administration (FHA): A division of the U.S. Department of Housing and Urban Development that insures mortgage loans for a variety of purposes, but primarily for those related to residential housing. Congress originally created the FHA in 1934 to make homeownership possible for first-time homebuyers. Today the FHA helps low- to middle-income families to purchase a home without making a large down payment, encourages improvement in housing standards and conditions, and provides a system of government-guaranteed mortgage insurance.

Federal National Mortgage Association (Fannie Mae): A tax-paying corporation, owned entirely by private stockholders, established in 1938 to provide additional liquidity to the mortgage market. In 1968, the original Fannie Mae was reorganized into two corporations: the privately-owned Fannie Mae and the government-owned Ginnie Mae. Fannie Mae purchases and sells residential mortgages insured by the Federal Housing Administration or guaranteed by the Veterans' Administration, as well as conventional home mortgages. Purchases of mortgages are financed by the sale of mortgage-backed securities to private investors. Fannie Mae operates with regulatory oversight from both the U.S. Treasury Department and the U.S. Department of Housing and Urban Development.

Federal Reserve Bank (FRB): One of the 12 regional banks in the Federal Reserve System. The 12 FRBs and their 25 branches, which are managed by the Board of Governors of the Federal Reserve System, perform a variety of functions, including operating a nationwide payments system, distributing the nation's currency, supervising and regulating member banks and bank holding companies, and serving as banker for the U.S. Treasury. The FRBs supervise and examine state chartered banks that are members of the Federal Reserve System (state member banks).

Federal Reserve System (Fed): The central banking system of the United States, founded by Congress in 1913 to provide the nation with a safer, more flexible, and more stable monetary and financial system. Over the years, the Fed's role in banking and the economy has expanded. The Fed administers the nation's monetary policy using three major tools: open market operations, the reserve requirement, and the discount rate. The Fed also plays a major role in the supervision and regulation of the U.S. banking system. The Board of Governors of the Federal Reserve System (the Federal Reserve Board) is made up of seven members appointed to 14-year terms by the president of the United States and confirmed by the Senate. The chairman and vice chairman of the board, however, serve four-year terms. The Federal Reserve Board's policies are carried out by the 12 regional Federal Reserve Banks.

Federal Savings and Loan Insurance Corporation (FSLIC): The federal corporation chartered by Congress in 1934 to insure deposits in savings institutions. The FSLIC also served as a conservator or receiver for troubled or failed insured savings associations. Effective April 1, 1980, for insured savings and loan institutions, the FSLIC insured savings accounts up to \$100,000. The FSLIC functioned under the direction of the FHLBB, which provided certain administrative services and conducted the examination and supervision of insured S&Ls. In 1989, Congress abolished the FSLIC, transferring its resolution, conservatorship, and receivership functions to the RTC and its responsibilities for the deposit insurance fund to the Savings Association Insurance Fund, which is administered by the FDIC.

fidelity bonds: Insurance provided to indemnify employees against loss by reason of the dishonesty of employees or as a result of the nonperformance of contracts. In fidelity insurance contracts, the insurance company issues fidelity insurance bonds as a guarantee against loss arising from the default or dishonesty of the insured person. Fidelity bonds are issued for three classes of risk: larceny, culpable negligence, and unfaithful discharge of duty.

financial advisers: Contractors in the private sector who are hired to help select assets for portfolio sales, manage the due diligence process, provide sellers with an opinion about the market value of the assets, find buyers, and negotiate the final terms and conditions of sales contracts. The expertise provided by financial advisors was especially useful to the FDIC and the RTC in organizing and executing their mortgage-backed securities programs.

Financial Institutions Reform, Recovery, and Enforcement Act (FIRREA): Legislation that established the Resolution Trust Corporation and the Oversight Board of the RTC as instrumentalities of the United States. Enacted by Congress on August 9, 1989, it includes section 21A of the Federal Home Loan Bank Act (*U.S. Code*, volume 12, 1441[a]), as added by section 501(a) of FIRREA (Public Law No. 101-73, section 501[a], 103 Statute 83, 363-393). Resulting from the thrift crisis of the late 1980s, FIRREA revised the structure of the deposit insurance system creating a new Bank Insurance Fund and a Savings Association Insurance Fund, both of which were to be administered by the FDIC. FIRREA abolished the FHLBB and the FSLIC. FIRREA divided the Federal Home Loan Bank System into three parts: the OTS, under the general oversight of the secretary of the Treasury; the SAIF; and the Federal Housing Finance Board, which was responsible for overseeing the lending activities of the 12 regional Federal Home Loan Banks. A separate FDIC fund, the FSLIC Resolution Fund, was established to assume the assets and liabilities of the FSLIC except for those transferred to the RTC.

forbearance: A bank resolution method used by the FDIC in the mid-1980s. Forbearance exempted certain distressed institutions that were operating in a safe and sound manner, from minimum capital requirements. The forbearance program was designed for well-managed, economically sound institutions with concentrations of 25 percent or more of their loan portfolios in agricultural or energy loans. Forbearance is also a means of handling a delinquent loan. A “forbearance agreement” is a written agreement providing that a lender will delay exercising its rights (in the case of a mortgage, foreclosure) as long as the borrower performs in accordance with certain agreed-upon terms.

FSLIC Resolution Fund (FRF): A federal fund established under FIRREA in 1989 in response to the thrift crisis of the 1980s. Funded by congressional appropriations, the FRF is responsible for the satisfaction of all debts and liabilities and the sale of all assets of the former FSLIC and the former RTC.

Garn–St Germain Depository Institutions Act (Garn–St Germain): Legislation enacted in 1982 that gave the thrift industry a great deal more flexibility in managing assets and liabilities. It gave the thrift industry the right to (1) invest up to 50 percent of assets in construction and development loans; (2) invest up to 30 percent of assets in consumer loans, commercial paper, and corporate debt; (3) own real estate development companies; (4) use land and other noncash assets in the capitalization of new charters, instead of the previously required cash; and (5) offer money market deposit accounts.

General Accounting Office (GAO): An investigative arm of the U.S. Congress charged with examining all matters relating to the receipt and disbursement of public funds. Established in 1921 to independently audit federal government agencies, the GAO functions under the direction of the comptroller general of the United States, who is appointed by the president and confirmed by the Senate for a 15-year term.

general creditors: Entities, including uninsured depositors, suppliers, tradespeople, and contractors, with unsecured claims against a failed financial institution.

general grade (GG): A classification of federal civil service employees who have “career status” regarding pay and benefits.

general partner: A type of partner within a general or limited partnership. In a general partnership, there are two or more general partners, all the partners are general, and they are all co-owners liable for company debts to the full extent of their personal assets. In a limited partnership, there are one or more general partners and the business is managed by the general partner(s).

generally accepted accounting principles (GAAP): Accounting rules and conventions established by the Financial Accounting Standards Board that define acceptable practices in preparing financial statements.

Government National Mortgage Association (Ginnie Mae): A wholly owned government corporation within HUD, established in 1968 as a spinoff from Fannie Mae. The main functions of Ginnie Mae are (1) the purchase and sale of certain FHA and VA mortgages pursuant to various programs designed to support the housing market and (2) the guarantee of mortgage-backed securities secured by pools of FHA and VA mortgages.

gross cash recovery (GCR): The gross cash collections projected during the expected holding period of an asset (or a pool of assets) in a receivership.

gross collections: The gross cash recoveries—prior to paying the holding, marketing, and selling costs—resulting from the disposition of one or more assets.

gross negligence: A standard of conduct under which an officer or director of a failed institution may be held personally liable for monetary damages in a civil action. This standard generally establishes “liability” based upon culpable conduct that is grossly negligent or worse, although definitions vary from state to state.

hard-to-sell asset: Those assets remaining unsold other than cash, securities, and performing single-family residential mortgages. By dollar amount, most of the RTC’s hard-to-sell assets consisted of commercial mortgages, owned real estate, and subsidiary assets.

income capital certificate (ICC): A method of assistance developed in 1981 by the FSLIC to provide noncash assistance to mutual savings institutions. From 1981 through 1985, the FSLIC gave notes to troubled institutions in exchange for ICCs. The troubled thrift carried the FSLIC note as an asset, and the offsetting liability (the dollar amount of the ICC) was included within regulatory capital.

income maintenance agreement (IMA): A resolution method used by the FDIC in the early 1980s to guarantee a market rate of return on the acquired assets of failed savings

banks. The FDIC paid the acquirer the difference between the yield on assets acquired and the average cost of funds of savings banks.

indemnification: In general, a collateral contract or assurance under which one person agrees to secure another person against either anticipated financial losses or potential adverse legal consequences.

Industrial Bank Savings Guaranty Corporation (IBSGC): A Colorado nonprofit corporation that provides deposit insurance for state chartered industrial banks.

information package: A collection of detailed information about the amounts and types of assets and liabilities of a failed or failing institution. The information varies, depending on the composition of assets and liabilities of the troubled institution. An information package, which is subject to a confidentiality agreement, is provided to potential purchasers to facilitate their analyses of the failing institution. (Also see *confidentiality agreement*.)

inherent risk: The potential for fraud, waste, abuse, or mismanagement in an organizational unit without regard to the controls contemplated or already in place, as defined in the FDIC Internal Control Review program.

initial targeted cash value (ITCV): An estimate of the gross cash collections expected from the disposition of a pool of assets assigned to an asset manager under an RALA.

insured deposit: Deposit in an FDIC insured commercial bank, savings bank, or savings association that is fully protected by FDIC deposit insurance. Savings, checking, and other deposit accounts, when combined, are generally insured up to \$100,000 per depositor in each financial institution insured by the FDIC. Deposits held in different ownership categories, such as single or joint accounts, are separately insured. Also, separate \$100,000 coverage is usually provided for retirement accounts, such as individual retirement accounts.

insured deposit transfer (IDT): A type of deposit payoff in which the insured and secured deposits of a closed bank or thrift are transferred to a transferee or agent institution in the community, permitting a direct payoff of the failed institution's depositors by the agent institution. The agent institution pays customers of the failed institution the amount of their insured deposits or, at the customer's request, opens a new account in the agent institution for the customer. When no assuming bank can be found for the failed bank, an insured deposit transfer is an alternative to a straight deposit payoff. (Also see *deposit payoff* and *straight deposit payoff*.)

internal control systems: Processes designed to provide reasonable assurance that control objectives are achieved, according to the FDIC Internal Control Review program.

internal rate of return (IRR): A discount rate at which the present value of future net cash flows of an investment equals the cost of the investment.

investment grade: Corporate debt securities that are rated in the top four rating categories (AAA, AA, A, BBB) by one of the nationally recognized bond rating organizations.

JDC Program: An RTC equity partnership program. The ownership entity was a limited partnership, in which an investor with collection experience was the general partner and the RTC was a limited partner. There were 30 partnerships created under this program, with an average book value of \$414 million in JDCs per partnership.

judgment: An obligation to pay; created by a court and evidenced by an official certificate. A judgment may include loan principal, unpaid interest, unpaid taxes, legal fees, court costs, and other collection expenses.

Judgments, deficiencies, and charge-offs (JDC): The three categories of the assets of a failed institution marketed together by the RTC in its JDC program.

junk bond: High-yield, high-risk debt that, in many cases, was issued to finance corporate takeovers.

Land Fund: One form of the RTC's equity partnerships, targeted for the smaller investor to broaden the market as much as possible. Land Fund portfolios consisted primarily of undeveloped and partially developed tracts of commercially and residentially zoned land. There were three RTC Land Fund transactions.

Land Use Restriction Agreement (LURA): An agreement that controls use of single-family and multi-family residential property sold in the RTC Affordable Housing Disposition Program. The LURA used for single-family residential property requires the purchaser to certify to owner occupancy and income eligibility. The LURA used for multi-family residential property requires that a certain percentage of units be continuously rented to lower-income households.

least cost test: A procedure mandated by FDICIA that requires the FDIC to implement the resolution alternative that is determined to be least costly to the relevant deposit insurance fund of all possible resolution alternatives, including liquidation of the failed institution. Before enactment of FDICIA, the FDIC could pursue any resolution alternative, as long as it was less costly than a deposit payoff combined with liquidation of the failed bank's assets. (Also see *deposit payoff* and *Federal Deposit Insurance Corporation Improvement Act*.)

letter of credit: An instrument or document issued on behalf of a buyer stating that the issuer will honor drafts or other demands for payment upon compliance with the conditions specified in the letter. Letters of credit must be issued in conformity with all applicable rules and regulations. The credit may be revocable or irrevocable. The engagement can be either an agreement to honor or a statement that the issuer is authorized to honor the credit.

limited branch P&A: A component of a purchase and assumption transaction in an RTC branch breakup resolution. Under the terms of the limited branch P&A, the acquiring institution assumes all of the deposits and other liabilities of the failed institution directly attributable to the acquired branches. The acquirer also purchases certain assets

directly attributable to the acquired branches. The limited branch P&A incorporates the terms of the standard P&A as the standard terms and conditions of the transaction. Generally, the limited branch P&A was used in branch breakup transactions for any branch or branches not transferred to the core branch P&A acquirer. (Also see *branch breakup*, *core branch P&A*, and *standard P&A*.)

limited partnership: A partnership in which certain partners are designated general partners and some are designated limited partners. A limited partnership registers as a limited partnership in the state in which it is organized. The general partners manage the business. The liabilities of the limited partners are limited if certain legal requirements are met.

liquidating dividend: A pro rata distribution to uninsured depositors and creditors of the net proceeds of the liquidated assets of a failed institution.

liquidation: The winding down of the business affairs and operations of a failed insured depository institution through the orderly disposition of its assets after it has been placed in receivership.

liquidation cost: The resolution cost that the FDIC will incur if it pays off only the insured depositors and liquidates the assets of the failed institution.

liquidation differential: The decrease in value (if any) of a failed bank's assets that results from liquidating them, rather than having the assets managed by an operating entity.

liquidation grade (LG): Classification of federal civil service employees who have temporary status regarding pay and benefits.

Loan Loss Amortization Program: A capital forbearance program authorized by Congress in 1986. This program provided relief to 33 agricultural banks by permitting them to defer the recognition of agricultural loan losses. Only institutions with less than \$100 million in total assets and with at least 25 percent of their total loans in qualified agricultural credits were eligible for the program. The Loan Loss Amortization Program allowed such banks to amortize these losses over a seven-year period.

loan purchase P&A: An FDIC purchase and assumption transaction in which the acquirer assumes the deposit liabilities and certain other liabilities of the failed institution and purchases only a portion of the loan portfolio, usually just the installment loans, in addition to the cash and cash equivalent assets.

loan servicer: A contractor hired by the FDIC and the RTC to manage loans of failed institutions.

loss sharing: A method in a purchase and assumption transaction in which the FDIC as receiver agrees to share with the acquirer losses on certain types of loans. Loss sharing may be offered by the receiver in connection with the sale of classified or nonperforming loans that otherwise might not be sold to an acquirer at the time of resolution. The FDIC usually agrees to absorb a significant portion (for example, 80 percent) of future disposition losses on assets that have been designated as "shared loss assets" for a specific

period of time (for example, three to five years). The economic rationale for such transactions is that retaining shared loss assets in the banking sector would produce a better net recovery than would the FDIC's liquidation of the assets.

management control review (MCR): An examination of a system of internal controls for a particular process or function as defined by the FDIC Internal Control Review program. The main goal of a management control review is to document controls that are currently in place.

managing agent (MA): The FDIC or RTC employee responsible for managing day-to-day operations of an institution in conservatorship. The MA prepares the institution for resolution by downsizing (selling assets).

market discipline: The forces in a free market (without the influence of government regulation) which tend to control and limit the riskiness of a financial institution's investment and lending activities. Such forces include the concern of depositors for the safety of their deposits and the concern of bank investors for the safety and soundness of their institutions.

minority resolution program: A resolution program that favors a minority individual, a minority-owned business, or a minority depository institution. For example, the Completion Act gave a bidding preference to minority bidders and acquirers in connection with the resolution of failed institutions located in "predominantly minority neighborhoods."

modified payoff: A variation of the straight deposit payoff. In a modified payoff, the FDIC sells some of the assets of a failed or failing institution to an acquirer, whereas in a straight deposit payoff the FDIC directly pays the insured amount of each insured depositor and liquidates the remaining assets. (Also see *straight deposit payoff*.)

modified whole bank P&A: A purchase and assumption transaction in which the acquiring institution assumes the deposits and certain other liabilities of the failed institution. In addition to purchasing the cash and cash equivalent assets, the acquiring institution also receives an exclusive call option to purchase fixed assets owned by the failed institution. (Also see *whole bank P&A*.)

moral hazard: A potentially costly side effect of most insurance. Persons or companies insured against a particular risk have a tendency to assume more risk. For example, deposit insurance tends to encourage banks to hold riskier portfolios than they otherwise would.

mortgage: An interest in land created by a written instrument providing security for the performance of a duty or the payment of a debt.

mortgage-backed security (MBS): An ordinary bond backed by an interest in a pool of mortgages or trust deeds. The interest and principal payments collected on the underlying mortgages are the source of income to the bondholders. The RTC, which began

issuing one-to-four family residential mortgage-backed securities in June 1991, was instrumental in developing the MBS market in the early 1990s. Most mortgage-backed securities have AA or AAA bond ratings. (Also see *securitization*.)

Multiple Investor Fund (MIF): An RTC equity partnership created in early 1993 and targeted for the large institutional investor market. The two MIF transactions disposed of approximately 1,000 nonperforming and subperforming commercial mortgages, with an aggregate book value of approximately \$2 billion.

mutual: A savings institution organized in a nonstock business form. Neither mutual savings banks nor mutual savings institutions have stockholders. All depositors in a mutual institution have a share in the ownership of the institution, according to the amounts of their deposits.

N-Series: An RTC equity partnership targeted for the institutional investor market. There were six Nonperforming Loan Series, or N-Series, transactions, consisting of relatively large portfolios of nonperforming and subperforming commercial mortgages. The N-Series asset pools had an average book value in excess of \$450 million.

national depositor preference amendment: Provisions of the Omnibus Budget Reconciliation Act, that established the priority for paying claims filed against a failed depository institution. The Omnibus Budget Reconciliation Act was enacted on August 10, 1993, and amended section 11(d) of the FDI Act and standardized the assets distribution scheme for all receiverships regardless of the institution's chartering agency. As a result of this act, deposit liabilities of the institution have priority over all claims except the administrative expenses of the receiver. (Also see *advance dividend*.)

nationalization: The takeover by the government with or without compensation of a private entity. The Continental Illinois Corporation assistance transaction of 1984 was referred to at the time by some commentators as a "nationalization" of the bank, since the FDIC acquired an 80 percent equity interest in the bank under the terms of the assistance agreement.

net collections: The net cash recoveries resulting from the disposition of a portfolio of assets. Generally speaking, net collections are equal to gross collections less all relevant holding, marketing, and selling costs during the collection period.

net present value (NPV): The net present value is the value today of a series of future cash flows discounted at a suitable discount rate. The net present value is sometimes referred to as the "present value." (Also see *net recovery rate*.)

net recovery rate: Ratio of the net-present-value-of-net-collections-to-book-value-reductions. This performance measurement, in contrast with the "recovery rate," involves discounting net collections at an appropriate discount rate to determine the "net present value of net collections" before this ratio can be calculated. The net recovery rate is sometimes referred to as the "net recovery."

net worth certificate (NWC): A capital instrument purchased by the FDIC or the former FSLIC under a special program created by Congress in 1982 to maintain or increase the capital of troubled institutions that qualified for the program. Under this program, the FDIC purchased a net worth certificate from a qualified institution in exchange for an FDIC insured promissory note, which was an asset on the bank's books, with the offsetting liability of the net worth certificate counted as regulatory capital. Extended twice by Congress, this program expired in 1986.

New Hampshire Plan: The strategy used in resolving seven New Hampshire banks that failed in October 1991. The FDIC combined and marketed the banks as two franchises instead of marketing the failed bank franchises individually. The FDIC appointed a third-party contractor under an asset management contract to manage and dispose of the failed banks' distressed assets. The New Hampshire Plan was significant in part because it was the first time the FDIC solicited asset management contractors that were not eligible to be assuming institutions.

NP-Series: An RTC equity partnership created in 1995 and designed for the smaller investor. The composition of NP-Series portfolios was similar to that of the N-Series, S-Series and SN-Series pools; however, the portfolios of the NP-Series were the smallest in the RTC equity partnership program, averaging under \$70 million in book value each.

Oakar Amendment: An amendment to section 5(d) of the FDI Act of 1950 named for its sponsor, Congresswoman Mary Rose Oakar. The amendment allowed an institution to avoid the prohibition against conversion of insured deposits between insurance funds, with approval of the appropriate federal regulatory authority. The Oakar amendment authorized any state depository institution to merge, consolidate, or transfer the assets and liabilities of an acquired institution while maintaining existing fund coverage of the acquired deposits.

Office of the Comptroller of the Currency (OCC): A bureau within the U.S. Department of the Treasury, established in 1863. The OCC charters, regulates, and supervises national banks, which can usually be identified because they have the word "national" or "national association" in their names. The OCC also supervises and regulates the federally licensed branches and agencies of foreign banks doing business in the United States. The comptroller of the currency, who is appointed by the president of the United States, with Senate confirmation, and who is one of the FDIC's five directors, heads the OCC.

Office of Inspector General (OIG): An independent federal organization established to audit the programs and operations of the FDIC and to investigate complaints of fraud, waste, and mismanagement in those programs. The Inspector General Act of 1978, as amended, required the chairman to appoint an inspector general beginning in 1989, the position changing to a presidential appointment in 1994. The RTC was required to have a presidentially-appointed inspector general throughout its life.

Office of Thrift Supervision (OTS): An organization within the U.S. Department of the Treasury, established on August 9, 1989, by FIRREA. The OTS, with five regional offices located in Jersey City, Atlanta, Chicago, Dallas, and San Francisco, is the primary regulator of all federal and many state chartered thrift institutions. A director, who is appointed by the president, with Senate confirmation, for a five-year term and who is one of the five FDIC directors, heads the OTS.

open bank assistance (OBA): A resolution method in which an insured bank in danger of failing receives assistance in the form of a direct loan, an assisted merger, or a purchase of assets. OBA usually entails a change in bank management and requires substantial dilution of shareholder interest in the troubled institution. Originally, as provided in the FDI Act of 1950, the FDIC could grant open bank assistance only if the institution's continued operation was deemed "essential." With the passage of the Garn–St Germain legislation in 1982, an institution could receive assistance if the cost of the assistance was less than the cost of liquidating the institution. When FDICIA was enacted in 1991, OBA had to be deemed least costly to the insurance fund of all possible resolution methods. A later amendment to FDICIA prohibited providing assistance to the shareholders of a troubled institution. The FDIC rescinded its OBA policy statement in 1996.

