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## Failure-Resolution Methods and Policy Considerations

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by John F. Bovenzi and Maureen E. Muldoon

The authors are, respectively, Deputy to the Chairman of the FDIC, and Financial Analyst in the FDIC's Division of Research and Statistics. In this paper the FDIC's methods for handling bank failures are examined and policy objectives and concerns are detailed. This is followed by a discussion of the difficult trade-offs that exist among sometimes competing policy goals, and how the various failure-resolution methods affect the achievement of these goals. The discussion is illustrated with a review of recent transactions involving large banks.

## An Overview of the U.S. Credit Union Industry

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The author is a Financial Analyst in the FDIC's Division of Research and Statistics. This article provides information on the history, growth, regulation and insurance of credit unions in the United States. The current condition of the credit union industry, and its insurance fund, also are discussed. The author traces the evolution of the common bond requirement, and summarizes arguments for and against tax-exemption. She concludes that the financial condition of the industry generally appears good, but that recent events underscore the need for high-quality examination and supervision.

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The author is a Financial Economist in the Office of Research and Statistics of the Resolution Trust Corporation. He estimates that almost half the assets of non-conservatorship thrifts are in thrifts that do not meet their capital requirements, while almost three-fourths of the assets of non-conservatorship thrifts are in thrifts that do not now meet the standards that ultimately will be required. He points out that thrifts not meeting the requirements are not doomed to failure, but that absent a major improvement in performance, options available to many appear limited to some combination of shrinkage, mergers with healthier institutions or attracting outside capital.

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by Benjamin B. Christopher

The author is a Financial Economist in the FDIC's Division of Research and Statistics, who contributes this regular section of the *FDIC Banking Review*.

# Failure-Resolution Methods and Policy Considerations

by John F. Bovenzi and Maureen E. Muldoon\*

In competitive markets, some institutions prosper while others do not. The evolution of the financial-services industry has forced banks and thrift institutions to operate in a highly competitive marketplace, one in which not every institution can survive. From a public-policy standpoint, the failure of an individual bank or thrift is not a great concern. It is the responsibility of the bank regulatory agencies, including the Federal Deposit Insurance Corporation (FDIC), to maintain public confidence and stability in the entire banking system, rather than in any individual bank or thrift within that system. The survival of the fittest produces a healthier, more efficient industry. Nevertheless, the manner in which individual institutions are handled as they approach, and then reach, the point of insolvency can have important implications for the stability of the entire banking system, and for the long-term health and viability of the deposit insurer.

These considerations warrant a careful review of the policies and procedures used by the FDIC to handle failing and failed institutions. In this article, the FDIC's traditional methods of handling bank failures are examined and policy objectives and concerns are detailed. This is followed by a discussion of the trade-offs that exist among the sometimes competing

policy goals, and how the various failure-resolution methods affect the achievement of these objectives. The discussion is illustrated with a review of recent large-bank transactions. These transactions highlight how the FDIC's recently acquired powers to establish bridge banks, to use *pro rata* payments more widely, and to impose liability on banks operating under common control (cross-guarantees) have given the FDIC greater flexibility to meet its policy objectives.

## Policy Considerations<sup>1</sup>

The FDIC has several primary objectives when determining the most appropriate failure-resolution method. First and foremost is the need to maintain public confidence and stability in the banking system. The deposit insurer must be aware that its handling of a particular failure may have adverse implications, and that failure-resolution methods that unnecessarily risk destabilizing the banking system should be avoided. Second, there is a need to encourage market discipline against risk-taking. The methods used to resolve bank failures have implications for the amount of discipline exerted by market participants against risk-taking by other banks. Failure-resolution policies influence the probability and size of loss that claimants may incur. In turn, these factors influence the degree to which any

particular group of claimants will monitor and attempt to control a bank's risk-taking. Third, the failure-resolution method should be cost-effective. Unless the institution is considered essential to the community, the FDIC is required to meet a statutory "cost test" in which it must be reasonably satisfied that the alternative pursued is not more costly than a deposit pay-off. Fourth, the FDIC should be as equitable and consistent as possible in its failure-resolution policies. In recent years, the most prominent equity issue has been the treatment of uninsured depositors and other general creditors in large *versus* small banks.

There are at least two secondary objectives of bank failure-resolution policies. The first of these objectives is to minimize disruption to the community where the insolvent institution is located. This requires transactions that can be implemented swiftly and smoothly.

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<sup>1</sup> For an additional discussion of policy objectives and failure-resolution methods, see John F. Bovenzi and Arthur J. Murton, "Resolution Costs of Bank Failures," *FDIC Banking Review* 1 (Fall 1988): 1-13.

The second goal is to minimize the government's role in owning, financing, and managing financial institutions and financial assets. This is achieved by pursuing private-sector resolutions whenever possible.

The objectives outlined above are not always mutually compatible, and the FDIC must decide how to balance these trade-offs in any given situation. The most basic trade-off exists between stability and market discipline. While market discipline is necessary to promote stability, there is concern that too much market discipline can lead to greater instability by encouraging depositor runs. A second inherent conflict exists between equity and cost-effectiveness. Consistency and equity considerations suggest that all bank failures should be handled in the same manner. However, this may reduce the FDIC's flexibility in obtaining the least costly or least disruptive transaction in any given situation. These and other possible conflicts among policy objectives make the selection of appropriate failure-resolution policies a difficult process.

### *Failure-Resolution Methods*

For most of its history, the FDIC has handled the majority of bank failures using one of three methods: the deposit payoff, the insured-deposit transfer, and the purchase-and-assumption (P&A) transaction. In addition, the FDIC has the authority to provide financial assistance to prevent the failure of an operating institution, and has done so on a number of occasions to resolve problem banks. In addition, in 1987 the FDIC was granted the authority to own and operate a newly chartered national bank until a more permanent solution can be arranged. The bridge bank, as it is called, provides a means of preserving the going-concern value of an institution until an acquirer can be found, and has significantly broadened the FDIC's failure-resolution alternatives.

**Table 1**  
**Ten Largest FDIC Failure-Resolution Transactions**  
**Through Year-End 1989**

Date	Bank Name	Type of Transaction*	Assets (in billions)
07-29-88	First Republic Bancorporation	BB	\$33.7
09-26-84	Continental Illinois	OBA	33.6
03-28-89	MCorp	BB	15.4
04-20-88	First City Bancorporation	OBA	11.2
04-28-80	First Pennsylvania	OBA	8.0
09-01-85	Bowery Savings Bank	OBA	5.3
07-20-89	Texas American Bancshares	BB	4.3
10-28-74	Franklin National Bank	P&A	3.7
03-20-82	New York Bank for Savings	OBA	3.4
11-28-81	Greenwich Savings Bank	OBA	2.5

\*BB—Bridge Bank; OBA—Open-Bank Assistance; P&A—Purchase-and-Assumption.

In a deposit payoff, as soon as the bank is closed by the chartering authority, the FDIC is appointed receiver, pays all insured depositors the full amount of their claims, and liquidates the assets of the failed bank. Uninsured depositors and other general creditors of the bank generally do not receive either immediate or full reimbursement on their claims. They obtain receivership certificates, which entitle their holders to their proportionate share of the collections on the failed bank's assets.<sup>2</sup> The FDIC also is entitled to a share of these collections since it stands in the place of the insured depositors in the receivership. In the absence of a depositor preference statute,<sup>3</sup> the FDIC, uninsured depositors, and all other general creditors have equal standing and receive a proportionate return on their claims from the liquidation of the receivership.

An insured-deposit transfer is generally viewed as a variation of a deposit payoff, in part because uninsured and unsecured depositors and creditors are not fully protected and usually suffer losses. In an insured-deposit transfer, only the insured deposits and secured and preferred<sup>4</sup> liabilities are transferred to another institution. Uninsured

and unsecured liabilities remain with the receivership. The FDIC makes a cash payment to the institution accepting these liabilities equal to the amount of the insured deposits and secured and preferred liabilities less any premium.

A P&A transaction generally has been preferred by the FDIC to a payoff or an insured-deposit transfer. Under this approach, an acquirer "purchases" all or some of the failed bank's assets and "assumes" its deposits and certain of

<sup>2</sup> At times in the past the FDIC has paid uninsured creditors a portion of their claims at the time of failure to minimize the disruption that can be caused by a deposit payoff. Cash outlays to uninsured creditors have been based on conservative estimates of what they ultimately would have received after all the failed bank's assets were liquidated. This variation of a payoff is called a "modified payoff."

