

# CHAPTER 1 - INTRODUCTION

The United States of America provides protection to depositors in its banks, savings and loan associations, and credit unions. One of the key players in this process is the Federal Deposit Insurance Corporation (FDIC), which oversees the insurance funds for banks and for savings and loan (S&L) associations (also known as thrifts).

The FDIC's primary mission is to maintain stability and public confidence in the United States financial system by insuring deposits up to the legal limit<sup>1</sup> and promoting sound banking practices. In its unique role as deposit insurer, and in cooperation with other federal and state regulatory agencies, the FDIC promotes the safety and soundness of insured depository institutions and the U.S. financial system by identifying, monitoring, and addressing risks to the deposit insurance funds through its bank examination practices.

The FDIC promotes public understanding of banking and sound public policies by providing financial and economic information and analysis. It minimizes disruptive effects from the failures of banks and savings and loan associations, and it assures fairness in the sale of financial products and the provision of financial services. The FDIC is responsible for effectively managing receivership operations and for making sure that failing institutions are resolved in the manner that will result in the least cost to the deposit insurance funds.

To fulfill its mission, the FDIC performs three functions.

- In its capacity as insurer, the FDIC maintains, manages, and controls risks to two deposit insurance funds.<sup>2</sup> Whenever a federally insured depository institution fails, the FDIC pays off insured deposits or, more frequently, it arranges for the transfer of accounts from the failed institution to a healthy one.
- The FDIC shares responsibility for the supervision and regulation of banks and thrifts in the United States with other federal regulators and with state banking authorities. Of the federal banking agencies, the Office of the Comptroller of the Currency is responsible for supervising national banks; the Federal Reserve System is responsible for supervising both state member banks and holding companies; and the FDIC is responsible for supervising state nonmember banks and FDIC insured savings bank.<sup>3</sup>

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<sup>1</sup> The limit for deposit insurance was initially set at \$2,500; this limit was raised to \$5,000 on June 30, 1934; \$10,000 in 1950; \$15,000 in 1966; \$20,000 in 1969; \$40,000 in 1974; and \$100,000 in 1980, where it remains to this day.

<sup>2</sup> The Financial Institutions Reform, Recovery, and Enforcement Act of 1989 established two separate deposit insurance funds, the Bank Insurance Fund (BIF) and the Savings Association Insurance Fund (SAIF).

<sup>3</sup> FDIC, *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), 463.

- The FDIC acts as the receiver or liquidating agent for failed federally insured depository institutions. In its role as receiver, the FDIC has a fiduciary obligation to all creditors of the receivership<sup>4</sup> and to stockholders of the failed institution to maximize the amounts recovered as quickly as possible.

The FDIC has learned a great deal about the regulation of bank and thrift institutions since it was created in 1933. An important part of that experience has been learning how best to resolve failed financial institutions. By “resolving” a failed bank or thrift, the FDIC meets its obligations to the failed institution’s customers who had insured deposits and helps maintain the stability of the banking system.

The **resolution process** involves valuing a failing federally insured depository institution, marketing it, soliciting and accepting bids for the sale of the institution, determining which bid is least costly to the insurance fund, and working with the acquiring institution(s) through the closing process (or ensuring the payment of insured deposits in the event there is no acquirer).

The **receivership process** involves performing the closing function at the failed bank or thrift; liquidating any remaining failed institution assets; and distributing any proceeds of the liquidation to the FDIC, to the failed institution’s customers who had uninsured deposit amounts, to general creditors, and to those with approved claims.

The United States has confronted massive bank failures more than once in its history. One notable time was in the midst of the Great Depression, when 9,096 banks failed from 1930 through the first three months of 1933. The FDIC was created in response to this crisis, and the foundation was laid for our current system of deposit insurance.

The success of the U.S. deposit insurance system through the 1950s and 1960s may be partly attributed to the generally stable and prosperous economic climate that prevailed, as well as to the regulated environment in which banks operated. During that 20-year period, 75 banks failed, an average of fewer than four banks per year. While this number of failures may seem large in comparison to bank failures in most other countries, it is important to note that the United States banking system consists of a large number of small, independent banks that serve their communities. For example, in 1979, there were 14,364 insured commercial and mutual savings banks in the United States and 4,363 S&Ls.

The banking economy began to change in the 1970s, leading up to the banking and thrift industry crisis of 1980 through 1994 during which time 1,617 banks and 1,295 savings and loan institutions failed or required financial assistance. By 1995, the number of financial institutions had decreased, leaving 9,040 insured commercial and mutual savings banks in the United States and 2,030 S&Ls.

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<sup>4</sup> A failed institution’s creditors include the FDIC (in its corporate capacity), which essentially stands in the place of the failed institution’s customers with insured deposits.

Until 1989, the Federal Savings and Loan Insurance Corporation (FSLIC), which was created in 1934 under the National Housing Act, insured savings and loan associations. The FSLIC insurance fund was declared insolvent in 1987, and the U.S. Congress dissolved that agency in 1989, transferring its failure resolution and receivership responsibilities to the newly created Resolution Trust Corporation (RTC). At that time, the U.S. Congress also gave responsibility for insuring the deposits in S&Ls to the FDIC.

The FDIC was responsible for developing a plan to address the savings and loan crisis of the 1980s and for helping the fledgling RTC begin to manage hundreds of thrift failures. The RTC was an independent temporary government agency created by the U.S. Congress specifically to handle the savings and loan crisis. At its inception on August 9, 1989, RTC's sunset date was established as December 31, 1996. Because of the efficiency with which it handled its task, the RTC was closed one year early. When the RTC was dissolved as of December 31, 1995, its duties with regard to failure resolution and receivership management for S&Ls were transferred to the FDIC.

Overall, from 1980 through 1994 the United States financial institution crisis resulted in 2,912 failed or assisted financial institutions. By 1995, the number of combined annual failures and assistance transactions had dropped to eight, and to six by 1996. In 1997, there was only one bank failure, and no failures of savings and loan associations. Chart 1-1 shows all the failures and assistance transactions per year, per agency during the crisis years.

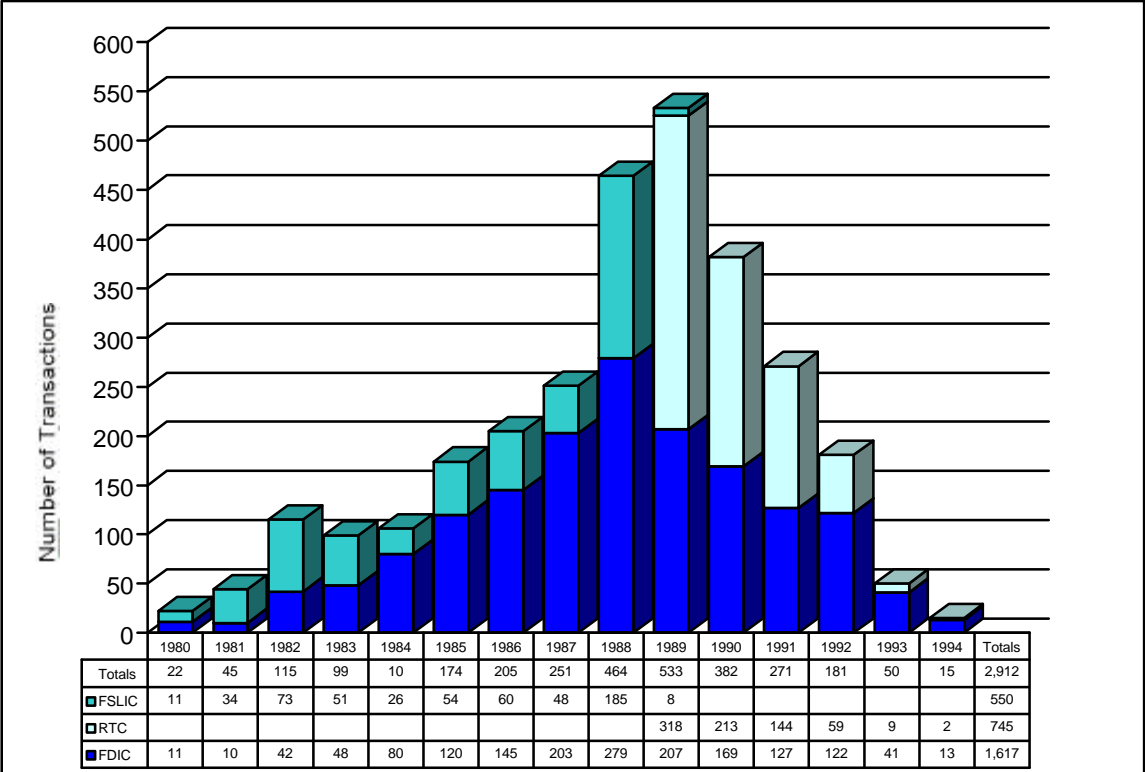
Many countries face difficulties with their financial industries not unlike the ones that the FDIC faced first at its inception and again in the 1980s and the early 1990s. Each year the FDIC provides information and resources to a wide range of foreign and domestic parties interested in the FDIC's resolution experiences. The purpose of this publication is to describe the FDIC's resolution process, to outline the different resolution methods, to provide information on other resolution alternatives, to describe the duties of the FDIC as receiver, and to highlight some important lessons learned through the FDIC's more than 60 years of experience in resolving failing and failed institutions.

The intended audiences for this publication are regulators and chartering authorities of foreign financial institutions, foreign central bankers, and others interested in the bank and thrift industries and their regulation. By sharing this information, the FDIC hopes to contribute to the international dialogue needed to promote stable banking systems and productive economies throughout the world.

A glossary is included in the back of this handbook for easy reference to the terms and abbreviations used herein.

**Chart 1-1**

**Total Failures and Assistance Transactions  
(Banks and Savings & Loans)  
1980-1994**



Figures include open bank assistance transactions.

Source: FDIC Division of Research and Statistics.

## CHAPTER 2 – THE RESOLUTIONS PROCESS

Protecting insured deposits in the event of a bank or thrift failure is one of the Federal Deposit Insurance Corporation's (FDIC) most critical roles. When an insured depository institution is about to fail, the FDIC takes immediate action to resolve it. Any resolution process should be performed quickly and smoothly. In the case of a small bank or thrift, swift resolution minimizes disruption to the local community. In the case of a very large institution, a failure can have national economic implications, and speed in resolving the problem is critical.

There are three basic resolution methods for failing institutions, which are described in more detail in Chapter 3, Purchase and Assumption Transactions, Chapter 4, Deposit Payoffs, and Chapter 5, Open Bank Assistance Transactions.

- A **purchase and assumption (P&A) transaction** is a closed institution<sup>1</sup> 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. Occasionally, an acquirer may receive assistance from the FDIC as insurer to complete the transaction. As a part of the P&A transaction, the acquirer usually pays a premium<sup>2</sup> to the FDIC for the assumed deposits, which decreases the total resolution cost.
- In a **deposit payoff**, as soon as the appropriate chartering authority closes the bank or thrift, the FDIC is appointed receiver. The FDIC as insurer pays all of the failed institution's depositors with insured funds the full amount of their insured deposits.<sup>3</sup> Depositors with uninsured funds and other general creditors (such as suppliers and service providers) of the failed institution do not receive either immediate or full reimbursement; instead, the FDIC as receiver issues them receivership certificates. A receivership certificate entitles its holder to a portion of the receiver's collections on the failed institution's assets.
- In an **open bank assistance (OBA) transaction**, the FDIC as insurer provides financial assistance to an operating insured bank or thrift determined to be in danger of failing. The FDIC can make loans to, purchase the assets of, or place deposits in a troubled institution. Where possible, an assisted institution is expected to repay its assistance loan.<sup>4</sup> Due to restrictions imposed under the Federal Deposit Insurance Corporation Improvement Act (FDICIA) of 1991 and under The Resolution Trust Corporation Completion Act of 1993,

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<sup>1</sup> A closed financial institution is one whose charter has been revoked by its chartering authority.

<sup>2</sup> The premium is the part of a bid for a failing institution's franchise value.

<sup>3</sup> 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 deposits are under the insurance limit. Similarly, the term “uninsured depositor” is used to refer to those depositors whose 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 that is over \$100,000 is uninsured.

<sup>4</sup> Generally, an OBA agreement includes provisions for the repayment of the assistance in whole or in part.

which amended the Federal Deposit Insurance Act of 1950, OBA is no longer a commonly used resolution method.

During the 1980s, there were a number of adaptations of these basic resolution methods as the nation grappled with a large number of failing banks under challenging economic conditions. Between 1980 and 1994, the FDIC and other financial regulatory agencies developed an array of strategies. Some of these strategies were refined over time, while others were abandoned after they had served their purpose. Although cost considerations determine the ultimate method through which a failed institution is resolved, the FDIC still possesses sufficient latitude to customize particular resolution methods within that framework. Circumstances frequently dictate that the methods be modified considerably.

In every failing institution transaction, the FDIC assumes two roles. First, the FDIC in its corporate capacity as insurer protects all of the failing institution's depositors for the amount of their insured deposits by using one of various resolution techniques. Second, the FDIC acts as the receiver of the failed institution and administers the receivership estate for all creditors. The FDIC as receiver is functionally separate from the FDIC acting in its corporate role as deposit insurer, and the FDIC as receiver has separate rights, duties, and obligations from those of the FDIC as insurer. U.S. courts have long recognized these dual and separate capacities. More information on this subject is provided in Chapter 7, The FDIC's Role as Receiver.

## Resolution Strategies

In the United States, a bank or thrift institution must obtain a charter from a recognized chartering authority in order to obtain federal deposit insurance and do business. The chartering authority typically closes an institution when the institution becomes insolvent, critically undercapitalized, or unable to meet requests for deposit withdrawals.<sup>5</sup> The chartering authority, which is the individual 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.

Although the FDIC monitors troubled banks, its 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.<sup>6</sup> Once the FDIC receives a failing bank letter, a planning team from the FDIC

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<sup>5</sup> In 1991, the FDIC was given the authority to close an institution that was considered to be critically undercapitalized (that is, 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 either 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.

<sup>6</sup> In the past, the FDIC was hesitant to undertake much pre-failure activity regarding a failing institution for fear that such action would cause the institution's customers to panic and withdraw their funds, causing a deposit "run" on the bank or thrift. A deposit run erodes an institution's liquidity and can accelerate its failure. Although bank and thrift customers have confidence in the stability of the banking system, the FDIC still maintains confidentiality regarding a failing institution's status.

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 of 5 to 15 FDIC resolution specialists visits the bank or thrift to gather additional information and analyze the institution's condition. The resolution team assigns a value to all the assets of the institution, determines the resolution options the FDIC will offer, prepares an information package for the FDIC to give to potential bidders, and plans for the closing and receivership.

### *Asset Valuation*

Simultaneously, the FDIC begins a review of the failing institution's assets using valuation models to estimate the liquidation value of the assets. This estimate is used in calculating the cost of a deposit payoff. Because the FDIC does not have enough time to assess every asset, it uses a statistical sampling procedure. Loans are divided into categories, such as real estate, commercial, and installment loans, and within each category the loans are identified as either performing or nonperforming. For each subcategory of loans, FDIC specialists identify a sample and carefully review the selected loans to establish an estimated liquidation value for each loan. The liquidation value is driven by the future cash flows and the expenses likely to be incurred during the collection of the loans. 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.

### *Determining the Resolution Structure*

All of the information gathered during the FDIC's review of a failing institution is used to determine the appropriate resolution structures to offer to potential bidders. In developing the marketing strategy, the FDIC considers four factors: 1) the asset and liability composition of the failing institution; 2) the competitive and economic conditions of the institution's market area; 3) any prior resolution experience with similar institutions in the same market; and 4) any other relevant information, such as potential fraud at the institution. Based on this 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 institution; that is, whether to sell it as a 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 prospective purchasers.
- How to package saleable assets; for example, should the acquirer be required to purchase them, should they be sold with loss sharing, or should they be offered as optional asset pools.<sup>7</sup>

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<sup>7</sup> Both loss sharing transactions and optional asset pools are described more fully in Chapter 3, Purchase and Assumption

- At what price the assets should be sold; for example, at book value, at a fixed value estimated by the FDIC, or at the reserve price.

In the early to mid-1980s, the FDIC was able to select the resolution method it preferred as long as the cost of the chosen method was less than the estimated cost of paying off the depositors and liquidating the failed institution's assets.<sup>8</sup> As the banking crisis became more acute toward the end of the 1980s, the FDIC tended to choose resolution transactions that passed a large portion of a failing institution's assets to the acquirer. This type of transaction was chosen for a variety of reasons that are described more fully in Chapter 3, Purchase and Assumption Transactions.

Since 1991, the FDIC has been subject to a new provision of the law that requires it to use the resolution type that is the least costly of all possible options. As a result, bidders of failed institutions have been offered a number of options, which tends to increase the number of bids the FDIC receives.

### *The Information Package*

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

### *Planning 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.

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Transactions.

<sup>8</sup> The FDIC developed a cost test in 1951 to determine the cost of a proposed resolution. The cost test was used to determine whether a purchase and assumption (or other) transaction would cost less than a deposit payoff. Purchase and assumption transactions resulted in *de facto* deposit insurance for all depositors, whereas deposit payoffs protected only customers with insured deposits.

## Marketing a Failing Institution

Once the information has been gathered and the resolution options to be offered have been selected, the FDIC, while still cognizant of confidentiality concerns, begins to market 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 approved financial institutions and private investors.<sup>9</sup> In compiling the list, the FDIC takes into account the failed institution's geographic location, competitive environment, minority-owned status, overall financial condition, asset size, capital level, and regulatory ratings. Private investors wishing to bid on a failing institution must have adequate funds and be engaged in the process of obtaining a charter to create a new institution.

### *The Information Meeting*

The FDIC invites all approved bidders to an information meeting. After signing confidentiality agreements, bidders receive copies of the information package, which includes financial data on the institution, legal documents, and descriptions of the resolution options being offered. At the meeting, the FDIC provides details on the failing institution, the resolution methods being offered, the legal documents, the due diligence process,<sup>10</sup> and the bidding procedures. Typically, the terms of the transaction focus 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 will pass to an acquirer as part of each of the various transactions terms; which assets the FDIC plans to retain; the 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. Chartering authority officials describe the regulatory requirements for bidding, as well as the application process for branches or new charters.<sup>11</sup>

### *Revealing the FDIC's Reserve Price for Assets*

For many years, the FDIC sold assets of failing institutions revealing only the book value of the assets, which is the principal amount shown on the failing institution's books or records. When only the book value was disclosed, bidding institutions were unaware of the FDIC's estimated value for the asset pool. The FDIC establishes the reserve price by estimating the fair market value of the assets in each pool and then deducting any estimated costs of disposition and direct marketing, arriving at a net figure that is known as the liquidation value of the assets. The reserve price is the liquidation value of the assets expressed as a percentage of the book value. For example, a reserve price for a mortgage loan pool might be listed as 94 percent.

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<sup>9</sup> The bid list is reviewed by the financial regulatory authorities concerned, including the Office of the Comptroller of the Currency, the Federal Reserve Board, the Office of Thrift Supervision, and the appropriate state banking authority to determine which bidders will be approved to acquire the failing institution.

<sup>10</sup> Due diligence is a potential purchaser's on-site inspection of the books and records of a failing institution.

<sup>11</sup> Private investors who do not already hold a financial institution charter must be approved for a new charter, known as a *de novo* charter, by the appropriate chartering authority, before they can purchase a failing institution. They cannot purchase a failed institution without the chartering authority's approval.

The estimated liquidation value of the assets is a part of the FDIC's cost test for the resolution of the institution. Therefore, if a potential acquirer offers an amount at least equal to the FDIC's estimated liquidation value of the assets, that bid will be evaluated as less expensive than the cost of the FDIC's conducting a payoff of the failed institution's insured deposits and a liquidation of the assets. If no investor bids an amount at least equal to the FDIC's estimated liquidation value, then the asset pool remains with the receivership.