Operation Clean Sweep: A catch phrase coined in the spring of 1990 by FDIC Chairman L. William Seidman in a speech to the National Press Club when he announced that the RTC would sell or liquidate 141 conservatorship institutions by June 30, 1990, including at least 50 institutions that would be liquidated without any sales attempts because these institutions were determined to have little franchise value. Chairman Seidman referred to these liquidations as "Operation Clean Sweep."

oversight manager: A person designated by a program office to monitor the activities of a contractor.

owned real estate (ORE): An accounting classification of real estate. Marketable title has normally been acquired by (1) judicial or nonjudicial foreclosure, (2) deed in lieu of foreclosure, or (3) by purchase or other acquisition to protect the institution's interest in a debt or debts previously contracted. The FDIC's ORE also includes all real estate acquired for investment or resale and the book value of any premises purchased directly or acquired by means of a capital lease used in the reporting receivership's business operations, net of accumulated depreciation. Also known as real estate owned (REO).

pass-through receivership: Method used by the OTS to transfer the assets and liabilities of a failed thrift to a newly chartered institution placed in RTC conservatorship. Under this method, the OTS closes the institution, appoints a receiver, and passes the assets and liabilities of the failed thrift to the new institution, which is then placed in conservatorship.

payoff: A resolution method for a failed bank or thrift in which the FDIC directly pays the insured amount of each insured depositor. Also known as a deposit payoff. (Also see *deposit payoff*.)

portfolio sale: The marketing and sale of a large portfolio of similar assets. Portfolio sales usually have been accomplished through sealed bid sales at the FDIC. Also known as a bulk sale.

professional liability program: An investigation by the FDIC or the RTC of all potential claims (inherited from each receivership) for losses caused by the wrongful conduct of officers, directors, lawyers, accountants, brokers, appraisers, or others who have provided services to the failed institution.

prompt corrective action (PCA): A provision of FDICIA, which amended the FDI Act by adding section 38. The PCA provision, among other things, requires regulators to take prompt corrective action to resolve the problems of an insured depository institution. Unless other action is determined to be appropriate, regulators are required to close an institution that is “critically undercapitalized” and unable to provide an adequate capital restoration plan. (Also see *critically undercapitalized* and *Federal Deposit Insurance Corporation Improvement Act*.)

purchase and assumption (P&A): A resolution method in which a healthy insured institution purchases some or all of the assets and assumes the deposit liabilities of a failed bank or thrift. On a case-by-case basis, the assuming institution’s bid may be sufficient to allow assumption of all the deposit liabilities of the failing institution, including the uninsured deposits.

put option: A provision in some purchase and assumption agreements under which an assuming institution has the option of requiring the FDIC, within a specified time frame, to repurchase certain loans that have been transferred to the acquiring institution under a P&A agreement.

qualified financial contract (QFC): A type of financial agreement that includes, but is not limited to, securities contracts, forward contracts, repurchase agreements, and swap agreements. When a receiver repudiates a QFC, damages are measured as of the date of the repudiation and may include the cost of acquiring a replacement QFC. Special rules for the repudiation of QFCs are necessary to protect domestic financial markets.

Real Estate Mortgage Investment Conduit (REMIC): A mortgage-backed securities vehicle, authorized by the Tax Reform Act of 1986, that holds residential or commercial mortgages and issues securities representing interests in those mortgages. The REMIC structure (1) qualifies as an asset sale for tax purposes, (2) offers tax and accounting flexibility to portfolio lenders, and (3) creates a broad investor market through multiple

classes of securities. The REMIC itself is normally exempt from federal income tax, but investors generally report the interest from the securities as taxable income.

Real Estate Owned Management System (REOMS): A national database system that provided the RTC with an online inventory control system designed to monitor the acquisition, management, and disposition of real estate owned.

receivership: The legal procedure for winding down the affairs of an insolvent institution.

receivership certificate: A document issued by the receiver that represents the total amount of the proved claim that each depositor or unsecured creditor has against a failed bank or thrift in receivership.

Reconstruction Finance Corporation (RFC): An entity established by Congress in 1932 to extend credit on an emergency basis “to stop deflation in agriculture and industry” to banks, agricultural credit institutions, railroads, insurance companies, and public works. In its heyday, the RFC was the leading federal domestic financing agency and its financing activities included war projects during World War II. The RFC went out of existence on June 30, 1954.

recovery rate: Ratio of net-collections-to-book-value-reductions. This performance measurement does not consider the time value of money. (Also see *net recovery rate*.)

Regional Asset Liquidation Agreement (RALA): Asset management contract between the FDIC and a private-sector contractor for the management and disposition of distressed assets, primarily nonperforming loans, designed for asset pools under \$500 million in aggregate book value. The FDIC issued four RALA contracts during 1992 and 1993.

representations and warranties: Legally binding statements, made by the parties to a contract, regarding, among other things, asset quality requirements. Representations and warranties, which may extend for only a few months or for the life of the asset or agreement, may protect the purchasers of loans from potential problems associated with missing loan documentation, title defects, or a change in payment status.

repudiate: A receiver’s (or conservator’s) right to disaffirm outstanding contractual obligations previously entered into by a failed insured depository institution. The receiver may take such action only if (1) the contracts are considered burdensome and (2) repudiation will promote the orderly administration of the receivership estate. The FDI Act provides that certain contracts cannot be repudiated.

repudiated contract: A contract of a failed institution that the receiver has repudiated. When contracts are repudiated, damages are limited to actual damages determined as of the date of the appointment of the receiver.

reserve price: The minimum price for which one asset or a portfolio of assets can be sold. A reserve price is often expressed as a percentage of book value for which an asset or a pool of assets can be sold.

residual: Cash flows resulting from the difference between the income stream generated by a pool of mortgages and the cash flow necessary to fund a series of collateralized mortgage obligations (CMOs) or REMIC bonds.

residual value: The economic value or money received by the R-Class bondholder, the FDIC, when (1) the bonds have been paid off and cash flows from the mortgage collateral are still to be generated, or (2) the proceeds from the sale of the mortgage collateral as whole loans are greater than the amount needed to retire the outstanding bonds.

resolution: The disposition plan for a failed institution, designed to (1) protect insured depositors and (2) minimize the losses to the relevant insurance fund, which are expected from covering insured deposits and disposing of the institution's assets. Resolution methods generally include purchase and assumption transactions, insured deposit transfers, and straight deposit payoffs. The term "resolution" can also refer to the assistance plan, through open bank assistance, for a failing institution.

resolution cost: For a given resolution method, the sum of the FDIC's expenditures and obligations incurred, including any immediate or long-term obligations and any direct or contingent liabilities for future payment. Since FDICIA was enacted in 1991, the FDIC has been required to select the resolution method that is least costly to the relevant insurance fund. (Also see *least cost test*.)

Resolution Funding Corporation (REFCORP): A corporation established under FIRREA to fund the activities of the RTC, primarily through bond sales. FIRREA provided private and public funds to deal with thrifts that failed between 1989 and 1999, as well as providing a mechanism to capitalize the new Savings Association Insurance Fund. (Also see *Thrift Depositor Protection Oversight Board*.)

Resolution Trust Corporation (RTC): An entity established in 1989 by FIRREA to oversee the resolution of insolvent thrifts and to dispose of assets acquired from the failed thrifts in the wake of the thrift crisis of the 1980s. The RTC operated from August 9, 1989, to December 31, 1995.

Resolution Trust Corporation Completion Act (RTCCA or Completion Act): Legislation enacted on December 17, 1993, that allowed the RTC to use up to \$18.3 billion to resolve the remaining insolvent thrifts. The Completion Act also (1) extended the RTC's authority to take institutions into conservatorship or receivership from September 30, 1993, to July 1, 1995; (2) accelerated the RTC's closing date by a year from December 31, 1996, to December 31, 1995; (3) reduced the maximum funding authorization of the SAIF; and (4) instituted a wide range of RTC management reforms.

risk: Exposure to uncertain change. In the investment field, risk is the probability that the actual return on an investment will differ from its expected return. For example, a Treasury bill is considered by most investors to have practically no risk. Risks associated with investments in general include interest rate risk, market risk, business risk, financial risk, and liquidity risk. In the FDIC Internal Control Review program, risk is consid-

ered to be the susceptibility of an organizational unit or process to mismanagement, erroneous reports or data, illegal or unethical acts, and adverse public opinion.

risk assessment: Generally, the identification and quantification of risk types, levels, and locations in a process or organizational unit. In the FDIC Internal Control Review program, management tries to identify the susceptibility of an organizational unit or process to the occurrence of waste, loss, unauthorized use, or misappropriation.

RTC Oversight Board: An instrumentality of the federal government created in 1989 by FIRREA and responsible for the general oversight of the REFCORP. (Also see *Thrift Depositor Protection Oversight Board*.)

RTC Refinancing, Restructuring, and Improvement Act (RTCRRIA): Legislation enacted in 1991 that provided funding and organization for the RTC. Among its major provisions, the act (1) provided \$25 billion in new loss funds for the RTC to be used through April 1, 1992; (2) extended the RTC's ability to accept appointment as conservator or receiver over failed thrifts from August 9, 1992, through September 30, 1993; (3) removed the FDIC as the exclusive manager of the RTC; (4) abolished the RTC Board of Directors; (5) established a chief executive officer position at the RTC; and (6) changed the RTC oversight body from the Oversight Board to the Thrift Depositor Protection Oversight Board.

S-Series: An RTC equity partnership created specifically for the smaller investor. The S-Series transactions consisted of relatively small portfolios of nonperforming and subperforming commercial mortgages, similar to the composition of N-Series pools; however, the S-Series pools were smaller in size to permit relatively small investors to participate.

Savings Association Insurance Fund (SAIF): One of the two federal deposit insurance funds created by FIRREA in 1989 and placed under the FDIC's administrative control. Created for the thrift industry, SAIF succeeded the FSLIC as the insurer of deposits to specified limits at savings associations (also called S&Ls) and many savings banks. (Also see *Bank Insurance Fund; Financial Institutions Reform, Recovery, and Enforcement Act; and Federal Savings and Loan Insurance Corporation*.)

sealed bid sale: A "silent auction" in which investors independently value an asset and submit bids by a certain date. Information on bids or bidders is not released before a sale closes.

securitization: The process by which generally illiquid assets with similar features are pooled into interest-bearing securities with marketable investment characteristics. In the securitization of commercial and multi-family residential mortgages, the cash flow associated with the mortgage payments is placed into the most appropriate legal package (for example, CMO and REMIC), techniques are used to reshape the mortgage cash flow, a credit enhancement feature is added, and a mortgage-backed security is created. From

1991 to 1997, 72 RTC and 2 FDIC securitizations were closed, disposing of conservatorship and receivership assets with a total book value of approximately \$44 billion.

seller financing: A purchase money mortgage provided to buyers by the FDIC and the RTC to facilitate the sale of hard-to-sell assets and to maximize the value of assets sold. Seller financing was used primarily to facilitate the sale of owned real estate. Seller financing was also offered by the RTC in the disposition of nonperforming loans in structured transactions.

sequential bidding: The FDIC's practice of reviewing bids for failing banks in the 1980s. On December 30, 1986, the FDIC Board of Directors established an order of priority for six alternative methods of passing assets to acquirers under authority delegated by the FDIC Board of Directors to staff prior to the receipt of the bids.

settlement: Usually, the final disposition of accounts between a receiver and a failed bank acquirer. It is a process that normally takes place after closing a sales transaction with an acquirer.

simple negligence: A civil, as opposed to a criminal, standard of negligence. Under simple or ordinary negligence, (1) a person acts negligently when he fails to perceive a substantial and unjustifiable risk that a particular result will occur, and (2) the risk must be of such a nature and degree that the failure to perceive it constitutes a deviation from the standard of care that a reasonable person would observe in such a situation.

site manager: The managing agent, financial institution specialist, or other employee responsible for overseeing the operation of a conservatorship or receivership.

Small Investor Program: A target marketing plan that was designed to meet the needs of small investors who wanted to buy or invest in RTC assets one at a time or in small pools. The Small Investor Program arranged for the marketing and sale of individual real estate assets (with a value of less than \$5 million) and relatively small pools of loans (up to \$10 million in value).

SN-Series: An RTC equity partnership created for both large and small investors. Like the N-Series and S-Series transactions, portfolios generally consisted of nonperforming and subperforming commercial mortgages. However, an SN-series pool was larger than an S-Series but smaller than an N-Series portfolio.

Standard Asset Management Amendment (SAMA): A SAMDA contract amended to transfer asset disposition from the SAMDA contractor to the RTC. The RTC began issuing SAMAs in January 1992. SAMDA contractors who accepted the SAMA allowed the RTC to dispose of their remaining assets while the contractors continued to manage assets but not to dispose of them. Later, SAMDA contracts with SAMAs were issued to some new contractors who were hired to perform asset management services only.

Standard Asset Management And Disposition Agreement (SAMDA): Contractual agreements for asset management and disposition services that allowed the RTC to manage and dispose of a large volume of distressed assets, primarily real estate and nonperform-

ing loans, through the use of private-sector contractors. The RTC issued the first SAMDA contract in August 1990.

standard P&A: The RTC or FDIC agreement that contained the standard terms and conditions under which an acquiring institution could assume the liabilities of and purchase the assets of a failed institution from the RTC or FDIC in its capacity as receiver of the failed institution. In RTC transactions, the standard P&A was originally conceived of as the equivalent of the FDIC's whole bank transaction; it was supplemented with the core branch P&A and the limited branch P&A for multi-acquirer branch breakup transactions. The FDIC's version of the standard P&A has certain optional provisions that allow its use for the range of P&A resolutions between a whole bank transaction and a clean bank transaction.

straight deposit payoff: A resolution method for failed FDIC insured institutions which can be used when the liquidation, closing, or winding down of the affairs is determined to be the least costly resolution of the institution. A straight deposit payoff is one of the two methods of deposit payoffs. (The other is an insured deposit transfer.) In a straight deposit payoff, the FDIC determines the amount of insured deposits and pays that amount directly to each depositor. The FDIC as receiver retains all assets and liabilities, and the receivership bears the cost of liquidating all of the assets. (Also see *deposit payoff*, *insured deposit transfer*, and *payoff*.)

structured transaction: An RTC multi-asset portfolio sale of distressed assets, which was normally coupled with seller financing with an equity participation feature so that the RTC's equity interest was tied to the terms of a seller financing note. This 1991–92 program generally is considered to have been a first-generation portfolio sales program of the RTC.

subcontractor: Any individual or entity with whom a primary contractor enters into a contract to provide goods or services to fulfill the primary contractor's obligation under its contract with the government.

subordinated debt: An obligation that has a claim on assets junior to other debt and is repayable only after other debt with a higher claim has been satisfied.

subrogated claim: An insured depositor's demand against the receivership that the FDIC acquires by virtue of having provided deposit insurance.

Subsidiary Information Management Network (SIMAN): A national system, developed by the RTC in 1992, currently used by the FDIC to collect and track information about subsidiaries, joint ventures, and partnerships.

systemic risk: Risk associated with the general health or structure of the financial system which would have serious adverse effects on economic conditions or financial stability. An example of systemic risk might be the probability that the failure of a major bank will cause a substantial number of other banks to fail, leading to a loss of confidence in the safety and soundness of a significant sector of the U.S. banking system. A finding of systemic risk is the only exception to the FDICIA mandate (and subject to satisfying

certain stringent, procedural requirements) that the FDIC choose the resolution method with the least cost to the insurance fund.

Tax Reform Act of 1986: A major tax legislation package that amended the Internal Revenue Code of 1954, which was redesignated as the Internal Revenue Code of 1986. In the design of this legislation, Congress attempted to deal with broad public policy implications instead of addressing specific issues such as recessions, energy shortages, and others. The broad objectives of the Tax Reform Act of 1986 were fairness, revenue neutrality, long-term economic growth, and simplicity. This legislation had a major effect on how individuals and businesses earn, spend, save, and invest. For individuals, many tax deductions were eliminated, thereby increasing individual gross income; at the same time, the tax rates were lowered.

technical assistance advisor (TAA): Local organizations hired in the RTC Affordable Housing Disposition Program (AHDP). TAAs were nonprofit organizations or public agencies located in every state where the RTC owned residential property marketed under the AHDP. TAAs provided training for single-family purchasers who were, for the most part, first-time homebuyers. The role of TAAs was to conduct training on how to buy a house, to assist the buyers in completing the income certifications required by the AHDP, and to provide post-closing seminars on homeowner responsibilities. In addition, TAAs assisted in the multi-family program. They helped the RTC to identify local nonprofit organizations and public agencies interested in owning multi-family properties and to locate state and federal sources of acquisition and rehabilitation financing.

thrift: A financial institution that ordinarily possesses the same depository, credit, financial intermediary, and account transactional functions as a bank, but that is chiefly organized and primarily operates to promote savings and home mortgage lending rather than commercial lending. Also known as a savings bank, a savings association, a savings and loan association, or an S&L.

Thrift Depositor Protection Oversight Board (TDPOB): The name chosen in 1992 for the redefined RTC Oversight Board. The original oversight board was an instrumentality of the federal government created in 1989 by FIRREA and was responsible for the general oversight of the RTC and REFCORP. In addition, the oversight board approved funding for the RTC. On February 1, 1992, pursuant to RTCRRIA, the oversight board was redesignated as the Thrift Depositor Protection Oversight Board and given the mandate to review the overall strategies, plans, and goals of the RTC and to continue to approve prior to implementation RTC financial plans, budgets, and periodic financing requests.

too big to fail: A catchphrase coined in the 1980s to describe the perception that a depository institution could be immune to failure because of its size or the magnitude of its correspondent relationships.

traditional dividend: A dividend paid to proven creditors after the FDIC has determined the net funds available for distribution. Traditional dividends are normally used to pay the final dividend due at the termination of a receivership.

troubled debt restructuring: A change in the makeup of an obligation in which the creditor, because of the debtor's financial difficulties, grants a concession to the debtor for the sake of transforming a nonperforming loan to a performing loan. The nature and extent of the concession depends on many factors, including the delinquency status, the value of the collateral, and the financial condition of the borrower.

unclaimed deposit: A deposit account in a failed FDIC insured institution that remains unclaimed after the appointment of a receiver. (Also see *Unclaimed Deposits Amendment Act*.)

Unclaimed Deposits Amendment Act (UDAA): Legislation enacted on June 28, 1993, to amend the claims procedures for the depositors of a failed institution. Under UDAA, the FDIC is required, among other things, to make insurance payments available for 18 months after the appointment of a receiver, after which all remaining unclaimed funds would be offered to the appropriate state.

uninsured deposit: The portion of any deposit of a customer at an insured depository institution that exceeds the applicable FDIC insurance coverage for that depositor at that institution. (Also see *Insured Deposit*.)

whole bank P&A: A type of purchase and assumption transaction in which the FDIC or the RTC as receiver sells to an insured institution all or substantially all of the assets of a closed bank or thrift in consideration for the assumption of all deposits and sometimes other liabilities. Prospective bidders are invited to analyze a failing institution's assets and submit bids to purchase essentially all of the assets "as is" on a discounted basis and to assume the outstanding deposits.

working capital: The excess of current assets over current liabilities, representing the liquid assets immediately available to fund the continued operation of the business.

yield: The effective annual rate of return on an investment expressed as a percentage.



APPENDIX C

Statistical Data

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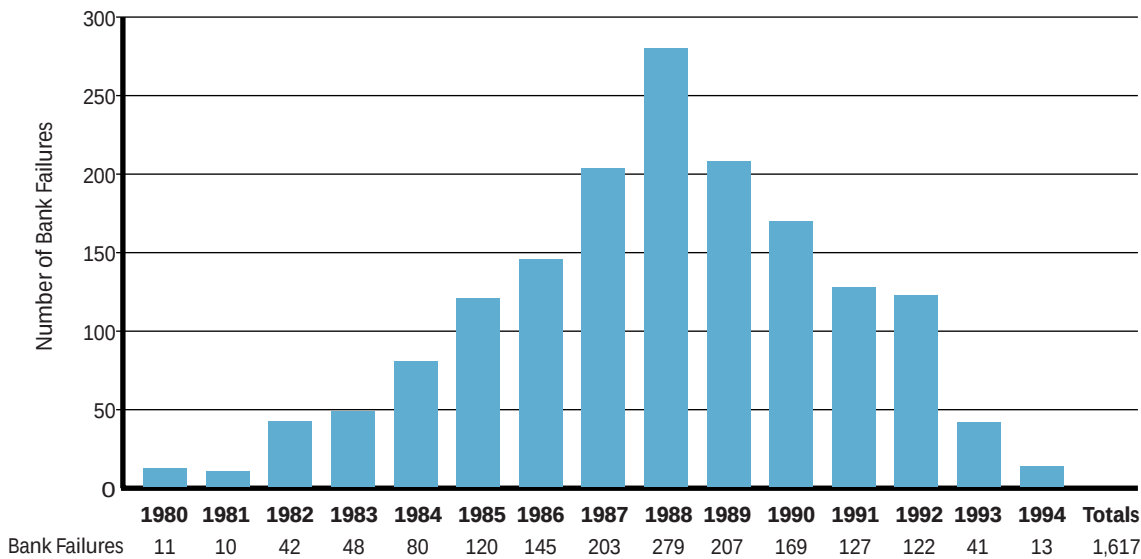
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Chart C.1

**Number of Bank Failures
1980–1994**

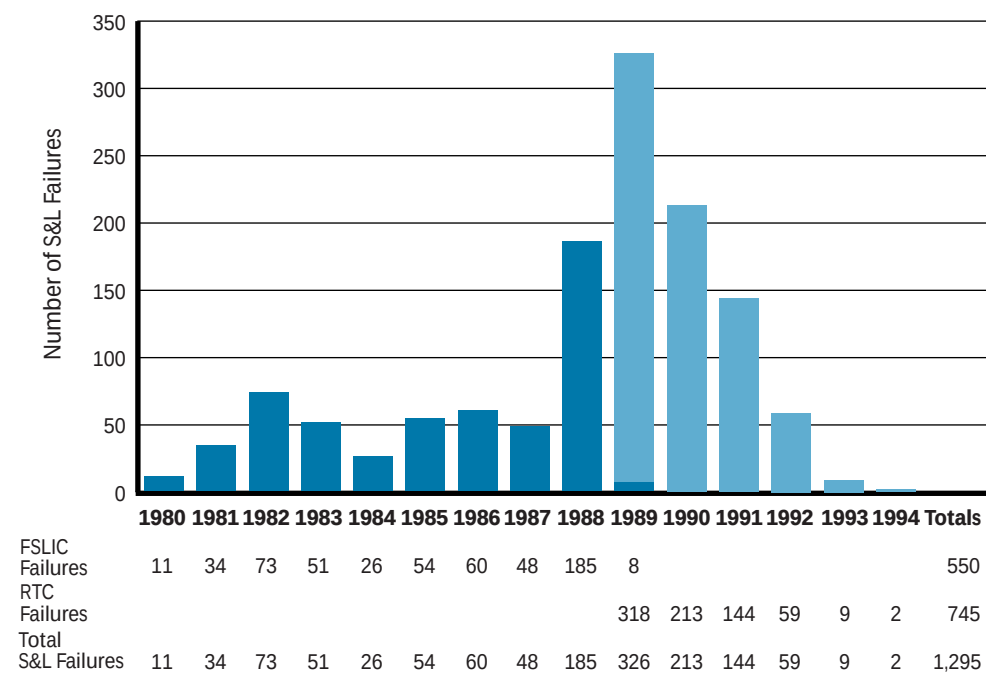


Figures include FDIC open bank assistance transactions.