<sup>3</sup> Depositor preference statutes exist in 24 states. These statutes elevate depositor claims over those of other general creditors in state-chartered banks. State laws vary widely, and even those without a depositor preference statute may have other similar priorities established. The Federal Home Loan Bank Board adopted depositor preference for federally chartered thrifts in these states. However, the National Bank Act, which governs the liquidation of insolvent federally chartered banks, does not contain a depositor preference provision.

<sup>4</sup> Claims for federal employment taxes at state-chartered banks.

its nondeposit liabilities.<sup>5</sup> The usual procedure is for the FDIC to invite a number of potential acquirers to a bidders' meeting. A transaction is consummated with the highest acceptable bidder. In the past, an important distinction between a P&A transaction and a payoff or an insured-deposit transfer has been that typically in a P&A all depositors, uninsured as well as insured, have received full payment on their claims since these are "assumed" by the acquiring institution. Absent a depositor preference statute, general creditors have sometimes also received full payment on their claims.<sup>6</sup>

In addition to the more traditional approaches to handling bank failures, the FDIC has granted assistance to prevent the failure of an insured bank.<sup>7</sup> In many respects, "open-bank assistance" has the same effects as a traditional P&A transaction. The primary difference is that with open-bank assistance, a transaction occurs before the failing bank is technically declared insolvent and closed, and the transaction may be structured as a recapitalization rather than an acquisition. Generally, the FDIC provides enough assistance to cover the difference between the estimated market value of the bank's assets and its liabilities (the bank's negative net worth). The FDIC requires that private investors inject new capital into the firm. As in a traditional P&A, all depositors and all general creditors have usually been protected against loss. However, as a matter of FDIC policy, the bank's management is usually replaced and losses generally are imposed on the bank's subordinated debt holders and stockholders. In addition, if there is a holding company, losses are generally imposed on its creditors and shareholders.

### Bridge Bank

In the Competitive Equality Banking Act of 1987, Congress

expanded the FDIC's powers to handle bank failures by granting what is known as bridge bank authority.<sup>8</sup> A failing bank is closed by the chartering authority and certain of its assets and liabilities<sup>9</sup> are transferred into a new, federally chartered institution owned by the FDIC. As the term bridge bank implies, this is simply meant to provide a temporary solution until a more permanent transaction can be arranged. The FDIC may operate a failing institution as a bridge bank for up to two years, with the option of three additional one-year extensions.<sup>10</sup> Through year-end 1989, the FDIC had exercised this authority on six occasions.

The bridge bank has several advantages. First, it may be worthwhile to keep an insolvent bank operating for a brief period until prospective acquirers can assess the institution's condition in order to

<sup>5</sup> P&A transactions vary depending on the amount of assets purchased by the acquirer. In a "clean bank" P&A, the acquirer purchases only the highest-quality assets, whereas in a "whole bank" deal (also referred to as a total-asset P&A or TAPA), the acquirer purchases substantially all of the failed-bank's assets, good and bad alike. In other P&A transactions, acquirers may purchase a specific pool of the failed bank's smaller installment loans. Bids received on P&A transactions will reflect the expected loss on assets purchased, the perceived franchise value of the bank, and the perceived value of the FDIC's assistance.

Table 2  
Failure Resolutions by Transaction Type  
1980-1989

Year	Purchase-and-Assumptions*			Insured-Deposit Transfers	Payoffs	Open-Bank Assistance	Total
	"Traditional"	"Whole Bank"	"Small Loan"				
1980	7	0	0	0	3	1	11
1981	8	0	0	0	2	3	13
1982	35	0	0	0	7	8	50
1983	36	0	0	0	9	3	48
1984	62	0	0	12	4	2	80
1985	87	0	0	7	22	4	120
1986	98	0	0	19	21	7	145
1987	114	19	0	40	11	19	203
1988	54	110	0	30**	6	21	221
1989	30	87	58	22	9	1	207

\*The FDIC began doing "whole bank" purchase-and-assumption transactions in April 1987 and "small loan" purchase-and-assumption transactions in March 1988.

\*\*Includes two "whole bank" insured-deposit transfers.

<sup>6</sup> The FDIC has provided these creditors less than full payment in P&A transactions even in states without a depositor preference statute. A more detailed discussion of this authority will be presented later in this article.

<sup>7</sup> The FDIC was granted the authority to provide assistance to a failing bank in the Federal Deposit Insurance Act of 1950. Section 13(c) permits such assistance when the banking services provided by the institution are deemed "essential" to the community. The FDIC did not use this authority until 1971. Open-bank assistance became more common in the 1980s. In the Garn-St Germain Depository Institutions Act of 1982, the FDIC was granted the authority to provide necessary assistance to prevent the failure of any insured bank. Only if the cost of such assistance would exceed the cost of liquidating the bank does the FDIC now have to make a finding of "essentiality."

<sup>8</sup> Section 214 of the Financial Institutions Reform, Recovery, and Enforcement Act of 1989 (FIRREA) clarified and extended the FDIC's authority to transfer the assets and liabilities of a failed bank into a bridge bank.

<sup>9</sup> Upon the granting of a charter, a bridge bank is empowered to purchase the assets and assume the deposits (both insured and uninsured) of an insured institution in danger of default, as the FDIC in its discretion deems appropriate. The law specifies that if any insured deposits are assumed, then all insured deposits must be assumed by the bridge bank or another insured depository institution. This is not necessarily the case for uninsured deposits and nondeposit liabilities. The bridge bank may assume uninsured deposits and nondeposit liabilities that the FDIC deems appropriate. Such nondeposit liabilities would consist generally of those incurred for essential services that if not assumed by the bridge bank could adversely affect the going-concern value of the institution. Unassumed liabilities have a claim against the receivership and receive their *pro rata* share of the liquidation proceeds.

<sup>10</sup> Once it has been determined that a bridge bank is to be dissolved, the FDIC is appointed receiver and handles the affairs of the bridge bank in accordance with the laws relating to the liquidation of closed national banks. There is nothing in the law to preclude the FDIC from paying off the depositors of a bridge bank and liquidating the assets.

make a reasonable offer for the bank. If it continues to function, the bank can retain much of its value, and there is likely to be less disruption to the local community. Secondly, the moral hazard problems<sup>11</sup> that arise as a result of prolonging the operations of a failing bank are eliminated, because the institution is actually closed, management is replaced and holding company creditors and shareholders lose their investment. In addition, the authority to create bridge banks has given the FDIC greater flexibility to handle the failure of banks within multibank holding companies. Because multibank holding companies are often very large banking organizations, completing a failed-bank transaction may require several months of analysis and negotiations. By creating a bridge bank, the FDIC is able to take control and stabilize the failing institution, reorganize it and prepare it to be sold. The ability to form bridge banks greatly expanded the FDIC's flexibility to handle the First RepublicBank Corporation and the MCorp transactions. These contrast with the open-bank assistance transaction involving First City Bancorporation, where obtaining voluntary concessions from holding company shareholders and creditors was a difficult process and as a result, some bond holders received full payment on their claims.<sup>12</sup>

### *Priority of Claims in a Bank Failure*

To understand the relationship between particular methods of handling bank failures and the FDIC's policy objectives, it is important to distinguish between the treatment of the affected parties when a bank fails. In addition, the benefits of greater flexibility in handling bank failures are best illustrated by reviewing the priority of claims in a bank failure. For discussion purposes, the relevant parties are divided into the following eight

groups:

1. Insured depositors and secured and preferred creditors
2. Uninsured and unsecured depositors
3. Unsecured, nondeposit creditors (excluding subordinated debt holders)
4. Holders of contingent claims
5. FDIC
6. Subordinated debt holders and bank stockholders
7. Bank management, directors and officers
8. Bank holding company creditors and shareholders

The FDIC's foremost responsibility is to protect insured depositors. However, the FDIC also may protect other creditors against loss. Moreover, regardless of the failure-resolution method chosen by the FDIC, some uninsured creditors may receive at least a partial reimbursement on their claims against the bank. The degree to which each group of creditors may or may not be protected against loss when a bank fails has important implications regarding the FDIC's policy objectives.