In the early 1990s, the FDIC attempted to increase the volume of assets sold at resolution by revealing the FDIC's reserve price for the asset pools. There are advantages and disadvantages to this practice. One advantage is that it promotes the sale of the loans. Revealing the reserve price encourages potential acquirers to have confidence that the FDIC's estimates are reasonable and that the time they invest in due diligence will be well spent.

The principle disadvantage to revealing the reserve prices of the asset pools occurs in transactions with few bidders. When bidders know there is little competition, revealing the reserve price may bias the bidding toward the reserve prices. For example, if an asset pool has a book value of \$1 million and if the FDIC estimates the fair market value to be only \$900,000 and the collection expenses to be another \$50,000, the FDIC's reserve price will be 85 percent of the book value of the assets. A potential acquirer, having completed its own due diligence, may have estimated the fair market value of the assets to be \$950,000 and its own collection costs as \$30,000. That potential acquirer might ordinarily have bid up to 92 percent. However, if the FDIC discloses its 85 percent reserve price, the potential acquirer facing little competition might bid closer to 85 percent than to 92 percent. Although the FDIC's acceptance of the bid at 85 percent is less expensive for the FDIC than the cost of liquidating the assets, the reduced bid results in a loss of income for the receivership estate.

Even though the FDIC requires separate bids for the deposits (franchise value) and for the assets, many potential bidders frequently view a failing institution as a whole and will formulate the total amount they are willing to bid. They submit bids that link their franchise and asset bids into one "all-or-nothing" bid. If the FDIC's reserve price for the asset pools is higher than what a bidder had wanted to pay, a potential acquirer may offer the reserve price of the assets and correspondingly lower the amount it offers for the deposit franchise.

For example, a bidder may have valued a hypothetical failing institution at \$1 million by estimating the value of the asset pools (net of collection costs) at \$800,000 and the value of the deposit franchise at \$200,000. In this example, the FDIC is offering two asset pools: one has a book value of \$500,000 with a reserve price of 85 percent (\$425,000), and the second has a book value of \$800,000 with a reserve price of 50 percent (\$400,000). The bidder must offer at least \$825,000 to acquire the two asset pools. The bidder may offer the same \$1 million bid for the entire institution by lowering its bid for the franchise to \$175,000. Exhibit 2-1 illustrates this example. Such a situation can occur only if competition among the bidders is minimal, because a bidder has a greater risk of losing the deposit franchise if it submits a low bid in a more competitive setting.

## ***Exhibit 2-1***

## **How Revealing the Reserve Price for Asset Pools May Affect Deposit Franchise Bidding**

<b>Bidder's calculations after due diligence</b>		<b>Bidder's calculations to meet reserve price on assets</b>	
Estimate of asset value	\$800,000	Bid for asset pools	\$825,000
Estimate of franchise value	<u>200,000</u>	Bid for franchise	<u>175,000</u>
Total bid	\$1,000,000	Total bid	\$1,000,000

Historically, bankers have been reluctant to purchase assets of failing banks or thrifts unless they received the corresponding deposit base to fund the acquisition of the loans. In transactions completed between 1992 and 1994, virtually all of the assets passed to acquirers were part of asset pool bids that were contingent on the bidding bank winning the franchise. On the other hand, the Resolution Trust Corporation (RTC) experienced little difficulty in marketing the deposit franchise separately from the assets. Both methods should be offered to determine what the market will bear in a particular area. Exhibit 2-2 shows the benefits and other considerations of disclosing the reserve price on optional asset pools.

### **Exhibit 2-2**

#### ***Disclosing the Reserve Price on Optional Asset Pools***

##### **Benefits**

- ◆ *Ensures that at least the minimum is bid for each asset pool.*
- ◆ *Encourages bidders to invest in due diligence.*
- ◆ *Eliminates unrealistic bids and provides serious bidders with information necessary to formulate their bids.*

##### **Other Considerations**

- ◆ *May potentially recoup less money for the receivership estate in less competitive situations.*

### ***Branch Breakups***

Some financial institutions may be worth more if sold in pieces. In certain failing institution situations, there may be few, if any, acquirers willing to assume the deposits of all branches of a multi-branch bank or thrift. A solution to this problem is to offer individual branches along with their deposits as a resolution option. The RTC used this strategy frequently in resolving multi-branch institutions, and the FDIC subsequently adopted this method.

Offering failing institutions on both a whole franchise and a branch breakup basis expands the universe of potential bidders. It allows smaller institutions to participate along with larger institutions

that may be interested only in certain branches or markets. The RTC/FDIC experience shows that this process results in more bidders and higher premiums than if failing institutions are only marketed on a whole franchise basis.

Branch breakup transactions have certain disadvantages. Electronic data processing and conversion costs to facilitate the acquisition are generally higher than in whole franchise deals, and it is more difficult to complete transactions quickly and smoothly in branch breakup transactions. Further, branch breakups require one of the acquiring institutions to be the “lead” acquirer and to provide backroom operations (accounting, payment posting, and check processing) 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, because there is little marketability for extra buildings and there is not ample opportunity for acquirers to generate new account activity. Exhibit 2-3 shows the benefits and other considerations of branch breakups.

### **Exhibit 2-3**

#### **Branch Breakups**

##### **Benefits**

- ◆ *Expands universe of potential bidders by allowing smaller institutions to participate in the bidding, which may increase the premiums received.*
- ◆ *Increases the resolution options available to the bidders.*

##### **Other Considerations**

- ◆ *Electronic data processing and conversion costs are generally higher.*
- ◆ *It is more difficult to complete transactions quickly and smoothly.*
- ◆ *Requires one of the acquiring institutions to be “lead” acquirer.*
- ◆ *Some branches may be undesirable, and a payoff of their insured deposits may have to be completed.*

#### *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 franchise, and is performed so the bidder can submit an educated bid. The failing institution’s board of directors must pass a board resolution authorizing the FDIC to conduct on-site due diligence before bidders visit the institution, because the institution is still an ongoing entity under private ownership. All bidders performing due diligence are provided the same information so no one bidder has an advantage.

Occasionally, the reality of the due diligence process spurs the failing bank into action to find sources of capital on their own. When this happens, the resolution process is put on hold. If the failing bank’s plan for an unassisted merger or capital injection pans out, the resolution process is

terminated; if the plan falls through, the resolution process resumes and all information is updated if there was a significant time lapse.

## Bid Submission

After all bidders have completed their due diligence, bidders submit their proposals to the FDIC. This generally occurs 12 to 15 days before the scheduled closing, but it is often as few as 6 or 7 days before closing. To determine the least cost resolution, all bids, including those that do not conform to the FDIC's previously identified resolution methods (referred to as nonconforming bids) are evaluated and compared with each other and with the FDIC's estimated cost of liquidation.

A bid has two parts: one amount, called the premium, is for the franchise value of the failing institution's deposits; and the second amount is what the bidder is willing to pay to acquire the institution's assets. The first figure generally represents the bidder's perception of the value of the customer base; and the second amount reflects the bidder's perception of the imbedded losses and the level of risk associated with the assets.<sup>12</sup>

## Least Cost Analysis

When selecting a resolution method, the FDIC has changed procedures over the years. Before the passage of FDICIA in 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 sometimes discouraged because they 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 had on banking stability and on discouraging shareholders and creditors of insured institutions from excessive risk-taking actions. The FDIC also considered the effect the selected method might have on increasing the inventory level of loans being serviced by the FDIC. After FDICIA, the FDIC amended its failure resolution procedures to accept the "least cost" bid.

The new procedures require the FDIC to choose the alternative in which the total amount of the FDIC's expected expenditures (including any immediate or long-term obligation and any direct or contingent liability for future payment) is the least costly to the deposit insurance fund of all possible methods for resolving the failed institution.

The FDIC determines the least costly resolution transaction by evaluating all possible resolution alternatives and computing costs on a net 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:

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<sup>12</sup> 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.

- The difference between total book value 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.<sup>13</sup>

In most cases, the FDIC will receive at least one bid that is less costly than the estimated cost of liquidation. 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 than liquidation.

The cost to the FDIC of a liquidation and payoff is generally calculated by the formula is shown in exhibit 2-4.

#### **Exhibit 2-4**

##### ***FDIC's Least Cost Test Calculation***

<p>FDIC's cost = (loss to depositors) x (the loss factor)</p> <p>Or more appropriately shown as</p> <p>(loss on all assets - equity capital - unsecured creditors' loss) x (insured deposits/total deposits)</p>
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The first term in parentheses in the equation (loss to depositors) defines the total expected loss on all receivership assets to be absorbed by the depositors. It includes all loan loss reserves as well as an estimate of the FDIC's receivership expenses. This loss is reduced by the amount of equity remaining and by the amounts owed to unsecured creditors (since they now absorb all losses first before the depositors.)

The second term in parentheses in the equation (the loss factor) accounts for the portion of losses absorbed by customers with uninsured deposits in a payoff. It is important to note that the FDIC shares pro rata with customers who had uninsured deposits. For example, if customers who had

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<sup>13</sup> The Financial Institutions Reform, Recovery, and Enforcement Act 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.

uninsured deposits constitute 30 percent of the total deposits, then the FDIC as subrogee<sup>14</sup> has the other 70 percent and will absorb 70 percent of any loss to the depositors.

Savings to the FDIC may come from several sources, such as the premium paid by the acquirer, cross guarantee provisions against affiliated institutions, assets sold to the assuming bank at a smaller discount than that estimated by FDIC staff, and future losses absorbed by the FDIC as a result of loss sharing agreements that are expected to be less than losses incurred through liquidation of assets.

### Calculation of Cash Amount Due to Acquirer

When an open financial institution acquires or assumes the liability for a failing institution’s deposits, the FDIC as insurer reimburses it for the amount of insured deposits.<sup>15</sup> This occurs in two types of transactions: a purchase and assumption transaction and an insured deposit transfer (IDT).<sup>16</sup>

In a P&A, the institution acquiring the deposits of the failed institution is called the acquiring institution; in an IDT, the institution assuming the liabilities is called the agent institution. The amount of cash to be transferred to the acquiring or agent institution is calculated the same way for both P&As and IDTs, as shown in exhibit 2-5.

#### **Exhibit 2-5**

#### ***FDIC’s Amount of Cash to be Transferred Calculation***

$$\text{Cash from FDIC} = \text{Liabilities Assumed} - \text{Assets Purchased} - \text{Premium}$$

An example of this calculation is a failing institution with total deposits of \$120 million, of which \$100 million is insured. The least cost bid submitted contained a \$5 million premium to acquire the insured deposits and an offer of \$48 million to purchase a package of loans. The FDIC would pay \$47 million to the acquiring institution, as shown in exhibit 2-6.

#### **Exhibit 2-6**

#### ***Amount of Cash to be Transferred Calculation Example***

Cash from FDIC	=	Liabilities Assumed	-	Assets Purchased	-	Premium
\$47 million	=	\$100 million	-	\$48 million	-	\$5 million

<sup>14</sup> Subrogee is a term used when the FDIC pays the insured depositors the amounts of their insured deposits and then substitutes itself in the place of the insured depositors in the claims process.

<sup>15</sup> If the premium is for *all* deposits (not just insured deposits), the FDIC can reimburse the acquirer for all deposits *provided* that the transaction is the least costly of all possible transactions.

<sup>16</sup> Purchase and assumption transactions are discussed fully in Chapter 3, Purchase and Assumption Transactions. Insured deposit transfers are a form of deposit payoff, and are discussed fully in Chapter 4, Deposit Payoffs.

## FDIC Board of Directors 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<sup>17</sup> should be paid to customers with uninsured deposits so that 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. Once the Board has approved the transaction, the FDIC staff notifies the acquirer(s), all unsuccessful bidders, and the chartering agency. The FDIC then arranges for the acquirer(s) to sign the appropriate legal documents before the institution's closure. At that time, the FDIC staff meets with the acquirer(s) 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 (usually on a Friday).<sup>18</sup> The FDIC as receiver is then responsible for settling the affairs of the closed bank or thrift. Such activities include balancing the accounts of the institution immediately after closing, transferring certain assets and liabilities to the new owner, and determining the exact amount of payment due the acquirer. The settling of various accounts between the receiver and the acquirer is called "settlement." This process takes from 6 to 12 months, depending on the size of the failed institution. See Chapter 7, The FDIC's Role as Receiver for more information.

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

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<sup>17</sup> Advance dividends are payments made to uninsured depositors soon after a bank fails based on the estimated value of the receivership's assets. Advance dividends typically range between 50 cents and 80 cents on the dollar of the receivership claims.

<sup>18</sup> Friday closings give the FDIC time to work over the weekend. Generally, the new institution opens for business on Saturday and resumes normal operations the following Monday.

## Resolution Timeline

The entire resolution process is generally carried out in 90 to 100 days, not including the post-closing settlement timeframes. It officially begins when the chartering authority advises the FDIC that an insured institution is in imminent danger of failing (although the FDIC monitors troubled institutions on an ongoing basis, the letter is a formal requirement), and ends when the chartering authority appoints the FDIC as receiver. Sometimes the usual resolution process cannot be fully completed before the institution fails, such as in cases of sudden or severe liquidity problems, for example, a systemic deposit run. In those instances, the FDIC usually does not have the time to prepare a review of the assets on site,<sup>19</sup> leaving a greater likelihood that 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, a payoff of the insured deposits, or the formation of a bridge bank. Insured deposit transfers and deposit payoffs are discussed in Chapter 4, Deposit Payoffs; bridge banks are discussed in Chapter 3, Purchase and Assumption Transactions.

A timeline of a typical resolution process is shown on table 2-1.

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<sup>19</sup> 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 as reflected by a sample of prior bank failures.

## CHAPTER 3 – PURCHASE AND ASSUMPTION TRANSACTIONS

Historically, the Federal Deposit Insurance Corporation (FDIC) has used three basic resolution methods: purchase and assumption (P&A) transactions, deposit payoffs, and open bank assistance (OBA) transactions. Of the three, purchase and assumption transactions are the most common.

### Structure of a Purchase and Assumption Transaction

A P&A is a resolution transaction in which a healthy institution *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. P&As are less disruptive to communities than payoffs. There are many variations of P&A transactions; two of the more specialized P&As are loss sharing transactions and bridge banks. Each type of P&A, including loss sharing and bridge banks, are discussed separately on the following pages.

In a P&A, the liabilities assumed by the acquirer include all or some of the deposit liabilities and secured liabilities, for example, deposit accounts secured by U.S. Treasury issues and repurchase agreements.<sup>1</sup> The assets acquired vary depending on the type of P&A. Some of the assets, typically loans, are purchased outright at the bank or thrift closing by the assuming bank under the terms of the P&A. Other assets of the failed institution may be subject to an exclusive purchase option by the assuming institution for a period of 30, 60, or 90 days after the bank or thrift closing.<sup>2</sup>

Some categories of assets *never* pass to the acquirer in a P&A; they remain with the receiver. These include claims against former directors and officers, claims under bankers blanket bonds and director and officer insurance policies, prepaid assessments, and tax receivables. Subsidiaries and owned real estate (except institution premises) pass infrequently to the acquirer in P&A transactions. Additionally, a standard P&A provision allows the assuming institution to require the receiver to repurchase any acquired loan that has forged or stolen instruments.

Before the banking crisis of the 1980s, the price paid by the assuming institution for assets other than cash was based on the value at which the assets were shown on the failing institution's books. Because asset values are generally overstated in a failing bank or thrift, the FDIC's ability to sell

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<sup>1</sup> Repurchase agreements, also known as "repos," are agreements between a seller and a buyer whereby the seller agrees to repurchase securities, usually of U.S. Government securities, at an agreed upon price and, usually, at a stated time. When a bank uses a repo as a short-term investment, it borrows money from an investor, typically a corporation with excess cash, to finance its inventory using the securities as collateral. Repos may have a fixed maturity date or may be "open," meaning that they are callable at any time.

<sup>2</sup> These assets include premises owned by the failed institution, some categories of loans, rights to an assignment of leases for leased premises, data processing equipment, and other contractual services.

assets to an acquiring institution based on book value was limited. As the number of failures increased and liquidity and workload pressures grew, the FDIC began to base the purchase price of assets on their value as established by an asset valuation review performed by FDIC staff.

Until the late 1980s, it was common for an acquiring institution to bid on and purchase a failing institution without performing any review (also known as due diligence) of the failing institution's books and records, especially the loan portfolio. An acquirer was not even selected before the institution was closed. There were two reasons for this. 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. The second reason was that, in the vast majority of transactions, only assets such as cash and cash equivalents<sup>3</sup> were passed to the acquirer, or assets were passed with a put option (discussed later in this chapter). In these circumstances, franchise bidders<sup>4</sup> did not require on-site due diligence. Bidders determined the potential value of the bank based on their knowledge of the local community and upon deposit information provided by examiners.

In a P&A transaction, acquirers may assume *all* deposits, thereby providing 100 percent protection to all depositors.<sup>5</sup> In contrast, in a deposit payoff the FDIC does not cover the portion of a customer's deposits that exceeds the insured limit.<sup>6</sup> In the two decades prior to the 1980s, most failing banks were resolved through P&As which passed all deposits to the acquiring institution. Critics observed that customers with uninsured deposits in large failed banks were less likely to suffer losses than those in small banks because the FDIC preferred to arrange P&A transactions to resolve large failures and because there was usually more market interest in large institutions. The increased market interest for larger institutions resulted in higher bids and smaller losses to the FDIC. The result was that customers with uninsured deposits rarely suffered losses in P&A transactions, and the FDIC essentially provided unlimited insurance coverage to the depositors. This subjected the FDIC to criticism that its resolution policies were inconsistent and inequitable, since smaller banks were more likely to be paid off.

Critics also indicated that when depositors had no fear that the uninsured portion of their deposits would be forfeited at a failure and others (for example, general creditors) with uninsured liabilities at the institution were certain of being paid, then there was essentially limitless deposit insurance which destroyed any market discipline. Although P&As minimized disruption to local communities

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<sup>3</sup> Cash equivalents are assets that readily convertible to cash, such as accounts of the failed institution in other banks, known as "due from" accounts, and marketable securities.

<sup>4</sup> Franchise bidders are potential acquirers bidding only to acquire the failed institution's deposits or the "franchise."

<sup>5</sup> All resolution methods, including P&A transactions which pass *all* deposits to the assuming institution must pass the "least cost" test; see Chapter 2, The Resolution Process.

<sup>6</sup> The owners of uninsured claims are given receiver's certificates that entitle them each to a share of collections from the receivership estate. The percentage of the claims they eventually receive depends on the value of the institution's assets, the total dollar amount of proven claims, and the claimant's relative position in the distribution of claims. See Chapter 7, The FDIC's Role as Receiver for more details.

and to financial markets generally, they appeared to provide inequitable protection for uninsured depositors in large institutions.

### *Preference for Passing Assets*

As the banking crisis became more acute toward the end of the 1980s, the FDIC tended to choose transactions that allowed a large proportion of the assets of a failing institution to pass to the acquirer. Those transactions were chosen for a variety of reasons. First, FDIC management became concerned that the accumulation of assets would drain the liquidity of the insurance fund. Former FDIC Chairman L. William Seidman (1985-1991), noting that prior to that 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 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.<sup>7</sup>

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 almost immediately suffered a loss in value.<sup>8</sup> This loss of value arose from several sources.<sup>9</sup>

Loans had unique characteristics, and prospective purchasers had to gather information about the loans to evaluate them. This “information cost” was factored into the price outside parties paid for loans. This cost tended to be greater when assets were from failed institutions.

Another reason for loss in value was disruption in financing for semi-completed projects. If the parties that made the financing loans were not available, it took time and effort to make decisions about further credit extensions. These delays may have caused disruptions in timing for operating or construction loans and may have contributed to a loss of asset value.

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<sup>7</sup> L. William Seidman, *Full Faith and Credit: The Great S & L Debacle and Other Washington Sagas* (New York: Times Books, 1993), 100.

<sup>8</sup> 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.