Sources: FDIC Division of Research and Statistics and FDIC annual reports.

Chart C.2

Number of S&L Failures
1980–1994

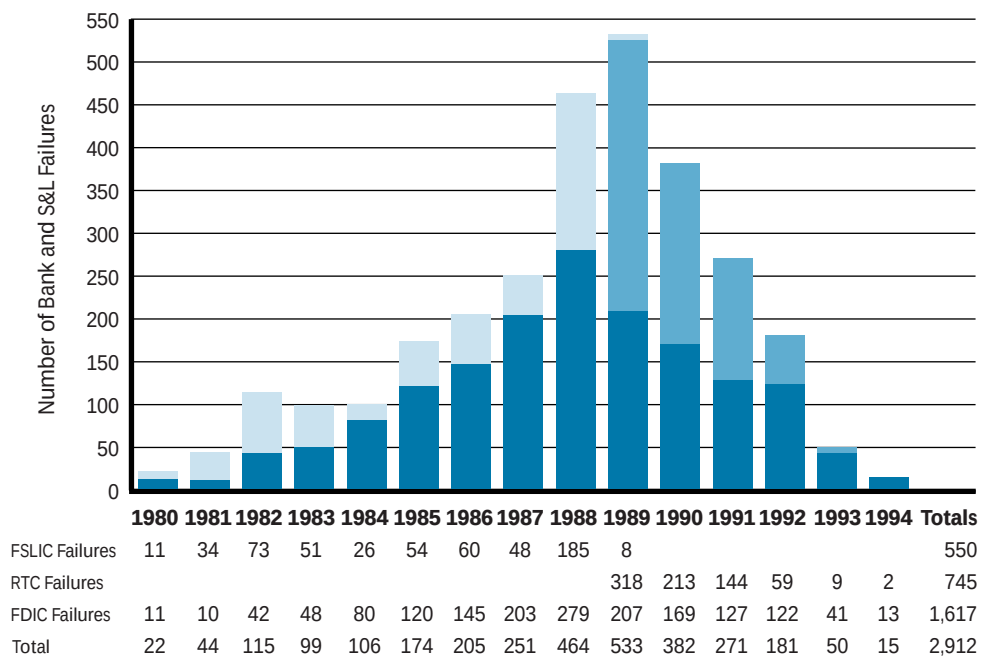


Figures include FSLIC open bank assistance transactions.

Source: Reports from FDIC Division of Research and Statistics.

Chart C.3

Number of Banks and S&L Failures 1980–1994

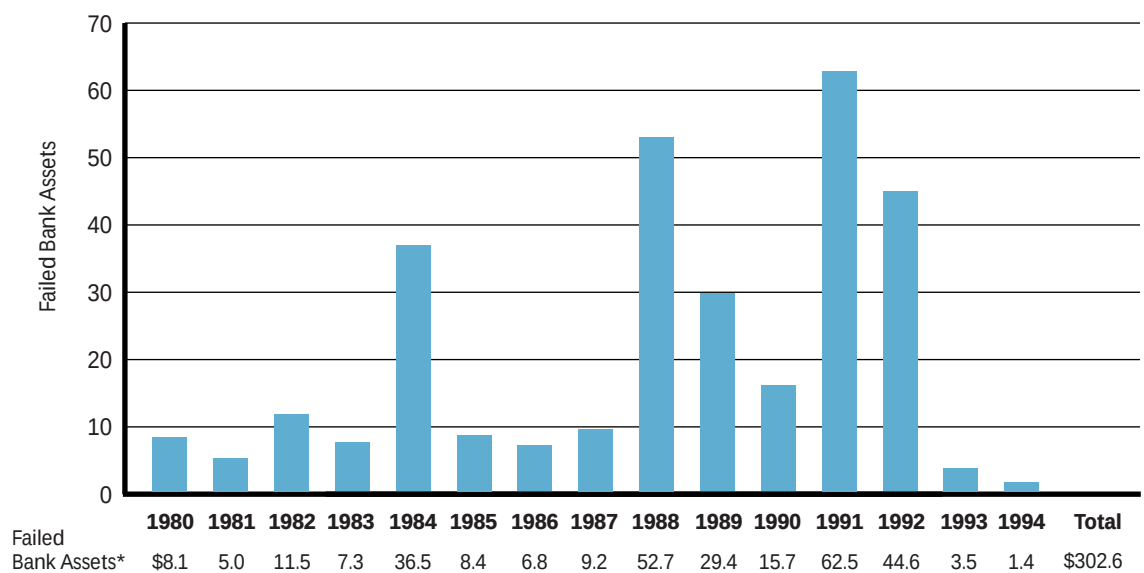


Figures include FDIC and FSLIC open bank assistance transactions.

Sources: FDIC Division of Research and Statistics and FDIC annual reports.

Chart C.4**Failed Bank Assets
1980–1994**

(\$ in Billions)



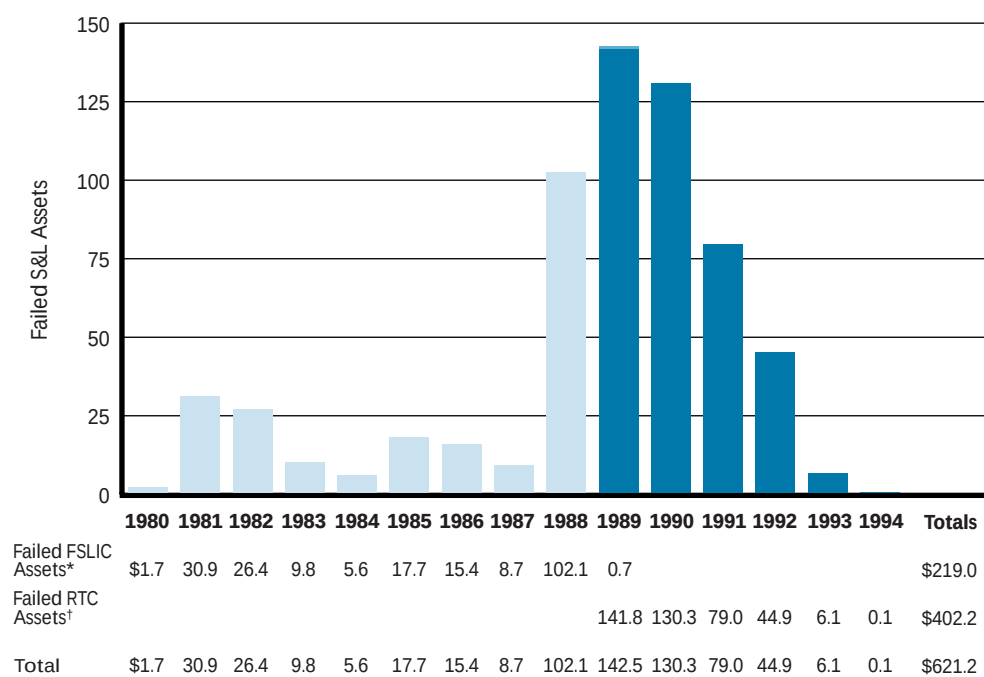
*Total assets as reported at resolution.
 Figures include open bank assistance transactions.

Sources: FDIC Division of Research and Statistics and FDIC annual reports.

Chart C.5

Failed S&L Assets**1980–1994**

(\$ in Billions)



* FSLIC assets as reported at time of resolution.

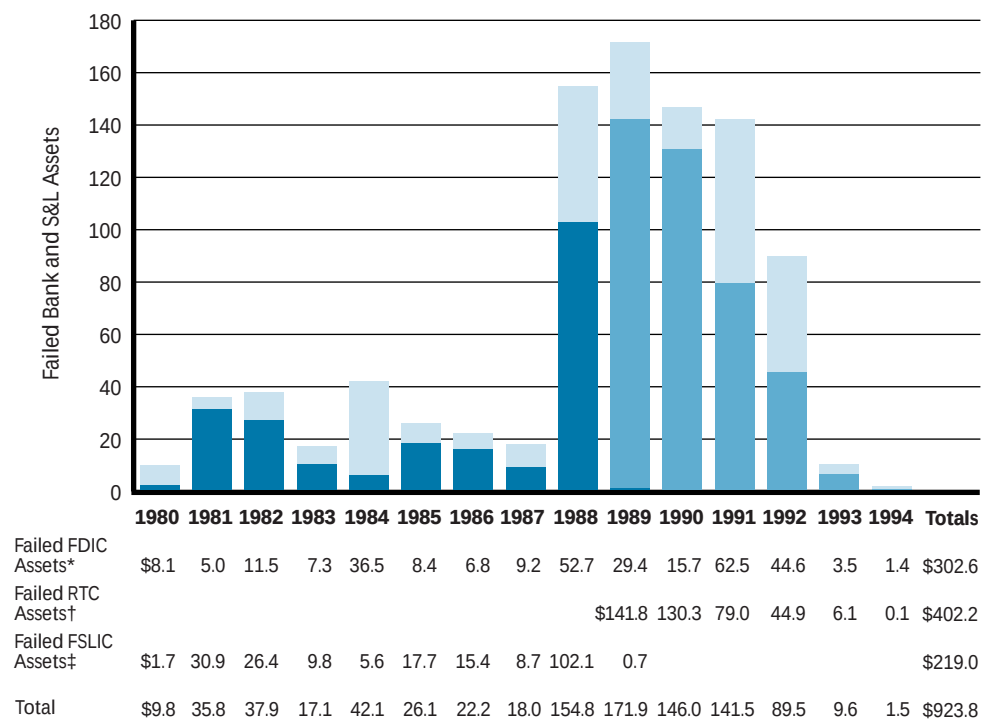
† RTC assets as reported at time of conservatorship/takeover.

Figures include FSLIC open bank assistance transactions.

Source: RTC Statistical Abstract and FSLIC annual reports.

Chart C.6

Failed Bank and S&L Assets
1980–1994
 (\$ in Billions)



* FDIC assets as reported at resolution.

† RTC assets as reported at time of conservatorship/takeover.

‡ FSLIC assets as reported at time of resolution.

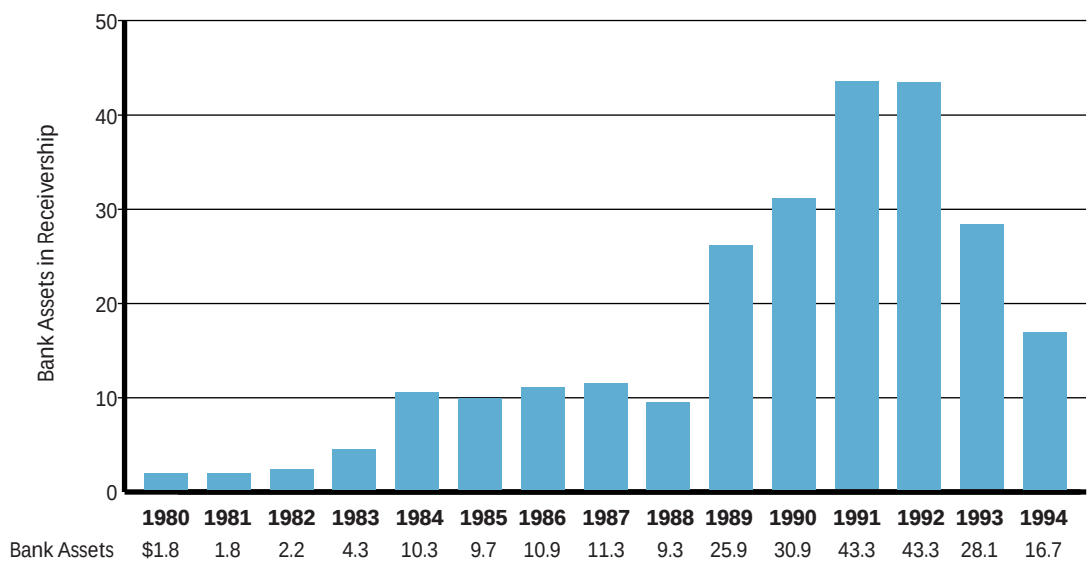
Figures include FDIC and FSLIC open bank assistance transactions.

Sources: RTC Statistical Abstract and FSLIC annual reports.

Chart C.7

Bank Assets in Receivership at Year End
1980–1994

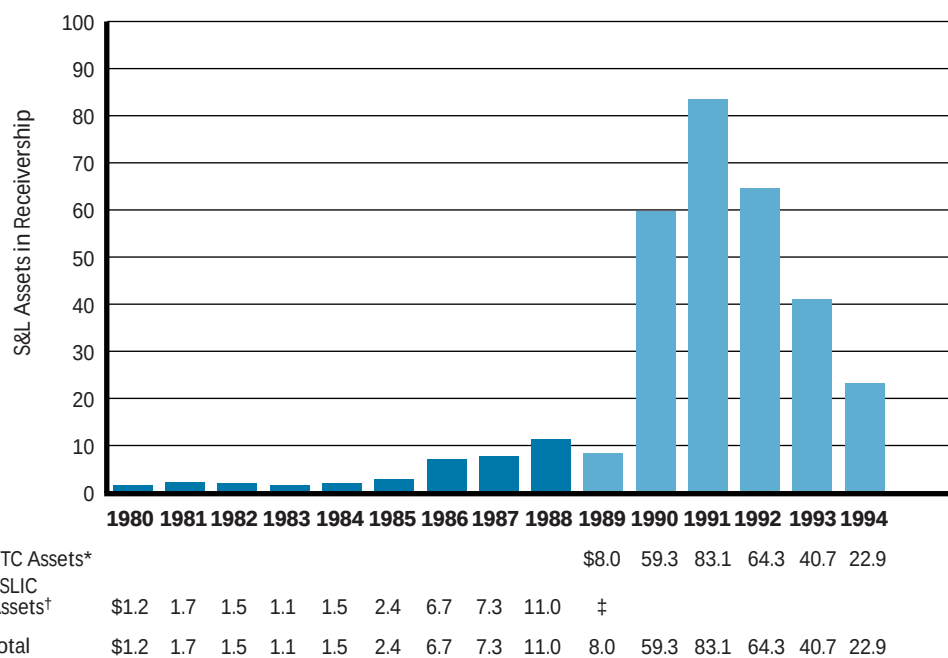
(\$ in Billions)



Sources: FDIC Division of Resolutions and Receiverships internal reports and FDIC Division of Research and Statistics.

Chart C.8**S&L Assets in Receivership at Year End
1980–1994**

(\$ in Billions)



* RTC figures do not include assets in conservatorship.

† FSLIC figures as of December 31, 1988, not available; balance shown as of August 9, 1989, transfer of liquidation responsibility to FDIC.

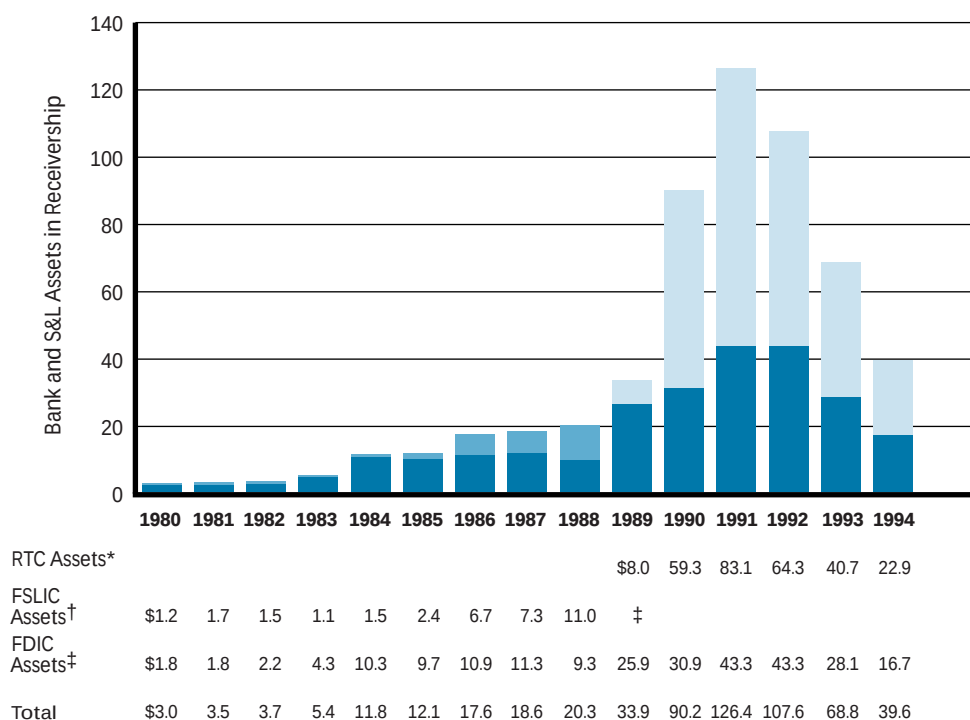
‡ 1989 FSLIC assets included in 1989 figure for FDIC.

Sources: RTC Statistical Abstract and FSLIC annual reports.

Chart C.9

Bank and S&L Assets in Receivership at Year End 1980–1994

(\$ in Billions)



* RTC figures do not include assets in conservatorship.

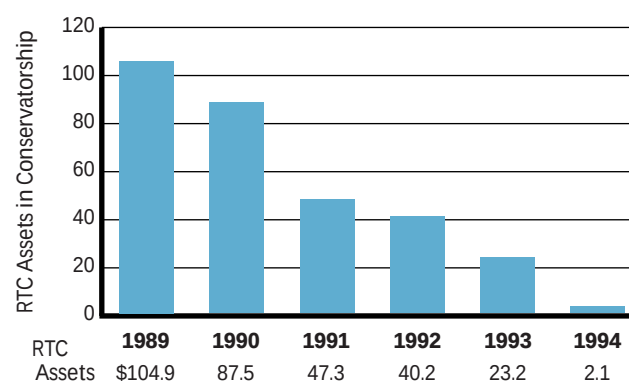
† FSLIC figures as of December 21, 1988, are not available; balance shown is as of August 9, 1989, transfer of liquidation responsibility to FDIC.

‡ 1989 FSLIC assets included in 1989 figure for FDIC.

Sources: FSLIC annual reports; *RTC Statistical Abstract*; FDIC Division of Resolution and Receivership internal reports; Division of Research and Statistics

Chart C.10**RTC Assets in Conservatorship at Year End
1989–1994**

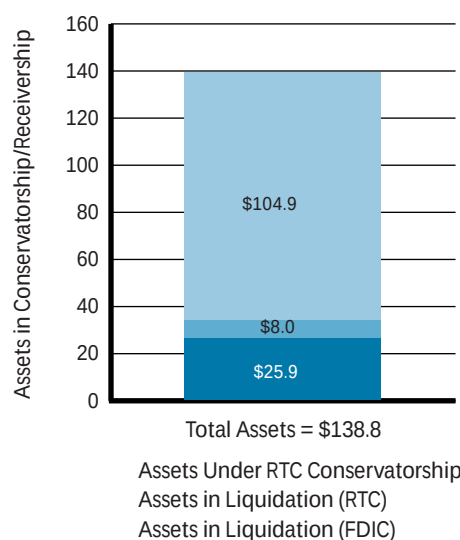
(\$ in Billions)



Source: RTC Statistical Abstract.

Chart C.11**Assets in
Conservatorship/Receivership
as of December 31, 1989**

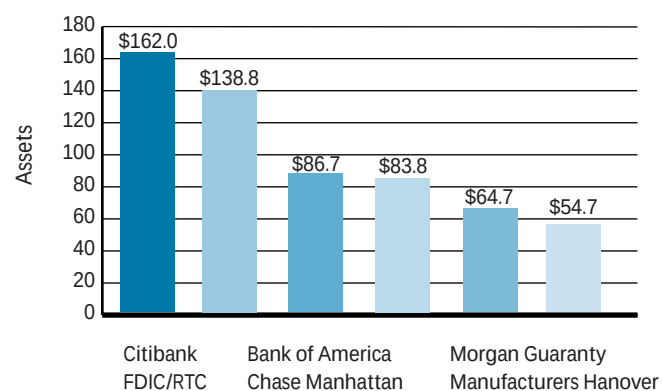
(\$ in Billions)



Source: RTC annual reports, 1989–1995.