**Insured depositors and secured creditors.** The claims of insured depositors and secured and preferred creditors take priority over all other claimants. Regardless of the failure-resolution method pursued by the FDIC, all insured depositors are completely protected against loss. Certain deposit liabilities and any nondeposit non-subordinated liability may be secured by assets on a bank's balance sheet. Because the assets pledged as collateral against a bank's debt generally consist of government securities or other high-quality assets, the holders of secured debt are generally fully protected against loss in the event the bank fails.

**Uninsured and unsecured depositors.** The treatment of uninsured, unsecured depositors varies depending on how a failure is handled. In a deposit payoff or an insured-deposit transfer, uninsured

depositors generally share losses on a *pro rata* basis with the FDIC and other general creditors. If a depositor preference statute is applicable, the claims of the FDIC and the uninsured depositors take priority over those of other general creditors. In a P&A or open-bank assistance transaction, uninsured and unsecured depositors typically have received treatment equal to that of insured depositors and secured debt holders; that is, depending on the structure of the transaction, they may be completely protected against loss.

Because the treatment of uninsured and unsecured depositors generally depends on the failure-resolution method pursued, the FDIC's policies often have been labeled inconsistent and inequitable. Depositors may be treated differently depending on the circumstances surrounding a bank's failure and especially, the market's perception of the franchise value of the failed institution. In addition, the FDIC is more likely to determine that the operations of a large bank, rather than a small bank, are essential to the community it services. Because of these factors, there is a much greater likelihood that the FDIC would pay off a small bank as opposed to a large bank.

**Unsecured, nondeposit creditors.** Unsecured, nondeposit creditors fall into the category of other general creditors. This group may include federal funds purchased and other similar borrowings. For national banks and state banks where a depositor preference statute is not ap-

<sup>11</sup> In a banking context, moral hazard refers to the incentive which banks have to increase their portfolio risk in an attempt to capture greater returns. Under the current system of deposit insurance, when an institution is at or near insolvency, the risks of such activities are largely passed on to the insurer, while the reward if the gamble is successful accrues entirely to the institution.

<sup>12</sup> The FDIC had authority to use bridge banks at the time of the First City transaction. In that instance, however, it was determined that open-bank assistance was a less costly and more viable alternative. The First City transaction will be discussed in more detail later in this article.

plicable, these creditors generally have had the same status as uninsured, unsecured depositors. This means they have usually shared *pro rata* in losses with uninsured, unsecured depositors and the FDIC if the failure was handled as a deposit payoff or an insured-deposit transfer; or ordinarily they have incurred no loss if the failure was handled as a P&A or an open-bank assistance transaction. For state-chartered banks where a depositor preference statute is applicable, other general creditors follow depositors in order of priority, and generally stand to recover little, if anything, on their claims. Thus, in depositor preference states, such creditors risk large losses if a state bank is nearing the point of insolvency, depending on how the FDIC handles the situation.

**Holders of contingent claims.** When a bank fails there may be a large number of outstanding contingent claims against the institution. These claims include letters of credit and loan commitments, as well as lawsuits. Contingent claims are generally treated as any other unassumed claim in a failure-resolution situation.

Significant contingent claims against a failed or failing bank sometimes foreclose the possibility of open-bank assistance or a P&A transaction. While many creditors flee a failing institution, the number of contingent claims may increase rather than decrease as a bank approaches insolvency. A troubled institution is likely to attract lawsuits from a variety of disgruntled customers and creditors. Hence, an outstanding lawsuit with a sizable potential judgment against a failed bank may render a P&A or open-bank assistance more expensive than a payoff.<sup>13</sup> Thus, contingent claims may be a significant factor for the FDIC to consider when evaluating failure-resolution alternatives.

**FDIC.** The FDIC assumes the status of the depositors' or credit-

ors' claims it settles. Once the FDIC satisfies its obligation as insurer, its priority relative to all other claimants depends on how the transaction is handled. The FDIC is almost always repaid less than insured depositors and secured creditors. Conversely, the FDIC usually recovers more than subordinated debt holders, bank stockholders and bank holding company creditors and shareholders. Practically speaking, the FDIC generally has received less payment on its claims than uninsured, unsecured depositors and other general creditors, since these groups normally have been fully protected in P&As and open-bank assistance transactions. If there is an applicable depositor preference statute the FDIC often protects only depositors in full and receives a greater proportional payment than nondeposit general creditors. If there is a payoff or insured-deposit transfer, only insured depositors are protected in full and the FDIC stands in their place, having equal status with uninsured, unsecured depositors.

**Subordinated debt holders and bank stockholders.** In bank-failure transactions these two groups are treated much the same. Although subordinated debt holders have priority over stockholders, both groups' claims have a lower priority than those of depositors, general creditors and the FDIC. Therefore, subordinated debt holders and shareholders face the greatest risk to their investment, and generally recover nothing when a bank fails. This is true whether the failure is handled as a payoff, an insured-deposit transfer or a P&A transaction. In open-bank assistance transactions, shareholders and subordinated debt holders have slightly more leverage since they must agree to the transaction. Nevertheless, because the FDIC conditions any assistance upon shareholder and subordinated debt holder concessions, these groups rarely receive more than a few

cents on the dollar from the assets of the failed banks in these transactions.<sup>14</sup> Because of their inferior status in bank-failure cases, the existence of subordinated debt and equity capital lowers the FDIC's failure-resolution costs and helps to impose market discipline on the banking system.

**Bank management, directors and officers.** Bank managers' careers and reputations are closely tied to the performance of their bank. When a bank fails, senior managers usually lose their jobs. An acquiring institution may choose to keep some of the top executives of the failed bank, but generally most are replaced regardless of how the failure is resolved. These individuals may have a difficult time finding comparable employment elsewhere, particularly if it is perceived that the bank's problems were due to mismanagement rather than to general economic conditions.

Legal liability extends to the directors and officers, who are ultimately responsible for approving the policies that bank managers implement. Regulatory agencies' powers to take strong enforcement actions and to impose civil and criminal penalties on bank directors and officers were greatly strengthened in FIRREA. Thus, the probable loss of employment, income and status for managers, as well as the potential for legal liability for directors and officers, provide strong incentives for these parties to ensure that their bank

<sup>13</sup> Some contingent claims are eliminated as a result of a bank closing. However such claims may not necessarily be eliminated if the bank remains open. FIRREA places certain requirements on the provability of contingent claims. If these criteria are not met, such claims are not recognized by the FDIC.

<sup>14</sup> Subordinated debt holders and bank stockholders may receive additional value, if there are nonbanking assets in the holding company to which they are entitled.

operates in an acceptable manner.<sup>15</sup>

Bank holding company creditors and shareholders. An additional incentive to curb excessive risk-taking exists in the form of creditors and shareholders of the parent holding company (if the institution is part of a holding company). When a bank becomes insolvent and is closed, holding company creditors and shareholders normally do not receive any value from the failed bank. The FDIC's handling of large-bank failures in recent years has made it increasingly clear that the safety net of federal deposit insurance does not extend to holding companies.

### "Pro Rata" Treatment of Claimants

As previously mentioned, an important distinction between a traditional P&A transaction and a payoff or an insured-deposit transfer, was that in a P&A all depositors and general creditors usually received full payment on their claims against the failed bank because these liabilities were assumed by the acquiring institution. In 1973, the FDIC arranged for Crocker National Bank to purchase the assets and assume the bulk of the liabilities of the failed United States National Bank of San Diego (USNB). Most of the creditors of the failed bank were paid in full; however, Crocker

National Bank did not assume certain standby letters of credit issued by USNB because of their perceived riskiness. First Empire Bank, one of the holders of the standby letters of credit, sued the FDIC, asserting that its claim against the failed bank should have been treated in the same manner as those that were assumed by Crocker National Bank. A federal district court in California held that the FDIC had properly exercised its discretion as receiver in deciding not to honor those claims. However, that decision was appealed and ultimately reversed in favor of First Empire Bank. In 1978, the Supreme Court declined to review the appellate court decision, and the FDIC was forced to pay the amount due on the letters of credit not assumed by Crocker National Bank.

Because of this experience, when the FDIC subsequently effected P&A transactions, all general bank creditors' claims were usually satisfied. In 1987 (in a case involving United American Bank, Knoxville), the Tennessee Supreme Court found that when the FDIC implements a P&A transaction it is not required to pay all unassumed creditors in full, but need only pay the amount they would have received in a straight liquidation. Absent specific codification, however, this approach was open to legal challenge.<sup>16</sup>

In FIRREA, the FDIC was granted greater flexibility to settle the claims of uninsured depositors and general creditors of a failed bank.