<sup>9</sup> Testimony of John F. Bovenzi in the United States Court of Federal Claims, Civil Action No. 90-733C, *Statesman Savings Holding Corp. v. United States of America*.

There was a natural reluctance on the part of receivers to make additional credit extensions, although they sometimes did so to preserve the value of the original loans. Receiverships were entities with limited life and did not operate to risk creating additional losses; receivers told borrowers of failed depository institutions to find new financing institutions. The time it took borrowers to find new lenders may have had an adverse effect on asset value.

Borrowers, who did not need future business dealings with receivers, had more incentive to resolve problem loans with open banks or thrifts than with receivers. Borrowers from failed institutions frequently negotiated with receivers for reduced payments because they knew receivers were interested in expeditiously winding up the affairs of the failed institutions. The receivers calculated the losses of prolonged litigation versus the losses of reduced payoffs and chose the options with the highest net present value.

Some assets lost their value simply because they were from a failed institution. Buyers were less comfortable purchasing assets of a failed institution than from ongoing entities. Assets of failed institutions were described as “tainted.” Prospective purchasers felt greater risk in such purchases and made lower purchase offers.

Receivership administrative costs may have reduced asset values. Things like operational costs, defense of litigation, and payment of claims reduced asset values (or correspondingly raised overall costs).

There was also the idea of supply and demand. In a time when many institutions were failing, there were many receivership assets for sale. That situation may have created downward pressure on prices for those assets.

Third, as the FDIC began managing an extremely large portfolio of failed bank, several logistical problems began to develop. It became more desirable to pass assets to acquirers rather than to incur additional costs of acquiring, maintaining, and subsequently remarketing or collecting those assets.

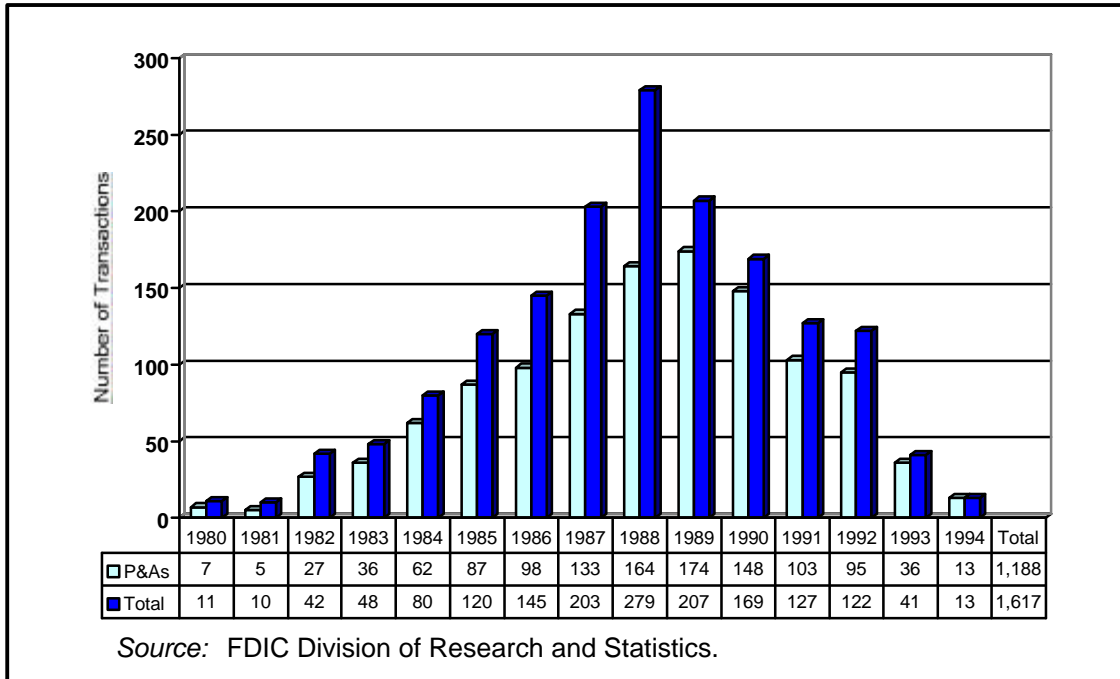
Fourth, it was simply considered more appropriate for private assets to remain within the private marketplace.

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

From 1980 through 1994, the FDIC used P&A transactions to resolve 1,188 out of 1,617 total failures and assistance transactions, or 73.5 percent. Chart 3-1 shows the distribution of P&A transactions per year for this period.

**Chart 3-1**

**FDIC Purchase and Assumption Transactions  
Compared to All Bank Failures and Assistance Transactions  
1980-1994**



**Types of Purchase and Assumption Transactions**

The P&A resolution structure has evolved over time to incorporate procedures and incentives to entice acquirers to take more assets of the failed institution. The following discussion describes some of the variations of the purchase and assumption transaction that the FDIC used under differing circumstances as appropriate.

*Basic P&As*

In basic P&As, assets that pass to acquirers generally are limited to cash and cash equivalents. The premises of failed banks and thrifts (including furniture, fixtures, and equipment) are often offered to acquirers on an optional basis; the price is based upon a post-closing appraisal that is mutually acceptable to the FDIC and the acquirer. The liabilities assumed by the acquirer generally include only the portion of the deposit liabilities covered by FDIC insurance.<sup>10</sup> The basic P&A was a valuable

<sup>10</sup> 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 resolution practices. Previously, the FDIC had structured most of its transactions to transfer both insured and uninsured deposits along with certain failed bank assets. Under FDICIA, however, when transferring the uninsured deposits was not the least cost

resolution method in the early 1980s before the FDIC began allowing due diligence. Once the practice of due diligence was established, other variations of the P&A were used more frequently. Exhibit 3-1 shows the benefits and other considerations of basic P&As.

### **Exhibit 3-1**

#### **Basic P&As**

##### **Benefits**

- ◆ *Customers with insured deposits suffer no loss in service.*
- ◆ *Customers with insured deposits have new accounts with new bank or thrift, but old checks can still be used.*
- ◆ *Customers with insured deposits do not lose interest on their accounts.*
- ◆ *Acquiring bank has the opportunity for new customers.*
- ◆ *Can be used when there is not enough time to complete due diligence.*
- ◆ *FDIC costs are reduced compared to a deposit payoff.*
- ◆ *Reduces the FDIC's initial cash outlay.*

##### **Other Considerations**

- ◆ *Receivership must liquidate the majority of the assets of the failed bank or thrift.*
- ◆ *Uninsured depositors may or may not suffer losses.*

Because of the tremendous increase in bank and thrift failures during the 1980s, the FDIC began to consider techniques and incentives to sell substantially more of the failed institution's assets to the acquirer. P&A transactions were restructured accordingly.

#### *Loan Purchase P&As*

In a loan purchase P&A, the winning bidder assumes a small portion of the loan portfolio, sometimes only the installment loans, in addition to the cash and cash equivalents. Installment loans are rarely the cause of the failing bank's troubles. Therefore, the installment loan portfolio is usually easy to transfer to the assuming institution. Loans that are past due 90 or more days may or may not be retained by the receiver. Typically, a loan purchase P&A transaction would pass between 10 percent and 25 percent of the failed institution's assets. Exhibit 3-2 shows the benefits of loan purchase P&As.

### **Exhibit 3-2**

#### **Loan Purchase P&As**

##### **Benefits**

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solution, the FDIC began entering into P&A transactions that included only the insured deposits.

- ◆ *All the benefits of the basic P&A, plus*
- ◆ *The FDIC passes a large number of small balance loans that are time-consuming for FDIC account officers to service.*

### *Modified P&As*

In a modified P&A, the winning bidder purchases the cash and cash equivalents, the installment loans, and all or a portion of the mortgage loan portfolio. As with the installment loan portfolio, single family residential loans are rarely the cause of a bank's failure and, therefore, can be transferred to the assuming institution easily. Although in a period of rising interest rates, concessions may have to be made to guarantee a certain yield. Installment loans and mortgage loans usually provide the acquirer with a base of loans tied to the deposit accounts. Typically, between 25 percent and 50 percent of the failed bank assets are purchased under a modified P&A structure. Exhibit 3-3 shows the benefits of modified P&As.

### **Exhibit 3-3**

#### **Modified P&As**

##### **Benefits**

- ◆ *All the benefits of the loan purchase P&A, plus*
- ◆ *The FDIC passes a portion of the mortgage loan portfolio; mortgage loans are time-consuming for FDIC account officers to service.*

### *P&As with Put Options*

To induce an acquirer to purchase additional assets, the FDIC offered a "put" option on certain assets that were transferred. Two option programs for purchasing assets that the FDIC typically offered to acquirers 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. 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. Exhibit 3-4 shows the benefits and other considerations of P&As with put options.

## **Exhibit 3-4**

### **P&As with Put Options**

#### **Benefits**

- ◆ *All the benefits of the modified P&A, plus*
- ◆ *Fewer assets were retained by the FDIC.*
- ◆ *Allowed the acquirer time to complete due diligence after the P&A was finalized.*

#### **Other Considerations**

- ◆ *Acquirer was able to “cherry pick” the assets.*
- ◆ *Acquirers tended to neglect assets during the put period.*
- ◆ *Delayed the transfer of assets between the acquirer and the receiver.*

### *P&As with Asset Pools*

In an effort to maximize the sale of assets during the resolution process and keep them in the local banking community, in 1991 the FDIC began offering a P&A transaction with optional asset pools for failing institutions with total assets under \$1 billion. For banks with a diverse loan portfolio, the FDIC believes that it is preferable to break the loan portfolio into separate pools of homogeneous loans (that is, those with the same collateral, terms, payment history, or location) and to market the pools on an optional basis separately from the deposit franchise. The FDIC also groups nonperforming loans, owned real estate, and other loans that do 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. Bidders are able to bid (as a percentage of book value) on those loan pools that interest them, thus improving the marketability of the pools.

Potential acquirers are allowed to submit proposals for the franchise (all deposits or only insured deposits) and for any or all of the pools. The bidders may link the options as a package or they may bid on various combinations of pools.<sup>11</sup> The linked bid is evaluated as one “all-or-nothing” bid. The flexibility of this resolution method has allowed the FDIC to market a failing institution to significantly more potential acquirers, to transfer a higher volume of assets at resolution, and to allow for multiple acquirers.

This resolution strategy is designed to provide additional flexibility since each acquirer has a different interest. Some acquirers believe it is essential to acquire a substantial portion of the assets with the deposit franchise; other acquirers may prefer to purchase assets but do not believe it is essential to

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<sup>11</sup> The largest number of bids ever submitted to date for one failing institution was 126 bids that were placed by only six potential acquirers.

acquire the franchise. There may be acquirers who do not want to purchase any assets, whereas other acquirers are willing to purchase assets only.

One problem with optional asset pools continues to be that many banking institutions are reluctant to acquire commercial assets, even at a discount, without a significant credit enhancement. Such enhancements may include the FDIC sharing in a credit loss, repurchasing assets that are found at some later date to have been misrepresented, or guaranteeing a specific rate of return on the acquirer's investment. Exhibit 3-5 shows the benefits and other considerations of P&As with optional asset pools.

### **Exhibit 3-5**

#### ***P&As with Optional Asset Pools***

##### ***Benefits***

- ◆ *All the benefits of the modified P&A, plus*
- ◆ *Improves marketability of loans.*
- ◆ *Fewer assets are retained by the FDIC.*

##### ***Other Considerations***

- ◆ *Many institutions are reluctant to purchase commercial credits without credit enhancements, even if the assets are purchased at a discount.*
- ◆ *Borrowers may have "split" lines of credit, that is, some loans with the acquirer and some with the FDIC, or even loans with multiple acquirers.*
- ◆ *Requires much pre-closing work for FDIC staff.*

#### ***Whole Bank P&As***

The FDIC's preference for passing assets to acquirers became formal corporate policy on December 30, 1986.<sup>12</sup> The FDIC Board of Directors established an order of priority, known as "sequential bidding," for six alternative transaction methods based on the amount of assets passed to the acquirer.<sup>13</sup>

The whole bank P&A structure emerged as the result of an effort to induce acquirers of failed banks or thrifts to purchase the maximum amount of a failed institution's assets. Bidders were asked to bid on all assets of the failed institution on an "as is," discounted basis (with no guarantees). This type

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<sup>12</sup> 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 again in May 1997 to reflect the changes mandated by the Federal Deposit Insurance Corporation Improvement Act of 1991.

<sup>13</sup> The six transaction types 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.

of sale was beneficial to the FDIC for three reasons. First, loan customers continued to be served locally by the acquiring institution. Second, the whole bank P&A minimized the one-time FDIC cash outlay, and the FDIC had no further financial obligation to the acquirer. Finally, a whole bank transaction reduced the amount of assets held by the FDIC for liquidation.

The FDIC offered 313 whole bank transactions from 1987 through 1989 and received 130 successful bids. Whole bank P&As were consummated for 43 failing institutions in 1990. During this period when sequential bidding was in effect, bids for whole bank P&As were opened first and the highest whole bank bid that was less costly than a payoff was accepted. Bids for other resolution methods were returned unopened. If there were no acceptable whole bank bids, the next type of P&A bids were opened, followed by insured deposit transfer bids. Even though whole bank transactions passed the maximum amount of assets to the acquirers, the *least costly* resolutions may not have been chosen. With the introduction of the least cost test by the Federal Deposit Insurance Corporation Improvement Act (FDICIA) of 1991, 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. As a result, only 29 whole bank transactions were completed in 1991 and 1992.

Since FDICIA required the FDIC to open all bids received and to select the resolution determined to be least costly to the insurance fund, 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 provisions. Exhibit 3-6 shows the benefits and other considerations of whole bank P&As.

## **Exhibit 3-6**

### **Whole Bank P&As**

#### **Benefits**

- ◆ *All the benefits of the P&A with optional asset pools, plus*
- ◆ *Loan customers continue to be served locally by the acquiring institution*
- ◆ *Minimizes the one-time FDIC cash outlay.*
- ◆ *Greatly reduces the amount of assets held by the FDIC for liquidation.*

#### **Considerations**

- ◆ *Seldom proves to be the least cost method in comparison to other types of resolutions.*

### *Loss Sharing P&As*

A loss sharing P&A uses the basic P&A structure except for the provision regarding transferred assets. Instead of selling some or all of the assets to the acquirer at a discounted price, the FDIC agrees to share in future loss experienced by the acquirer on a fixed pool of assets. The FDIC learned from its experiences in the late 1980s and early 1990s that it is more desirable to keep the assets of a failed bank or thrift in the private banking sector than to take them over for liquidation.

Assets left in the banking sector retain more value than those placed in liquidation. Once assets are placed in receivership or liquidation, they lose value because of a break in the customer/institution relationship (the concept of liquidation differential was discussed earlier). Keeping the assets in the private banking sector softens the impact on the local community. The acquiring institution can work more easily with the borrowers to restructure the credits and advance additional funding where appropriate.

The FDIC originally developed the loss sharing concept in 1991 as a resolution tool for handling failed institutions with more than \$500 million in assets. The FDIC designed loss sharing to address the problems associated with marketing large institutions with sizeable commercial loan and commercial real estate loan portfolios. In the past, acquiring institutions had been extremely reluctant to acquire commercial assets in the FDIC transactions for three reasons. First, the time allowed to perform due diligence is most often limited. The FDIC tries to accommodate a number of potential acquirers who wish to perform due diligence at the failing institution, and all acquirers must complete their reviews prior to the bid submission date. This allows very little time for any given bidder to perform more than a cursory review of an often complex loan portfolio.

Second, many acquirers are reluctant to purchase large portfolios of loans that they did not underwrite. In many cases, the underwriting standards of the failing institution are poor and may be a primary reason for the institution's failure. Also, information in the bank file may be limited or inaccurate. Acquirers wish to avoid the additional costs associated with managing and working out these potentially problem assets.

Finally, almost every region of the United States experienced declining commercial real estate markets in the late 1980s and early 1990s, causing considerable uncertainty about collateral values. Even when acquiring institutions were willing to purchase the commercial real estate loan portfolios, they incorporated large discounts into their bids to compensate for the additional risk of anticipated market declines.

Loss sharing P&As address these concerns by limiting the downside risk associated with acquiring large loan portfolios. The FDIC absorbs a significant portion of credit loss on commercial loans and commercial real estate loans, typically 80 percent, and acquiring institutions assume the remaining 20 percent of loss.<sup>14</sup> By having the acquirer absorb a limited amount of credit loss, the FDIC hopes to pass most of the failed institution's commercial loans and commercial real estate loans to the acquirer while still receiving a premium for the institution's deposit franchise. By having the acquirer absorb a portion of the loss, the FDIC is also attempting to induce rational and responsible credit management behavior from the acquirer. The FDIC also reimburses acquiring institutions for 80 percent of expenses, except overhead and personnel expenses, incurred in relation to the disposition or collection of the shared loss assets.

During the shared recovery period, which runs concurrently with the loss share period, the acquiring bank pays the receiver 80 percent of any recoveries (less any recovery expenses) on shared loss assets previously experiencing a loss. The shared recovery period generally lasts another one to three years beyond the expiration of the loss sharing period. Loss sharing provisions apply to all loans in a designated shared loss category, for example, commercial loans or commercial real estate loans, whether the loans are performing or not.

Loss sharing was also structured to include a "transition amount" so that if losses exceeded a projected amount, the FDIC would absorb a higher percentage of the losses beyond the projected amount, typically 95 percent. The transition amount was defined as the FDIC's estimate of the loss on the shared loss assets purchased by the acquirer. The FDIC used the transition amount to address the acquirer's concerns about catastrophic losses resulting from limited time for due diligence and uncertain collateral values stemming from deteriorating markets.

There are some negative aspects of the loss sharing structure. It requires both the FDIC and the acquirer to take on additional administrative duties and costs in managing the shared loss assets

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<sup>14</sup> The percentage amounts to be split between the FDIC and the assuming institution can vary and are determined with every transaction.

throughout the life of the agreement. Some acquirers may find these added administrative duties and costs unacceptable, and the acquirers may lose interest in bidding.

Another concern in offering loss sharing is that many healthy, small financial institutions may not have the appropriate experience in working out problem assets. They may not have an interest in bidding if this is the only option, or they may acquire the assets but not manage them in the best interests of all involved. If this occurs, the FDIC loses control of the assets but is obligated to absorb a significant portion of the risk. In recognition of the different skills and interests of potential acquirers, the FDIC normally offers other resolution methods simultaneously with the loss sharing structure to encourage more institutions to bid.

Since it has been used generally in larger transactions, loss sharing has been very successful a number of times at keeping assets in the private banking sector and resulting in lower 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.

In cases where loss sharing is determined to be the preferred resolution structure for a transaction, the P&A agreement includes terms describing how charge-offs, recoveries, and expenses will be treated for the different types of assets.

Shared Loss Assets. Shared loss assets are generally commercial loans, commercial real estate loans, and owned real estate although some earlier agreements included additional types of loans.<sup>15</sup> The acquiring institution may subsequently take title to or transfer owned real estate to a subsidiary without forfeiting shared loss coverage.

Shared loss assets are initially recorded by the acquirer at the failed institution's book value. Thereafter, the value of a shared loss asset may be increased by additional advances,<sup>16</sup> capitalized expenses,<sup>17</sup> and accrued interest (subject to certain limitations); the value may be decreased by the amount of payments received and charge-offs recorded. Advances cannot exceed certain specified percentage limitations (generally 10 percent of the book value as of the agreement date), and are not allowed for any loan on which the acquiring institution has recorded a loss. Capitalized expenses are only permitted on owned real estate, and such expenditures must be capitalized in accordance with generally accepted accounting principles.<sup>18</sup>

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<sup>15</sup> Consumer loans, home equity loans, residential mortgage loans, and loan participations are generally not part of a loss sharing agreement because those loans are of a better quality. Typically, performing consumer loans and residential mortgage loans pass at book value to the acquirer.