Chart C.12**FDIC Managed Assets vs. Assets of the
Five Largest Domestic Banks as of
December 31, 1989**

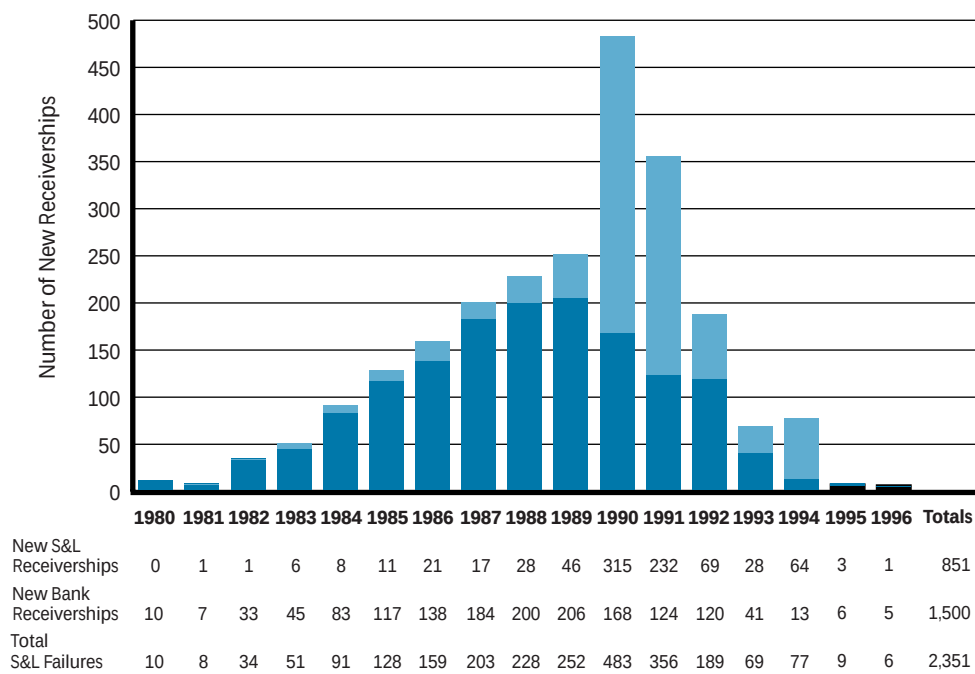
(\$ in Billions)



Source: FDIC Division of Research and Statistics.

Chart C.13

Number of New Bank and S&L Receiverships
1980–1996

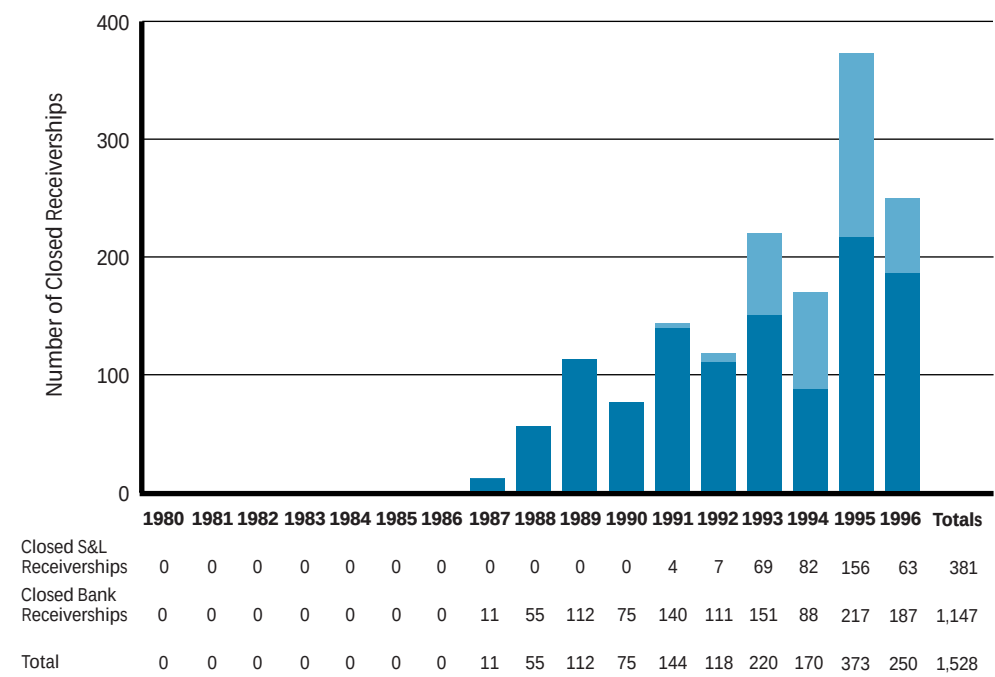


Note: Receiverships are generally not established for failures resolved by assistance transactions.

Source: Financial Information Management System.

Chart C.14

Number of Closed Bank and S&L Receiverships
1980–1996

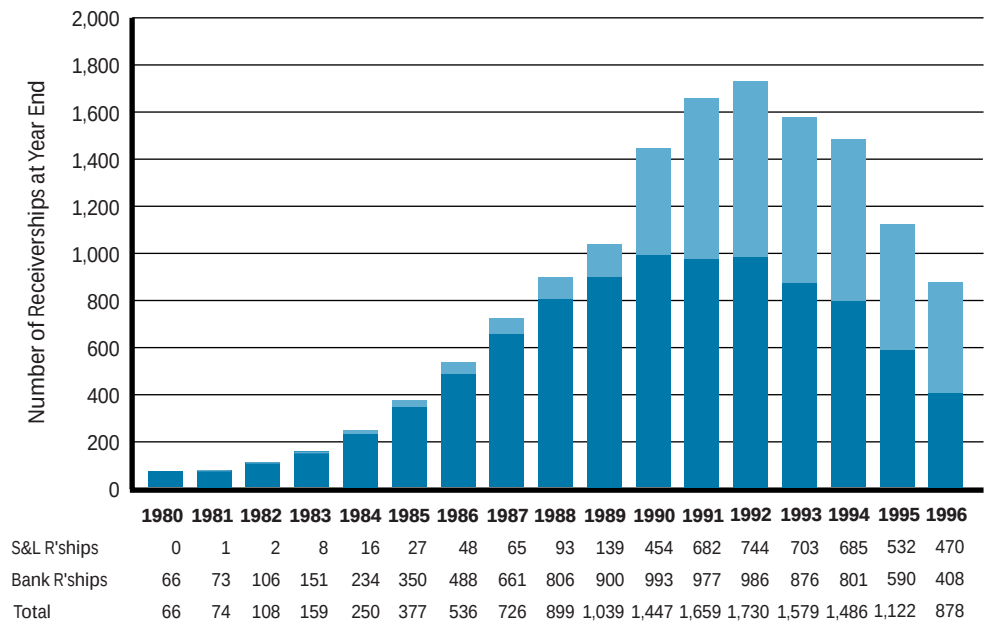


Note: No information is available on bank receiverships closed before 1986 because of the manual system of recordkeeping for those years.

Source: Financial Information Management System.

Chart C.15

Number of Bank and S&L Receiverships at Year End
1980–1996

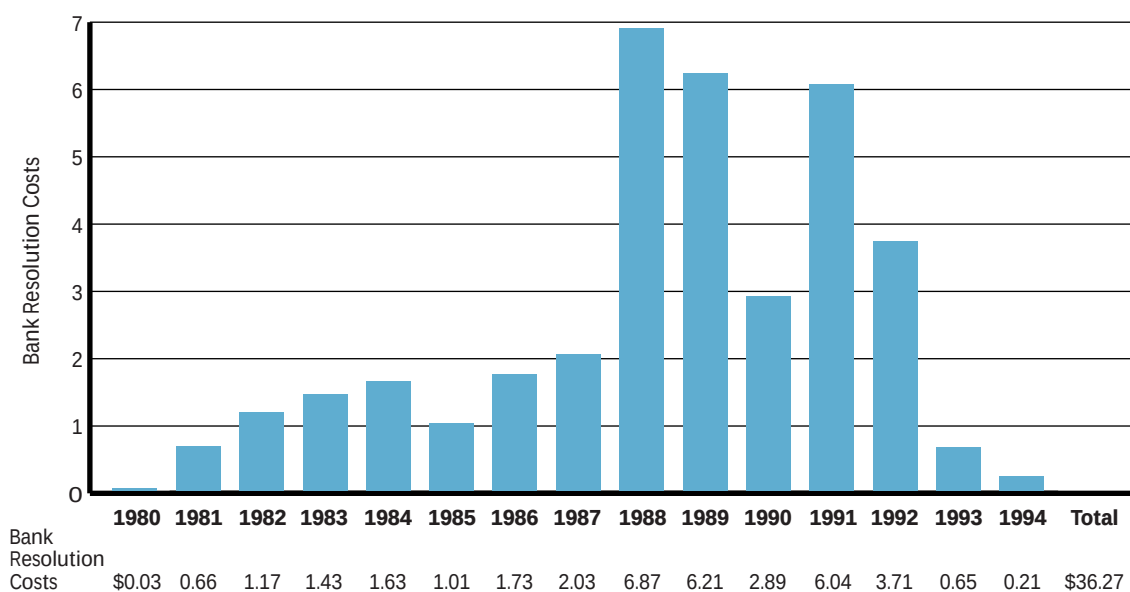


Before 1986, 473 receiverships were established; however, only 378 of those receiverships are reflected in the Financial Information Management System bank table and this chart.

Source: Financial Information Management System.

Chart C.16**Bank Resolution Costs by Year of Failure
1980–1994**

(\$ in Billions)



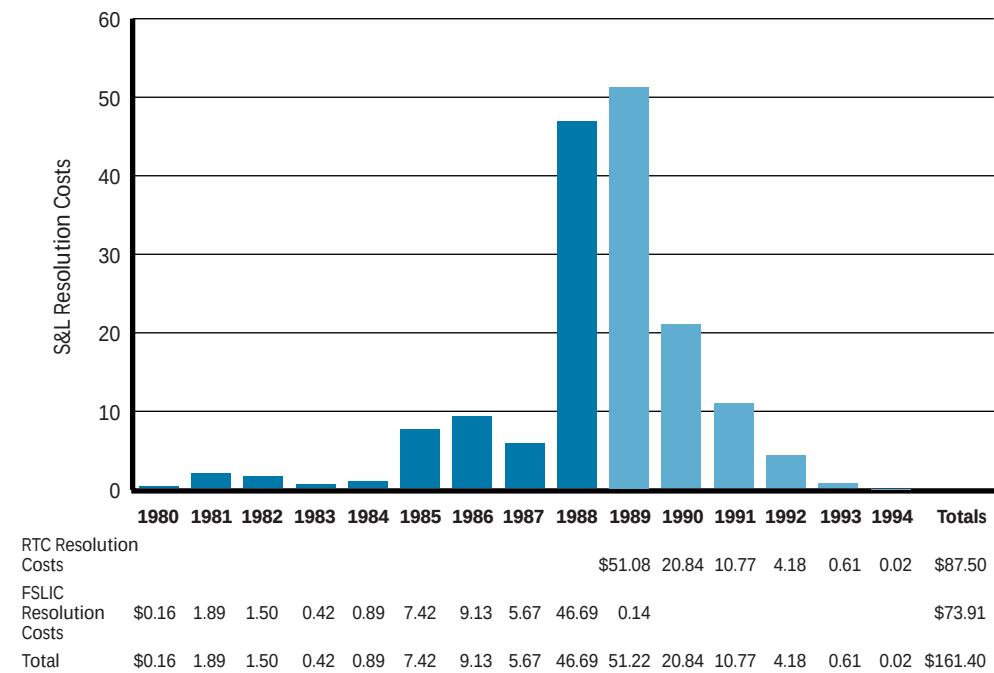
Costs are as of December 31, 1995. The amounts are routinely adjusted with updated information from new appraisals and asset sales that affect the asset values and projected recoveries from active receiverships.

Figures include FDIC open bank assistance transactions.

Sources: FDIC Division of Research and Statistics and FDIC annual reports.

Chart C.17

S&L Resolution Costs by Year of Failure
1980–1994
(\$ in Billions)



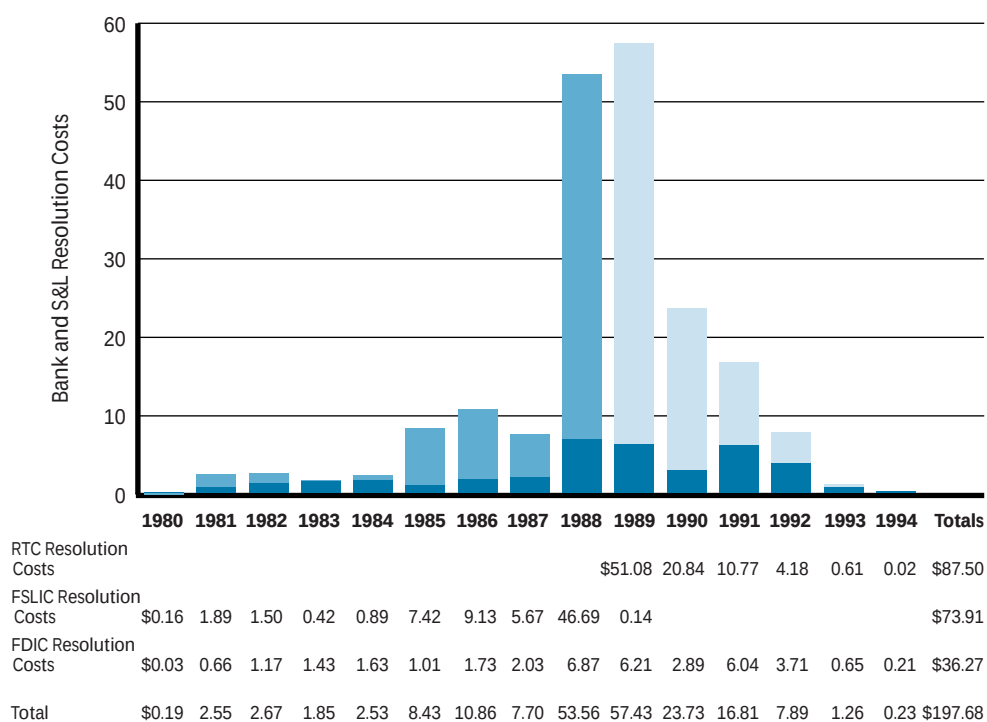
Costs are as of December 31, 1995. The amounts are routinely adjusted with updated information from new appraisals and asset sales that affect the asset values and projected recoveries from active receiverships.

Figures include FSLIC open bank assistance transactions.

Source: FDIC Division of Research and Statistics and FDIC annual reports.

Chart C.18**Bank and S&L Resolution Costs by Year of Failure
1980–1994**

(\$ in Billions)



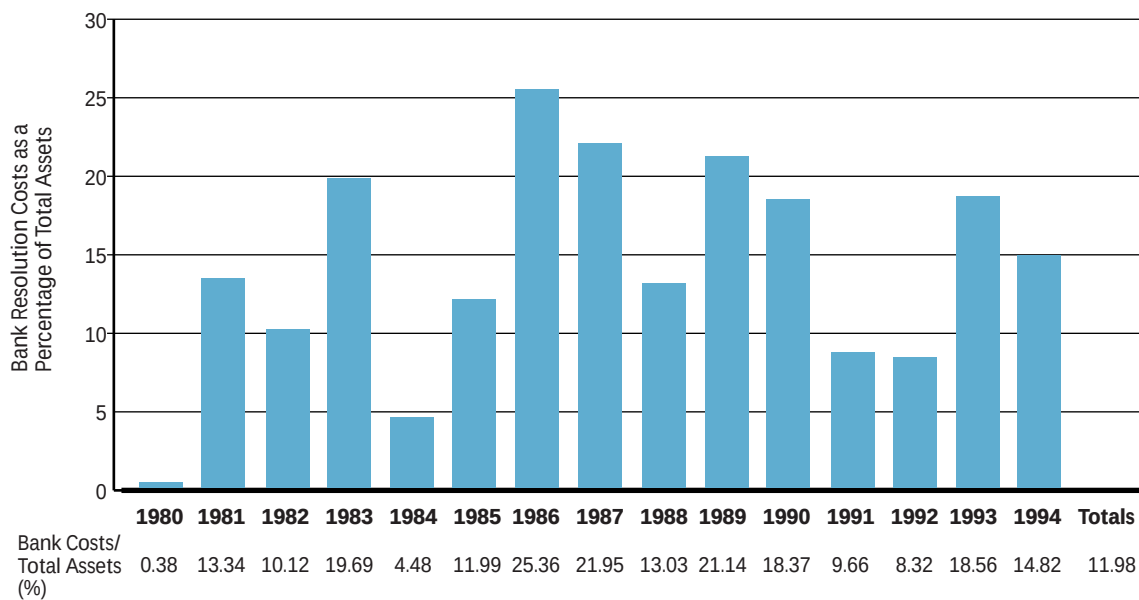
Costs are as of December 31, 1995. The amounts are routinely adjusted with updated information from new appraisals and asset sales that affect the asset values and projected recoveries from active receiverships.

Figures include FDIC and FSLIC open bank assistance transactions.

Sources: FDIC Division of Research and Statistics.

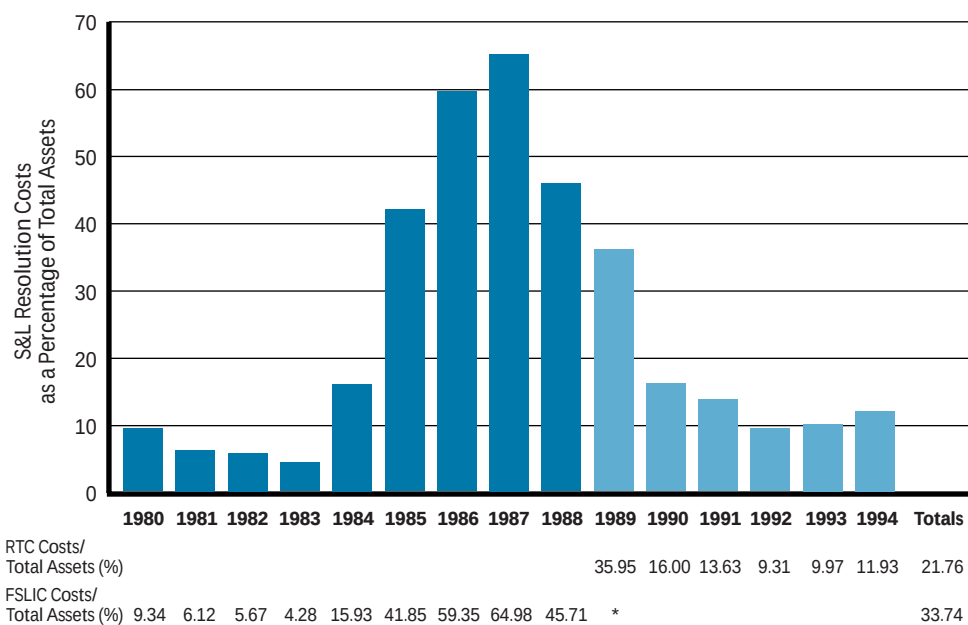
Chart C.19

Bank Resolution Costs as a Percentage of Total Assets 1980–1994



Figures include FDIC open bank assistance transactions.

Sources: FDIC Division of Research and Statistics.

Chart C.20**S&L Resolution Costs as a Percentage of Total Assets
1980–1994**

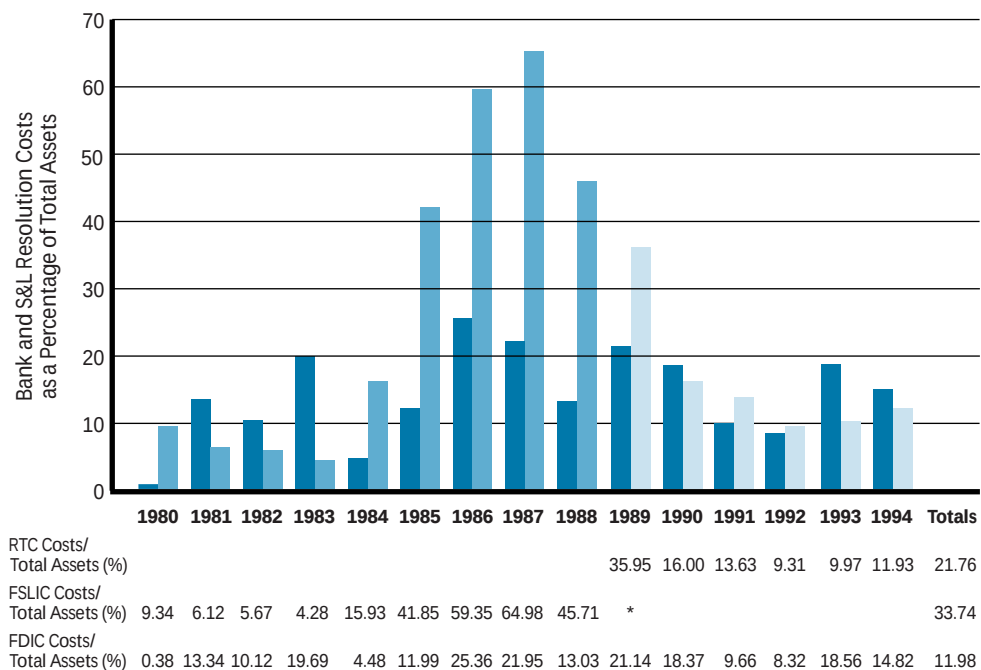
* FSLIC costs included in 1989 percentage for RTC.

Figures include FSLIC open bank assistance transactions.

Source: FDIC Division of Research and Statistics.