<sup>15</sup> Offsetting these incentives to some extent are "golden parachutes," which are often part of executive compensation packages. Because such compensation is generally not tied to performance, managers may be generously rewarded when the institution they manage fails or requires FDIC assistance to prevent its failure.

<sup>16</sup> The FDIC chose to utilize the *pro rata* payment approach to certain classes of uninsured depositors in its handling of two major pre-FIRREA bank failures: First Republic Bank Corporation and MCorp. The FDIC faces a legal challenge in both of these cases as a result of this decision. The impact of *pro rata* payments on these transactions will be discussed later in this article.

Table 3  
Bank-Failure Costs  
By Region, 1985-1989\*

	Number**	Assets (in billions)	Costs*** (in billions)	Cost As a Percentage of Assets
Nation	803	\$100.3	\$14.9	14.9
Southwest	461	83.2	12.0	14.5
Texas Only	317	75.1	10.9	14.5
Southwest, Excluding Texas	144	8.1	2.3	28.5
Northeast	12	7.6	0.9	12.0
Southeast	26	2.1	0.4	18.2
Central	20	0.4	0.06	15.4
West	113	3.9	0.9	23.9
Midwest	117	3.0	0.6	20.0

\*Data through September 30, 1989.

\*\*Includes failures through September 30, 1989 and only the major open-bank assistance transactions.

\*\*\*Costs are based on FDIC reserves as of September 30, 1989.

REGIONS: Southwest — Arkansas, Louisiana, New Mexico, Oklahoma, Texas  
 Northwest — Connecticut, Delaware, District of Columbia, Maine, Maryland, Massachusetts, New Hampshire, New Jersey, New York, Pennsylvania, Puerto Rico, Rhode Island, Vermont  
 Southeast — Alabama, Florida, Georgia, Mississippi, North Carolina, South Carolina, Tennessee, Virginia, West Virginia  
 Central — Illinois, Indiana, Kentucky, Michigan, Ohio, Wisconsin  
 Midwest — Iowa, Kansas, Minnesota, Missouri, Nebraska, North Dakota, South Dakota  
 West — Alaska, Arizona, California, Colorado, Hawaii, Idaho, Montana, Nevada, Oregon, Pacific Islands, Utah, Washington, Wyoming

This legislation specifically codified the “*pro rata*” approach to handling bank failures. FIRREA states that the FDIC’s maximum liability to any category of claimants is limited to the amount these parties would have received if the bank’s assets had been liquidated. In addition, this legislation allows the FDIC complete discretion to use its own resources to make additional (full) payments to any claimant or categories of claimants in the interest of maintaining stability and confidence in the banking system, without obligating itself to make similar payments to all other claimants. According to FIRREA, both uninsured depositors and other general creditors are only legally entitled to receive their *pro rata* share of the liquidation proceeds in bank-failure situations, even if the FDIC chooses to fully protect certain claimants against loss.

The use of *pro rata* payments affects the priority of claims of uninsured depositors and general creditors in P&A transactions. Instead of receiving treatment equal to that of insured depositors and secured debt holders, uninsured depositors and general creditors are only legally entitled to their *pro rata* share of the receivership proceeds, and therefore are exposed to potential loss.<sup>17</sup> The FDIC has been utilizing its *pro rata* authority in all P&A transactions since the enactment of FIRREA, absent an applicable depositor preference statute. While the statute permits the FDIC to provide *pro rata* payments to all uninsured or unsecured claimants or categories of claimants (including depositors), in recent P&A transactions the FDIC has chosen to fully protect *all* depositors in a bank failure.

In handling the failures of large banks such as Continental Illinois, the FDIC has been unwilling to impose losses on uninsured depositors.<sup>18</sup> The possibility that depositors would not be protected in the event the bank failed could

heighten the threat of bank runs at large institutions facing financial difficulty. Thus, the decision to impose losses on uninsured depositors has implications for the stability of the banking system.

*Pro rata* payments also help to equalize the treatment of uninsured depositors at both large and small banks. The FDIC is often criticized for its handling of large-bank failures because traditionally these have been handled in a manner that extends *de facto* 100 percent deposit insurance to all depositors. It may be difficult for the FDIC to attract an acquirer interested in a P&A transaction for a small bank. Therefore, the FDIC may be forced to handle the failure of a small bank in a way that imposes losses on uninsured depositors. With the use of *pro rata* payments, the FDIC may treat the liabilities of large and small failed banks more uniformly, and provide protection to all depositors of small banks, even absent a depositor preference statute. Thus, there may be little difference between an insured-deposit transfer and a P&A transaction.<sup>19</sup> In addition, the use of *pro rata* payments is more equitable than a depositor preference statute from the standpoint of nondeposit creditors, since additional payments to uninsured depositors are made from FDIC resources, not from receivership proceeds.

The FDIC may also deem appropriate the full protection of certain nondeposit liabilities. In some instances, failure to protect certain liabilities may adversely impact the going-concern value of an institution. These creditors are generally providing some essential services, such as data processing or accounting services. Such claimants would receive the additional payment from FDIC resources, not from receivership proceeds. Unprotected general creditors will obtain receivership certificates, which entitle them to their *pro rata* share of the value of the assets of the failed

institution.

In essence, FIRREA has greatly expanded the FDIC’s authority to handle the liabilities of a failed bank. This flexibility better enables the FDIC to balance its various policy objectives, such as maintaining equity, stability and market discipline in the banking system. For instance, the use of *pro rata* P&A transactions provides an effective means of limiting the federal deposit insurance safety net. Deposit insurance was never intended to provide protection to all bank creditors. Indeed, insurance premiums are based on deposit liabilities only. Because bank creditors are subject to loss regardless of how the FDIC handles a bank failure, the level of market discipline imposed on bank risk-taking by creditors should increase.

### Trade-offs among Policy Objectives

The FDIC’s foremost objective is to maintain public confidence and stability in the banking system. For any individual bank failure such a policy objective might suggest protecting as many creditor groups as possible. However, while this approach might satisfy the desired objective over a relatively short time frame, it would be self-defeating in the long run. Protecting all creditor groups at all times would remove any market discipline from the sys-

<sup>17</sup> As a matter of practice, general-creditor claims receiving *pro rata* payments include unsecured borrowing (including federal funds), accrued expenses, contingent liabilities and nonbook liabilities.

<sup>18</sup> In the MCorp and First Republic transactions, intracompany loans and some uninsured deposits were treated differently than other uninsured deposits. Intracompany loans and certain uninsured deposits were dealt with on a *pro rata* basis, while other uninsured depositors received full protection.

<sup>19</sup> The same results could be achieved in an insured-deposit transfer or a P&A transaction by using *pro rata* payments, because the FDIC has the ability to treat uninsured depositors and creditors in the same manner in both transactions if it chooses to do so. Other things being equal, the only difference between the two transactions would be the legal distinction between a paying agent in an insured-deposit transfer and an acquirer in a P&A transaction.



tem, leading to greater risk-taking by insured institutions and eventually to more insolvencies, higher failure-resolution costs and less, rather than more, stability.

Any failure-resolution policy designed for more than the shortest of time frames must address the critical issue of how much market discipline is appropriate. Clearly, some market discipline is necessary to control excessive risk-taking. However, too much market discipline could result in a return to the atmosphere of the 1930s, when bank runs posed a constant threat to the stability of the banking system.

Of the eight different groups of creditors and other affected parties discussed previously, six groups almost always suffer losses when a bank fails; one group occasionally suffers losses; and one group, insured depositors and fully secured creditors, never suffers a loss when a bank fails. The group of six that almost always will suffer losses now includes unsecured nondeposit creditors and holders of contingent claims, as a result of the *pro rata* treatment of claimants, in addition to the FDIC, subordinated debt holders and bank stockholders, bank management, and bank holding company creditors and shareholders. Each of these groups has an incentive to control a bank's risk-taking. The only time that this incentive may become perverse is when the bank is nearing the point of insolvency and the incentive for self-preservation (moral hazard) may lead unprotected creditors and management to encourage the very risk-taking that is viewed as imprudent when the bank is healthy. The increased incentive to take risks as an institution nears insolvency was apparent in the savings and loan industry. The resulting crisis provides a mandate for stringent supervision of problem banks and thrifts, and the timely closure of insolvent institutions.