<sup>16</sup> Additional advances are funds given to a borrower after the original loan has been finalized; these amounts are added to the principal amount of the borrower's loan. For example, the bank might advance funds to pay taxes or to pay for harvesting a crop in the field.

<sup>17</sup> Capitalized expenses are major expenditures that typically involve real estate. The amount of money is treated as an asset by the borrower (increasing the value of the real estate) and not as a one-time expense. For example, the bank might provide funds to pay for remodeling a commercial building to make it more rentable. Expenditures for the remediation of environmentally contaminated real estate are excluded.

<sup>18</sup> In the United States, the Financial Accounting Standards Board is a private-sector organization empowered to establish

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. Pay-downs 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 previously. 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.

Loss Sharing Arrangement. During the shared loss period, generally the first five years of the agreement, the receiver reimburses the acquiring institution for 80 percent of net charge-offs (charge-offs minus recoveries) of shared loss assets, plus reimbursable expenses. During the recovery period, generally the last two-year period of the agreement,<sup>19</sup> the acquiring institution pays the receiver 80 percent of recoveries, less recovery expenses.<sup>20</sup> Charge-offs are defined as write-downs of the principal amount of shared loss assets if such write-downs are taken in accordance with standards used by FDIC examiners. Losses on the sale of owned real estate are included, but losses on the sale of shared loss loans are generally excluded.<sup>21</sup>

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 to effect recoveries and to manage, operate, and maintain owned real estate. (Expenses

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financial accounting and reporting standards for the guidance and education of the public. These standards are referred to as “generally accepted accounting principles” or GAAP. In keeping with our free enterprise economy, it is appropriate that financial accounting and reporting standards be established by those that rely on them so heavily, that is, the participants in the private sector. Standard setting can remain in the private sector only with the support of its many constituent groups—the financial statement preparers, auditors, and those who make decisions based on information in financial statements.

<sup>19</sup> 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 and for an additional one to three years. The loss sharing and recovery sharing percentages may also vary by transaction and by asset category.

<sup>20</sup> For those agreements that include a transition amount, at the termination of the agreement the receiver will also reimburse the acquiring institution an additional 15 percent of the amount by which aggregate charge-offs, reimbursable expenses, and recovery expenses, minus aggregate recoveries, exceeds the transition amount.

<sup>21</sup> 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, the FDIC establishes limitations regarding the dollar amount of loans that may be sold and the amount of resulting losses that may be eligible for reimbursement.

are reduced by income received on owned real estate.) An acquiring institution may not claim payments to affiliates. Expenses which are *not* reimbursable include income taxes; salaries and related benefits of employees; occupancy, furniture, equipment, and data processing expenses; fees for accounting and other independent professional consultants (other than legal fees and consultants retained for environmental assessment purposes); overhead or general and administrative expenses; expenses not incurred in good faith; and any extravagant expenses.

Transition Amounts (Catastrophic Insurance). Agreements included transition amounts, which were the FDIC's estimates of credit loss on the shared loss assets. If losses exceeded the transition amount, the acquirer was responsible for a smaller percentage of the additional loss, typically 5 percent, rather than the 20 percent typically covered for losses up to the transition amount. The FDIC transition amounts were for acquirers concerned about unanticipated losses resulting from limited due diligence time and uncertain collateral values resulting from deteriorating markets.

Certificates and Payments. Acquiring institutions file certificates within 30 days of the end of each calendar quarter during the shared loss period and the shared recovery period. The certificates report charge-offs, recoveries, net charge-offs (charge-offs less recoveries, amount may be negative), and reimbursable expenses (amount may be negative). If the shared loss amount is positive, the FDIC pays the acquirer 80 percent of the amount within 15 days of receipt of the certificate; if the shared loss amount is negative, the acquiring institution remits 80 percent of the amount with the certificate.

Administration of Agreement. The acquiring institution manages, administers, and collects shared loss assets consistent with usual and prudent business and banking practices and in a manner consistent with its own internal practices, procedures, and written policies. It may not contract with third parties for services on shared loss assets if it does not contract with third parties for those services for its own assets. Separate accounting records must be maintained for shared loss assets.

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 with 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.

Loss sharing P&As are sometimes combined with other types of resolution agreements. For example, in the P&A agreements with New Dartmouth Bank, Manchester, New Hampshire, and First New Hampshire Bank, Concord, New Hampshire, the FDIC also agreed to provide shared loss coverage on the installment loans to ensure that those small balance assets with high service costs stayed with the acquirer. Table 3-1 lists the loss share agreements consummated from 1991 through 1993, and exhibit 3-7 shows the benefits and other considerations of P&As with loss sharing.

**Table 3-1**

**FDIC Loss Share Transactions  
1991-1993  
(\$ in Millions)**

<b>Transaction Date</b>	<b>Failed Bank*</b>	<b>Location</b>	<b>Total Assets</b>	<b>Resolution Costs</b>	<b>Resolution Costs as % of Total Assets</b>
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	25.18
10/10/91	First New Hampshire	Concord, NH	2,109	319	15.13
11/14/91	Connecticut Savings Bank	New Haven, CT	1,047	207	19.77
08/21/92	Attleboro Pawtucket SB	Pawtucket, RI	595	32	5.38
10/02/92	First Constitution Bank	New Haven, CT	1,580	127	8.04
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	1.65
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	Kansas City, MO	1,911	356	18.63
06/04/93	The First National Bank of Vermont	Bradford, VT	225	34	15.11
08/13/93	CrossLand Savings, FSB	Brooklyn, NY	7,269	740	10.18
	<b>Total</b>		<b>\$41,384</b>	<b>\$2,512</b>	<b>6.07 %</b>

\*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.

## **Exhibit 3-7**

### ***P&As with Loss Sharing***

#### **Benefits**

- ◆ *All the benefits of a whole bank P&A, plus*
- ◆ *Reduced risk for the acquirer can lower FDIC's cost.*
- ◆ *FDIC's and acquirers' interests in the asset pools are closely aligned.*
- ◆ *Assets remain in the private sector.*

#### **Other Considerations**

- ◆ *Requires additional administrative duties for both the acquirer and the FDIC.*
- ◆ *Many healthy, small institutions may not have the expertise to manage a problem loan portfolio.*
- ◆ *Time-consuming as agreements generally last five to seven years.*
- ◆ *The FDIC does not control the assets yet retains a large portion of the potential loss.*

### ***Bridge Banks***

The Competitive Equality Banking Act of 1987 provided the FDIC with a new tool to help handle failing institutions: the bridge bank. A bridge bank transaction is a type of P&A in which the FDIC itself acts temporarily as the acquirer. This provides uninterrupted service to bank customers, while it allows the FDIC sufficient time to evaluate and market the institution.

A bridge bank is a new, temporary, full-service national bank chartered by the Office of the Comptroller of the Currency and controlled by the FDIC. 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.

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 permanent transaction. It also provides prospective purchasers with the time necessary to assess the bank's condition in order to submit their offers. Absent systemic risk, 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.

The FDIC may establish a bridge bank in either its corporate or receivership capacity. However, the FDIC does not have the authority to bridge a thrift institution; in that instance the FDIC would have to use a conservatorship<sup>22</sup> 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.

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<sup>22</sup> A conservatorship is established when a manager has been appointed to take control of a failing financial institution to

Although not used very often, a bridge bank resolution is especially useful in situations when the failing bank is large or unusually complex. From the inception of the program in 1987 through 1994, the FDIC used the bridge bank method a total of 10 times to create 32 bridge banks from 114 separate institutions.<sup>23</sup>

Before establishing a bridge bank, a cost analysis must show that the estimated operating cost of the bridge bank is less costly than a payoff. A resolution timetable and strategy are also completed. The resolution strategy for the bridge bank will vary depending on whether the bridge bank is to be held long term (more than nine months) or short term (less than nine months). A bridge bank is established only if it is projected to be the least costly resolution alternative for the FDIC insurance fund.

The FDIC Board of Directors has broad powers to operate, manage, and resolve a bridge bank. 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. Performing assets, which are assumed by the bridge bank at their book value, enhance the bank's franchise value. Bank management may attempt to restructure nonperforming assets to increase their value.

The FDIC Board of Directors selects a chief executive officer (CEO)<sup>24</sup> to conduct day-to-day operations and appoints a bridge bank board of directors, composed of senior FDIC personnel and the CEO. The bridge bank board of directors is responsible for reviewing and approving the bank's business plan and for other management and oversight duties. The FDIC Board of Directors retains the authority to effect the bank's final resolution and approve the sale of the bank's assets.

Within 10 days after receiving the charter, the bridge bank's board of directors must develop and implement policies and procedures designed to guide operations safely and soundly, in line with the business plan. An operating budget is prepared to support the business plan's goals. If the CEO and the bridge bank board need assistance or additional expertise in specific areas, consultants may be hired on a short-term basis.

**Lending.** To prevent a significant outflow of commercial and retail loan customers, the bridge bank strives to maintain a profile in the local community. Specifically, the bridge bank is expected to make limited loans to the local community and to honor commitments made by the previous institution that

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preserve assets and protect depositors. Conservatorships were primarily used by the RTC, however, the FDIC does have the power to establish conservatorships.

<sup>23</sup> Multiple failing banks in a bank holding company can be combined when creating bridge banks. For example, First RepublicBank Corporation, Dallas, Texas, was a holding company with 41 banks. The FDIC created two bridge banks, one for 40 banks in Texas and one for the bank in Delaware. On the other hand, First City Bancorporation of Texas, Inc., Houston, Texas, had 20 banks, and the FDIC formed 20 separate bridge banks.

<sup>24</sup> The CEO is not required to be an FDIC employee.

would not create additional losses for the institution, including advancing funds necessary for the completion of unfinished projects.

Assets. The bridge bank officials' primary focus on the asset side is to ensure that the value of the performing loans is retained and to identify problem assets that should be transferred to the receivership. Realistic market values are developed for assets by marking them to market (determining a realistic value based on present market conditions) and assigning appropriate loss reserves. If appropriate, assets may be sold. A complete asset inventory is taken to identify, evaluate, and work out troubled assets of the failed bank. The most problem-ridden assets with the least potential for improvement, including nonperforming loans, owned real estate, and fraud-related assets, remain in the failed bank receivership or are transferred to the receivership as soon as they are identified.

For a period of 30 to 90 days after the bridge bank is chartered, assets may be transferred to the receivership or they may be returned to the bridge bank from the receivership (which rarely happens). The bridge bank strives to "work out," or reduce, the volume of nonperforming assets. A workout program can offer a greater chance for recovery than other alternatives, such as foreclosure or litigation. Another cost-effective option is a compromise settlement. If a borrower cannot pay the full amount of the debt and if potential litigation costs are expected to be substantial, then the bridge bank may reach a compromise settlement with the borrower by accepting a repayment of less than the full amount.

Liabilities. Before its chartering authority closes the failing bank, the FDIC decides whether to pass all deposits or only insured deposits (those funds determined to be within the \$100,000 insurance limit) to the bridge bank. Usually, only insured deposits are passed when there is an expected loss to the receivership. Customers with uninsured deposits share in any loss in the liquidation of the receivership with the FDIC. The FDIC must notify all depositors that their accounts have been transferred to the bridge bank, and the depositors must contact the bridge bank (or its successor institution) within 18 months to claim their deposits. Unclaimed deposits will be turned over to the respective state government. Typically, customers with deposits in the bridge bank do not lose any funds when an acquirer takes over the bridge bank.

Bridge bank management must decide whether to maintain or lower the interest rates paid on deposits by the failing bank. The FDIC requires that the rates remain the same for the first 14 days, and depositors must have 7 days' notice of any rate change. Customers with deposit agreements, such as certificates of deposit, may withdraw their funds without penalty until they agree to a new savings agreement.

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 requires access to the FDIC's revolving credit facility. The bridge bank also attempts to re-establish lines of credit and correspondent banking relationships that were maintained by the failing institution.

Media Relations. Once the FDIC is appointed receiver of the failing bank, the FDIC issues a press release to inform the public of the actions the FDIC has taken and of its plans to resolve the failing bank. The public is kept apprised of all significant events during the bridge bank period. Once the bridge bank has been sold, a press release is issued to the public announcing the sale and the name of the acquirer.

Resolution. The sale and closing of a bridge bank is similar to the sale and closing of other failed banks. The FDIC requires at least 16 to 24 weeks to properly prepare for the sale, which includes gathering information, soliciting interest from potential acquirers, arranging for due diligence by potential acquirers, and receiving and analyzing bids. The bridge bank may be resolved through a P&A transaction, a merger, or a stock sale.<sup>25</sup> The most common resolution method for bridge banks is the P&A. Of the 32 bridge banks resolved, all but 2 were short-term, lasting seven months, or less.

The FDIC used its bridge bank authority in 1988 and 1989 to resolve 86 failed institutions of which 85 were affiliated with three large Texas bank holding companies. The FDIC resolved the three Texas bank groups by transferring all the problem assets from the bridge banks to the receiverships and selling the good portfolios to the acquirers with the option to require the FDIC to repurchase certain loans (put option). The acquirers also were given management contracts to service and to collect on the bad assets in the pools for the FDIC. The bad loan pools included foreclosed loans, classified loans, charged-off loans, and other classified assets.<sup>26</sup> Those problem assets were passed to the acquiring banks, which were reimbursed by the FDIC for the administrative costs of managing the pools and for the costs of carrying the problem assets. The FDIC also paid the acquirers incentive fees based on the amounts realized in liquidating the problem assets.

The put option was necessary due to the large size of the loan assets in the bridge bank. No matter how much due diligence was completed before the bid process, the acquirer needs additional time to properly evaluate the performing loan pools and the borrowers. The put options gave the acquirers two to three years to identify other assets that were or became problem assets (based on classification standards used by FDIC examiners) and to put such assets into the bad loan pools.

Some of the initial management contracts were costly for the FDIC and contained some overly generous incentives for the acquirers. Later bridge bank resolutions were modified so that the pools of bad assets were retained by the FDIC as receiver and managed by professional asset managers with more reasonable incentives. Even after this change, the acquirers of the bridge banks were still given limited options to return originally purchased assets to the receiver. Some recent resolution options have included loss sharing provisions. Table 3-2 shows the FDIC's use of bridge bank authority from 1987 through 1994, and exhibit 3-8 shows the benefits and other considerations of bridge banks.

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<sup>25</sup> A bridge bank is essentially an asset of the receivership. As receiver, the FDIC controls all of the stock in the bridge bank.

<sup>26</sup> An FDIC examiner reviews assets to assess their credit quality. If an examiner concludes that an asset possesses characteristics or weaknesses that jeopardize the collection of the debt, then the asset is classified in the examination report according to its potential for loss.

**Table 3-2**

**The FDIC's Use of Bridge Bank Authority  
1987-1994  
(\$ in Thousands)**

<b>Bridge Bank Situations</b>	<b>Failure Date</b>	<b>Bridge Banks</b>	<b># of Failed Banks</b>	<b>Total Assets</b>	<b>Total Deposits</b>
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
.	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
<b>10</b>	<b>Totals</b>	<b>32</b>	<b>114</b>	<b>\$89,877,439</b>	<b>\$61,043,683</b>

Data for Total Assets and Total Deposits is as of resolution.  
Data marked with an asterisk (\*) are from the quarter before resolution.

Source: FDIC Division of Research and Statistics.

## **Exhibit 3-8**

### **Bridge Banks**

#### **Benefits**

- ◆ *Provides the FDIC time to arrange a permanent transaction.*
- ◆ *Provides prospective purchasers the time necessary to assess the bank's condition in order to submit reasonable bids.*
- ◆ *Is an improvement over the deposit payoff or IDT alternatives.*

#### **Other Considerations**

- ◆ *Duplicates part of the resolution process; the FDIC must complete two closings, one for the original bank and one for the bridge bank.*
- ◆ *Takes much FDIC time and effort.*
- ◆ *The FDIC becomes responsible for the operation of the bridge bank.*
- ◆ *Difficult to retain key employees during this transition period.*
- ◆ *Economic conditions may continue to deteriorate, leading to lower premiums.*
- ◆ *Best customers may leave institution for more stable environment, thereby reducing the franchise value.*

## CHAPTER 4 – DEPOSIT PAYOFFS

Although purchase and assumption transactions are the most common resolution method, deposit payoffs are used when no acquiring institution can be found. When a bank or thrift is closed by its chartering authority, the Federal Deposit Insurance Corporation (FDIC) in its corporate capacity as deposit insurer makes sure that customers receive the full amount of their insured deposits. Customers with uninsured deposits and other general creditors of the failed institution are given receivership certificates that represent their uninsured claims that will be held against the failed institution's estate. In a deposit payoff, because there is no acquiring institution, the FDIC as receiver must liquidate all of the failed institution's assets.

### Structure of a Deposit Payoff

Deposit payoffs currently have two forms: the straight deposit payoff<sup>1</sup> and the insured deposit transfer. A third form, the Deposit Insurance National Bank (DINB),<sup>2</sup> is rarely used and has not been used since 1982.

In a **straight deposit payoff**, the FDIC determines the insured amount due each depositor and prepares a check for that amount. Arrangements are made either for the depositors to come to the bank and get the checks or for the FDIC to mail the checks to the depositors.

In an **insured deposit transfer**, the FDIC also determines the insured amount due each depositor. Arrangements are then made with a healthy institution that is willing to act as agent for the FDIC and to pay insured deposits to customers of the failed institution. The FDIC transfers insured deposit accounts and secured liabilities of the failed bank or thrift, along with an equal amount of cash or other assets, to the healthy institution. Service to customers with insured deposits is uninterrupted. Each of these transactions is discussed on the following pages.

### Straight Deposit Payoff

The straight deposit payoff method is generally the most costly method of resolution, because the receiver must liquidate all of the failed institution's assets, bear the cost of paying off all the customers with insured deposits, and monitor the estate for the creditors.

A straight deposit payoff is only executed if the FDIC does not receive a bid for a P&A transaction or for an insured deposit transfer transaction that will result in a lower cost than the payoff method

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<sup>1</sup> A straight deposit payoff is frequently referred to simply as a "payoff," since it is the only time the FDIC actually prepares checks for failed institution customers with insured deposits.

<sup>2</sup> 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, but could not make loans. Depositors were given up to two years to move their deposit accounts to other institutions.

(as discussed in Chapter 2, The Resolutions Process). In a straight deposit payoff, no liabilities are assumed and no assets are purchased by another institution. The FDIC must pay depositors of the failed institution the total of their insured deposits.

In a straight deposit payoff, the FDIC determines the insured amount for each depositor and pays that amount to him or her. In the past, the bank customers would come to the bank to receive their checks from the FDIC. More recently, because of the size of some failed institutions and the geographic dispersion of their customer bases, the FDIC has paid insured deposits by mailing customers checks equal to the amount of their insured deposits. In calculating each customer's total deposit amount, the FDIC includes all the interest accrued up to the date of failure under the contractual terms of the depositor's account. In other words, the FDIC pays the entire principal plus all accrued interest, up to the insurance limit.

For example, a customer with only one individual account, a certificate of deposit in the amount of \$80,000 with \$15,000 in accrued interest (\$95,000 total), would be paid the full \$95,000. A customer with only one individual account, a certificate of deposit in the amount of \$90,000 with \$15,000 in accrued interest (\$105,000 total), would be paid only \$100,000 because of the insurance limit.

Any checks which a failed institution's customer has written but which have not yet "cleared" the customer's checking account are returned to the payee (person to whom the check was written), because there is no succeeding bank to pay the check. These checks are stamped "Bank Closed" before they are returned to the payee and are not considered "insufficient funds checks." Even so, this situation causes some disruption to the customers of the failed institution.

The deposit liabilities (both insured and uninsured deposits), together with all other liabilities of the failed bank or thrift, represent claims against the receivership estate. The FDIC as receiver retains all assets and liabilities and liquidates the assets of the failed institution for the benefit of all claimants entitled to payment from the estate.