Chart C.21

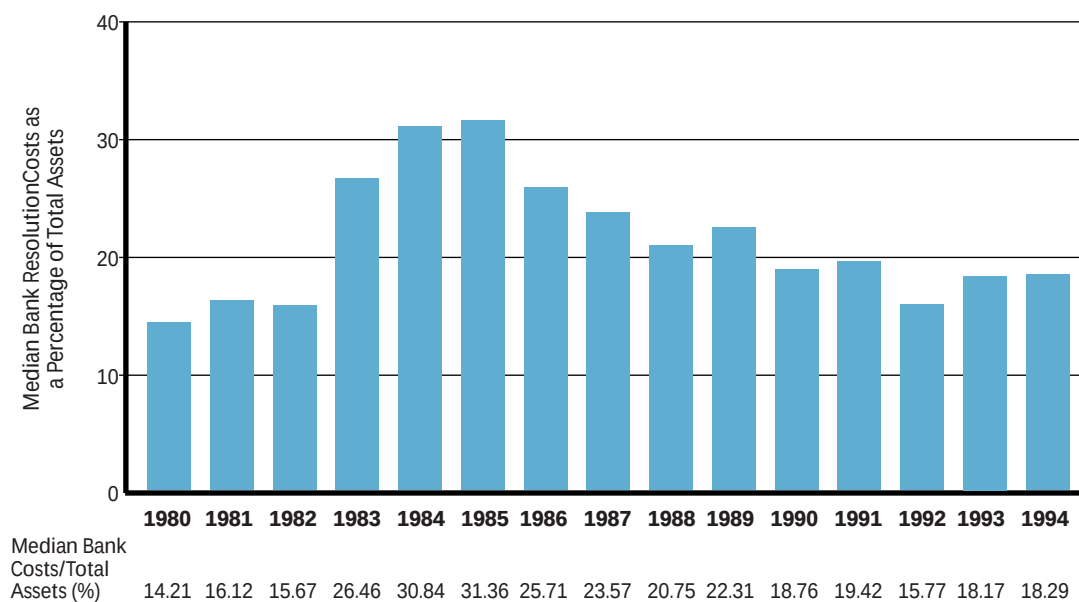
Bank and S&L Resolution Costs as a Percentage of Total Assets 1980–1994



* FSLIC costs included in 1989 percentage for RTC.

Figures include FDIC and FSLIC open bank assistance transactions.

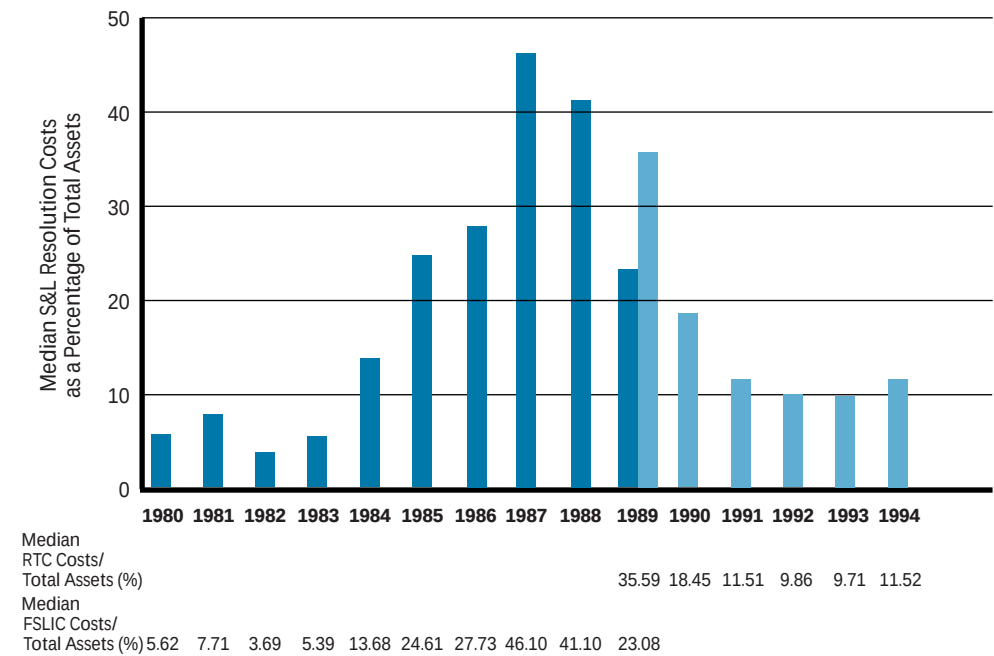
Source: FDIC Division of Research and Statistics.

Chart C.22**Median Bank Resolution Costs as a Percentage of Total Assets
1980–1994**

Source: FDIC Division of Research and Statistics.

Chart C.23

Median S&L Resolution Costs as a Percentage of Total Assets
1980–1994

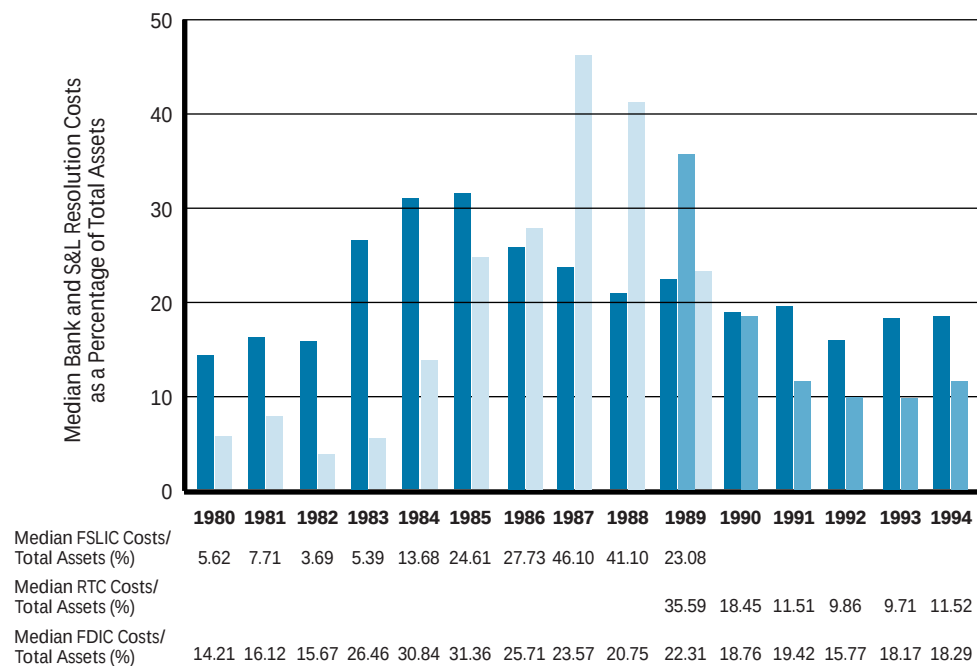


Figures include FSLIC open bank assistance transactions.

Source: FDIC Division of Research and Statistics.

Chart C.24

Median Bank and S&L Resolution Costs as a Percentage of Total Assets 1980–1994

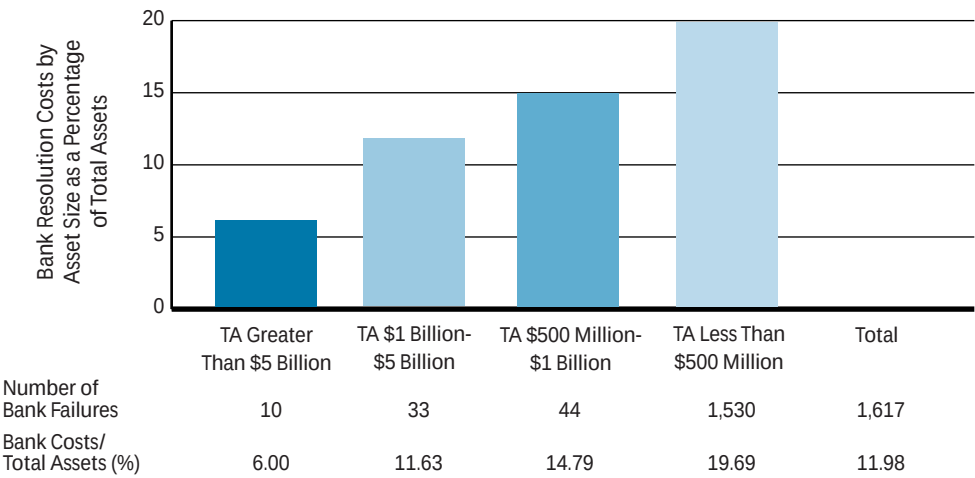


Figures include FDIC and FSLIC open bank assistance transactions.

Source: FDIC Division of Research and Statistics.

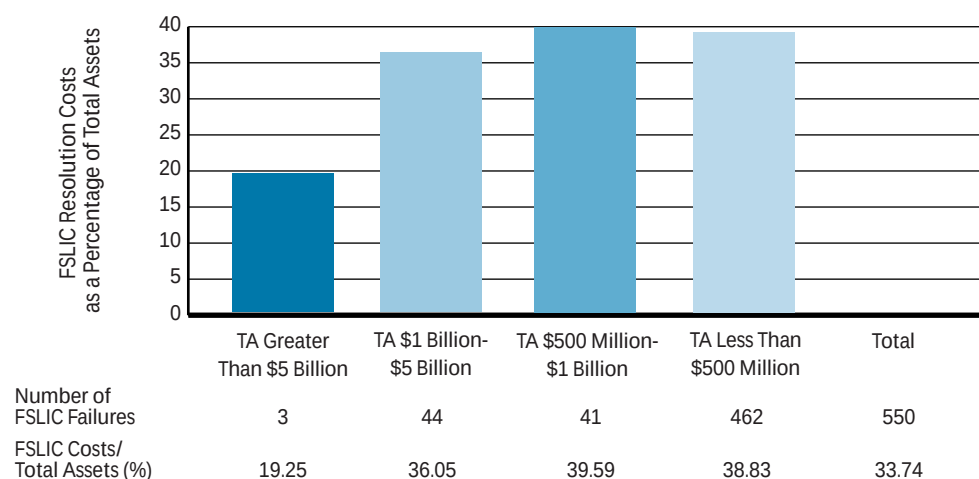
Chart C.25

Bank Resolution Costs by Asset Size as a Percentage of Total Assets
1980–1994

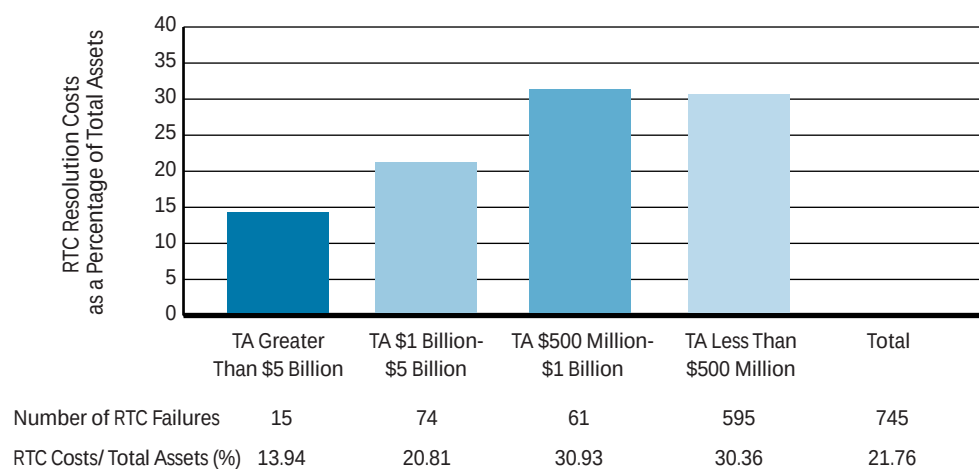


Source: FDIC Division of Research and Statistics and FDIC annual reports.

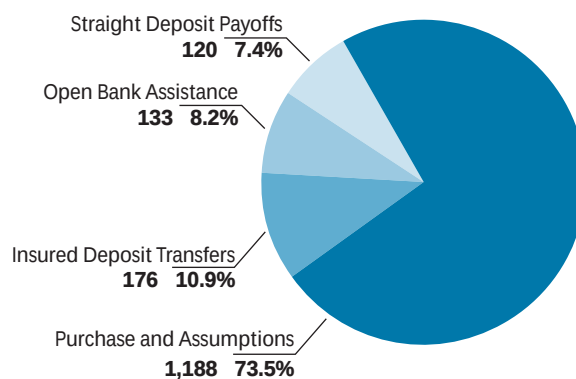
Chart C.26

S&L Resolution Costs by Asset Size as a Percentage of Total Assets**1980–1989 FSLIC**

Source: FDIC Division of Research and Statistics and FDIC annual reports.

1989–1994 RTC

Source: FDIC Division of Research and Statistics and FDIC annual reports.

Chart C.27**Bank Failures by Resolution Method
1980–1994****Total Bank Failures = 1,617**

Sources: FDIC Division of Research and Statistics and FDIC annual reports.

Chart C.28

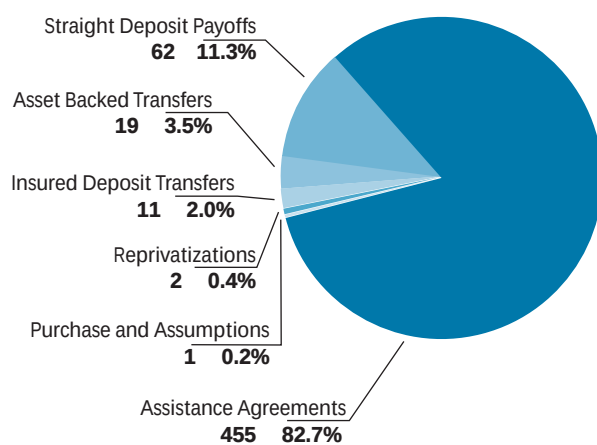
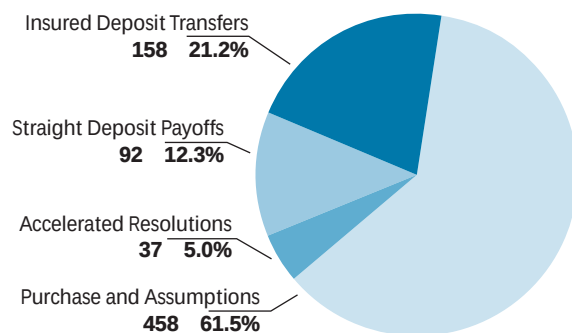
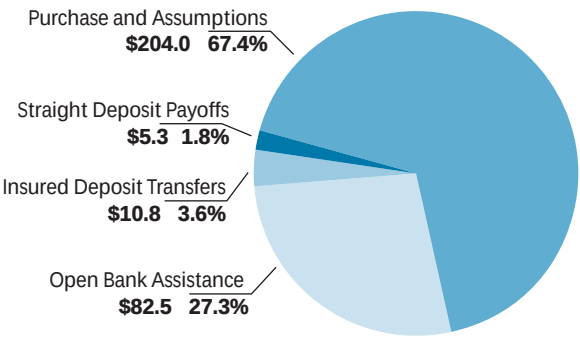
S&L Failures by Resolution Method**1980–1989 FSLIC****Total FSLIC Failures= 550***Source:* FDIC Division of Research and Statistics.**1989–1994 RTC****Total RTC Failures= 745***Source:* FDIC Division of Research and Statistics.

Chart C.29

**Failed Bank Assets by Resolution Method
1980–1994**
(\$ in Billions)

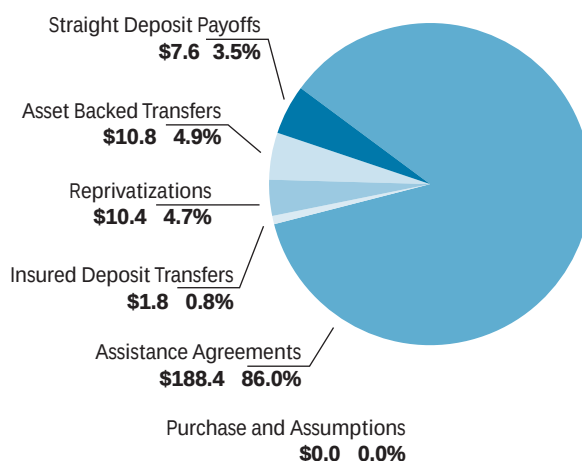


Total Failed Bank Assets = \$302.6

Source: FDIC Division of Research and Statistics.

Chart C.30**Failed S&L Assets by Resolution Method****1980–1989 FSLIC**

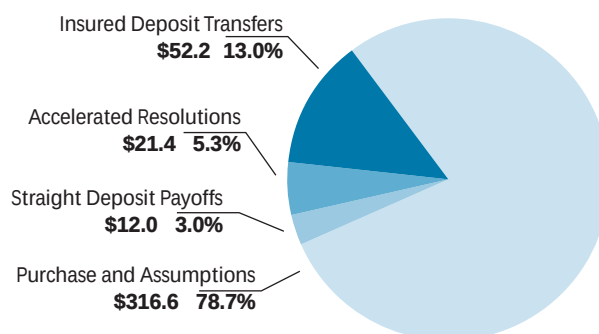
(\$ in Billions)

**Total Failed FSLIC Assets= \$219.0**

Source: FDIC Division of Research and Statistics.

1989–1994 RTC

(\$ in Billions)

**Total Failed RTC Assets= \$402.2**

Source: FDIC Division of Research and Statistics.

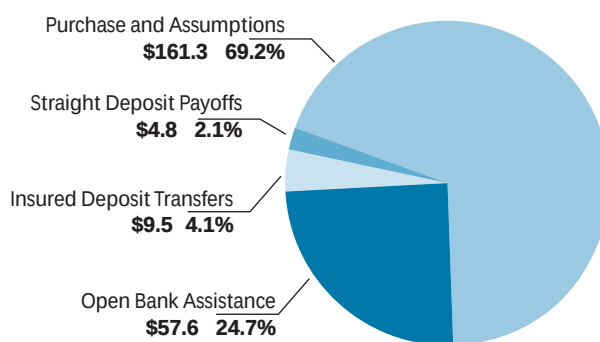
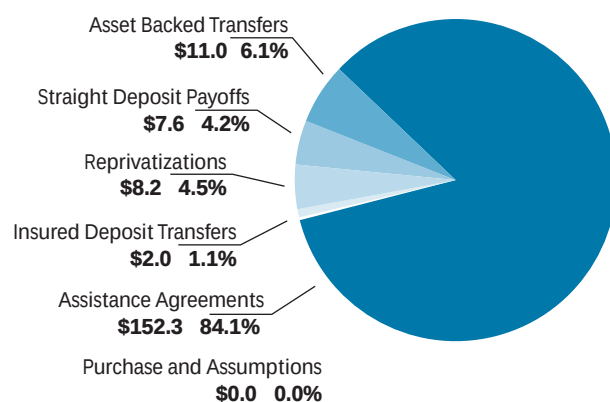
Chart C.31**Failed Bank Deposits by Resolution Method
1980–1994***(\$ in Billions)***Total Failed Bank Deposits = \$233.2***Source:* FDIC Division of Research and Statistics.

Chart C.32

Failed S&L Deposits by Resolution Method**1980–1989 FSLIC**

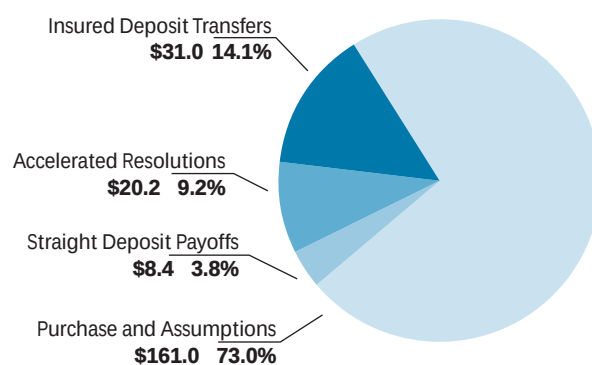
(\$ in Billions)

**Total Failed FSLIC Deposits= \$181.1**

Source: FDIC Division of Research and Statistics.

1989–1994 RTC

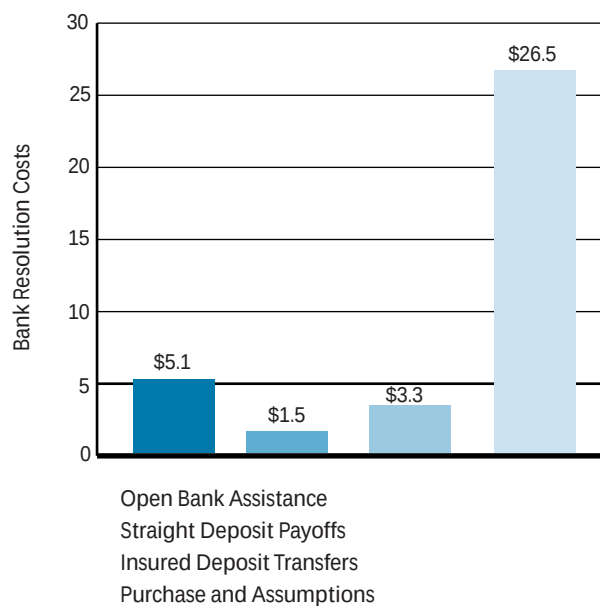
(\$ in Billions)

**Total Failed RTC Deposits= \$220.6**

Source: FDIC Division of Research and Statistics.

Chart C.33**Bank Resolution Costs by Resolution Method
1980–1994**

(\$ in Billions)

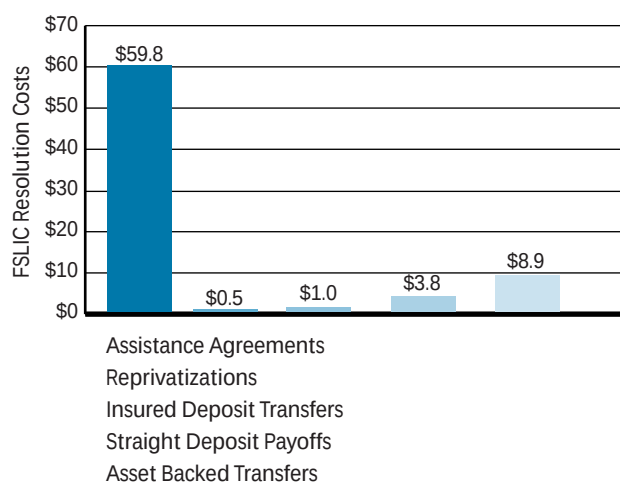
**Total Bank Resolution Costs = \$36.3**

Source: FDIC Division of Research and Statistics.

Chart C.34

S&L Resolution Costs by Resolution Method**1980–1989 FSLIC**

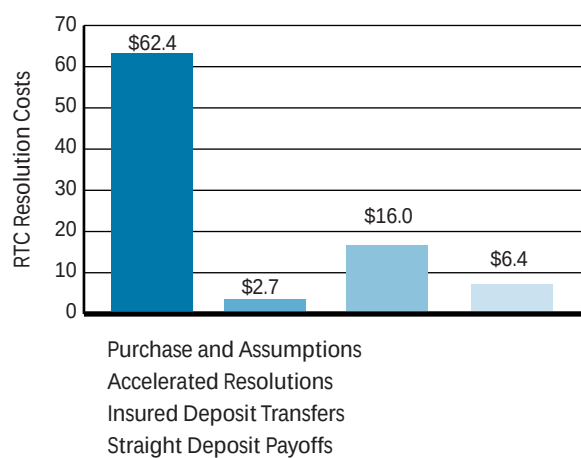
(\$ in Billions)

**Total FSLIC Resolution Costs = \$74.0**

Source: FDIC Division of Research and Statistics.