Equity in the handling of bank failures also is an important objec-

tive. However, it cannot be viewed in isolation. Any policy strides toward greater equity also must consider the effects on stability, market discipline and cost-effectiveness before it can be determined whether such a policy change is desirable. For example, a more uniform (*i.e.*, equitable) treatment of all creditors reduces the FDIC's flexibility in handling bank failures. Limiting this flexibility could increase market disruption and failure-resolution costs.

#### *Illustrating the Policy Trade-offs— First City Bancorporation Transaction*

The FDIC has continually sought the regulatory flexibility necessary to effect transactions that achieve a balance between its various policy considerations. The FDIC's handling of bank failures evolved in the 1980s, as the number of failures increased, and as some of the nation's largest banks failed or required financial assistance. This progress toward balancing policy objectives in the framework of failure-resolution methods may be illustrated by reviewing the FDIC's approach to one of the major failing-bank transactions of the 1980s.

In 1987, the financial condition of First City Bancorporation of Texas had deteriorated to the point that the failure of the lead bank, First City National Bank, Houston, appeared imminent. With approximately \$10 billion in assets and 62 banking subsidiaries, the Texas banking firm was the fifth largest in the state and the 39th largest in the nation. Next to the 1984 near collapse of Continental Illinois, First City was at that time the second largest potential bank failure in history. Because of the restrictions on branching in Texas, large bank holding companies comprised of one or two "lead" banks in the

larger cities, and several small subsidiary banks generally located outside the metropolitan areas, developed and functioned much like branch banking networks. The subsidiary banks provided the necessary funding, while the lead bank generated most of the lending. Though they were part of the same holding company and may have functioned as one unit, the subsidiary banks were separate entities. As discussed more fully in the following section, this type of structure complicated the failure-resolution process for the FDIC.

Losses were concentrated in, but not confined to, the firm's lead bank. First City, Houston, had \$2.8 billion in deposits (\$819 million of which were insured) in June of 1987, and the task of completing a payoff or an insured-deposit transfer on an institution of that size had never been attempted. In 1982, the FDIC paid off the depositors of Penn Square Bank, N.A., the largest bank ever to be handled in that manner. Total deposits (\$470 million, of which \$250 million were insured) in Penn Square prior to its failure were substantially less than in First City, Houston. As with other large banks, the FDIC was concerned about the implications for the stability of the banking system in Texas and the nation if insured depositors were paid off and losses were imposed on uninsured depositors and other general creditors.

Because of the holding company structure, arranging a P&A of the lead bank would have meant that the capital of the subsidiary banks would not have been available to offset losses in the lead bank. To the benefit of the holding company, much of the loss in the firm would have been effectively removed by the FDIC had a P&A of First City, Houston, been completed. In essence, by effecting a traditional P&A transaction, the FDIC would have borne the burden of the losses in the lead bank, without the ability

to share them with the subsidiary banks.<sup>20</sup>

Faced with the stability problems of a payoff and essentially enriching the holding company if it pursued a P&A, the FDIC opted to pursue an open-bank assistance. The agreement with a private investor group led by A. Robert Abboud, which consisted of \$970 million of FDIC assistance, was less costly than a payoff or a P&A, and it brought \$500 million in private-sector capital into the banking firm. Significant concessions were required from holding company debt holders and shareholders before the transaction could be consummated. If an appropriate level of concessions could be obtained, an open-bank transaction would have an effect similar to that of using the capital of the affiliates to offset losses. However, because holding company creditors and shareholders must agree, obtaining these concessions is often a major obstacle to completing open-bank assistance. The First City transaction was no exception.

Once a discount rate has been established for the redemption of the outstanding holding company debt, the approval of the transaction depends on the number of bond holders who tender their notes. In this transaction, it was determined that 90 percent of the \$226 million in affected holding company debt would have to be tendered at a discount of between 65 and 75 percent of face value. Bond holders who agreed to these concessions would receive between 35 and 45 cents per dollar of investment; however, those who refused to tender their notes could potentially receive 100 cents per dollar of investment. It was this aspect of the transaction that enticed arbitragers to purchase the holding company's bonds at discount prices with the hope that the FDIC would have to sweeten the transaction in order to obtain their concessions. The risk of this approach is that the transaction will

not be approved and bond holders will receive nothing on their investment.

The presence of the arbitragers made it significantly more difficult to obtain the necessary concessions. In an effort to preserve the transaction, the tender level was reduced to 70 percent, and was finally consummated with 67.5 percent of the bond holders tendering their notes. Because the tender level was less than 90 percent, the overall cost of the transaction was increased. In order to repay the 32.5 percent of the outstanding bonds at 100 percent of face value, an extra issue of senior notes had to be issued by the "collecting bank" which was set up to sell the estimated \$1.79 billion of bad assets of First City. The FDIC's share of the proceeds from the sale of these assets would be subordinate to these notes.<sup>21</sup>

The First City transaction illustrates the difficult decisions which must frequently be made in resolving bank failures. Neither a payoff nor a traditional P&A transaction was completely appropriate in this situation, and the open-bank assistance that was ultimately agreed to was not without drawbacks. Since the First City transaction, the FDIC has attempted to reconcile these trade-offs by refining the traditional failure-resolution methods so that policy goals may be implemented more effectively. Provisions contained in FIRREA have greatly facilitated this process.

### *The Impact of FIRREA on the Treatment of Problem Banks within Multibank Holding Companies*

The FDIC encounters a unique set of problems when resolving the failure of a bank within a multibank holding company, as illustrated in the First City transaction and in subsequent large-bank failure situations. These problems arise because banks within a multibank holding

company generally conduct business as though they are a single corporate entity, which can make the FDIC's task of resolving bank failures more difficult and expensive. FIRREA contains a number of important provisions that enhance the agency's ability to handle effectively the failure of a bank that is a member of a multibank holding company.

Because there are few restrictions on intracompany transactions in a multibank holding company, subsidiary banks often behave as branches of a single bank.<sup>22</sup> In many cases this means that the larger banks within the holding company generate most of the loan business, while drawing much of their funding from the smaller subsidiary banks.

In theory, this problem could arise whenever more than one bank is owned by a common parent. In states with unrestricted intrastate expansion, the branches of an individual bank are actually part of one corporate entity. There may be good reasons why some institutions may prefer to operate in-state units as banks within multibank holding companies rather than as branches within a single bank, just as there may be valid reasons why banks within a multibank holding com-

<sup>20</sup> Had the *pro rata* approach to general creditors been a clear option at that time, the FDIC could have imposed losses on the subsidiary banks that had claims against the lead bank because of intracompany funding arrangements. However, the *pro rata* treatment of claimants in P&A transactions was in its early stages of development, and not commonly practiced by the FDIC in failure-resolution situations at the time of this transaction. The effect of the *pro rata* provisions contained in FIRREA on the failure-resolution treatment of banks within multibank holding companies will be discussed later in this article.

<sup>21</sup> In addition, the transaction could have been jeopardized by shareholder approval had it not fallen under Delaware law. In Texas, two-thirds of each class of stockholders must approve the transaction, rather than two-thirds of the aggregate, as is the case in Delaware.

<sup>22</sup> Sections 23A and 23B of the Federal Reserve Act limit transactions between member and nonmember banks and their nonbanking affiliates. Similar restrictions do not apply for transactions between subsidiary banks within a holding company.

pany should be able to transfer funds among themselves. Nevertheless, it would be inconsistent to allow banks to behave either as a single unit or as separate entities as it suits their benefit, because this allows banks to reap the rewards in prosperity and to burden the FDIC with potentially greater losses in insolvency.

The FDIC has taken the view that if a multibank holding company functions as a branch banking system when solvent, then it should be treated as such if it becomes insolvent. The *pro rata* treatment of claimants and the authority to enforce cross-bank guarantees have broadened the FDIC's policy options in this area.

*Pro rata* treatment of claimants in multibank holding companies. In recent large-bank transactions, the FDIC has effectively used the *pro rata* treatment of claimants to ease the problems associated with handling failing banks in multibank holding companies. A review of the First RepublicBank and the MCorp transactions illustrates how the *pro rata* treatment of claimants facilitates the FDIC's policy objectives with respect to the treatment of problem banks within multibank holding companies.