In the United States, laws provide that all depositors are paid from the receivership estate before any general creditors (such as, suppliers, trades people, or contractors) or other unsecured creditors. The FDIC in its corporate capacity pays the customers with insured deposits up to the insurance limit. These customers actually exchange their claims against the receivership estate for the insurance payments from the FDIC in its corporate capacity, so that the FDIC in its corporate capacity is substituted as the claimant for the amount of insurance payments made. This process is called "subrogation," and the FDIC is the "subrogee." Therefore, claimants against the receivership estate include the FDIC in its corporate capacity as the payer of deposits.

For example, a customer with one individual account, a certificate of deposit in the amount of \$80,000 with \$15,000 in accrued interest, would be owed \$95,000 by the receivership estate. If that customer accepted \$95,000 in cash from the FDIC in its corporate capacity, then the customer was paid the full amount due to him. The customer "subrogated" his claim to the FDIC. The customer

now has no claim against the receivership estate; instead, the FDIC in its corporate capacity now has the \$95,000 claim.

Deposit payoffs occur more often in smaller banks rather than in large banks. Prior to 1982, the largest bank failure handled through a straight deposit payoff was the \$78.9 million Sharpstown State Bank, Houston, Texas, in 1971.<sup>3</sup> On July 5, 1982, Penn Square Bank, N.A. (Penn Square), Oklahoma City, Oklahoma, which had \$516.8 million in total assets, failed. Penn Square, with \$470.4 million in deposits in 24,534 deposit accounts, was handled as a DINB. The largest straight deposit payoff since 1982 was for Independence Bank, Los Angeles, California, which failed January 30, 1992. Independence Bank, which had \$564.2 million in total assets, had \$503.4 million in deposits in 33,677 accounts. The largest straight deposit payoff handled by the Resolution Trust Corporation was Brookside Federal Savings & Loan Association (Brookside), Los Angeles, California, which failed November 16, 1990. Brookside had total assets of \$450.1 million and total deposits of \$416 million in 15,414 accounts.

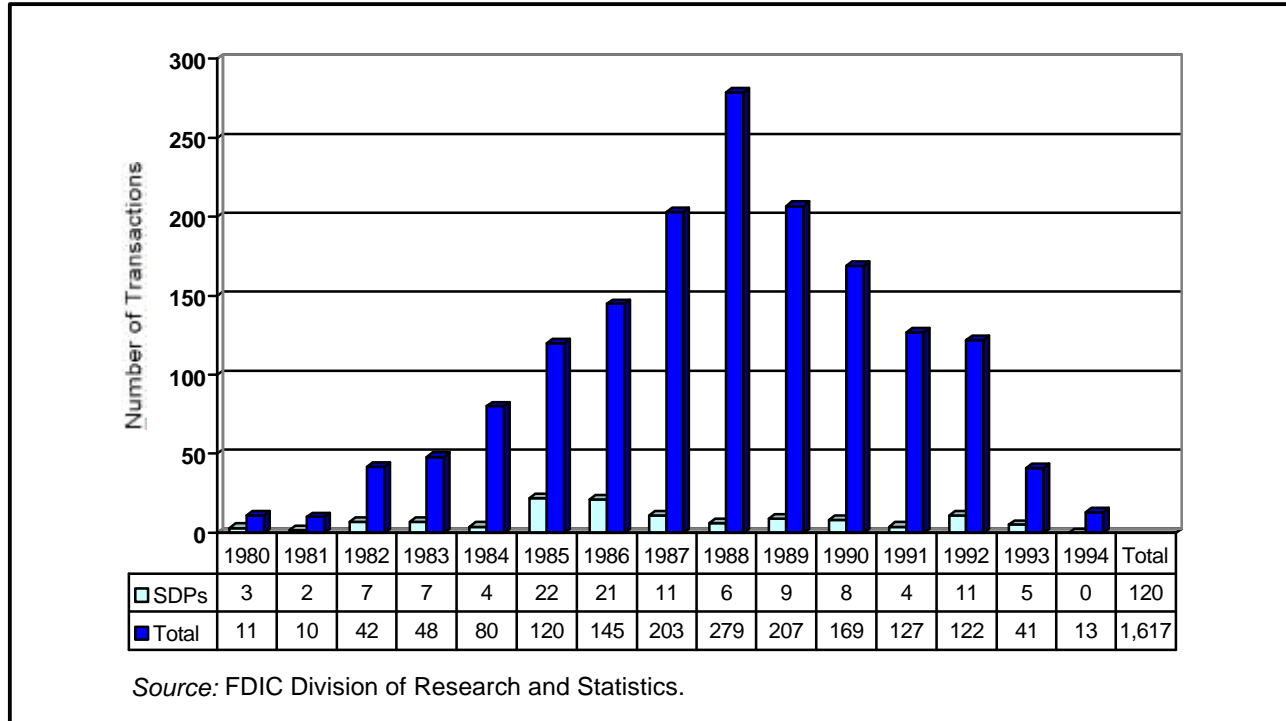
From 1980 through 1994, the FDIC managed 120 straight deposit payoffs out of a total of 1,617 failed and assisted banks, or 7.4 percent of all closings. Chart 4-1 shows the distribution of straight deposit payoff transactions per year from 1980 through 1994, and exhibit 4-1 shows the benefits and other considerations of straight deposit payoffs.

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<sup>3</sup> Irvine H. Sprague, *Bailout* (New York: Basic Books, Inc., 1986), 117.

**Chart 4-1**

**Straight Deposit Payoffs  
Compared to All Bank Failures and Assistance Transactions  
1980-1994**



**Exhibit 4-1**

**Straight Deposit Payoffs**

**Benefits**

- ◆ Customers with insured deposits receive money quickly without having to wait for proceeds from the liquidation of receivership assets.

**Other Considerations**

- ◆ Customers must find a new bank and set up new accounts.
- ◆ Customers with uninsured deposits are not paid the uninsured amount.
- ◆ Customers experience a loss of service, including the return to payees of checks that had not cleared the customers' accounts.
- ◆ Customers lose interest on funds from the date of failure until the FDIC check is deposited in an account elsewhere.
- ◆ Community can experience economic disruption from the loss of an institution.
- ◆ Receivership bears the cost of liquidating all of the assets of the estate
- ◆ Usually considered a "last resort" resolution method due to its high cost to the insurer.

## Insured Deposit Transfer

In 1983, the FDIC created the insured deposit transfer (IDT) transaction as an alternative to the straight deposit payoff. In an IDT, the insured deposits and secured liabilities of a failed bank or thrift are transferred to a healthy institution (the agent institution), and the FDIC makes a matching payment of cash and/or assets to the institution. The agent institution pays customers with insured deposits the amounts due to them or, if a customer requests it, opens an account in the agent institution. Thus, service to customers with insured deposits continues uninterrupted. All insured deposits are made available to their owners, checks drawn on those accounts are honored, and interest-bearing accounts continue to earn the same amount of interest as they were earning at the failed institution. However, the agent institution may change the interest rate after 14 days; if a change is made, customers must be given at least 7 days notice. Alternatively, customers with insured deposits may withdraw their balances and close their accounts.<sup>4</sup>

An insured deposit transfer minimizes the disruption to customers and to the local community caused by a straight deposit payoff. An IDT also reduces the FDIC's costs to handle the failure since the accepting institution acts as the paying agent on behalf of the FDIC and disburses insured funds to depositors. The agent institution generally pays a premium<sup>5</sup> for this right; although, there have been rare instances when the FDIC paid an agent institution to perform this function. Insured deposit transfers are a way to extract some franchise value for the failed institution's deposits even when an agent bank is unwilling to enter into a purchase and assumption transaction. In an IDT, the receiver retains all the remaining assets and liabilities of the failed institution that are not passed to the agent institution.

From 1980 through 1994, the FDIC oversaw 176 insured deposit transfers out of a total 1,617 closings, or 10.9 percent of all failed and assisted institutions. Since IDTs were created in 1983, through 1994, they have represented 62 percent of the total deposit payoffs while straight deposit payoffs represented 38 percent. Chart 4-2 shows the distribution of IDTs per year from 1980 through 1994, and exhibit 4-2 shows the benefits and other considerations of insured deposit transfers.

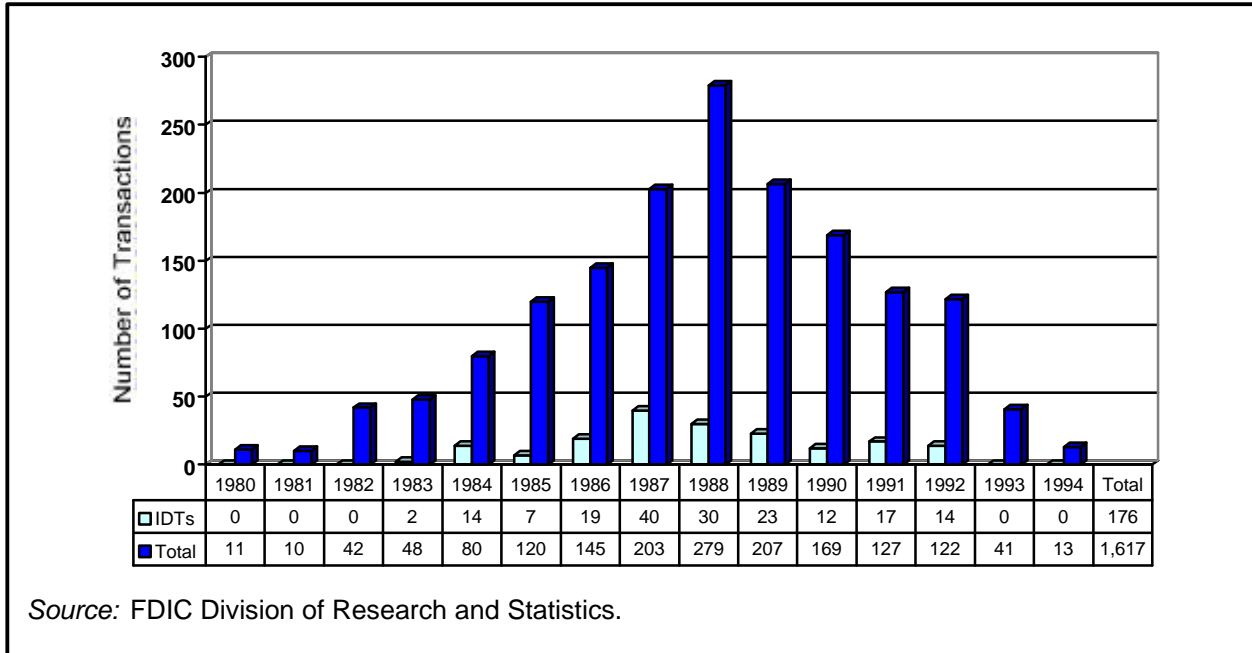
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<sup>4</sup> If a depositor does not take action to claim the transferred deposit within 18 months after the failure, the agent institution is required to transfer the funds to the receiver, who then escheats the funds to the state, that is, turns the property over to the state in the absence of legal heirs or claimants.

<sup>5</sup> A premium is an amount paid for the franchise value of a failed institution's deposits.

**Chart 4-2**

**Insured Deposit Transfers  
Compared to All Bank Failures and Assistance Transactions  
1980-1994**



**Exhibit 4-2**

**Insured Deposit Transfers**

**Benefits**

- ◆ Customers with insured deposits suffer no loss in service.
- ◆ Customers with insured deposits have new accounts in a new bank, but old checks can still be used.
- ◆ Agent institutions have the opportunity for new customers.
- ◆ Customers with insured deposits continue to earn the same rate of interest on their accounts for at least 14 days.
- ◆ The FDIC's administrative costs are reduced.

**Other Considerations**

- ◆ An institution must be willing and technically able to become an agent bank.
- ◆ Customers with uninsured deposits are not paid the uninsured amount.
- ◆ Receivership bears the cost of liquidating all or almost all of the assets of the failed institution.

## CHAPTER 5 – OPEN BANK ASSISTANCE TRANSACTIONS

The third basic resolution method for failing financial institutions is an open bank assistance (OBA) transaction.<sup>1</sup> In an OBA, the Federal Deposit Insurance Corporation (FDIC) provides financial assistance to an operating insured bank or thrift to keep it from failing. The FDIC can make cash contributions to, make loans to, purchase the assets of, or place deposits in the troubled bank or thrift.<sup>2</sup>

### Structure of an Open Bank Assistance Transaction

Open Bank Assistance can be used to facilitate the acquisition of a failing bank or thrift by a healthy institution. An OBA transaction is very similar to a whole bank purchase and assumption in that the majority of the failing institution's assets remain intact. While an OBA can be structured in several ways, the FDIC's ultimate goal is minimizing cost to the deposit insurance funds.

A major criticism of OBA, however, is that shareholders of failing institutions have benefited from the assistance provided by the government, even though most of the OBA transactions required the shareholders of the failing institutions to significantly dilute their ownership interests. 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. A 1993 amendment to the Federal Deposit Insurance Act (FDI Act) of 1950 prohibited the use of insurance fund monies in any manner that benefits any shareholder of an institution that had failed or was in danger of failing. That amendment made obtaining assistance even more difficult than in the past for open institutions.

Before the FDIC can provide open bank assistance, it must establish that the assistance is the least costly to the insurance fund of all possible methods for resolving the institution. The FDIC may deviate from the least cost requirement only to avoid "serious adverse effects on economic conditions or financial stability" or "systemic risk" to the banking system.<sup>3</sup> The appropriate federal banking agency or the FDIC must also determine that the institution's management is competent, has complied with all applicable laws, rules, and supervisory directives and orders, and has never engaged in any insider dealings, speculative practices, or other abusive activity.

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<sup>1</sup> There are several types of assistance to open banks, including forms of cash and noncash assistance. To the FDIC, the term "open bank assistance" refers specifically to a resolution method where financial assistance is given to a troubled bank or thrift to prevent its failure. See Chapter 6, Other Resolution Alternatives for a discussion of other types of assistance to open institutions.

<sup>2</sup> In open bank assistance agreements, the FDIC provides a cash contribution to restore deficit capital to a positive level (referred to as "filling the hole"). For a large institution, the FDIC may use a note or loan to fill the hole. Additionally, the FDIC may cover losses for a specific amount on a pool of assets over a specified period of time.

<sup>3</sup> Only the secretary of the Treasury has the power to grant this exception, after consulting with the president of the United States and with the recommendation by two-thirds of the boards of directors of the FDIC and the Federal Reserve System.

Since the inception of OBA in 1950,<sup>4</sup> the legislative process and public policy have transformed OBA. Originally, the FDIC could grant OBA only if the institution's continued existence was determined to be "essential" to the community.<sup>5</sup> This was seldom deemed to be the case as only four institutions received OBA from 1950 to 1979. In 1982, the FDIC received broader authority from the U.S. Congress with the passage of the Garn-St Germain Depository Institutions Act (Garn-St Germain) to provide OBA. For example, the FDIC no longer had to satisfy the essentiality test; an institution could receive assistance if the FDIC Board of Directors determined that the amount of assistance was less than the cost of liquidating the institution.

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

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

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, the responsibility for pursuing legal claims against bonding and insurance companies, and fee arrangements.<sup>6</sup>

The FDIC completed the majority of the OBA agreements (with 98 institutions) in 1987 and 1988.<sup>7</sup> Those transactions represented approximately 20.3 percent of the total OBA and failure transactions during those years. One reason for the increase in OBA transactions was that the FDIC instituted a policy to communicate to bankers the deficiencies of their assistance proposals and to allow them to make adjustments to conform to the policy statement. If the proposal cost less than liquidation, FDIC staff would recommend the open bank assistance proposal without requesting closed bank bids. Another reason for the increase in OBA transactions was the existence of federal income tax benefits,

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<sup>4</sup> Federal Deposit Insurance Act, *U.S. Code*, volume 12, section 1823(c)(1).

<sup>5</sup> 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).

<sup>6</sup> FDIC News Release, "FDIC Revises Policy on Assistance to Failing Banks," PR-189-86 (December 2, 1986).

<sup>7</sup> 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.

including 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.<sup>8</sup> 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.<sup>9</sup>

The number of OBA transactions decreased significantly after 1988. Of the 625 failed or failing banks handled by the FDIC from 1989 through 1992, only 7 were resolved by open bank assistance. The decline in OBA 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,<sup>10</sup> or the proponents for open bank assistance failed to satisfy the criteria.
- The passage of FIRREA in 1989 repealed many of the potential tax benefits listed above. Furthermore, the FDIC had to consider any tax benefits when evaluating bids, that is, if the transaction resulted in a lower federal tax liability for the acquirers, that decrease in taxes had to be added to the cost of the transaction.
- 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.

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 providing assistance to troubled savings associations before they were placed into the Resolution Trust Corporation's conservatorship program. None of the savings and loans that applied to the FDIC for open assistance was 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

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

<sup>9</sup> 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.

<sup>10</sup> Closed bank transactions offer advantages over open bank transactions because, in a closed bank transaction, contingent liabilities can be eliminated, burdensome leases and contracts can be terminated, and troublesome assets can be left in the receivership. Furthermore, uninsured depositors and unsecured creditors can share in the loss.

factors. Some of the more important factors were that (1) acceptance of proposals by the FDIC would be within a competitive bidding process, (2) institutions requesting assistance had to agree to unrestricted due diligence by all parties cleared by the FDIC, and (3) proposals had to quantify limits on indemnities and guarantees.<sup>11</sup> The guidelines and criteria for assistance proposals were flexible and the FDIC was receptive toward innovative ideas from investors in structuring OBA proposals.

In 1992, the FDIC again revised its policy statement for open bank assistance. The revision mainly reflected changes mandated by the Federal Deposit Insurance Corporation Improvement Act (FDICIA) of 1991, which included the possibility of “early resolution” of institutions that were troubled, and the requirement that failing institutions generally be resolved in the manner that was least costly to the deposit insurance fund. The policy statement also required the FDIC to make certain findings with respect to ongoing management of the institution.<sup>12</sup> The 1992 policy statement detailed 19 criteria for evaluating proposals and identified certain information that should be included in a proposal.

With the passage of an amendment to section 11 of the FDI Act in 1993, 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. The passage of this statute has virtually eliminated the possibility of OBA, except in the cases of a systemic risk determination. Therefore, in 1997 the FDIC Board of Directors decided to rescind the 1992 policy statement and consider proposals from open, failing institutions based only on current statutory requirements (that is, least cost, management competence, and no benefit to former shareholders). Table 5-1 shows the number of open bank assistance transactions completed per year in relation to the significant legislation passed during that year.

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<sup>11</sup> FDIC, Financial Institution Letter, “Policy Statement on Assistance to Operating Insured Banks and Savings Associations,” April 6, 1990, FIL-27-90.

<sup>12</sup> Section 13(c)(8) requires management of the resulting institution to be competent and to have complied with applicable laws.

**Table 5-1**

**Summary of  
Open Bank Assistance Transactions**

Significant Legislation	Year	Number of Banks Receiving Open Bank Assistance	Total # of Bank Failures and Assistance Transactions
FDI 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
<b>TOTAL</b>	<b>1950-1992</b>	<b>137</b>	<b>1,718</b>
* Includes 11 BancTexas Group, Inc. institutions that were part of one transaction.			
** Includes 59 First City Bancorporation of Texas, Inc. institutions that were part of one transaction.			
<i>Source:</i> FDIC Division of Resolutions and Receiverships.			

### Assistance to Continental Illinois National Bank and Trust, Chicago, Illinois

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, although it was not the largest bank. As of March 31, 1984, shortly before its resolution, the bank held approximately \$40 billion in assets. Continental had followed a high-risk expansion strategy based on the rapid growth of its loan portfolio, which was funded by volatile, short-term liabilities. Continental had purchased energy loan participations from Penn Square Bank, N.A. (Penn Square), Oklahoma City, Oklahoma. Those loans contributed significantly to the more than \$5.1 billion in nonperforming loans Continental held in 1982. After Penn Square’s failure, confidence in Continental, particularly among its many international customers, was severely shaken. As a result, a rapid and massive electronic deposit run began in early 1984. The FDIC’s options in resolving Continental were either to payoff the customers with insured deposits, to merge the institution, or to provide direct open assistance.