1989–1994 RTC

(\$ in Billions)

**Total RTC Resolution Costs = \$87.5**

Source: FDIC Division of Research and Statistics.

Chart C.35

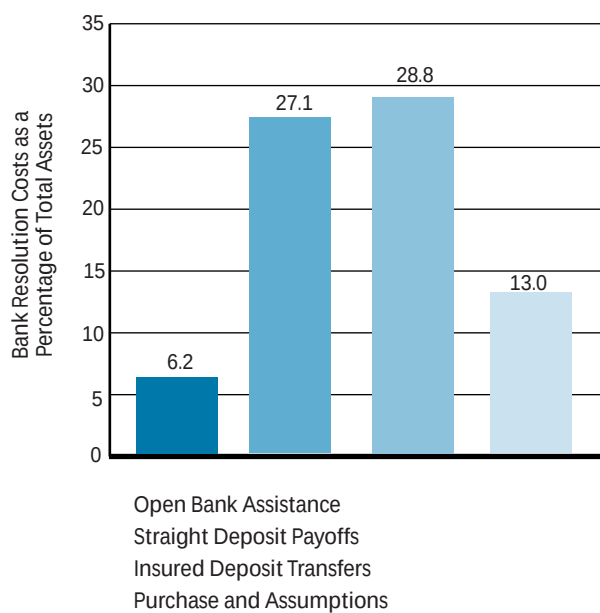
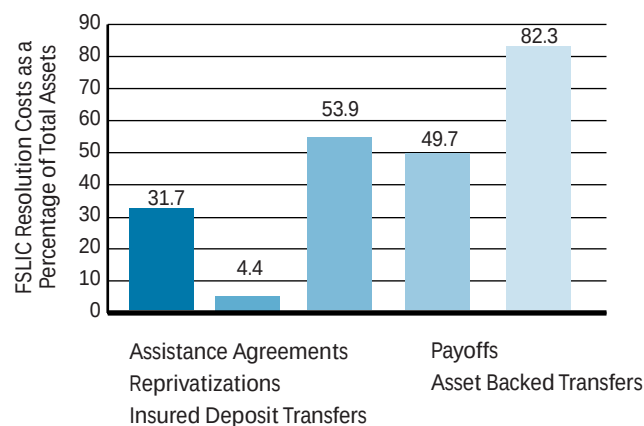
**Bank Resolution Costs by Resolution Method
as a Percentage of Total Assets
1980–1994****Bank Resolution Costs as a Percentage of Total Assets = 11.98%***Source:* FDIC Division of Research and Statistics.

Chart C.36

S&L Resolution Costs by Resolution Method as a Percentage of Total Assets

1980–1989 FSLIC

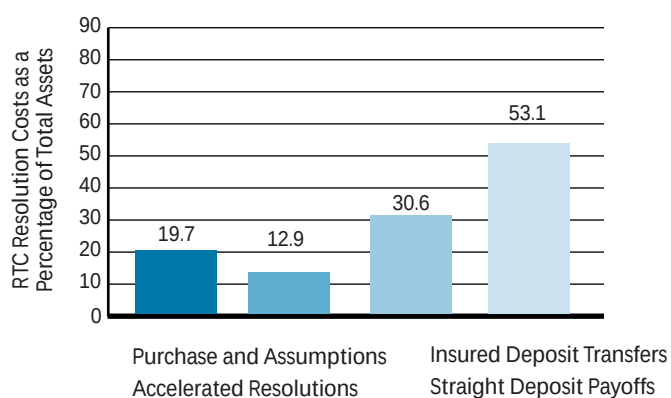
(\$ in Billions)



FSLIC Resolution Costs as a Percentage of Total Assets = 33.74%

Source: FDIC Division of Research and Statistics.

1989–1994 RTC



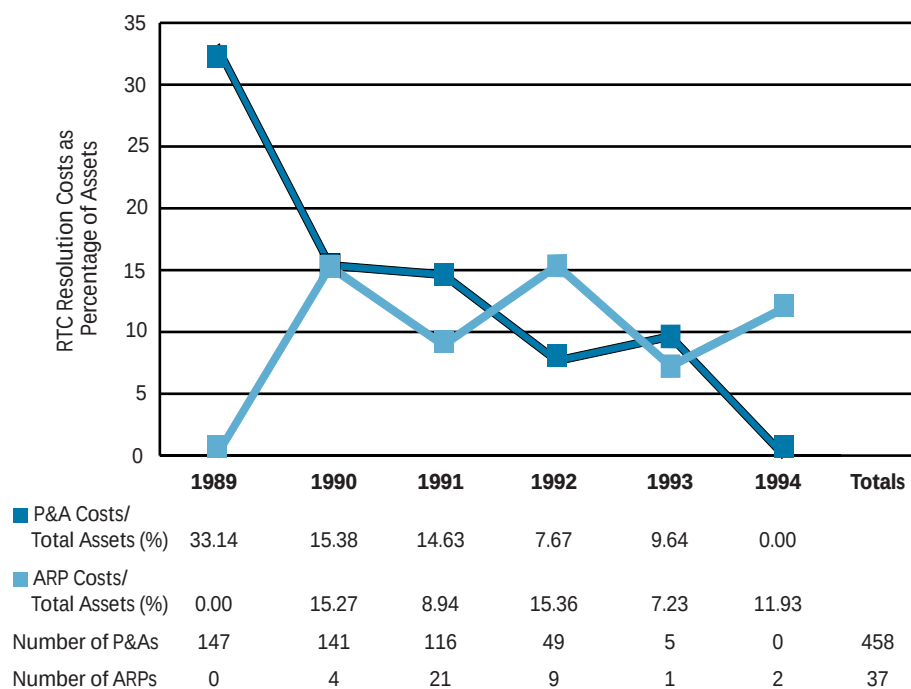
RTC Resolution Costs as a Percentage of Total Assets = 21.76%

Source: FDIC Division of Research and Statistics.

Chart C.37

**RTC Resolution Costs for P&A and ARP Transactions
as a Percentage of Total Assets by Year of Failure
1989–1994**

(\$ in Billions)



ARP = Accelerated Resolution Program

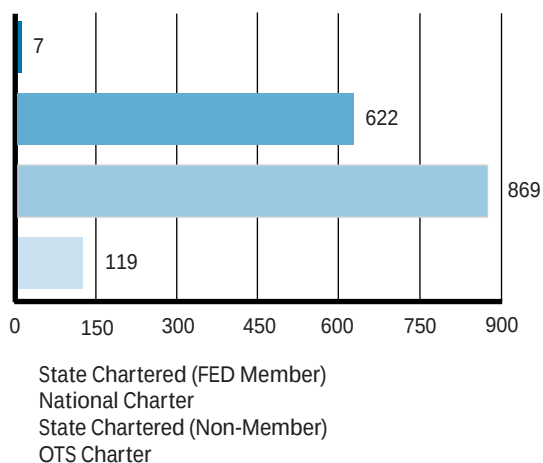
P&A = Purchase and Assumption

Source: FDIC Division of Research and Statistics.

Chart C.38

Bank Resolutions by Charter Type 1980–1994

Number of Bank Resolutions

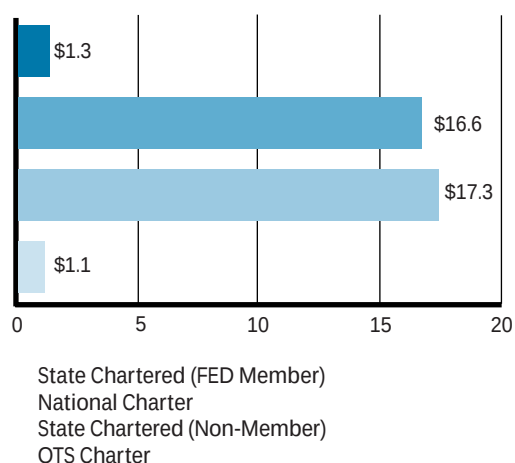


Total Number Resolutions = 1,617

Source: FDIC Division of Research and Statistics.

Bank Resolution Costs

(\$ in Billions)

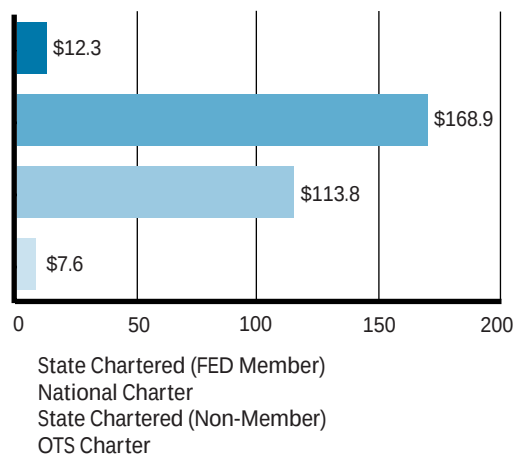


Total Resolution Costs = \$36.3

Source: FDIC Division of Research and Statistics.

Total Bank Assets

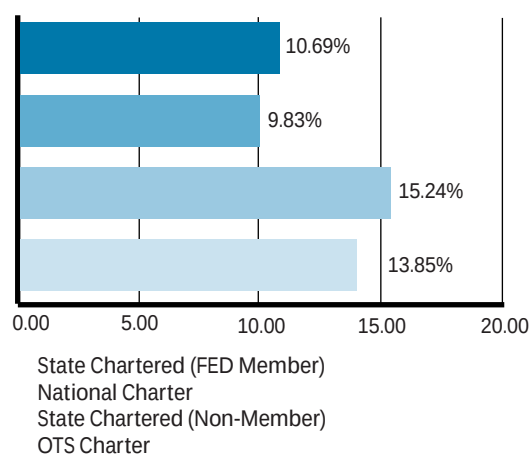
(\$ in Billions)



Total Assets = \$302.6

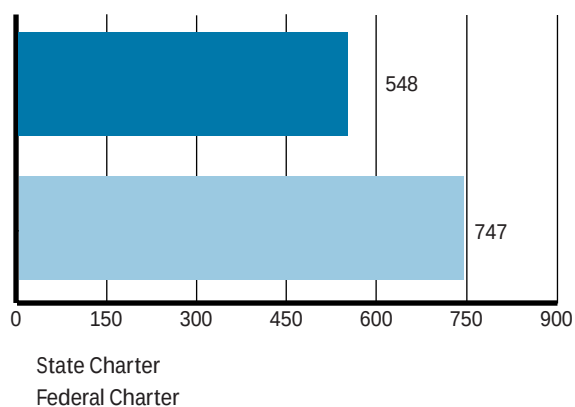
Source: FDIC Division of Research and Statistics.

Bank Resolution Costs as a Percentage of Total Assets



Source: FDIC Division of Research and Statistics.

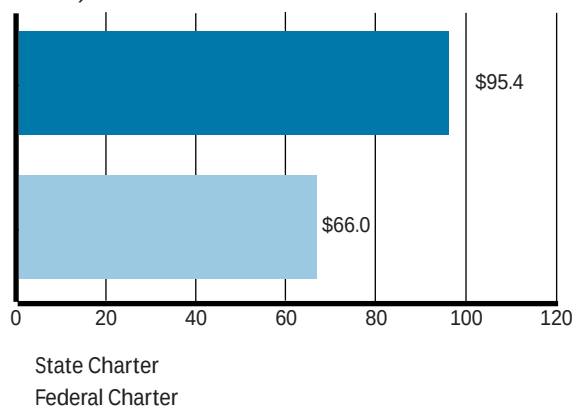
Chart C.39

**S&L Resolutions by Charter Type
1980–1994****Number of S&L Resolutions****Total Number Resolutions = 1,295**

Source: FDIC Division of Research and Statistics.

S&L Resolution Costs

(\$ in Billions)

**Total Resolution Costs = \$161.4**

Source: FDIC Division of Research and Statistics.

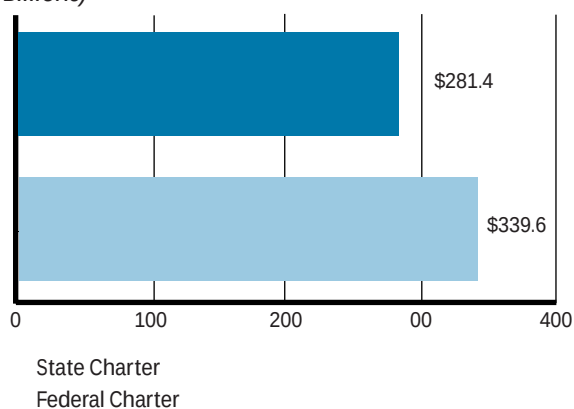
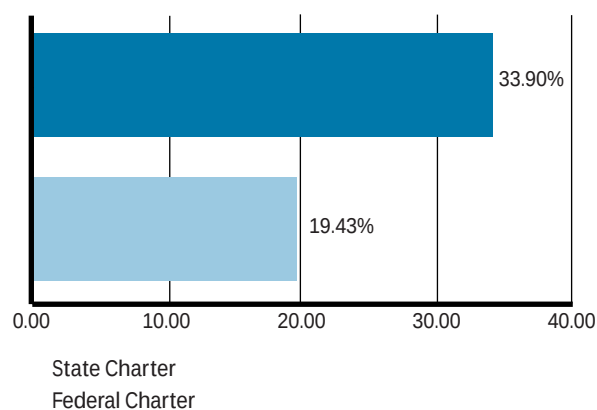
Chart C.39**S&L Resolutions by Charter Type
1980–1994*****Continued*****Total S&L Assets***(\$ in Billions)***Total Resolution Costs = \$621.0***Source:* FDIC Division of Research and Statistics.**S&L Resolution Costs as a Percentage of Total Assets***Source:* FDIC Division of Research and Statistics.

Chart C.40

Failed S&Ls Resolved by FSLIC/RTC (State Charter)*
Estimated Costs of Resolutions 1980–1994
Summary by Location
(\$ in Millions)

Location	Total Assets[†]	Number of Resolutions	Resolution Costs
Texas	\$82,750	183	\$59,390
California	95,633	70	15,294
Arizona	13,493	6	4,696
Florida	17,950	25	3,999
Louisiana	7,373	27	2,671
Colorado	3,697	9	2,027
New Jersey	9,412	35	1,467
Pennsylvania	5,994	13	1,294
Illinois	10,441	41	888
Kansas	12,545	13	554
Ohio	7,450	20	497
Virginia	1,199	6	296
Oklahoma	540	7	291
Mississippi	986	10	285
Missouri	2,174	9	271
Iowa	1,035	8	205
Arkansas	677	6	192
Oregon	688	5	160
Tennessee	343	8	112
North Carolina	762	3	98
Utah	1,606	5	94
Connecticut	446	3	86
Arkansas	145	3	79
Minnesota	690	1	74
Maryland	585	1	71
Washington	491	6	38
Wisconsin	186	1	38
New Mexico	125	4	27
Indiana	193	1	26

Chart C.40

Failed S&Ls Resolved by FSLIC/RTC (State Charter)***Estimated Costs of Resolutions 1980–1994****Summary by Location**

(\$ in Millions)

Continued

Location	Total Assets[†]	Number of Resolutions	Resolution Costs
New Hampshire	\$107	1	\$25
Rhode Island	90	2	24
Maine	385	1	18
Montana	29	1	13
Guam	9	1	9
North Dakota	123	1	9
Wyoming	23	1	9
Nevada	322	3	8
Hawaii	258	2	5
South Carolina	59	1	5
South Dakota	88	4	3
Michigan	396	1	1
Alabama	0	0	0
District of Columbia	0	0	0
Delaware	0	0	0
Georgia	0	0	0
Idaho	0	0	0
Kentucky	0	0	0
Massachusetts	0	0	0
Nebraska	0	0	0
New York	0	0	0
Puerto Rico	0	0	0
Vermont	0	0	0
West Virginia	0	0	0
Totals	\$281,498	548	\$95,349

* At time of resolution

† Assets at time of takeover.

Source: FDIC Division of Research and Statistics

Chart C.41

Failed S&Ls Resolved by FSLIC/RTC (Federal Charter)*
Estimated Costs of Resolutions 1980–1994
Summary by Location
(\$ in Millions)

Location	Total Assets[†]	Number of Resolutions	Resolution Costs
California	\$39,628	43	\$7,696
Texas	20,659	62	7,472
Florida	31,988	47	5,030
New York	31,578	32	4,316
Arkansas	6,105	16	3,906
Illinois	25,496	56	3,717
Louisiana	7,143	56	3,096
New Jersey	20,642	13	2,562
Oklahoma	8,661	33	2,442
Virginia	12,577	26	2,331
Colorado	6,179	15	2,155
New Mexico	4,433	13	2,090
Pennsylvania	12,241	11	1,861
Missouri	8,743	19	1,561
Kansas	4,460	15	1,425
Massachusetts	6,906	8	1,363
Minnesota	4,665	13	1,350
Ohio	9,269	22	1,267
Maryland	10,574	18	1,137
Arizona	5,907	3	1,066
Oregon	8,413	7	826
Iowa	4,264	20	666
Georgia	5,273	23	615
Nebraska	1,823	8	545
Alabama	4,113	14	526
Utah	2,666	3	518
Mississippi	2,018	17	481
Puerto Rico	4,228	5	417
Washington	3,262	8	379

Chart C.41**Failed S&Ls Resolved by FSLIC/RTC (Federal Charter)*****Estimated Costs of Resolutions 1980–1994****Summary by Location**

(\$ in Millions)

Continued

Location	Total Assets[†]	Number of Resolutions	Resolution Costs
North Carolina	\$2,832	10	\$378
Michigan	3,908	12	357
Tennessee	2,121	15	353
Wyoming	935	6	277
Kentucky	2,013	11	233
Indiana	1,814	17	222
North Dakota	1,593	5	208
West Virginia	1,108	8	177
South Carolina	1,559	7	151
Rhode Island	2,034	2	150
Arkansas	263	2	146
Connecticut	974	6	131
Idaho	610	3	130
District of Columbia	1,895	3	83
Wisconsin	465	4	81
South Dakota	1,048	5	64
Maine	131	2	28
New Hampshire	257	1	26
Montana	207	2	16
Delaware	0	0	0
Hawaii	0	0	0
Nevada	0	0	0
Vermont	0	0	0
Totals	\$339,681	747	\$66,027

* At time of resolution

† Assets at time of takeover.

Source: FDIC Division of Research and Statistics.

Table C.1

**Bank Failures by Location
Ranked by Number of Bank Failures
1980–1994**
(*\$ in Thousands*)

Location	Number of Failed Banks	Bank Assets at Resolution	Bank Resolution Costs	Resolution Costs/ Bank Assets at Resolution (%)
Texas	599	\$92,973,964	\$13,612,645	14.64
Oklahoma	122	5,504,937	1,460,113	26.52
California	87	5,445,302	1,061,335	19.49
Louisiana	70	4,401,121	1,088,554	24.73
Kansas	69	1,561,223	347,580	22.26
Colorado	59	989,252	277,217	28.02
Massachusetts	43	26,124,470	3,375,599	12.92
Missouri	41	3,075,528	535,963	17.43
Iowa	40	721,125	116,627	16.17
Florida	39	14,965,281	920,709	6.15
Minnesota	38	1,579,218	196,940	12.47
Tennessee	36	2,331,813	778,258	33.38
New York	34	49,108,444	5,115,311	10.42
Illinois	33	34,302,370	1,213,368	3.54
Nebraska	33	343,342	71,151	20.72
Connecticut	32	17,685,983	2,415,691	13.66
Wyoming	20	375,109	117,122	31.22
Oregon	17	575,551	66,382	11.53
Arizona	17	434,486	88,904	20.46
New Hampshire	16	4,908,983	1,014,347	20.66
New Jersey	14	6,658,401	470,659	7.07
New Mexico	11	714,363	183,713	25.72
Arkansas	11	191,678	42,711	22.28
Utah	11	446,839	80,564	18.03
Montana	10	209,164	40,392	19.31
Indiana	10	291,556	33,422	11.46
North Dakota	9	107,903	18,869	17.49
Alabama	9	\$285,516	\$21,975	7.70

Table C.1

**Bank Failures by Location
Ranked by Number of Bank Failures
1980–1994**
(*\$ in Thousands*)

Continued

Location	Number of Failed Banks	Bank Assets at Resolution	Bank Resolution Costs	Resolution Costs/ Bank Assets at Resolution (%)
Alaska	8	\$2,862,202	\$615,834	21.52
South Dakota	8	659,667	16,887	2.56
Kentucky	7	120,678	21,947	18.19
Virginia	7	284,769	40,691	14.29
Puerto Rico	5	336,849	111,926	33.23
Ohio	5	140,193	4,067	2.90
District of Columbia	5	2,285,178	351,803	15.39
Pennsylvania	5	13,705,317	43,803	0.32
West Virginia	5	77,174	13,743	17.81
Washington	4	758,588	54,119	7.13
Rhode Island	3	1,140,025	48,945	4.29
Georgia	3	88,003	20,383	23.16
Michigan	3	129,832	22,994	17.71
Mississippi	3	286,729	28,160	9.82
North Carolina	2	70,760	6,863	9.70
Wisconsin	2	74,129	3,259	4.40
Maryland	2	55,771	7,777	13.94
Maine	2	2,224,770	5,614	0.25
Hawaii	2	11,798	1,762	14.93
Vermont	2	260,755	44,706	17.14
Idaho	1	61,231	17,244	28.16
Delaware	1	612,745	249	0.04
South Carolina	1	62,790	20,879	33.25
Nevada	1	8,789	0	0
Guam	0	0	0	0
Totals	1,617	\$302,631,664	\$36,269,776	11.98

Source: FDIC Division of Research and Statistics.