In the First RepublicBank Corporation transaction, the FDIC provided only *pro rata* coverage in settling the claims of intracompany creditors (subsidiary banks), while fully protecting other categories of uninsured depositors and general creditors.<sup>23</sup> The FDIC viewed the funding arrangement between the lead banks and the subsidiaries as the operations of a single entity, rather than as separate and distinct units. Had intracompany transactions between the bank subsidiaries been completely protected, some of the parties with direct responsibility for the insolvency of the lead bank would not have suffered any loss as a result of their actions. Rather, the FDIC would have had to absorb the

losses resulting from these intracompany transactions. In turn, the *pro rata* treatment of intracompany transactions was a contributing factor to the insolvency of some of the other 39 banks and the credit card subsidiary.<sup>24</sup>

In the MCorp transaction, the FDIC's *pro rata* policy yielded slightly different results. Since there were no prior assurances given to any categories of claimants, certain categories of general creditors were subjected to losses. The FDIC distinguished between claimants inside and outside the holding company. Intracompany federal funds claims received only a *pro rata* recovery, while similar claimants outside the holding company were fully protected against loss. As a result, 20 of the 25 MCorp banking subsidiaries were declared insolvent. The five surviving MCorp subsidiaries were not rendered insolvent as a result of the *pro rata* treatment of intracompany transactions, and remained part of the surviving holding company.

Cross-Guarantees. Prior to FIRREA, bank regulatory agencies lacked the explicit statutory authority to force banks within holding companies to support their financially troubled bank affiliates. Under FIRREA, however, the FDIC is permitted to impose liability on commonly controlled depository institutions to recoup any loss resulting from handling the failure of, or providing financial assistance to, an insured bank. The FDIC is required to estimate the amount of the loss it will incur, and inform each commonly controlled institution of its estimated share of the loss within two years of the date of failure or no liability may be imposed. For a period of five years, no bank will be held liable under the cross-guarantee provisions for losses incurred as a result of the acquisition of a troubled thrift institution prior to the enactment of FIRREA, and *vice versa*. In addition, the FDIC may waive the collection of losses

from commonly controlled depository institutions if it determines that an exemption is in the best interest of the deposit insurance funds.

The general policy of the FDIC is to assess liability in all cases except: (1) where the acquirer held no direct or indirect financial interest in the institution prior to insolvency; and (2) where the cumulative projected losses to the FDIC are greater than the cost of waiving the liability. The FDIC determines the applicability of the cross-guarantee provisions, and if they will be enforced, on a case-by-case basis.

The cross-guarantee provisions of FIRREA enable the FDIC to address the problems multibank holding companies may pose in failure-resolution situations. Cross-bank guarantees are designed to ensure that the deposit insurance fund does not suffer disproportionate losses in situations where assets that could be used to offset bank-failure costs are held in commonly controlled depository institutions. Since the FDIC's experience in implementing cross-guarantees is very limited, it is difficult at this time to evaluate how successful this new tool will be in handling bank failures. At the very least, however, by enforcing cross-guarantees, the FDIC should be better able to protect the bank insurance fund from losses stemming from interaffiliate transactions by banks within a holding company.

<sup>23</sup> The FDIC provided assurances to fully protect the claims of certain creditors outside the holding company in an attempt to ease the liquidity problems experienced by the lead bank. As a result of these prior assurances, certain creditors to the lead bank that were not part of the holding company were completely protected from loss.

<sup>24</sup> The FDIC also provided a \$1 billion emergency loan to halt a run on deposits. The loan was secured by the capital of the affiliate banks. Once the FDIC declared that the loan would not be renewed some of the affiliates were declared insolvent because of the pledge of their capital. The *pro rata* treatment of intracompany transactions alone could have rendered a number of affiliates insolvent. However, the combination of these two conditions precipitated the failure of the remaining banks in the holding company.

### *Concluding Comments*

This article discusses the various policy objectives the FDIC seeks to achieve when determining the most appropriate method for resolving bank failures. The FDIC's primary policy objective is to maintain public confidence and stability in the banking system. However, the FDIC must also be concerned with issues such as maintaining market discipline against excessive risk-taking by banks, pursuing the least-costly

failure-resolution method, limiting the deposit insurance safety net, and implementing policies that are both consistent and equitable. Unfortunately, these goals are not always compatible, and important trade-offs exist among the various public-policy objectives.

In an effort to more satisfactorily achieve its policy objectives, the FDIC has significantly modified its handling of bank failures. This was facilitated by the legislative changes

discussed in this article that have enabled the FDIC to refine and enhance its traditional failure-resolution methods. With greater flexibility to adapt resolution methods to the particular circumstances surrounding each bank failure, policy goals are more easily achieved. The ability to effectively implement policy goals, in turn, should produce a stronger, more effective system of federal deposit insurance.

# An Overview of the U.S. Credit Union Industry

by Alane K. Moysich\*

In recent years, credit unions have grown much faster than other types of federally insured financial institutions, in part as a result of expanded powers and liberalized membership requirements. This rapid growth, and the corresponding increased importance of credit unions in the financial-services marketplace, have led to vocal claims by commercial bankers that credit unions have an unfair competitive advantage due to their tax-exempt status and other regulatory discrepancies. Furthermore, the failure of large numbers of commercial banks and thrift institutions, and the need for legislation to restructure the thrift industry, have led many to question whether credit unions also pose substantial risks to the current system of federal deposit insurance.

As a result, two studies were mandated by Congress in the Financial Institutions Reform, Recovery, and Enforcement Act of 1989 (FIRREA). The first study is a review of the entire federal deposit insurance system, to be conducted by the Treasury Secretary in consultation with other federal officials. One part of this review will be an examination of whether the insurance of credit unions should be handled by an agency other than the National Credit Union Administration (NCUA), which currently oversees the National Credit Union Share Insurance Fund (NCUSIF).

The second study, to be prepared by the General Accounting Office (GAO), will focus solely on the role credit unions play in the marketplace, the financial condition of the industry and its insurance fund, and whether any changes are needed in the current regulatory structure. These studies will be presented to Congress in early 1991.

This article provides information on the history, growth, regulation, and insurance of credit unions in the United States. The current condition of the credit union industry, and its insurance fund, also are discussed. Finally, this article presents information on the evolution of the common bond requirement as well as a summary of arguments for and against tax exemption.

## *Origins and Growth of the Credit Union Industry Early European Credit Cooperatives*

The origins of the credit union industry in the U.S. can be traced to mid-19th century Germany where two men, Hermann Schulze-Delitzsch and Friedrich Wilhelm Raiffeisen, began organizing cooperative credit societies in response to the economic depression of the late 1840s. These men sought to combat usury and to improve the economic lot of the working class through mutual self-help and democratic organization. Credit cooperatives rapidly spread through-

out Germany, where the social and economic structure was traditionally centered around the community, and developed into a significant segment of the 20th century banking industry there. During the late 1800s, cooperative credit societies, or people's banks, similar to those in Germany, were formed in several other European countries.

## *Credit Unions in North America*

Although some cooperative activities were organized in New York City among immigrant German craftsmen in the 1860s, credit unionism came to North America largely through the work of Canadian journalist Alphonse Desjardins, who established the first *caisse populaire* in Levis, Quebec, in 1900. The United States' credit union movement claims Boston merchant and philanthropist Edward A. Filene as its founder. Filene and Pierre Jay, the first commissioner of banks for Massachusetts, were interested in fighting usury and in finding alternative sources of consumer credit. With the help of Desjardins, they drafted the first credit union law, passed by Massachusetts in 1909.<sup>1</sup> This law defined

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<sup>1</sup> That same year, St. Mary's Cooperative Credit Association in Manchester, New Hampshire, actually became the first credit union to gain legal status in the U.S., through a special act of the State Legislature.

a credit union as "a cooperative association formed for the purpose of promoting thrift among its members,"<sup>2</sup> and adopted the principle of member share capital to finance member loans.

Unlike their European counterparts, credit unions in the U.S. were designed to be self-contained units, thereby eliminating much of the need for outside credit. The authors of the first U.S. credit union law also incorporated the notion of membership limited to groups with a common bond. Finally, unlike the European cooperatives, which were designed to make production loans to farmers and small businessmen, U.S. credit unions were founded primarily to make consumer loans.

Filene promoted the credit union concept vigorously during the early 1900s, eventually spending over \$1 million of his own money to organize the credit union movement at the national level.<sup>3</sup> By 1920, however, although nine states had enacted credit union laws there were still less than 200 credit unions in operation.<sup>4</sup> The growth of credit unionism began in earnest during the 1920s, aided by the general economic prosperity that prevailed during the decade, and later, by passage of the Federal Credit Union Act in 1934.