The FDIC ruled out a payoff of customers with insured deposits because of the negative effect it would have had on other banks and the economy. This negative effect 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 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.

The FDIC Board of Directors decided that a payoff of Continental's insured deposits could cause panic in the financial and banking markets. Former FDIC Director Irvine H. Sprague (1969-1972 and 1979-1985) wrote:

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.<sup>13</sup>

Merging Continental on a closed basis was not viewed as a viable option because prospective purchasers would have needed a significant amount of time to evaluate the bank. In addition, it would have required significant FDIC financial involvement to protect against uncertainties, such as contingent liabilities.<sup>14</sup>

The FDIC elected to provide direct assistance to Continental. Because of this deposit run, 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 provide liquidity and to halt a run on deposits until a permanent solution could be arranged. The permanent solution involved replacing senior management, purchasing \$4.5 billion in problem loans for \$3.5 billion, and

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<sup>13</sup> Irvine H. Sprague, *Bailout* (New York: Basic Books, Inc., 1986), 155.

<sup>14</sup> 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.

injecting \$1 billion in capital. In exchange, the FDIC received the right to purchase 80 percent ownership in the parent company, Continental Illinois Corporation.<sup>15</sup> As a result, the shareholders of the parent company suffered an 80 percent dilution of their investments, and the shareholders further became subject to losing their entire investment depending on the losses suffered by the FDIC in collecting the problem loans.<sup>16</sup>

The assistance agreement with Continental created tremendous outcries from critics for several reasons. First, the FDIC guaranteed all depositors and other general creditors, thus assuming their share of loss and removing the market risk. Second, it was generally believed that the FDIC should have penalized the shareholders to a greater degree.<sup>17</sup> Third, the agreement called for the FDIC to receive a majority equity interest, effectively nationalizing the institution. Finally, the issue of “Too Big to Fail”<sup>18</sup> created resentment by many of the smaller institutions due to their belief that the resolutions of larger institutions were treated differently from those of smaller banks. Assisting Continental sowed the seed for future legislation that addressed each of these points. The assistance provided to Continental accomplished the FDIC’s objectives of stabilizing liquidity, preventing Continental’s failure, and restoring Continental’s capital to an adequate level. The assistance also proved to be cost-effective for the FDIC.

## Results of Open Bank Assistance

The majority of open bank assistance transactions completed between 1980 and 1983 involved mutual savings institutions. Assistance was in the form of a merger or acquisition, and the remaining institutions were recapitalized on a stand-alone basis. The FDIC’s methods for handling these institutions were varied and included contributing cash, purchasing assets, offering income maintenance guarantees, issuing FDIC notes, purchasing the institution’s stock, and/or indemnifying against certain types of losses. Most of the acquirers adequately capitalized the institutions. In some cases cash was contributed, and in the other agreements the acquirer’s current capital position was sufficient to absorb the assisted institutions. The importance of this is that the investors assumed some risk and brought fresh capital into the banking system. Replacement of management and the dilution of shareholders’ interest also characterized the open bank assistance transactions.<sup>19</sup>

Since the Continental transaction, an additional 117 institutions received OBA through year-end 1994. All of those transactions were entered into because they were viewed to be less costly than a

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<sup>15</sup> Isaac, 4-5.

<sup>16</sup> Isaac, 4.

<sup>17</sup> The holding company for Continental owned 100 percent of the bank. The shareholders of the holding company suffered an 80 percent dilution with the possibility of losing their entire investment.

<sup>18</sup> Most of the institutions considered “Too Big to Fail” were actually closed; however, certain troubled institutions were too large to be resolved by paying off their customers with insured deposits. A straight deposit payoff of such an institution could have had a devastating effect on the deposit insurance fund. A more accurate name might be “Too Big to Pay Off All Deposits.”

<sup>19</sup> There were a few cases where senior management was not replaced. In each case it was determined that the current management was not considered the cause of the problem.

payoff of customers with insured deposits. Several of the transactions completed in 1984 and 1985 were approved under the FDIC's Voluntary Assisted Merger Plan, under which the FDIC took direct action to arrange a merger of a failed or failing insured bank with another insured bank.

In 1986, former FDIC Chairman L. William Seidman (1985-1991) told the Association of Bank Holding Companies that there are three potential advantages of open bank assistance:

They can provide substantial savings to the insurance fund when compared with the cost of closing a bank;

They provide a mechanism for keeping loans and other assets within the banking system since all borrowers would be dealing with bankers instead of liquidators; and

They can minimize the disruption to the local community that may result from bank failures.<sup>20</sup>

In addition, Chairman Seidman stated: "There is nothing wrong with assisting a bank, but the advantages have to be weighed against the substantial disadvantages of the FDIC's short-term (hopefully) involvement in the private sector through its ownership of warrants, preferred stock or loans in the rescued institution."<sup>21</sup>

From 1980 through 1994, the FDIC provided OBA to 133 institutions out of 1,617 total failures and assistances, or 8.2 percent of the total. Nearly 75 percent of all OBA transactions were completed in 1987 and 1988. Public policy has significantly affected OBA, and in many cases the FDIC has had to wrestle between its role as regulator and insurer against that of investor. OBA has been controversial for several reasons.

- First, OBA allowed weak institutions to remain open and compete with nonassisted institutions.
- Second, shareholders and creditors of failing institutions, while losing substantial portions of their investments, did not lose everything because of OBA.
- Third, many of the OBA transactions were used to resolve larger institutions, resulting in resentment by many of the owners of smaller institutions.
- Fourth, some of the OBA transactions provided significant tax benefits to the acquirers at a cost to the U. S. taxpayer that appeared to exceed any financial benefit received by the government.

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<sup>20</sup> L. William Seidman, *Perspectives on Open Bank Assistance*, (Washington, D.C.: Government Relations Committee of the Association of Bank Holding Companies, September 17, 1986), 5.

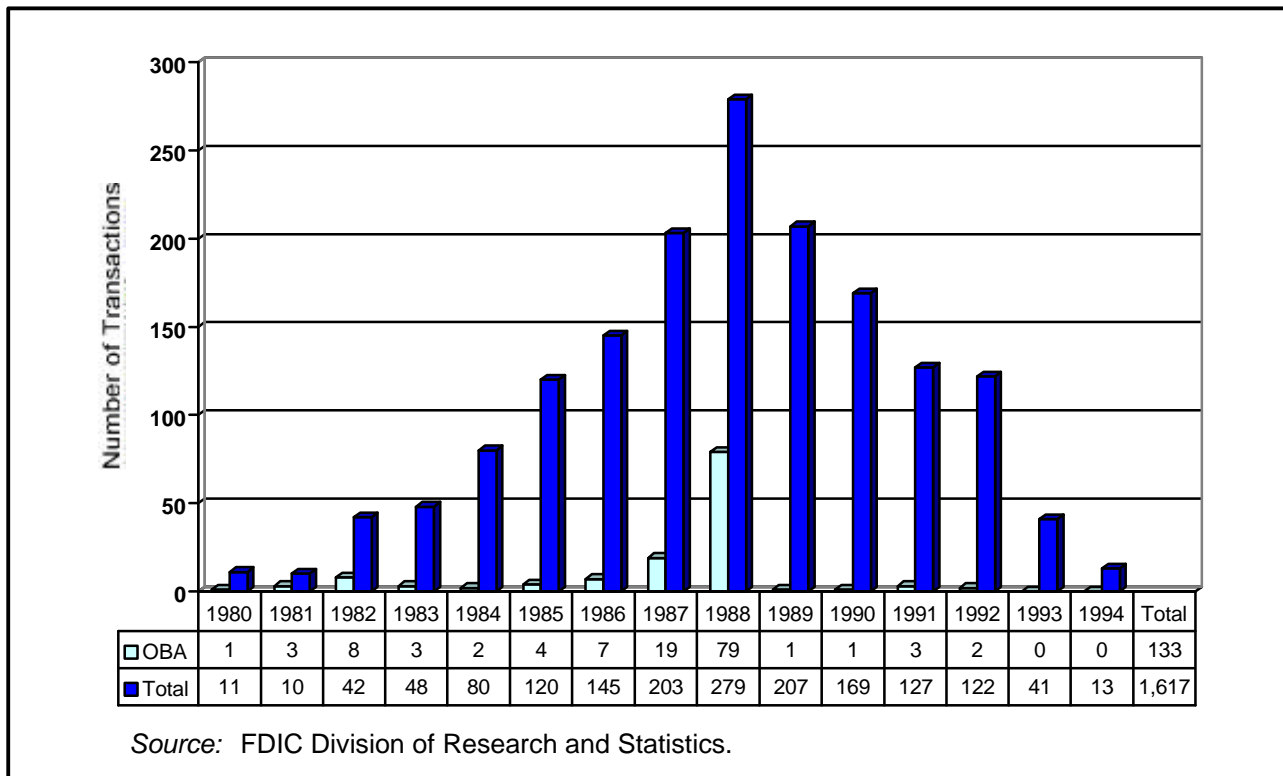
<sup>21</sup> Seidman, 5.

- Fifth, OBA protected all uninsured depositors, which had the result of reducing depositor discipline.

Because of these controversial issues, legislation has been adopted that makes it extremely difficult to complete an OBA transaction. FDICIA, which requires the FDIC to use the least costly method for resolving a failing institution, is intended to provide greater incentives for shareholders and large creditors of insured banks or thrifts to impose more discipline on the management of insured institutions to operate safely and soundly. Chart 5-1 shows the distribution of open bank assistance transactions per year from 1980 through 1994, and exhibit 5-1 shows the benefits and other considerations of open bank assistance.

**Chart 5-1**

**FDIC Open Bank Assistance Transactions  
Compared to All Bank Failures and Assistance Transactions  
1980-1994**



## **Exhibit 5-1**

### **Open Bank Assistance Transactions**

#### **Benefits**

- ◆ *OBA may represent the most cost-effective method for resolving a failing institution.*
- ◆ *The transaction can minimize disruption to the local community.*
- ◆ *Investors assume some of the risk and bring new capital into the institution.*
- ◆ *Assets are kept in the private sector.*

#### **Other Considerations**

- ◆ *Contingent liabilities remain with the troubled institution.*
- ◆ *Also protects customers with uninsured deposits and general creditors, promoting a belief in "Too Big to Fail."*
- ◆ *Time necessary for a troubled institution to put together an assistance proposal is sometimes outside the FDIC's parameters for resolving failing institutions.*

## CHAPTER 6 – OTHER RESOLUTION ALTERNATIVES

In addition to the three basic resolution methods (purchase and assumption transactions, deposit payoffs, and open bank assistance transactions), other resolution methods were used by the Federal Deposit Insurance Corporation (FDIC), the Federal Home Loan Bank Board (FHLBB), and the Federal Savings and Loan Insurance Corporation (FSLIC). These alternatives were used primarily in the 1980s in response to the increasing problems facing the banking and thrift industries. These methods may provide other countries with some alternative resolution options. All of these methods would fit under the general description of forbearance, which is defined as the act of refraining from enforcement of regulatory action. As a result of changes in U.S. banking laws in the early 1990s, there are very limited circumstances in which the FDIC can use forbearance. Most forbearance programs come at the behest of the U.S. Congress.

Forbearance is a controversial concept. One view is that it should never be used. Proponents of this view look at the high cost to taxpayers from the savings and loan crisis. In large part, those costs were a direct result of delayed action. Another view is that the prudent use of forbearance can be an effective tool in an economic crisis. The responses to the FDIC savings bank problems and the agricultural crisis of the early 1980s are cited as cases in point. Under this view, forbearance can be considered in certain circumstances but should be carefully structured if used. In order to qualify for forbearance programs, institutions should be well managed and have reasonable chances of survival. Once relief has been granted, regulatory authorities should closely monitor the situations and end the forbearance program if the situation deteriorates beyond some predetermined point. Forbearance can take many forms and can provide flexibility in resolving problem institutions, but there must be effective governmental oversight controls.

### Net Worth Certificate Program

In 1982, the U.S. Congress established a program that allowed banks and thrifts to apply for capital assistance. Deposit rate structures for banks and thrifts, which had been legally restricted for decades, were deregulated. Financial institutions were required to compete for deposit funds in an inflationary setting, which caused interest rates to sharply increase. Institutions that had primarily lent funds on a long-term basis, such as for 30-year fixed-rate mortgages or long-term government bonds, suddenly had to pay higher rates for deposits to meet their liquidity needs.

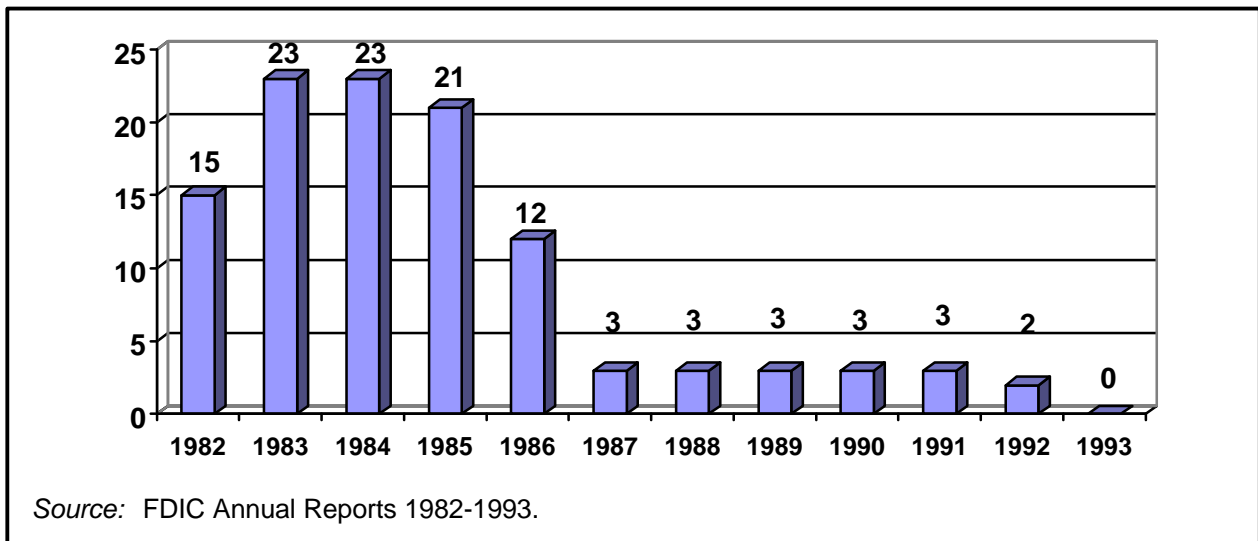
The primary purpose of the Net Worth Certificate Program was to provide capital forbearance to institutions that were not performing well in the new, competitive, deregulated environment. The FDIC's program was restricted to institutions with insufficient net worths; that had recurring losses that were not caused by mismanagement; that would agree to establishing a comprehensive, goal-oriented business plan; and that would consider reasonable merger opportunities. The FDIC "bought" net worth certificates (NWC) from participating institutions in exchange for FDIC promissory notes with terms (such as interest rate, amount, and maturity) identical to those of the net worth certificates. In other words, no cash changed hands. The

NWCs were considered capital for regulatory purposes, but they did not qualify as capital under generally accepted accounting principles (GAAP).

The NWCs were a temporary form of capital that the institution gradually replaced as it became profitable. Institutions were required to reduce the certificates by one-third of their net operating income each year, and the FDIC could request full payment after seven years. The FDIC constantly monitored banks participating in the program. The FSLIC had a similar program for the thrifts. Charts 6-1 and 6-2 show the number of institutions and volume of assets that were involved in the FDIC's Net Worth Certificate Program by year.

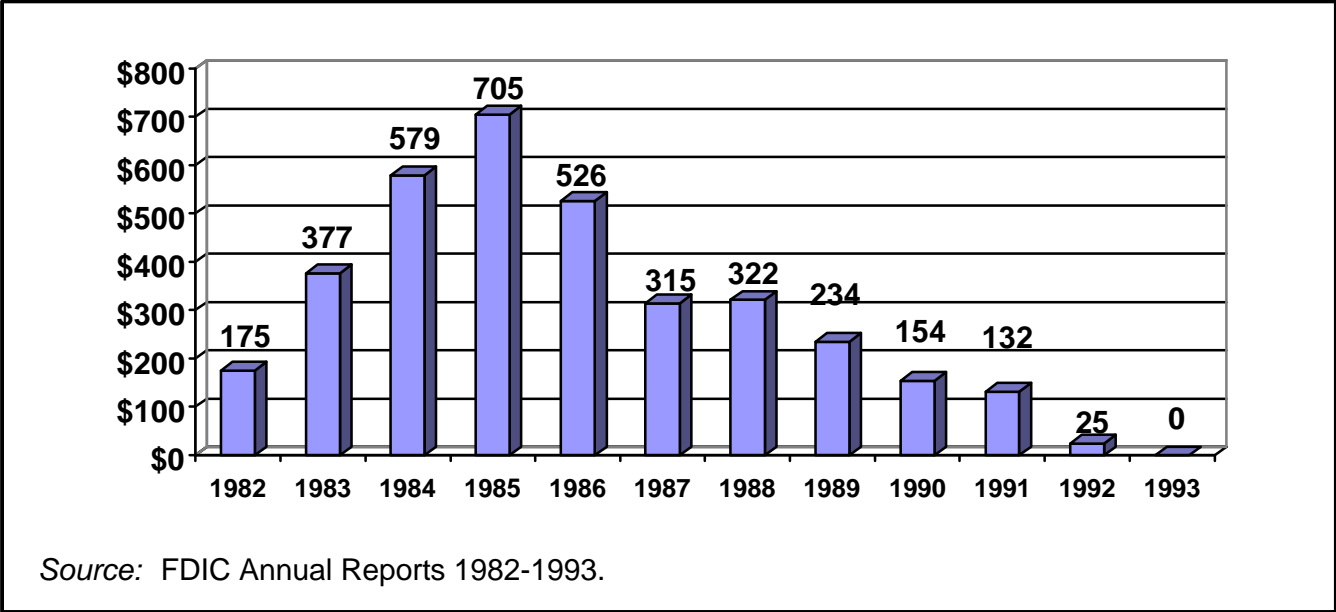
**Chart 6-1**

**FDIC Net Worth Certificate Program  
Number of Banks in Program  
1982-1993**



**Chart 6-2**

**FDIC Net Worth Certificate Program  
Dollars in Program  
1982-1993  
(\$ in Millions)**



Overall, 29 savings banks with total assets of approximately \$40 billion received aid from the program. Of the 29 savings banks participating in the plan, 22 required no further assistance and eventually paid off their NWCs. The remaining seven institutions required additional assistance and cost the FDIC approximately \$480 million. Of those seven, four repaid all assistance, and three were merged into healthy institutions with FDIC assistance. Two institutions failed after paying off their NWCs. Those two failures were the result of actions taken by management after they left the NWC program. Table 6-1 below shows the effect of NWCs on an institution's balance sheet.

**Table 6-1**

**An Example of How Net Worth Certificates  
Affect a Financial Institution's Balance Sheet**

Prior to Net Worth Certificates		After Net Worth Certificates	
Assets	Liabilities	Assets	Liabilities
Loans 800	Deposits 1,000	Loans 800	Deposits 1,000
Other Assets 200	Other Liab. 50	Other Assets 200	Other Liab. 50
	Total Liabilities 1,050	NWC 100	Total Liabilities 1,050
	Capital -50		NWC 100
	Total Liab. & Capital 1,000		Capital -50
Total Assets 1,000		Total Assets 1,100	Total Capital 50
	Capital/Assets Ratio -5.00%		Total Liab. & Capital 1,100
			Capital/Assets Ratio 4.55%

**Income Maintenance Agreements**

From 1981 through 1983, the FDIC used income maintenance agreements to adjust for the effect that the deregulation of interest rates was having on some of its larger savings banks. Those institutions' income was primarily tied to low-yielding, single-family, long-term mortgage loans. The credit quality of the collateral supporting the loans was not a problem.