Table C.2

**S&L Failures by Location
Ranked by Number of S&L Failures
1980–1994**
(*\$ in Thousands*)

Location	Number of Failed S&Ls	S&L Assets at Resolution	S&L Resolution Costs	Resolution Costs/ S&L Assets at Resolution (%)
Texas	245	\$103,408,572	\$66,861,464	64.66
California	113	135,260,798	22,990,269	16.99
Illinois	97	35,936,456	4,604,791	12.81
Louisiana	83	14,515,935	5,767,132	39.73
Florida	72	49,938,098	9,028,286	18.08
New Jersey	48	30,054,685	4,029,902	13.41
Ohio	42	16,718,997	1,763,972	10.55
Oklahoma	40	9,200,335	2,733,291	29.71
New York	32	31,644,130	4,322,884	13.66
Virginia	32	13,776,450	2,627,266	19.07
Iowa	28	5,298,848	871,209	16.44
Kansas	28	17,005,609	1,978,361	11.63
Missouri	28	10,916,604	1,831,618	16.78
Mississippi	27	3,004,666	766,489	25.51
Colorado	24	9,876,593	4,182,186	42.34
Pennsylvania	24	18,234,605	3,154,120	17.30
Georgia	23	5,273,423	614,587	11.65
Tennessee	23	2,463,690	465,233	18.88
Arkansas	22	6,781,825	4,098,766	60.44
Maryland	19	11,158,497	1,208,951	10.83
Indiana	18	2,006,905	248,116	12.36
New Mexico	17	4,557,560	2,116,378	46.44
Alabama	14	4,113,188	525,890	12.79
Minnesota	14	5,354,597	1,423,952	26.59
Washington	14	3,753,558	431,647	11.50
Michigan	13	4,303,581	358,084	8.32
North Carolina	13	3,593,858	475,849	13.24
Oregon	12	9,101,048	986,178	10.84

Table C.2

**S&L Failures by Location
Ranked by Number of S&L Failures
1980–1994**

(\$ in Thousands)

Continued

Location	Number of Failed S&Ls	S&L Assets at Resolution	S&L Resolution Costs	Resolution Costs/ S&L Assets at Resolution (%)
Kentucky	11	\$2,013,011	\$232,744	11.56
Arizona	9	19,400,000	5,761,817	29.07
Connecticut	9	1,419,524	217,249	15.30
South Dakota	9	1,135,703	66,945	5.89
Massachusetts	8	6,906,223	1,362,526	19.73
Nebraska	8	1,823,000	545,276	29.91
South Carolina	8	1,617,471	155,563	9.62
Utah	8	4,272,100	612,170	14.33
West Virginia	8	1,107,542	177,045	15.99
Wyoming	7	957,498	286,064	29.88
North Dakota	6	1,716,381	217,047	12.65
Alaska	5	407,474	224,919	55.20
Puerto Rico	5	4,228,007	417,863	9.88
Wisconsin	5	650,761	118,523	18.21
Rhode Island	4	2,123,893	173,849	8.19
District of Columbia	3	1,894,805	82,530	4.36
Idaho	3	610,144	130,288	21.35
Maine	3	516,078	45,157	8.75
Montana	3	235,725	28,597	12.13
Nevada	3	321,888	7,887	2.45
Hawaii	2	257,678	4,445	1.73
New Hampshire	2	364,000	50,073	13.76
Guam	1	9,444	8,825	93.45
Delaware	0	0	0	0
Vermont	0	0	0	0
Totals	1,295	\$621,241,461	\$161,394,273	25.98

Sources: FDIC Division of Research and Statistics, *RTC Statistical Abstract*, and FSLIC annual reports.

Table C.3

**Bank and S&L Failures by Location
Ranked by Number of Institution Failures
1980–1994**

(\$ in Thousands)

Location	Number of Failed Institutions	Institution Assets at Resolution	Institution Resolution Costs	Resolution Costs/ Institution Assets at Resolution (%)
Texas	844	\$196,382,536	\$80,474,109	40.98
California	200	140,706,100	24,051,604	17.09
Oklahoma	162	14,705,272	4,193,404	28.52
Louisiana	153	18,917,056	6,855,686	36.24
Illinois	130	70,238,826	5,818,159	8.28
Florida	111	64,903,379	9,948,995	15.33
Kansas	97	18,566,832	2,325,941	12.53
Colorado	83	10,865,845	4,459,403	41.04
Missouri	69	13,992,132	2,367,581	16.92
Iowa	68	6,019,973	987,836	16.41
New York	66	80,752,574	9,438,195	11.69
New Jersey	62	36,713,086	4,500,561	12.26
Tennessee	59	4,795,503	1,243,491	25.93
Minnesota	52	6,933,815	1,620,892	23.38
Massachusetts	51	33,030,693	4,738,125	14.34
Ohio	47	16,859,190	1,768,039	10.49
Nebraska	41	2,166,342	616,427	28.45
Connecticut	41	19,105,507	2,632,940	13.78
Virginia	39	14,061,219	2,667,957	18.97
Arkansas	33	6,973,503	4,141,477	59.39
Mississippi	30	3,291,395	794,649	24.14
Pennsylvania	29	31,939,922	3,197,923	10.01
Oregon	29	9,676,599	1,052,560	10.88
Indiana	28	2,298,461	281,538	12.25
New Mexico	28	5,271,923	2,300,091	43.63
Wyoming	27	1,332,607	403,186	30.26
Arizona	26	19,834,486	5,850,721	29.50
Georgia	26	5,361,426	634,970	11.84

Table C.3

**Bank and S&L Failures by Location
Ranked by Number of Institution Failures
1980–1994**

(\$ in Thousands)

Continued

Location	Number of Failed Institutions	Institution Assets at Resolution	Institution Resolution Costs	Resolution Costs/ Institution Assets at Resolution (%)
Alabama	23	\$4,398,704	\$547,865	12.46
Maryland	21	11,214,268	1,216,728	10.85
Utah	19	4,718,939	692,734	14.68
New Hampshire	18	5,272,983	1,064,420	20.19
Washington	18	4,512,146	485,766	10.77
Kentucky	18	2,133,689	254,691	11.94
South Dakota	17	1,795,370	83,832	4.67
Michigan	16	4,433,413	381,078	8.60
North Dakota	15	1,824,284	235,916	12.93
North Carolina	15	3,664,618	482,712	13.17
Alaska	13	3,269,676	840,753	25.71
West Virginia	13	1,184,716	190,788	16.10
Montana	13	444,889	68,989	15.51
Puerto Rico	10	4,564,856	529,789	11.61
South Carolina	9	1,680,261	176,442	10.50
District of Columbia	8	4,179,983	434,333	10.39
Rhode Island	7	3,263,918	222,794	6.83
Wisconsin	7	724,890	121,782	16.80
Maine	5	2,740,848	50,771	1.85
Idaho	4	671,375	147,532	21.97
Hawaii	4	269,476	6,207	2.30
Nevada	4	330,677	7,887	2.39
Vermont	2	260,755	44,706	17.14
Delaware	1	612,745	249	0.04
Guam	1	9,444	8,825	93.45
Totals	2,912	\$923,873,125	\$197,664,049	21.40

Sources: FDIC Division of Research and Statistics, *RTC Statistical Abstract*, and FSLIC annual reports.

Table C.4

**Bank Failures by Location
Ranked by Assets at Resolution
1980–1994**
(*\$ in Thousands*)

Location	Number of Failed Banks	Bank Assets at Resolution	Bank Resolution Costs	Resolution Costs/ Bank Assets at Resolution (%)
Texas	599	\$92,973,964	\$13,612,645	14.64
New York	34	49,108,444	5,115,311	10.42
Illinois	33	34,302,370	1,213,368	3.54
Massachusetts	43	26,124,470	3,375,599	12.92
Connecticut	32	17,685,983	2,415,691	13.66
Florida	39	14,965,281	920,709	6.15
Pennsylvania	5	13,705,317	43,803	0.32
New Jersey	14	6,658,401	470,659	7.07
Oklahoma	122	5,504,937	1,460,113	26.52
California	87	5,445,302	1,061,335	19.49
New Hampshire	16	4,908,983	1,014,347	20.66
Louisiana	70	4,401,121	1,088,554	24.73
Missouri	41	3,075,528	535,963	17.43
Alaska	8	2,862,202	615,834	21.52
Tennessee	36	2,331,813	778,258	33.38
District of Columbia	5	2,285,178	351,803	15.39
Maine	2	2,224,770	5,614	0.25
Minnesota	38	1,579,218	196,940	12.47
Kansas	69	1,561,223	347,580	22.26
Rhode Island	3	1,140,025	48,945	4.29
Colorado	59	989,252	277,217	28.02
Washington	4	758,588	54,119	7.13
Iowa	40	721,125	116,627	16.17
New Mexico	11	714,363	183,713	25.72
South Dakota	8	659,667	16,887	2.56
Delaware	1	612,745	249	0.04
Oregon	17	575,551	66,382	11.53

Table C.4

**Bank Failures by Location
Ranked by Assets at Resolution
1980–1994**

(\$ in Thousands)

Continued

Location	Number of Failed Banks	Bank Assets at Resolution	Bank Resolution Costs	Resolution Costs/ Bank Assets at Resolution (%)
Utah	11	\$446,839	\$80,564	18.03
Arizona	17	434,486	88,904	20.46
Wyoming	20	375,109	117,122	31.22
Nebraska	33	343,342	71,151	20.72
Puerto Rico	5	336,849	111,926	33.23
Indiana	10	291,556	33,422	11.46
Mississippi	3	286,729	28,160	9.82
Alabama	9	285,516	21,975	7.70
Virginia	7	284,769	40,691	14.29
Vermont	2	260,755	44,706	17.14
Montana	10	209,164	40,392	19.31
Arkansas	11	191,678	42,711	22.28
Ohio	5	140,193	4,067	2.90
Michigan	3	129,832	22,994	17.71
Kentucky	7	120,678	21,947	18.19
North Dakota	9	107,903	18,869	17.49
Georgia	3	88,003	20,383	23.16
West Virginia	5	77,174	13,743	17.81
Wisconsin	2	74,129	3,259	4.40
North Carolina	2	70,760	6,863	9.70
South Carolina	1	62,790	20,879	33.25
Idaho	1	61,231	17,244	28.16
Maryland	2	55,771	7,777	13.94
Hawaii	2	11,798	1,762	14.93
Nevada	1	8,789	0	0
Guam	0	0	0	0
Totals	1,617	\$302,631,664	\$36,269,776	11.98

Source: FDIC Division of Research and Statistics.

Table C.5

**S&L Failures by Location
Ranked by Assets at Resolution
1980–1994**
(*\$ in Thousands*)

Location	Number of Failed S&Ls	S&L Assets at Resolution	S&L Resolution Costs	Resolution Costs/ S&L Assets at Resolution (%)
California	113	\$135,260,798	\$22,990,269	16.99
MCorp	245	103,408,572	66,861,464	64.66
Florida	72	49,938,098	9,028,286	18.08
Illinois	97	35,936,456	4,604,791	12.81
New York	32	31,644,130	4,322,884	13.66
New Jersey	48	30,054,686	4,029,902	13.41
Arizona	9	19,400,000	5,761,817	29.70
Pennsylvania	24	18,234,605	3,154,120	17.30
Kansas	28	17,005,609	1,978,361	11.63
Ohio	42	16,718,997	1,763,972	10.55
Louisiana	83	14,515,935	5,767,132	39.73
Virginia	32	13,776,450	2,627,266	19.07
Maryland	19	11,158,497	1,208,951	10.83
Missouri	28	10,916,604	1,831,618	16.78
Colorado	24	9,876,593	4,182,186	42.34
Oklahoma	40	9,200,335	2,733,291	29.71
Oregon	12	9,101,048	986,178	10.84
Massachusetts	8	6,906,223	1,362,526	19.73
Arkansas	22	6,781,825	4,098,766	60.44
Minnesota	14	5,354,597	1,423,952	26.59
Iowa	28	5,298,848	871,209	16.44
Georgia	23	5,273,423	614,587	11.65
New Mexico	17	4,557,560	2,116,378	46.44
Michigan	13	4,303,581	358,084	8.32
Utah	8	4,272,100	612,170	14.33
Puerto Rico	5	4,228,007	417,863	9.88
Alabama	14	4,113,188	525,890	12.79
Washington	14	3,753,558	431,647	11.50

Table C.5

**S&L Failures by Location
Ranked by Assets at Resolution
1980–1994**

(\$ in Thousands)

Continued

Location	Number of Failed S&Ls	S&L Assets at Resolution	S&L Resolution Costs	Resolution Costs/ S&L Assets at Resolution (%)
North Carolina	13	\$3,593,858	\$475,849	13.24
Mississippi	27	3,004,666	766,489	25.51
Tennessee	23	2,463,690	465,233	18.88
Rhode Island	4	2,123,893	173,849	8.19
Kentucky	11	2,013,011	232,744	11.56
Indiana	18	2,006,905	248,116	12.36
District of Columbia	3	1,894,805	82,530	4.36
Nebraska	8	1,823,000	545,276	29.91
North Dakota	6	1,716,381	217,047	12.65
South Carolina	8	1,617,471	155,563	9.62
Connecticut	9	1,419,524	217,249	15.30
South Dakota	9	1,135,703	66,945	5.89
West Virginia	8	1,107,542	177,045	15.99
Wyoming	7	957,498	286,064	29.88
Wisconsin	5	650,761	118,523	18.21
Idaho	3	610,144	130,288	21.35
Maine	3	516,078	45,157	8.75
Alaska	5	407,474	224,919	55.20
New Hampshire	2	364,000	50,073	13.76
Nevada	3	321,888	7,887	2.45
Hawaii	2	267,678	4,445	1.73
Montana	3	235,725	28,597	12.13
Guam	1	9,444	8,825	93.45
Vermont	0	0	0	0
Delaware	0	0	0	0
Totals	1,295	\$621,241,461	\$161,394,273	25.98

Sources: FDIC Division of Research and Statistics, *RTC Statistical Abstract*, and FSLIC annual reports

Table C.6

**Bank and S&L Failures by Location
Ranked by Assets at Resolution
1980–1994**

(\$ in Thousands)

Location	Number of Failed Institutions	Institution Assets at Resolution	Institution Resolution Costs	Resolution Costs/ Institution Assets at Resolution (%)
Texas	844	\$196,382,536	\$80,474,109	40.98
California	200	140,706,100	24,051,604	17.09
New York	66	80,752,574	9,438,195	11.69
Illinois	130	70,238,826	5,818,159	8.28
Florida	111	64,903,379	9,948,995	15.33
New Jersey	62	36,713,086	4,500,561	12.26
Massachusetts	51	33,030,693	4,738,125	14.34
Pennsylvania	29	31,939,922	3,197,923	10.01
Arizona	26	19,834,486	5,850,721	29.50
Connecticut	41	19,105,507	2,632,940	13.78
Louisiana	153	18,917,056	6,855,686	36.24
Kansas	97	18,566,832	2,325,941	12.53
Ohio	47	16,859,190	1,768,039	10.49
Oklahoma	162	14,705,272	4,193,404	28.52
Virginia	39	14,061,219	2,667,957	18.97
Missouri	69	13,992,132	2,367,581	16.92
Maryland	21	11,214,268	1,216,728	10.85
Colorado	83	10,865,845	4,459,403	41.04
Oregon	29	9,676,599	1,052,560	10.88
Arkansas	33	6,973,503	4,141,477	59.39
Minnesota	52	6,933,815	1,620,892	23.38
Iowa	68	6,019,973	987,836	16.41
Georgia	26	5,361,426	634,970	11.84
New Hampshire	18	5,272,983	1,064,420	20.19
New Mexico	28	5,271,923	2,300,091	43.63
Tennessee	59	4,795,503	1,243,491	25.93
Utah	19	4,718,939	692,734	14.68
Puerto Rico	10	4,564,856	529,789	11.61

Table C.6

**Bank and S&L Failures by Location
Ranked by Assets at Resolution
1980–1994**

(\$ in Thousands)

Continued

Location	Number of Failed Institutions	Institution Assets at Resolution	Institution Resolution Costs	Resolution Costs/ Institution Assets at Resolution (%)
Washington	18	\$4,512,146	\$485,766	10.77
Michigan	16	4,433,413	381,078	8.60
Alabama	23	4,398,704	547,865	12.46
District of Columbia	8	4,179,983	434,333	10.39
North Carolina	15	3,664,618	482,712	13.17
Mississippi	30	3,291,395	794,649	24.14
Alaska	13	3,269,676	840,753	25.71
Rhode Island	7	3,263,918	222,794	6.83
Maine	5	2,740,848	50,771	1.85
Indiana	28	2,298,461	281,538	12.25
Nebraska	41	2,166,342	616,427	28.45
Kentucky	18	2,133,689	254,691	11.94
North Dakota	15	1,824,284	235,916	12.93
South Dakota	17	1,795,370	83,832	4.67
South Carolina	9	1,680,261	176,442	10.50
Wyoming	27	1,332,607	403,186	30.26
West Virginia	13	1,184,716	190,788	16.10
Wisconsin	7	724,890	121,782	16.80
Idaho	4	671,375	147,532	21.97
Delaware	1	612,745	249	0.04
Montana	13	444,889	68,989	15.51
Nevada	4	330,677	7,887	2.39
Hawaii	4	269,476	6,207	2.30
Vermont	2	260,755	44,706	17.14
Guam	1	9,444	8,825	0
Totals	2,912	\$923,873,125	\$197,664,049	21.40

Sources: FDIC Division of Research and Statistics, *RTC Statistical Abstract*, and FSLIC annual reports.

Table C.7

**Bank Failures by Location
Ranked by Bank Resolution Costs
1980–1994**

(\$ in Thousands)

Location	Number of Failed Banks	Bank Assets at Resolution	Bank Resolution Costs	Resolution Costs/ Bank Assets at Resolution (%)
Texas	599	\$92,973,964	\$13,612,645	14.64
New York	34	49,108,444	5,115,311	10.42
Massachusetts	43	26,124,470	3,375,599	12.92
Connecticut	32	17,685,983	2,415,691	13.66
Oklahoma	122	5,504,937	1,460,113	26.52
Illinois	33	34,302,370	1,213,368	3.54
Louisiana	70	4,401,121	1,088,554	24.73
California	87	5,445,302	1,061,335	19.49
New Hampshire	16	4,908,983	1,014,347	20.66
Florida	39	14,965,281	920,709	6.15
Tennessee	36	2,331,813	778,258	33.38
Alaska	8	2,862,202	615,834	21.52
Missouri	41	3,075,528	535,963	17.43
New Jersey	14	6,658,401	470,659	7.07
District of Columbia	5	2,285,178	351,803	15.39
Kansas	69	1,561,223	347,580	22.26
Colorado	59	989,252	277,217	28.02
Minnesota	38	1,579,218	196,940	12.47
New Mexico	11	714,363	183,713	25.72
Wyoming	20	375,109	117,122	31.22
Iowa	40	721,125	116,627	16.17
Puerto Rico	5	336,849	111,926	33.23
Arizona	17	434,486	88,904	20.46
Utah	11	446,839	80,564	18.03
Nebraska	33	343,342	71,151	20.72
Oregon	17	575,551	66,382	11.53
Washington	4	758,588	54,119	7.13
Rhode Island	3	1,140,025	48,945	4.29

Table C.7

**Bank Failures by Location
Ranked by Bank Resolution Costs
1980–1994**

(\$ in Thousands)

Continued

Location	Number of Failed Banks	Bank Assets at Resolution	Bank Resolution Costs	Resolution Costs/ Bank Assets at Resolution (%)
Vermont	2	\$260,755	\$44,706	17.14
Pennsylvania	5	13,705,317	43,803	0.32
Arkansas	11	191,678	42,711	22.28
Virginia	7	284,769	40,691	14.29
Montana	10	209,164	40,392	19.31
Indiana	10	291,556	33,422	11.46
Mississippi	3	286,729	28,160	9.82
Michigan	3	129,832	22,994	17.71
Alabama	9	285,516	21,975	7.70
Kentucky	7	120,678	21,947	18.19
South Carolina	1	62,790	20,879	33.25
Georgia	3	88,003	20,383	23.16
North Dakota	9	107,903	18,869	17.49
Idaho	1	61,231	17,244	28.16
South Dakota	8	659,667	16,887	2.56
West Virginia	5	77,174	13,743	17.81
Maryland	2	55,771	7,777	13.94
North Carolina	2	70,760	6,863	9.70
Maine	2	2,224,770	5,614	0.25
Ohio	5	140,193	4,067	2.90
Wisconsin	2	74,129	3,259	4.40
Hawaii	2	11,798	1,762	14.93
Delaware	1	612,745	249	0.04
Nevada	1	8,789	0	0
Guam	0	0	0	0
Totals	1,617	\$302,631,664	\$36,269,776	11.98

Source: FDIC Division of Research and Statistics.

Table C.8

**S&L Failures by Location
Ranked by S&L Resolution Costs
1980–1994**
(*\$ in Thousands*)

Location	Number of Failed S&Ls	S&L Assets at Resolution	S&L Resolution Costs	Resolution Costs/ S&L Assets at Resolution (%)
Texas	245	\$103,408,572	\$66,861,464	64.66
California	113	135,260,798	22,990,269	16.99
Florida	72	49,938,098	9,028,286	18.08
Louisiana	83	14,515,935	5,767,132	39.73
Arizona	9	19,400,000	5,761,817	29.70
Illinois	97	35,936,456	4,604,791	12.81
New York	32	31,644,130	4,322,884	13.66
Colorado	24	9,876,593	4,182,186	42.34
Arkansas	22	6,781,825	4,098,766	60.44
New Jersey	48	30,054,685	4,029,902	13.41
Pennsylvania	24	18,234,605	3,154,120	17.30
Oklahoma	40	9,200,335	2,733,291	29.71
Virginia	32	13,776,450	2,627,266	19.07
New Mexico	17	4,557,560	2,116,378	46.44
Kansas	28	17,005,609	1,978,361	11.63
Missouri	28	10,916,604	1,831,618	16.78
Ohio	42	16,718,997	1,763,972	10.55
Minnesota	14	5,354,597	1,423,952	26.59
Massachusetts	8	6,906,223	1,362,526	19.73
Maryland	19	11,158,497	1,208,951	10.83
Oregon	12	9,101,048	986,178	10.84
Iowa	28	5,298,848	871,209	16.44
Mississippi	27	3,004,666	766,489	25.51
Georgia	23	5,273,423	614,587	11.65
Utah	8	4,272,100	612,170	14.33
Nebraska	8	1,823,000	545,276	29.91
Alabama	14	4,113,188	525,890	12.79
North Carolina	13	3,593,858	475,849	13.24

Table C.8

**S&L Failures by Location
Ranked by S&L Resolution Costs
1980–1994**

(\$ in Thousands)

Continued

Location	Number of Failed S&Ls	S&L Assets at Resolution	S&L Resolution Costs	Resolution Costs/ S&L Assets at Resolution (%)
Tennessee	23	\$2,463,690	\$465,233	18.88
Washington	14	3,753,558	431,647	11.50
Puerto Rico	5	4,228,007	417,863	9.88
Michigan	13	4,303,581	358,084	8.32
Wyoming	7	957,498	286,064	29.88
Indiana	18	2,006,905	248,116	12.36
Kentucky	11	2,013,011	232,744	11.56
Alaska	5	407,474	224,919	55.20
Connecticut	9	1,419,524	217,249	15.30
North Dakota	6	1,716,381	217,047	12.65
West Virginia	8	1,107,542	177,045	15.99
Rhode Island	4	2,123,893	173,849	8.19
South Carolina	8	1,617,471	155,563	9.62
Idaho	3	610,144	130,288	21.35
Wisconsin	5	650,761	118,523	18.21
District of Columbia	3	1,894,805	82,530	4.36
South Dakota	9	1,135,703	66,945	5.89
New Hampshire	2	364,000	50,073	13.76
Maine	3	516,078	45,157	8.75
Montana	3	235,725	28,597	12.13
Guam	1	9,444	8,825	93.45
Nevada	3	321,888	7,887	2.45
Hawaii	2	257,678	4,445	1.73
Delaware	0	0	0	0
Vermont	0	0	0	0
Totals	1,295	\$621,241,461	\$161,394,273	25.98

Sources: FDIC Division of Research and Statistics, *RTC Statistical Abstract*, and FSLIC annual reports.