### Credit Union Growth, 1935-Present

As shown in Table 1, the number of credit unions rose from 3,372 in 1935 to over 9,000 in 1940. At the same time, credit union membership grew by over 300 percent and savings by nearly 500 percent. Savings at credit unions continued to increase during the 1940s, but membership growth slowed greatly and the number of credit unions actually declined between 1940 and 1945, as the country's attention was focused on World War II.

Credit union growth began to accelerate in 1950, and the number of credit unions doubled from 10,591 to 20,456 over the next decade.

During that same period, membership rose from roughly 4.5 million to over 12 million and member savings increased fivefold, from \$850 million to nearly \$5 billion. Growth in the number of credit unions slowed dramatically during the 1960s, and the emphasis of the industry's trade organization shifted from organizing credit unions to developing those already in operation. The number of credit unions peaked sometime during 1969 or 1970, at slightly less than 24,000, then declined slowly over the course of the 1970s. Credit union membership and savings, however, continued to grow throughout the 1960s and 1970s. Membership rose to over 22 million by 1970, and exceeded 44 million by 1980; while credit union savings, which exceeded \$15 billion in 1970, grew to \$60 billion by 1980. This latter trend was due, in part, to the introduction of federal share insurance in 1970.

The 1980s was a decade of consolidation for the United States' credit union industry,<sup>5</sup> which now consists of approximately 15,000 institutions. During this time, credit union savings continued to grow,

from \$61.7 billion at year-end 1980 to \$178.5 billion at year-end 1988, an increase of 189 percent. In contrast, deposit growth at commercial banks and savings and loans was 64 percent and 93 percent, respectively, during the 1980-1988 period. Total credit union assets, which were \$69 billion in 1980, rose to nearly \$200 billion by 1988. Despite the credit union industry's recent rapid growth, however, it is still small relative to the commercial banking industry, which had assets of \$3,131 billion at year-end 1988, and the savings and loan industry, which had assets of \$1,352 billion.

<sup>2</sup> J. Carroll Moody and Gilbert C. Fite, *The Credit Union Movement: Origins and Development, 1850-1970* (Lincoln: University of Nebraska Press, 1971), 36.

<sup>3</sup> Judy Weidman, "Are We Forgetting Who We Are?" *Credit Union Magazine* 54 (October 1988): 37.

<sup>4</sup> Donald J. Melvin, Raymond N. Davis and Gerald C. Fischer, *Credit Unions and the Credit Union Industry: A Study of the Powers, Organization, Regulation, and Competition* (New York Institute of Finance, 1977), 12.

<sup>5</sup> This trend also has been observed among cooperative credit institutions in Europe.

Table 1  
Selected Credit Union Statistics, 1935-1988  
(\$ in Millions)

Year	# of Credit Unions	# of Members	Assets	Savings	Loans
1935	3,372	641,797	\$ 50	\$ 38	\$ 36
1940	9,023	2,826,612	253	222	190
1945	8,683	2,842,989	435	369	127
1950	10,591	4,610,278	1,005	850	680
1955	16,201	8,153,641	2,743	2,447	1,934
1960	20,456	12,037,533	5,653	4,975	4,377
1965	22,219	16,753,106	10,552	9,249	8,095
1970	23,688	22,776,676	17,951	15,484	14,100
1975	22,678	31,321,234	37,554	32,800	28,105
1980	21,467	44,047,759	68,996	61,748	48,707
1985	17,581	51,721,709	137,168	125,512	85,139
1988	15,719	58,629,214	196,424	178,532	126,542

Source: CUNA, *Credit Union Report*, 1988.

### *Structure and Operation of the Credit Union Industry*

Credit unions are financial institutions organized by individuals having a "common bond," which serves to define the eligible field of membership. The common bond may be one of occupation or association; or it may be a well-defined neighborhood, community, or rural district. Like banks, credit unions may apply for federal or state charters.<sup>6</sup> Branch operations, though uncommon, may be established, and credit union charter conversions, mergers and liquidations are easier to facilitate than is the case with other financial institutions.

Credit unions are democratic organizations; each member has one vote, and therefore, an equal say in how the organization is operated. Credit union members elect a board of directors, only one of whom can be compensated for his or her services, and other officers of the credit union, who volunteer their services. The board of directors is responsible for appointing a supervisory committee of between three and five credit union members, whose function is to oversee the organization's financial operations through internal audits and reports to the board. Additionally, credit unions are required to have a three-person credit committee to pass judgment on all loan applications. The credit committee may be elected by the credit union's members, or it may be appointed by the credit union's board of directors.

By definition, credit union members own their credit unions cooperatively. Thus, savings deposits, called "shares," earn dividends instead of interest, and are classified as equity, rather than liabilities, on financial statements.<sup>7</sup> In the event of a liquidation, credit union members are entitled to a *pro rata* distribution of assets in excess of liabilities. Credit unions are formed as nonprofit organizations, with the

purpose of serving the financial needs of members by acting as an intermediary between member savers and member borrowers. Theoretically, the existence of a common bond among members lessens credit risk; the lack of pressure to provide strong earnings to stockholders may also be a disincentive for excessive risk-taking by credit unions.

Credit union capital is comprised of statutory reserves, voluntary reserves, and undivided earnings. There is no initial minimum capital requirement for new credit unions, but each credit union must set aside a percentage of gross income annually until the minimum reserve requirement is met. Until 1978, federal credit unions were required by the Federal Credit Union Act to reserve ten percent of outstanding loans and risk assets against bad debt losses. In contrast, many state credit union statutes required reserves of seven percent or lower. The reserve requirement for federal credit unions in operation for more than four years and having assets in excess of \$500,000, was lowered to six percent in the 1977 revision of the Federal Credit Union Act<sup>8</sup> (referred to in the industry as the "Mini Bill"). The reserve requirement remains ten percent for smaller and newer institutions.

### *The Credit Union System*

The U.S. credit union industry has evolved into a four-tier structure composed of individual credit unions, local chapters, state leagues, and the national trade association. Local chapters provide credit unions with a means to cooperatively offer programs and services to their members. About 90 percent of credit unions also belong to their state leagues, organizations which exist in each of the fifty states, as well as the District of Columbia and Puerto Rico.<sup>9</sup>

State leagues, which are really trade associations, provide member

credit unions with services ranging from technical help and education to public relations and legislative lobbying. Leagues are funded by member dues, and most associations work in conjunction with a statewide service corporation and a corporate central credit union. Service corporations offer products and services for credit unions, such as office supplies and data processing. Corporate credit unions are essentially credit unions for credit unions; they provide investment, liquidity, and transaction-settlement services for other credit unions. They also may loan funds to the officers of member credit unions who are restricted by law as to the amount that they may borrow from the institutions they control. In 1988, there were 41 corporate credit unions, 30 of which were federally insured.<sup>10</sup>

Each state league is a member of the Credit Union National Association (CUNA). CUNA, its affiliated service organizations, and the U.S. Central Credit Union provide the same types of services nationally that the state leagues provide locally. In particular, the U.S. Central Credit Union acts as a credit union for the corporate centrals, and provides the main link to the

<sup>6</sup> According to *The Comparative Digest of Credit Union Acts*, three states (Delaware, South Dakota and Wyoming), and the District of Columbia, do not charter credit unions; the Commonwealth of Puerto Rico does, however.

<sup>7</sup> This practice was challenged by the American Institute of Certified Public Accountants in its 1986 guidebook, *Audits of Credit Unions*, which states that member shares should be classified as liabilities, rather than equity, on audited credit union financial statements. This ruling was reinforced by the Financial Accounting Standards Board's (FASB) Emerging Issues Task Force in Issue 89-3. In practice, credit union share capital is not considered equity for purposes of calculating the capital-to-asset ratio required by regulators, but it is considered equity for certain investment regulations.

<sup>8</sup> Amendments to the federal credit union statute are contained in Title III of the Depository Institutions Amendments of 1977 Act, PL 95-22. This Act was passed on April 19, 1977, to extend temporarily the flexible Regulation Q authority of the financial regulatory agencies to establish ceiling rates paid on time and savings deposits.

<sup>9</sup> Judy Weidman, "Cooperation Works," *Credit Union Magazine* 55 (July 1989): 35.

<sup>10</sup> NCUSIF, *Annual Report*, 1988, 3.

Federal Reserve System. Thus, even small credit unions or those lacking financial expertise have access to correspondent services such as share draft processing, wire transfers and federal funds trading, as well as a vehicle to obtain competitive rates on their investments.