A major concern to the FDIC was how to resolve those failing savings banks without incurring enormous losses to the insurance fund. The FDIC's resolution strategy was to force the weaker savings banks to merge into healthier banks or thrifts. In order to attract a merger partner, the FDIC guaranteed a market rate of return on the acquired assets through the use of an income maintenance agreement. The FDIC paid a merger partner (the assuming institution) the difference between the yield on acquired earning assets and the average cost of funds for savings banks, plus a "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 these agreements only if the resulting institutions would 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. There are no shareholders in mutual savings banks, so the issue of an unexpected windfall gain for existing shareholders did not need to be addressed.

The FDIC took some risks in issuing net worth certificates and income maintenance agreements and in allowing the institutions to continue to operate. The savings banks were large institutions,

and continued depreciation in their loan portfolios would have had a significant effect on the insurance fund if they had failed. The FDIC reduced its risk by preparing the institutions for mergers or by allowing them time to gradually adjust their asset mixes to more profitable structures. Also, the problem for the savings banks was not tied to collateral values but rather the result of the major change of banking deregulation in the country.

## Capital Forbearance Program and Loan Loss Amortization Program

In the early 1980s, the U.S. agricultural economy was in trouble. In 1983, 37 percent of the banks on the FDIC Problem Bank List (a list of banks that could potentially fail) were considered agricultural banks. Over the years, farmers had taken on large sums of debt supported by the rapidly increasing collateral value of their land. As farm income reached a point where it could not support payments on those debts, the loans started to become delinquent. Collapsing land values compounded the problem. Many borrowers' loans had been based on the equity in their land, and that equity had disappeared. Since the borrowers had no way to repay their notes, the banks had no alternative but to begin foreclosure to try to recover at least a portion of their funds. The many foreclosures tended to push land values even lower because as the bank's owned real estate portfolios grew, banks were forced to sell those nonearning assets as quickly as possible. Large numbers of farm foreclosures were quickly followed by large numbers of bank failures in states where the economy depended on agriculture.

As large numbers of agricultural banks failed in the 1980s, methods were developed to save institutions that were historically well-managed but financially troubled as a result of the depressed economy in their areas. The FDIC instituted two programs that were called the Capital Forbearance Program and the Loan Loss Amortization Program.

The Capital Forbearance Program allowed well-managed, economically sound institutions with concentrations of 25 percent or more in agricultural or energy loans to be temporarily exempt from regulatory capital requirements. 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.

The Loan Loss Amortization Program allowed banks to amortize agricultural losses on their books over a seven-year period. Only institutions of less than \$100 million in total assets and with at least 25 percent of their total loans in agricultural credits were eligible for this program. Qualified institutions were judged to be economically viable and fundamentally sound, except for needing additional capital to carry the weak agricultural credits.

A total of 301 institutions participated in the Capital Forbearance Program, and an additional 33 were in the Loan Loss Amortization Program. Although most of those institutions were either insolvent or close to being insolvent, only 21 percent of those institutions subsequently failed. Table 6-2 shows the distribution of banks among the two programs.

**Table 6-2**

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

	<b>Capital Forbearance Program</b>	<b>Loan Loss Amortization Program</b>
Number of Banks in Program	301	33
Assets of Banks in Program (\$ in Billions)	\$13.0	\$0.5
Avg. Size of Banks in Program (\$ 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 Capital Forbearance Program.		
**Banks that left the program as independent institutions or were merged without assistance.		
<i>Source:</i> FDIC Division of Research and Statistics.		

There are many risks in offering forbearance programs, but carefully managed forbearance programs have been used successfully to prevent institution failures. In both the Capital Forbearance Program and the Loan Loss Amortization Program, the participating banks were primarily small institutions that served farm communities. The farm crisis was temporary, and these methods of forbearance allowed banks the time to recover. The risk to the insurance fund was minimal because the banks were small and easily identifiable. The effects on the insurance fund would have been much larger if the farm crisis had continued indefinitely, if the losses had not been recognized early, or if the value of the collateral had continued to erode.

### Resolution of Savings & Loan Associations Prior to FIRREA

In response to the increasing problems facing the thrift industry, the Federal Home Loan Bank Board and the Federal Savings and Loan Insurance Corporation used the following resolution methods.

#### *Easing of Capital Requirements*

The cause of failure of most thrifts in the early 1980s was the economic issues faced by the entire industry. The mismatch between the rates generated by the long-term assets (mostly mortgage loans) held by thrifts and the shorter-term liabilities used to fund those assets created what is commonly referred to as a “spread problem.” The FHLBB pursued strategies to keep those

“spread problem thrifts” open until rates returned to lower, more traditional levels. The FHLBB’s first strategy in response to the developing thrift crisis was a general easing of the thrift industry’s capital requirements which was accomplished by the following methods.

Lower Capital Requirements. In the early 1980s, the FHLBB lowered thrift capital requirements from 5 percent of liabilities to 3 percent of liabilities.

Deferred Loan Losses. Thrifts were able to amortize certain loan losses attributable to the rise in interest rates over an extended period of time.

Appraised Equity Capital. Thrifts were allowed to report the value of owned premises at the current market value instead of at the typically lower historical value.

Averaging of Liabilities. Thrift capitalization allowed for five-year averaging of liabilities. Although this capital requirement had been in place long before the thrift crisis, it had the unintended effect in the mid-1980s of allowing aggressive thrifts to grow without a commensurate infusion of capital. That lack of capitalization in conjunction with more lending and investment freedom resulted in increased risk to the FSLIC insurance fund.

Easing capital requirements can be a useful tool in allowing financial institutions to remain open through temporary periods of operating difficulties. A very diligent examination and supervision function must be maintained to ensure that institutions with capital problems continue to be managed in a prudent manner. In institutions where poor management becomes an issue, corrective action must be taken promptly to bring management under control.

#### *Use of Mergers and Acquisitions*

In cases where thrifts failed even with the easing of capital requirements, the FHLBB encouraged mergers between thrifts. The FHLBB used mergers and acquisitions as resolution tools throughout its history. There were two types of mergers and acquisitions: unassisted and assisted.<sup>1</sup>

The FSLIC did not have the cash resources to liquidate what would have been a large percentage of the industry. Mergers and acquisitions were methods of managing the FSLIC’s limited resources. Whether a failing thrift was resolved with or without FSLIC assistance depended on a number of factors, including the extent of the thrift’s problems, the types of asset problems in the institution, and the perceived market value of the franchise.

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<sup>1</sup> In the unassisted merger, supervisory authorities would encourage a weak thrift to merge with a healthier thrift, with no direct financial assistance from the FSLIC. In an assisted merger, an acquirer would assume all (or nearly all) the assets and liabilities of a failed thrift and would receive assistance from FSLIC. The assisted merger was the most popular form of FSLIC resolution since it deferred FSLIC cash payments.

Unassisted Mergers. The FHLBB encouraged mergers between failing mutually owned thrifts and other, healthier, mutually owned thrifts *without FSLIC assistance*. In those mergers, favorable accounting rules allowed the acquirer to count the losses in the acquired thrift's assets as goodwill that could be amortized over a relatively long period of time. In instances where GAAP did not allow for that treatment, the FHLBB allowed the acquiring thrift to report increased capital for regulatory purposes and to amortize the goodwill over a longer period of time than was allowed under GAAP. The majority of those mergers occurred in the early 1980s before many credit problems appeared.

Assisted Mergers and Acquisitions. When an unassisted merger could not be arranged, the FSLIC marketed the failing thrift with the offer of direct FSLIC financial assistance to the acquirer. When a failing thrift was mutually owned, there were no windfalls for stockholders. When stockholders owned a failing thrift, the FSLIC resolved the failing institution with an assisted, whole institution purchase and assumption transaction. Claims of existing shareholders were left with the receiver of the failed institution.

Like the FDIC, the FSLIC used income maintenance and net worth certificates for simple spread problem thrifts in the early 1980s. The FSLIC also provided acquirers with capital assistance by purchasing income capital certificates (ICC), which were similar to cumulative preferred stock.<sup>2</sup> That capital assistance helped reduce the direct FSLIC assistance payment, and the acquirer was provided with the regulatory capital needed to grow so that it could absorb any losses in the portfolio of acquired assets.

In the mid- to late-1980s, the problems seen at failing thrifts resulted from poor or speculative management decisions that created asset "credit quality" issues. Credit quality problems, coupled with the FSLIC's lack of liquidity, made it necessary for the FSLIC to enter into longer-term assistance agreements with acquirers. Those agreements minimized the FSLIC's immediate outlay of cash. If an acquirer took title to all of a failing thrift's assets, the FSLIC agreed to make periodic assistance payments that covered the costs of holding and disposing of the assets. The FSLIC also gave cash or notes equal to the negative net worth on the books of a failing institution and made periodic payments for income maintenance and loss reimbursement.

Assistance agreements can be useful in the resolution process especially when the preservation of liquidity is important and staff is limited. Because the insurance fund continues to bear credit risk, it is important that an acquirer's staff has sufficient asset management expertise and agreements are structured so that the acquirers' interests and incentives are aligned with those of the insurer. This means that the acquirer shares in the losses (and gains) of the portfolio of

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<sup>2</sup> Income capital certificates were used as a form of noncash FSLIC assistance. A troubled thrift would issue an ICC to the FSLIC in exchange for a FSLIC note. The FSLIC note was an asset on the thrift's books with the offsetting liability (ICC) counting as regulatory capital. If the thrift had earnings and had achieved a certain level of net worth, it paid a portion of its net income to the FSLIC in the form of interest (dividends) based on a variable rate. The FSLIC generally paid interest on the note to the institution in cash. The ICC program was in effect from 1981 through 1986.

acquired assets. It is equally important to carefully monitor and oversee the acquirer's management of the assets covered under the agreement.

#### *Use of Tax Incentives in Assisted Transactions*

In response to continuing concerns regarding the solvency of the FSLIC, in 1981 the U.S. Congress passed legislation that allowed FSLIC assistance payments to accrue tax-free to acquiring institutions. The tax benefits were intended to reduce the cash assistance required for the FSLIC to complete acquisitions of failed institutions. The FSLIC did achieve cost savings, but it did not always receive a dollar-for-dollar reduction in the cost of assisted transactions.

Merging poorly performing institutions with healthy institutions can be beneficial to an insurer. Healthy banks or thrifts may have better management, there may be cost savings achieved in the operations area, and there may be a reduction in the number of open competing institutions that may allow the survivors to be more profitable. On the other hand, mergers may delay problems and result in much larger institution failures. The FSLIC's extensive use of forbearance was a result of an inadequate insurance fund in an industry in which many institutions were insolvent. This eventually led to FSLIC's insolvency and demise. However, the FSLIC programs may be effective in more limited situations, if used with care.

#### Management Control

In addition to the various forbearance programs mentioned above, the FHLBB also used an additional noncash resource to attempt to resolve the thrift crisis. In 1985, in response to the heavy pace of failures and the lack of FSLIC funding, the FHLBB initiated the Management Consignment Program (MCP) to immediately address management control. The MCP was, in effect, a conservatorship program and addressed the FSLIC's lack of staff resources needed to immediately close failing institutions. Under the MCP, new management was brought in to manage troubled institutions; the FHLBB indemnified managers in the MCP. Institutions being managed under the FSLIC's MCP when the Resolution Trust Corporation (RTC) was created became the initial RTC conservatorship caseload. Insurance funds that are strapped for cash might use this method as a temporary means to share industry expertise to stabilize a situation.

## CHAPTER 7 – THE FDIC’S ROLE AS RECEIVER

Before the creation of the Federal Deposit Insurance Corporation (FDIC), the Office of the Comptroller of the Currency (OCC), which had the authority to appoint the receiver of a failed national bank, supervised national bank liquidations. Liquidations of state banks varied considerably from state to state, but most were handled under the provisions for general business insolvencies.

The U.S. Congress recognized the importance of deposit protection in providing stability in the nation’s economy. As such, Congress gave the FDIC special powers to use in the liquidation of assets from failed banks or thrifts and the payment of claims against the receivership estate. Federal laws governing the resolution of failed depository institutions were designed to promote the efficient and expeditious liquidation of failed banks and thrifts. The more significant of those powers are detailed below.

### Comparison with Bankruptcy Law

In many ways the powers of the FDIC as receiver of a failed institution are similar to those of a bankruptcy trustee. Like a bankruptcy trustee, a receiver steps into the shoes of an insolvent party. The receiver may liquidate the insolvent institution or transfer some or all of its assets to an acquiring institution. Although many of the concepts central to the operation of an FDIC receivership are similar to those of the bankruptcy process, federal law grants the FDIC additional powers that lead to critical differences between bankruptcy and the FDIC receivership law.

The FDIC’s role and responsibilities when serving as receiver are defined by specific statutory provisions contained in the Federal Deposit Insurance Act of 1950. These additional powers allow the FDIC to both expedite the liquidation process for banks and thrifts in order to maintain confidence in the nation’s banking system and to maximize the cost-effectiveness of the receivership process to preserve a strong insurance fund. The primary advantage is that the FDIC, in administering the assets and liabilities of a failed institution as its receiver, is not subject to court supervision, and its decisions are not reviewable except under very limited circumstances. A few key differences are—

- Claims Process. A receiver has the power to allow or disallow claims. The holder of a disallowed claim may litigate its claim in federal district court. A bankruptcy trustee can object to a claim, but the decision of whether to allow or disallow the claim is made by the bankruptcy court.
- Contract Repudiation. A receiver may repudiate any burdensome contract within a “reasonable time” of its appointment. A bankruptcy trustee can repudiate only executory contracts.

- Stay of Litigation. A receiver can request a stay of legal proceedings of up to 90 days. The automatic stay in bankruptcy becomes effective immediately upon the filing of a bankruptcy petition.
- Avoidance Powers. Both a receiver and a bankruptcy trustee have avoidance powers. A receiver can pursue fraudulent transfers by obligors of a failed financial institution made with the intent to hinder, delay, or defraud the institution. This power applies to transfers made five years before or after the date of the receiver's appointment. A bankruptcy trustee can avoid fraudulent transfers and recover property for the bankruptcy estate.
- Special Defenses. A receiver has special statutory defenses that it can use to defeat the defenses of obligors of a failed institution. A bankruptcy trustee generally can use only the defenses that were available to the debtor to defeat claims.

A more detailed discussion of the FDIC's special receivership powers follows later in this chapter.

## Why the FDIC Acts as Receiver

To understand why the U.S. Congress gave the FDIC the powers it has, it is necessary to look at the structure of the banking industry and the conditions of the 1930s. The FDIC was created in 1933 to halt a banking crisis. Nine thousand banks—a third of the banking industry in the United States at that time—failed in the four years before the FDIC was established. The failure of one bank 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 banks. The behavior of depositors was not irrational. They had learned from hard experience that if they kept their money in a bank, the money might not be available when they needed it, and they might lose a large portion of it if their bank failed.

Before the creation of the FDIC, the OCC supervised national bank liquidations. Liquidations of state banks were generally handled under the provisions for general business insolvencies. By 1933, most state banking authorities had at least some control over state bank liquidations. However, the increased incidence of national bank failures from 1921 through 1932 created a shortage of experienced receivers. Furthermore, there were concerns that appointments of receivers, both national and state, had been handed out as political favors, with the recipients attempting to make large commissions and to extend the work 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, to pay the depositors, and to close the bank's books—although in at least one instance this process took 21 years. Even when depositors did ultimately receive their funds, the amounts were significantly less than they had originally deposited into the banks. From 1921 through

1930, more than 1,200 banks failed and were liquidated. From those liquidations, depositors at state chartered banks received, on average, 62 percent of their deposits back. Depositors at banks chartered by the federal government received an average of 58 percent of their deposits back. Given the long delays in receiving any money and the significant risk in getting their deposits back, it was understandable why anxious depositors withdrew their savings at any hint of problems. With the wave of banking failures that began in 1929, it became widely recognized that the lack of liquidity that resulted from the process for resolving bank failures contributed significantly to the economic depression in the United States.<sup>1</sup>

To deal with the crisis, the government of the United States 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, the U.S. Congress addressed that problem by (1) providing that the FDIC would insure deposits up to the deposit limit, 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 simplified procedures, eliminated duplication of records, and vested responsibility for liquidation in the largest creditor (the FDIC in its corporate capacity, as subrogee for the insured deposits it had paid), whose interest was to obtain the maximum possible recovery. For state chartered banks, the U.S. Congress preferred that the FDIC be receiver, but allowed each state to appoint a receiver according to state law. By 1934, 30 states had provisions under which the FDIC could be appointed receiver but, in practice, most states often did not do so. Today, however, it is the rare exception when the FDIC is not appointed, and most states now require that the FDIC be appointed as receiver.

## How the FDIC Becomes a Receiver

A depository institution's charter determines which state or federal regulatory agency will appoint a conservator or a receiver for a failing institution.<sup>2</sup> For federal savings associations and national banks, the Office of Thrift Supervision and the Office of the Comptroller of the Currency, respectively, are the chartering authorities responsible for determining when the appointment of a receiver is necessary. 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 required to do so. In the case of state chartered banks that are members of the Federal Reserve System, the state banking authority may also appoint the FDIC as receiver. In certain limited instances, the FDIC may appoint itself as receiver for a state chartered insured depository institution. In 1991, the U.S. Congress provided the FDIC that additional authority to appoint itself receiver out of concern that the FDIC depended on the judgment of individual state chartering authorities or that

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<sup>1</sup> C.D. Bremer, *American Bank Failures* (New York: Columbia University Press, 1935), chapters IV and V.

<sup>2</sup> 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 a state regulatory authority and may decline the appointment if tendered; the FDIC was appointed conservator once by the Office of Thrift Supervision.

of other federal chartering authorities. Also, Congress needed an independent basis to protect the insurance fund in a timely manner. Since receiving that power 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.

The FDIC as receiver is functionally and legally separate from the FDIC acting in its corporate role as deposit insurer, and the FDIC as receiver has separate rights, duties, and obligations from those of the FDIC as insurer. Courts have long recognized these dual and separate capacities.

## The FDIC's Functions as Receiver

The U.S. Congress has entrusted the FDIC with virtually complete responsibility for resolving failed federally insured depository institutions and has conferred expansive powers to ensure the efficiency of the process. In exercising this significant authority, the FDIC is required by statute to maximize the return on the assets of the failed bank or thrift and to minimize any loss to the insurance funds.

A receivership is designed to market the assets of a failed institution, liquidate them, and distribute the proceeds to the institution's creditors. The FDIC as receiver succeeds to the rights, powers, and privileges of the institution and its stockholders, officers, and directors. The FDIC may collect all obligations and money due to the institution, preserve or liquidate its assets and property, and perform any other function of the institution consistent with its appointment.

A receiver 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, a receiver may form a new institution, such 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.<sup>3</sup>

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. These provisions allow the receiver to operate without interference from other executive agencies and to exercise its discretion in determining the most effective resolution of the institution's assets and liabilities.

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 to return the institution to a sound and solvent

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<sup>3</sup> 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. Refer to Chapter 3, Purchase and Assumption Transactions, for further discussion of bridge banks.

operation. 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 disaffirm or repudiate contracts such as leases, but it may choose not to do so if the contracts would benefit the open institution.

## The FDIC's Closing Function

When its chartering authority closes a bank or thrift and appoints the FDIC as receiver, the first task for the FDIC is to take custody of the failed institution's premises and all its records, loans, and other assets. After taking possession of the premises, the FDIC posts notices to explain the action to the public and changes locks and combinations as soon as possible. It then 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.

## Resolution of Claims Against the Failed Institution

Immediately after its appointment, the FDIC as receiver must notify the failed institution's creditors (which include customers with uninsured deposits) to submit their claims to the receiver. The FDIC arranges for a notice to be published in a local newspaper stating that the financial institution has failed and how claimants may file their claims. The receiver must also mail notices to file claims to all creditors identified in the institution's records.