Table C.9

**Bank and S&L Failures by Location
Ranked by Institution Resolution Costs
1980–1994**

(\$ in Thousands)

Location	Number of Failed Institutions	Institution Assets at Resolution	Institution Resolution Costs	Resolution Costs/ Institution Assets at Resolution (%)
Texas	844	\$196,382,536	\$80,474,109	40.98
California	200	140,706,100	24,051,604	17.09
Florida	111	64,903,379	9,948,995	15.33
New York	66	80,752,574	9,438,195	11.69
Louisiana	153	18,917,056	6,855,686	36.24
Arizona	26	19,834,486	5,850,721	29.50
Illinois	130	70,238,826	5,818,159	8.28
Massachusetts	51	33,030,693	4,738,125	14.34
New Jersey	62	36,713,086	4,500,561	12.26
Colorado	83	10,865,845	4,459,403	41.04
Oklahoma	162	14,705,272	4,193,404	28.52
Arkansas	33	6,973,503	4,141,477	59.39
Pennsylvania	29	31,939,922	3,197,923	10.01
Virginia	39	14,061,219	2,667,957	18.97
Connecticut	41	19,105,507	2,632,940	13.78
Missouri	69	13,992,132	2,367,581	16.92
Kansas	97	18,566,832	2,325,941	12.53
New Mexico	28	5,271,923	2,300,091	43.63
Ohio	47	16,859,190	1,768,039	10.49
Minnesota	52	6,933,815	1,620,892	23.38
Tennessee	59	4,795,503	1,243,491	25.93
Maryland	21	11,214,268	1,216,728	10.85
New Hampshire	18	5,272,983	1,064,420	20.19
Oregon	29	9,676,599	1,052,560	10.88
Iowa	68	6,019,973	987,836	16.41
Alaska	13	3,269,676	840,753	25.71
Mississippi	30	3,291,395	794,649	24.14
Utah	19	4,718,939	692,734	14.68

Table C.9

**Bank and S&L Failures by Location
Ranked by Institution Resolution Costs**

1980–1994

(\$ in Thousands)

Continued

Location	Number of Failed Institutions	Institution Assets at Resolution	Institution Resolution Costs	Resolution Costs/ Institution Assets at Resolution (%)
Georgia	26	\$5,361,426	\$634,970	11.84
Nebraska	41	2,166,342	616,427	28.45
Alabama	23	4,398,704	547,865	12.46
Puerto Rico	10	4,564,856	529,789	11.61
Washington	18	4,512,146	485,766	10.77
North Carolina	15	3,664,618	482,712	13.17
District of Columbia	8	4,179,983	434,333	10.39
Wyoming	27	1,332,607	403,186	30.26
Michigan	16	4,433,413	381,078	8.60
Indiana	28	2,298,461	281,538	12.25
Kentucky	18	2,133,689	254,691	11.94
North Dakota	15	1,824,284	235,916	12.93
Rhode Island	7	3,263,918	222,794	6.83
West Virginia	13	1,184,716	190,788	16.10
South Carolina	9	1,680,261	176,442	10.50
Idaho	4	671,375	147,532	21.97
Wisconsin	7	724,890	121,782	16.80
South Dakota	17	1,795,370	83,832	4.67
Montana	13	444,889	68,989	15.51
Maine	5	2,740,848	50,771	1.85
Vermont	2	260,755	44,706	17.14
Guam	1	9,444	8,825	0
Nevada	4	330,677	7,887	2.39
Hawaii	4	269,476	6,207	2.30
Delaware	1	612,745	249	0.04
Totals	2,912	\$923,873,125	\$197,664,049	21.40

Sources: FDIC Division of Research and Statistics, *RTC Statistical Abstract*, and FSLIC annual reports.

Table C.10

**Bank Failures by Location
Ranked by Resolution Costs/Bank Assets
1980–1994**
(*\$ in Thousands*)

Location	Number of Failed Banks	Bank Assets at Resolution	Bank Resolution Costs	Resolution Costs/ Bank Assets at Resolution (%)
Tennessee	36	\$2,331,813	\$778,258	33.38
South Carolina	1	62,790	20,879	33.25
Puerto Rico	5	336,849	111,926	33.23
Wyoming	20	375,109	117,122	31.22
Idaho	1	61,231	17,244	28.16
Colorado	59	989,252	277,217	28.02
Oklahoma	122	5,504,937	1,460,113	26.52
New Mexico	11	714,363	183,713	25.72
Louisiana	70	4,401,121	1,088,554	24.73
Georgia	3	88,003	20,383	23.16
Arkansas	11	191,678	42,711	22.28
Kansas	69	1,561,223	347,580	22.26
Alaska	8	2,862,202	615,834	21.52
Nebraska	33	343,342	71,151	20.72
New Hampshire	16	4,908,983	1,014,347	20.66
Arizona	17	434,486	88,904	20.46
California	87	5,445,302	1,061,335	19.49
Montana	10	209,164	40,392	19.31
Kentucky	7	120,678	21,947	18.19
Utah	11	446,839	80,564	18.03
West Virginia	5	77,174	13,743	17.81
Michigan	3	129,832	22,994	17.71
North Dakota	9	107,903	18,869	17.49
Missouri	41	3,075,528	535,963	17.43
Vermont	2	260,755	44,706	17.14
Iowa	40	721,125	116,627	16.17
District of Columbia	5	2,285,178	351,803	15.39
Hawaii	2	11,798	1,762	14.93

Table C.10

**Bank Failures by Location
Ranked by Resolution Costs/Bank Assets
1980–1994**

(\$ in Thousands)

Continued

Location	Number of Failed Banks	Bank Assets at Resolution	Bank Resolution Costs	Resolution Costs/ Bank Assets at Resolution (%)
Texas	599	\$92,973,964	\$13,612,645	14.64
Virginia	7	284,769	40,691	14.29
Maryland	2	55,771	7,777	13.94
Connecticut	32	17,685,983	2,415,691	13.66
Massachusetts	43	26,124,470	3,375,599	12.92
Minnesota	38	1,579,218	196,940	12.47
Oregon	17	575,551	66,382	11.53
Indiana	10	291,556	33,422	11.46
New York	34	49,108,444	5,115,311	10.42
Mississippi	3	286,729	28,160	9.82
North Carolina	2	70,760	6,863	9.70
Alabama	9	285,516	21,975	7.70
Washington	4	758,588	54,119	7.13
New Jersey	14	6,658,401	470,659	7.07
Florida	39	14,965,281	920,709	6.15
Wisconsin	2	74,129	3,259	4.40
Rhode Island	3	1,140,025	48,945	4.29
Illinois	33	34,302,370	1,213,368	3.54
Ohio	5	140,193	4,067	2.90
South Dakota	8	659,667	16,887	2.56
Pennsylvania	5	13,705,317	43,803	0.32
Maine	2	2,224,770	5,614	0.25
Delaware	1	612,745	249	0.04
Nevada	1	8,789	0	0
Guam	0	0	0	0
Totals	1,617	\$302,631,664	\$36,269,776	11.98

Source: FDIC Division of Research and Statistics.

Table C.11

S&L Failures by Location
Ranked by Resolution Costs/S&L Assets
1980–1994
(\$ in Thousands)

Location	Number of Failed S&Ls	S&L Assets at Resolution	S&L Resolution Costs	Resolution Costs/ S&L Assets at Resolution (%)
Guam	1	\$9,444	\$8,825	93.45
Texas	245	103,408,572	66,861,464	64.66
Arkansas	22	6,781,825	4,098,766	60.44
Alaska	5	407,474	224,919	55.20
New Mexico	17	4,557,560	2,116,378	46.44
Colorado	24	9,876,593	4,182,186	42.34
Louisiana	83	14,515,935	5,767,132	39.73
Nebraska	8	1,823,000	545,276	29.91
Wyoming	7	957,498	286,064	29.88
Oklahoma	40	9,200,335	2,733,291	29.71
Arizona	9	19,400,000	5,761,817	29.70
Minnesota	14	5,354,597	1,423,952	26.59
Mississippi	27	3,004,666	766,489	25.51
Idaho	3	610,144	130,288	21.35
Massachusetts	8	6,906,223	1,362,526	19.73
Virginia	32	13,776,450	2,627,266	19.07
Tennessee	23	2,463,690	465,233	18.88
Wisconsin	5	650,761	118,523	18.21
Florida	72	49,938,098	9,028,286	18.08
Pennsylvania	24	18,234,605	3,154,120	17.30
California	113	135,260,798	22,990,269	16.99
Missouri	28	10,916,604	1,831,618	16.78
Iowa	28	5,298,848	871,209	16.44
West Virginia	8	1,107,542	177,045	15.99
Connecticut	9	1,419,524	217,249	15.30
Utah	8	4,272,100	612,170	14.33
New Hampshire	2	364,000	50,073	13.76
New York	32	31,644,130	4,322,884	13.66

Table C.11

**S&L Failures by Location
Ranked by Resolution Costs/S&L Assets**

1980–1994

(\$ in Thousands)

Continued

Location	Number of Failed S&Ls	S&L Assets at Resolution	S&L Resolution Costs	Resolution Costs/ S&L Assets at Resolution (%)
New Jersey	48	\$30,054,685	\$4,029,902	13.41
North Carolina	13	3,593,858	475,849	13.24
Illinois	97	35,936,456	4,604,791	12.81
Alabama	14	4,113,188	525,890	12.79
North Dakota	6	1,716,381	217,047	12.65
Indiana	18	2,006,905	248,116	12.36
Montana	3	235,725	28,597	12.13
Georgia	23	5,273,423	614,587	11.65
Kansas	28	17,005,609	1,978,361	11.63
Kentucky	11	2,013,011	232,744	11.56
Washington	14	3,753,558	431,647	11.50
Oregon	12	9,101,048	986,178	10.84
Maryland	19	11,158,497	1,208,951	10.83
Ohio	42	16,718,997	1,763,972	10.55
Puerto Rico	5	4,228,007	417,863	9.88
South Carolina	8	1,617,471	155,563	9.62
Maine	3	516,078	45,157	8.75
Michigan	13	4,303,581	358,084	8.32
Rhode Island	4	2,123,893	173,849	8.19
South Dakota	9	1,135,703	66,945	5.89
District of Columbia	3	1,894,805	82,530	4.36
Nevada	3	321,888	7,887	2.45
Hawaii	2	257,678	4,445	1.73
Delaware	0	0	0	0
Vermont	0	0	0	0
Totals	1,295	\$621,241,461	\$161,394,273	25.98

Sources: FDIC Division of Research and Statistics, *RTC Statistical Abstract*, and FSLIC annual reports.

Table C.12

**Bank and S&L Failures by Location
Ranked by Resolution Costs/Institution Assets
1980–1994**
(*\$ in Thousands*)

Location	Number of Failed Institutions	Institution Assets at Resolution	Institution Resolution Costs	Resolution Costs/ Institution Assets at Resolution (%)
Guam	1	\$9,444	\$8,825	93.45
Arkansas	33	6,973,503	4,141,477	59.39
New Mexico	28	5,271,923	2,300,091	43.63
Colorado	83	10,865,845	4,459,403	41.04
Texas	844	196,382,536	80,474,109	40.98
Louisiana	153	18,917,056	6,855,686	36.24
Wyoming	27	1,332,607	403,186	30.26
Arizona	26	19,834,486	5,850,721	29.50
Oklahoma	162	14,705,272	4,193,404	28.52
Nebraska	41	2,166,342	616,427	28.45
Tennessee	59	4,795,503	1,243,491	25.93
Alaska	13	3,269,676	840,753	25.71
Mississippi	30	3,291,395	794,649	24.14
Minnesota	52	6,933,815	1,620,892	23.38
Idaho	4	671,375	147,532	21.97
New Hampshire	18	5,272,983	1,064,420	20.19
Virginia	39	14,061,219	2,667,957	18.97
Vermont	2	260,755	44,706	17.14
California	200	140,706,100	24,051,604	17.09
Missouri	69	13,992,132	2,367,581	16.92
Wisconsin	7	724,890	121,782	16.80
Iowa	68	6,019,973	987,836	16.41
West Virginia	13	1,184,716	190,788	16.10
Montana	13	444,889	68,989	15.51
Florida	111	64,903,379	9,948,995	15.33
Utah	19	4,718,939	692,734	14.68
Massachusetts	51	33,030,693	4,738,125	14.34
Connecticut	41	19,105,507	2,632,940	13.78

Table C.12

**Bank and S&L Failures by Location
Ranked by Resolution Costs/Institution Assets**

1980–1994

(\$ in Thousands)

Continued

Location	Number of Failed Institutions	Institution Assets at Resolution	Institution Resolution Costs	Resolution Costs/ Institution Assets at Resolution (%)
North Carolina	15	\$3,664,618	\$482,712	13.17
North Dakota	15	1,824,284	235,916	12.93
Kansas	97	18,566,832	2,325,941	12.53
Alabama	23	4,398,704	547,865	12.46
New Jersey	62	36,713,086	4,500,561	12.26
Indiana	28	2,298,461	281,538	12.25
Kentucky	18	2,133,689	254,691	11.94
Georgia	26	5,361,426	634,970	11.84
New York	66	80,752,574	9,438,195	11.69
Puerto Rico	10	4,564,856	529,789	11.61
Oregon	29	9,676,599	1,052,560	10.88
Maryland	21	11,214,268	1,216,728	10.85
Washington	18	4,512,146	485,766	10.77
South Carolina	9	1,680,261	176,442	10.50
Ohio	47	16,859,190	1,768,039	10.49
District of Columbia	8	4,179,983	434,333	10.39
Pennsylvania	29	31,939,922	3,197,923	10.01
Michigan	16	4,433,413	381,078	8.60
Illinois	130	70,238,826	5,818,159	8.28
Rhode Island	7	3,263,918	222,794	6.83
South Dakota	17	1,795,370	83,832	4.67
Nevada	4	330,677	7,887	2.39
Hawaii	4	269,476	6,207	2.30
Maine	5	2,740,848	50,771	1.85
Delaware	1	612,745	249	0.04
Totals	2,912	\$923,873,125	\$197,664,049	21.40

Sources: FDIC Division of Research and Statistics, *RTC Statistical Abstract*, and FSLIC annual reports.

Table C.13

Ten Largest Bank Failures 1980–1994

(\$ in Thousands)

Institution	Location	Failure Date	Resolution Costs	Assets*	Resolution Costs/Assets (%)	Resolution Method
Continental Illinois National Bank & Trust	Chicago, IL	5/17/84	\$1,104	\$33,633	3.28	OBA
First Republic Bank Corporation	Dallas, TX	7/29/88	3,857	33,448	11.53	P&A ^{1, 2}
Bank of New England	Boston, MA	1/6/91	889	21,754	4.09	P&A ^{1, 2}
MCorp	Dallas, TX	3/28/89	2,840	15,749	18.03	P&A ^{1, 2}
First City Bancorporation	Houston, TX	4/20/88	1,069	11,200	9.54	OBA
Southeast Bank	Miami, FL	9/19/91	0	10,478	0.00	P&A ³
First City Bancorporation	Houston, TX	10/30/92	0	8,852	0.00	P&A ^{1, 3}
Goldome FSB	Buffalo, NY	5/31/91	848	8,690	9.76	P&A ²
First Pennsylvania Bank	Philadelphia, PA	4/28/80	0	7,953	0.00	OBA
CrossLand Savings Bank, FSB	Brooklyn, NY	1/24/92	740	7,269	10.18	P&A ^{1, 3}

* Assets at resolution. Includes affiliated failed banks.

¹ Resolved following formation of bridge bank.

² Resolution included an Asset Servicing Agreement.

³ Resolution included loss-sharing on specified assets.

OBA = Open Bank Assistance

P&A = Purchase and Assumption

Source: FDIC Division of Research and Statistics.

Table C.14**Ten Most Costly Bank Failures
1980–1994**

(\$ in Thousands)

Institution	Location	Failure Date	Resolution Costs	Assets*	Resolution Costs/Assets (%)	Method
First Republic Bank Corporation	Dallas, TX	7/29/88	\$3,857	\$33,448	11.53	P&A ^{1, 2}
MCorp	Dallas, TX	3/28/89	2,840	15,749	18.03	P&A ^{1, 2}
Continental Illinois National Bank & Trust	Chicago, IL	5/17/84	1,104	33,633	3.28	OBA
Texas American Bank	Fort Worth, TX	7/29/89	1,077	4,753	22.65	P&A
First City Bancorporation	Houston, TX	4/20/88	1,069	11,200	9.54	OBA
Bank of New England	Boston, MA	1/6/91	889	21,754	4.09	P&A ^{1, 2}
Goldome FSB	Buffalo, NY	5/31/91	848	8,690	9.76	P&A ²
New York Bank for Savings	New York, NY	3/26/82	751	3,403	22.08	OBA
CrossLand Savings Bank, FSB	Brooklyn, NY	1/24/92	740	7,269	10.18	P&A ^{1, 3}
The First National Bank of Midland	Midland, TX	10/14/83	526	1,647	31.95	P&A

* Assets at resolution. Includes affiliated failed banks.

¹ Resolved following formation of bridge bank.² Resolution included an Asset Servicing Agreement³ Resolution included loss-sharing on specified assets.

OBA = Open Bank Assistance

P&A = Purchase and Assumption

Source: FDIC Division of Research and Statistics.

Table C.15**Ten Largest S&L Failures
1980–1994**

(\$ in Thousands)

Institution	Location	Failure Date	Resolution Costs	Assets*	Resolution Costs/ Assets (%)	Charter	Resolution Method	Resolved By
American Savings and Loan Association	Stockton, CA	Sep-88	\$5,751	\$33,841	16.99	State	AA	FSLIC
Homefed Bank	San Diego, CA	Jul-92	1,256	12,886	9.75	Federal	P&A	RTC
Gibraltar Savings Association	Simi Valley, CA	Mar-89	777	12,313	6.31	State	P&A	RTC
Franklin Federal Savings Association	Ottawa, KS	Feb-90	118	10,543	1.12	State	P&A	RTC
City Savings Bank	Somerset, NJ	Dec-89	1,759	10,228	17.20	Federal	IDT	RTC
Imperial Federal Savings Association	San Diego, CA	Feb-90	696	9,395	7.41	State	P&A	RTC
Great American Federal Savings Association	San Diego, CA	Aug-91	1,231	9,214	13.36	Federal	P&A	RTC
EmpireFederal Savings Bank	Buffalo, NY	Jan-90	1,567	8,050	19.47	Federal	P&A	RTC
CenTrust Bank	Miami, FL	Feb-90	1,281	7,765	16.49	State	P&A	RTC
Western Savings and Loan Association	Phoenix, AZ	Jun-89	2,273	6,467	35.15	State	P&A	RTC

* Assets at time of takeover for RTC resolutions. Assets for FSLIC transactions are recorded at time of resolution.

AA = Assistance Agreement

P&A = Purchase and Assumption

IDT = Insured Deposit Transfer

Sources: RTC Statistical Abstract and FSLIC annual reports

Table C.16**Ten Most Costly S&L Failures
1980–1994**

(\$ in Thousands)

Institution	Location	Failure Date	Resolution Costs	Assets*	Resolution Costs/Assets (%)	Charter	Resolution Method	Resolved By
American Savings and Loan Association	Stockton, CA	Sep-88	\$5,751	\$33,841	16.99	State	AA	FSLIC
Sunbelt Savings Association	Dallas, TX	Aug-88	3,788	2,214	171.08	State	AA	FSLIC ¹
Gibraltar Savings Association	Houston, TX	Dec-88	2,875	6,398	44.93	State	AA	FSLIC ¹
Lincoln Savings	Irvine, CA	Apr-89	2,661	5,374	49.51	State	P&A	RTC
First Texas Savings Association	Dallas, TX	Dec-88	2,545	2,920	87.16	State	AA	FSLIC ¹
University Federal Savings Association	Houston, TX	Feb-89	2,545	3,762	51.36	State	P&A	RTC
Western Savings and Loan Association	Phoenix, AZ	Jun-89	2,273	6,467	35.15	State	P&A	RTC
Guaranty Federal Savings and Loan Association	Dallas, TX	Sep-88	2,131	1,961	108.68	Federal	AA	FSLIC ¹
Lamar Savings Association	Austin, TX	May-88	2,018	1,919	105.13	State	AA	FSLIC
San Jacinto Savings Association	Houston, TX	Nov-90	\$1,795	\$2,228	55.34	State	P&A	RTC

* Assets at time of takeover for RTC resolutions. Assets for FSLIC transactions are recorded at time of resolution.

¹ Resolved as part of FSLIC's Southwest Plan.

AA = Assistance Agreement

P&A = Purchase and Assumption

Sources: RTC Statistical Abstract and FSLIC annual reports.