All claimants, including those who may have been suing the failed institution, must then file proof of their claims with the receiver by a specified deadline. The receiver may seek to put any pending litigation to which the failed institution was a party on hold. Once a claim has been filed, the receiver has 180 days to determine if the claim should be allowed. If the receiver is not satisfied that the claim has merit, the claim will be disallowed.

An allowed claim will be paid on a pro rata basis with other allowed claims of the same class, to the extent there are funds available in the receivership after the expenses are paid. If a creditor's claim is denied, the creditor may seek judicial review of the claim by filing a lawsuit or continuing pending litigation within 60 days after the date the claim is denied. If the receiver has not acted on the claim within 180 days of its filing, it is deemed to have been disallowed and the creditor may file suit within 60 days thereafter.

## Payment of Claims

The priority for paying allowed claims against a failed depository institution is now determined by federal law. On August 10, 1993, a uniform distribution plan for depository institutions, the National Depositor Preference Amendment, became effective. The law gives payment priority to depositors, including the FDIC as subrogee, over general unsecured creditors. 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. The statute applies to all receiverships established after its enactment. For receiverships commenced prior to that, distribution of the assets of a failed depository institution was determined according to the law of the chartering jurisdiction, either state or federal. A number of states had depositor preference statutes for their state chartered institutions prior to enactment of the federal statute.

Claims against the failed institution are paid from monies recovered by the receiver through its liquidation efforts. 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 FDIC claim takes the position of all insured deposits),<sup>4</sup>
3. Other general or senior liabilities of the institution,
4. Subordinated obligations,<sup>5</sup> and
5. Shareholder claims.

Payments on these claims are known as dividends. Customers with uninsured deposits are sometimes issued advance dividends based on the estimated recovery value of the failed bank's assets. This provides customers with uninsured deposits some reasonable amount of liquidity protection without eliminating the incentive for large depositors to exercise market discipline.

Advance dividends are based on the estimated value of the failed bank's assets. Advance dividends usually range between 50 cents and 80 cents on the dollar of receivership claims. The FDIC does not pay advance dividends when the value of the failed institution's assets can not be reasonably determined at the closing.

Federal law applicable to all depository institution receiverships provides that a receiver's maximum liability to a claimant is an amount equal to what the claimant would have received if the institution's assets had been liquidated.

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<sup>4</sup> Because of the manner in which the Federal Deposit Insurance Act of 1950 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.

<sup>5</sup> Any liability of the insured depository for a cross guarantee assessment would receive distributions after subordinated debtholders but before distributions were made to shareholders.

## Special Receivership Powers

As mentioned earlier in this chapter, the FDIC as receiver has a number of special powers that have been granted by federal law. A discussion of some of the more significant powers follows.

### *Repudiation of Contracts*

A receiver may repudiate or disaffirm a contract of the depository institution if the receiver (1) deems it burdensome, and (2) finds that repudiation would promote the orderly administration of the receivership estate. 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 act to repudiate a contract within a “reasonable time” after appointment. While the receiver may be liable for damages resulting from the repudiation of a contract, those damages are limited to actual direct compensatory damages determined as of the date of the receiver’s appointment.

Slightly different rules apply for contracts that are “qualified financial contracts” (QFC), which include securities contracts, commodity contracts, forward contracts, repurchase agreements, and swap agreements. When the receiver repudiates a QFC, damages are measured as of the date of the repudiation and may include the cost of acquiring a replacement QFC. These special rules are necessary to protect the U.S. financial markets.

### *Placing Litigation on Hold*

The receiver is substituted as a party for litigation pending against the failed bank or thrift. However, because the receiver may need time to assess and evaluate the facts of each case to decide whether and how to proceed, the law permits the receiver to request a court to put on hold, or “stay,” the litigation. 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.<sup>6</sup>

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.<sup>7</sup>

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<sup>6</sup> A receiver may obtain a stay for 90 days; a conservator is allowed 45 days.

<sup>7</sup> Tort actions are lawsuits that seek compensation for a civil wrong (as opposed to a crime) committed by one party against another party. They include lawsuits for personal injury or property damage due to negligence, as well as suits for libel, false arrest, and other disputes.

## *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.

## *Special Defenses*

Over the years, federal statutes and court decisions have provided certain "special defenses" to the FDIC in its role as receiver to allow for the efficient resolution of a failed institution's affairs.

Improperly documented agreements are not binding on the receiver. Like a bank regulator, the receiver must be able to rely upon 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 to the effective collection of debts due to the failed bank or thrift.

As a result, both the common law (*D'Oench Doctrine*) and its statutory counterparts, *U.S. Code*, volume 12, section 1821(e) and section 1821(d)(9)(A), recognize that, unless an agreement is properly documented in the institution's records, it cannot be enforced either in making a claim or defending against a claim by the receiver. Therefore, an argument by an obligor on a promissory note that an undocumented, unrecorded side agreement with the failed bank, changes or releases the duty to repay the loan will generally be barred.

Courts may not enjoin the receiver. The U.S. 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, *U.S. Code*, volume 12, section 1821(j), 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. These 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. Adjustments to the closing books may be made between the date of the closing of the institution and the "settlement date." 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 reflect (1) the exercise of options by the acquirer, (2) either any repurchase of assets by the receiver or any "put

back” of assets to the receiver by the assuming institution, and (3) the valuation of assets sold to the acquirer at market prices.

## Disposal of Assets and Termination of Receivership

In order to have funds to disburse, the FDIC works to dispose of the remaining assets of the failed institution in a timely manner through a variety of methods. In addition, the FDIC conducts an investigation into each failed institution to determine if negligence, misrepresentation, or wrongdoing was committed and, when appropriate, may file a lawsuit to help recover losses caused by these acts.

Receivership termination represents the final process of winding up the affairs of the failed institution. Following payment of eligible claims and final disposition of the assets, the FDIC then proceeds with terminating the receivership. The duration of a receivership varies depending on individual circumstances, such as the 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. All significant issues of the receivership must be resolved prior to its termination.

## CHAPTER 8 – OTHER SIGNIFICANT ISSUES

During the bank and thrift crisis that began in 1980, the Federal Deposit Insurance Corporation (FDIC) resolved many institutions under widely different circumstances. The FDIC learned many valuable lessons from these experiences. In response to changes in the banking industry as well as legislative changes, the FDIC has adopted a number of revisions changes in the strategies used to market and sell the assets and liabilities of failing banks and thrifts since the early 1980s. While the techniques have evolved over time, the FDIC's primary resolution considerations remain, conducting the least cost resolution and quickly selling as many assets as possible to the private sector.

### Maintaining Public Confidence in the Banking System

One of the FDIC's primary missions is to maintain public confidence in the U.S. financial system. When a bank fails, the FDIC accomplishes this by ensuring the prompt and efficient payment to customers with insured deposits, by minimizing the impact of an institution failure on the local economy, by finding an assuming or agent institution to handle insured deposits, and by transferring as many of the failed bank or thrift's assets as possible back into the private sector.

### Adequacy of Insurance Funds

To efficiently resolve a banking crisis, it is critical to have an adequate insurance fund reserve. If such funds are not available, the problems may become worse as a result of delay. As the Federal Savings and Loan Insurance Corporation (FSLIC) began to experience a greater outflow of funds than it had coming in, it took steps to conserve cash. Although many of its programs were designed to give failing institutions time to work out their problems, some programs had the unintended effect of postponing the problems and actually increasing resolution costs. The FSLIC lacked the financial liquidity to promptly close insolvent institutions, and many of them remained open to compete with healthy institutions. In addition, several state-run insurance funds folded in the 1980s and the 1990s due to liquidity problems and inadequate insurance funds to protect the depositors in their states.

### Other Resolution Concerns

#### *Expeditious Resolutions*

Experience suggests that failing financial institutions should be resolved as quickly as possible. Asset and franchise values are preserved and maximized, making them more desirable to healthy institutions. Normally, the more quickly an institution is resolved, the lower the cost. Finally, failing financial institutions can have negative effects on the markets in which they compete, and their quick exit from those markets minimizes those effects.

A problem situation should be dealt with immediately. This is an important lesson from the savings and loan crisis. The FSLIC's lack of funds to fully resolve the crisis and the relaxation of accounting and regulatory standards which was intended to give the problems time to correct themselves, only made the situation worse.

### *Bidders' Qualifications*

It has always been the FDIC's practice to offer a failing institution to both operating financial institutions and investors who qualify for and have been given conditional approval for a charter to create a new institution (called a *de novo* institution). However, the application process may be difficult to complete within the timeframes required for resolving failing institutions. Although *de novo* charters are granted by the various chartering authorities, the FDIC must also approve the application so that the new institution's deposits can be insured. Currently, all states and federal chartering authorities require FDIC insurance as a condition for granting a new charter.

### *Bidders' Due Diligence*

A concern that arises during the bidders' due diligence is the fair and equitable treatment of all due diligence participants. Bidders should be given as much time as possible to perform their reviews, while keeping in mind the time constraints of the resolution process. If information is revealed late in the due diligence process, all bidders who have already completed their reviews must be contacted and apprised of the additional information. If more than one potential purchaser must be scheduled to perform due diligence during the same time period (because of bank size limitations or time constraints), it is important to have identical sets of information for each group.

### *Choosing the Appropriate Resolution Structure*

There is no one right way to resolve a failing institution. The method must be chosen to fit the situation at hand. Choosing the appropriate resolution structures can ease the economic dislocation of financial institution failures. Examples of economic dislocations that disrupt orderly economic activity in an industry or region may include: the loss of a local institution in an isolated area, a severe reduction in available credit for an industry or region, and massive government ownership of a failed institution's assets. Transactions that tend to lessen economic dislocations are those that maximize private ownership of assets, preserve franchise values, minimize the time that assets are under FDIC control, and preserve competitive markets.

A resolution process that most closely resembles a free market should yield the best economic results for all involved. Such a process maximizes the number of bidders, allows for a wide variety of transaction structures, provides as good information as is available, and provides as much time as possible for due diligence.

## *Resolution Timeframes*

Resolution structures that involve working with an acquirer over a period of time must be carefully crafted to provide appropriate incentives for acquiring institutions. For example, loss sharing transactions have been successful because they align the economic interests of the asset purchasers with those of the FDIC.

## Receivership Issues

### *Working with the Local Media*

Assistance can be gained and goodwill can be created by sharing with the local media as much information as possible about the resolution. Announcements through television, radio, and the local newspapers should provide failed institution customers with information about how the resolution will be handled. For some institutions, especially those in small towns or where there has not been a closing for some time, it can be beneficial to conduct a town meeting to answer questions about the failure, the resolution process, the closing process, the transfer of insured deposit accounts, and other general questions.

Occasionally, reporters have asked to observe the FDIC as it goes through a resolution and closing process. These reporters are required to sign confidentiality agreements regarding any institution- or borrower-specific information they might see. Although the FDIC does not seek this coverage, every attempt is made to accommodate reporters' requests. It is beneficial to have knowledgeable, experienced reporters familiar with the resolution and closing process, because these reporters can be especially helpful in keeping the public informed.

### *Closing Matters*

When planning for any closing, whether there is to be an acquiring institution or not, it is important to make arrangements for direct deposits coming into the failing bank or thrift.<sup>1</sup> These direct deposits should be routed to another institution so that depositor cash flows are not interrupted. If arrangements for direct deposits are not made, incoming deposits will be returned to the senders, and it can take months for depositors to get their funds.

Another closing issue is automated teller machines (ATM). On-line debit servicers (for example, Cirrus, Bank Plus, and Versatel) must be contacted so that withdrawals from failed institution accounts are not permitted unless the accounts are transferred to an acquiring or agent institution. Additionally, deposits in ATMs on the day of closing must be collected and posted as of the last day of business.

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<sup>1</sup> Direct deposits are funds automatically deposited to a customer's account using electronic fund transfers. These payments are usually repetitive and are normally periodic, such as weekly, monthly, or quarterly. Examples of direct deposits might include paychecks, government assistance payments, and pension payments.

If the failed institution's closing results in a straight deposit payoff, whether by mail or at the failed institution, it is necessary to consider two important things:

- Large numbers of customers may come to the institution, either to collect their checks that represent the insured portion of their deposits or to discuss their accounts. Long lines may form at the institution's doors many hours before the scheduled opening time if customers fear the insurer will run out of money.
- Customers with uninsured deposits may be confused about the amounts of their insurance checks and will need personal attention from claims agents. Confidential conference rooms should be set up where these customers can have private discussions. It is also necessary to counsel customers with uninsured deposits about how to file claims on the uninsured portion of their deposit.

### *Value of Assets in Receivership*

Assets not sold to acquirers at resolution should be given prompt attention. Assets that are not loans, such as automobiles and furniture, should be sold or otherwise converted to cash as quickly as possible. Loan assets need special handling. It is essential to establish procedures for receivership representatives to work with those who had loans with the failed institution. These borrowers will need to establish new banking relationships with healthy financial institutions that can address their on-going credit needs. One of a receiver's main goals should be to assist borrowers in establishing these new credit relationships.

However, not all borrowers can be refinanced. The receiver should decide if more can be recovered through sale of the asset than through other liquidation means. Assets that should be sold need to be sold quickly, so they retain their value.

Restructuring a loan for a financially distressed borrower is normally more productive for the receiver than foreclosing on the collateral or initiating lawsuits to collect the debt. Maximizing recovery on failed institution assets is the receiver's responsibility, and litigation expenses can very rapidly consume any funds recovered.

It is important to note that when liquidating a failed institution's loans, on-going businesses that are borrowers need to continue to operate. The receiver must consider the repayment sources of loans when in determining a liquidation strategy. For example, if a small business loan is secured by all of the furniture and equipment in its office or factory, but repayment comes from on-going business activity, then it would not be prudent on the part of the receiver to foreclose on the furniture and equipment. This would put the firm out of business and eliminate any further sources of repayment.

## GLOSSARY

**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*.)

**advance dividend:** A payment made to an uninsured depositor 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. Sometimes when it is projected that all depositor claims will be paid in full an advance dividend will be provided to unsecured creditors.

**agent institution:** The healthy bank or thrift that accepts the insured deposits and secured liabilities of a failed institution in an insured deposit transfer, in exchange for a transfer of cash from the FDIC.

**appraised equity capital:** A regulatory capital item established by the former Federal Home Loan Bank Board 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 valuation review:** A review of all of a failing institution's assets to estimate the liquidation value of the assets. This estimate is used in the least cost analysis that is required by Federal Deposit Insurance Corporation Improvement Act (FDICIA) of 1991.

**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 Federal Deposit Insurance Act (FDI Act) of 1950 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 mergers were the Federal Savings and Loan Insurance Corporation's preferred resolution method.

**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*.)

**bank:** A financial institution which in the normal course of its business operations accepts deposits; pays, processes, or transacts checks or other deposit accounts; and performs related financial services for the public. Also a bank generally makes loans or advances credit.

**Bank Insurance Fund (BIF):** One of the two federal deposit insurance funds created by the U.S. 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*.)

**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, owned real estate or securities).

**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.

**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.

**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 Office of the Comptroller of the Currency (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.

**cash equivalents:** Assets on the balance sheet of a financial institution that can be readily converted into cash. Examples include accounts due from correspondent banks and federal funds 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 Office of Thrift Supervision (OTS).

**claim:** An assertion of the indebtedness of a failed institution to a depositor, general creditor, subordinated debtholder, or shareholder.

**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.

**conservatorship:** The legal procedure provided by statute for the interim management of financial institutions used by the FDIC and Resolution Trust Corporation (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.

**contingent liability:** potential claims on bank assets for which any actual or direct liability is contingent upon some future event or circumstance. Contingencies usually result from off-balance sheet lending activities such as loan commitments and letters of credit. Other examples are pending litigation in which the bank is defendant and contingent liabilities arising from trust operations.

**cross guarantee:** A provision of the FDI Act added by the Financial Institutions Reform, Recovery, and Enforcement Act (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.

**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 *insured deposit transfer, payoff, and straight deposit payoff*.)

**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.

**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.

**Federal Deposit Insurance Corporation (FDIC):** The federal corporation chartered by Congress in 1933 to promote confidence in the nation’s banking system by establishing a federal deposit insurance program and by acting as the primary federal bank regulator of state chartered banks that are not members of the Federal Reserve System. The FDIC has a five-member board of directors, all of whom are appointed by the president of the United States with the advice and consent of the Senate. The comptroller of the Currency and the director of the Office of Thrift Supervision are two of the five members. The FDIC manages the Bank Insurance Fund and the Savings Association Insurance Fund, insuring deposits in commercial and savings institutions. Additionally, the FDIC acts

as the receiver (and occasionally, as conservator) of failed financial institutions. In performing and discharging its role as deposit insurer or as a primary federal bank regulator, the FDIC is considered to be acting in its “corporate capacity,” namely, as an agency of the United States government. In contrast, the FDIC acts in a conservatorship or receivership capacity when it performs and discharges its obligations as the conservator or receiver of a failed institution. The FDIC performs its roles in accordance with the statutory conditions, duties, powers, and rights that Congress has imposed on it.

**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 the U.S. 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 savings and loan associations. 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.

**forbearance:** A bank resolution method that exempts certain distressed institutions that are operating in a safe and sound manner, from minimum capital requirements. The forbearance program used by the FDIC in the mid-1980s 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.

**fund balance:** The equity or net worth of each of the primary insurance funds—bank insurance fund or savings association insurance fund—administered by the FDIC. The fund balance for each fund is annually reflected in financial statements prepared by the FDIC, which are audited and reported to the U.S. Congress by the General Accounting Office.

**general creditors:** Entities, including uninsured depositors, suppliers, trades people, and contractors, with unsecured claims against a failed financial institution.

**Generally Accepted Accounting Principles (GAAP):** Accounting rules and conventions established by the Financial Accounting Standards Board that define acceptable practices in preparing financial statements.

**income maintenance agreement:** 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 savings bank's 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.

**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.

**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. (Also see *Uninsured Deposit*.)

**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*, *payoff*, and *straight deposit payoff*.)

**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*)

**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.

**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.

**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.

**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.

**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.

**net worth certificate (NWC):** A capital instrument purchased by the FDIC or the former FSLIC under a special program created by the U.S. 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.

**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 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 of the United States, 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, 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 Depository Institutions Act of 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.

**pass-through receivership:** A resolution term used 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.”

**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*, *insured deposit payoff*, and *straight deposit payoff*.)

**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 exist to protect domestic financial markets.

**receiver:** A person or entity, including a government agency, appointed to handle the assets and liabilities of a failed insured depository institution. A receiver succeeds to all the interests and property owned by the failed institution. The U.S. Congress requires the FDIC to be the receiver for insured federal depository institutions. The FDIC may accept appointment as the receiver of a state chartered insured institution and has authority under certain circumstances to appoint itself as the receiver for a state chartered insured depository 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.

**reimbursable expenses:** Out-of-pocket expenses paid to third parties during the shared loss period of a loss sharing agreement. The expenses are paid to effect recoveries and to manage, operate, and maintain owned real estate net of income received on that property. Examples of reimbursable expenses include the cost of appraisals, title policies, and environmental site assessments.

**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.

**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.

**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 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.

**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*)

**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.

**straight deposit payoff:** A resolution method for failed FDIC insured institutions which can be used when the liquidation, closing or winding up 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*.)

**subrogation:** The process where the FDIC is substituted as the claimant for the insured deposits paid by the FDIC. The claims against the receivership estate include the FDIC, in its corporate capacity, as payer of insured deposits.

**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.

**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*.)

**yield maintenance:** Assistance from a financial institution's insurer that provided a guarantee that certain assets purchased by an acquiring institution in a resolution would yield a prescribed rate of return. In many cases, the yield on these assets could be substantially higher than the institution's cost of funding or cost of carrying the assets. Conceptually, yield maintenance and income maintenance agreements are similar in that they both essentially provide for income protection for nonperforming or low-yielding assets acquired in an assistance transaction.