### *Credit Union Powers*

Until recently, credit union operations were limited by statute to serving the savings and short-term credit needs of consumers; investment options were limited to government securities and deposits in federally insured institutions. Over the last decade, credit unions have received expanded investment authority and virtually the same powers as banks and thrifts in terms of retail financial services. Many of the services offered by credit unions today are extensions of their traditional activities, albeit set in a far more sophisticated and competitive financial marketplace.

### *Traditional Services*

One of the stated purposes of credit unions has always been to improve the financial condition of members by encouraging thrift and by offering consumer financial services in a convenient location, often the workplace, at a reasonable cost. Thus, credit unions were among the first financial institutions to offer payroll deduction and direct-deposit plans. In the past, many credit unions provided, free of charge, some limited amount of credit life insurance, as well as financial counseling and consumer education services. Other activities were developed according to the needs of a particular credit union and included services such as safe deposit boxes, automatic teller machines, and the sale of money orders, travelers checks, savings bonds, food stamps, and even hunting and fishing licenses.

The national trade association, CUNA, and the affiliated state leagues have always had an active

role in the development of new services for credit unions and their members. Over the years, CUNA has organized a number of profit-making (and tax-paying) organizations whose services are marketed to credit unions and their members. The earliest service affiliate, CUNA Mutual Insurance Society, formed in 1935 to provide health and life insurance to credit union members, is now only one of CUNA's affiliates providing consumer-related insurance products including property, casualty, automobile and credit life disability coverage.

### *Expanded Powers*

**Savings.** The 1977 "Mini Bill" was the first legislation to alter substantially federal credit union powers since the original Federal Credit Union Act was passed in 1934. Among other provisions, it gave credit unions savings-gathering authority extending far beyond the regular passbook-type share account. Thus, for the first time, credit unions could offer a wide variety of savings instruments including variable-rate share accounts, money-market certificates, jumbo CDs, and other time accounts.

One of the most hotly contested new powers at that time, the ability to offer checking (share draft) accounts, was not included in the 1977 legislation, although an experimental share draft program had begun in 1974. Share draft authority was challenged at the state level and in several lawsuits filed by the American Bankers Association before being made permanent in 1980 with enactment of the Depository Institutions Deregulation and Monetary Control Act (DIDMCA).

**Loans.** Lending activities also were greatly enhanced by the "Mini Bill." Previously, credit unions were empowered to make loans to members for "provident or productive purposes," with maturities not to exceed five years for unsecured loans and ten years for secured

loans. Under that authority, credit unions could, for example, make ten-year real-estate loans to help members purchase homes; on the other hand, credit unions could not make line-of-credit loans where the ultimate use of the money could not be determined.

Loan authority was substantially rewritten in the "Mini Bill," and credit unions were given the power to "make loans, the maturities of which shall not exceed twelve years except as otherwise provided," and were authorized to make line-of-credit loans, participation loans, loans to other credit unions, and government-insured or guaranteed loans.<sup>11</sup> The ability to offer a self-replenishing line of credit effectively introduced credit unions to the credit card market and allowed them to offer members overdraft privileges on share draft accounts.

Perhaps the most important authority granted in this legislation was the provision permitting federal credit unions to make residential real-estate loans with maturities up to 30 years. Long-term lending (up to 15 years) also was granted to finance the purchase of a mobile home, if used by the member as a principal residence, and for home-improvement loans. In 1978, the NCUA adopted a regulation permitting federal credit unions to sell mortgage loans in the secondary market. Mortgage lending was further deregulated by the Garn-St Germain Depository Institutions Act of 1982, which eliminated limits on the size and maturity of first-mortgage loans at credit unions (subject to NCUA regulations), permitted refinancing of mortgage loans, and extended the maturity limit to 15 years for all second mortgages, not just those used for home improvements. The Competitive Equality Banking Act of 1987 empowered the NCUA to extend the permissible maturity on second-mortgage, home-improvement

<sup>11</sup> Melvin, Davis and Fischer, 237-241.



and mobile-home loans beyond 15 years; as a result, in October 1989, the NCUA Board voted to extend the maturity limit on these loans to 20 years.<sup>12</sup>

Despite the deregulation of credit union lending powers, one traditional restriction on their activities remains: federal credit unions are the only financial institutions subject to a federally imposed ceiling on the rates that may be charged for consumer loans. Until 1980, the maximum amount that credit unions could charge members for loans was one percent per month simple interest, inclusive of fees, or 12 percent annually. In 1980, when lending at federal credit unions had virtually stopped, DIDMCA amended the statute to allow a 15 percent ceiling, with the provision that the NCUA Board could raise it higher for temporary periods if economic conditions warranted. In December 1980, the Board voted to raise the loan-rate ceiling to 21 percent, where it remained until May 1987, when the NCUA Board voted to lower the cap to 18 percent. The NCUA Board voted in January 1990, to extend the 18 percent ceiling until September 8, 1991.<sup>13</sup> Lobbying efforts through the years to abolish the loan-rate ceiling have, thus far, proved unsuccessful.

**Credit Union Service Organizations.** Another specific lending authority included in the 1977 amendments to the Federal Credit Union Act permits credit unions to make loans to organizations which provide services associated with the routine operations of credit unions. As noted earlier, credit union service organizations (CUSOs) were formed by the trade associations to provide services, such as data processing, to credit unions lacking the size or expertise to develop internally. The maximum amount that may be loaned to CUSOs is one percent of the credit union's "paid-in and unimpaired capital and surplus,"<sup>14</sup> with an additional one percent permitted to be invested in the

stock of these organizations.

During the 1980s, a wide variety of CUSOs were formed, prompting the NCUA to issue a list of permissible activities for CUSOs owned by federal credit unions. This list of approved activities, issued in 1986, is broader than that permitted bank holding companies or national banks and includes, for example, real-estate-brokerage activities. Also allowed are: insurance and discount brokers, credit card servicers, and firms providing financial planning, tax preparation, personal property leasing, and travel planning.

**Other Investment Powers.** Federal credit union investment powers also were expanded by the NCUA in 1984, when the agency authorized credit unions to invest in Yankee dollars, Eurodollars, bankers' acceptances, and cash-forward agreements. In 1988, the NCUA began permitting federal credit unions to invest in mortgage-related securities and to purchase real-estate loans, as long as they are bought for the purpose of completing a pool of loans to be sold or pledged on the secondary market. Finally, in 1989, the NCUA Board voted to permit federal credit unions to purchase put options on Government National Mortgage Association (GNMA), Federal National Mortgage Association (FNMA), and Federal Home Loan Mortgage Corporation securities, as a means to reduce interest-rate risk resulting from mortgage lending.

### *Use of Expanded Powers and Current Balance-Sheet Trends*

Many of the expanded powers granted credit unions over the years were necessitated by the combined effects of several trends. These include, in particular, technological changes resulting in the development of new products in the financial-services industry and the deregulation of interest rates at depository institutions. Additionally, consolidation within the credit

union industry has permitted credit unions to offer more services, such as automatic teller machine networks, that may not have been cost-effective at smaller credit unions. Finally, competition from other institutions for traditional credit union business, particularly automobile financing, has led credit unions to expand into new markets.

In recent years, the fastest growth in service offerings by credit unions has been for credit cards and first mortgages. CUNA reports that the number of credit unions offering credit cards doubled from 10.2 percent in 1985 to 22.4 percent in 1988.<sup>15</sup> In contrast, only two percent of credit unions offered credit cards to members in 1980. First mortgages were being offered by nearly 30 percent of credit unions surveyed in 1988, up from 12 percent at the beginning of the decade. Among credit unions with more than \$50 million in assets, the proportion offering first mortgages rose from 35 percent in 1980 to 88.4 percent in 1988.

The relative distribution of credit union assets, liabilities and equity at midyear 1989, is presented in Table 2. These data indicate that approximately two-thirds of credit union assets currently are in the form of loans to members,<sup>16</sup> while investments now account for about 30 percent of credit union assets. Fixed assets, such as land, buildings, furniture, etc., account for less than two percent of the total; other

<sup>12</sup> BNA's *Banking Report*, Vol. 53, 23 October 1989, 584.

<sup>13</sup> BNA's *Banking Report*, Vol. 54, 22 January 1990, 99.

<sup>14</sup> According to the statute, "paid-in and unimpaired capital and surplus" means the balance of all member share accounts as of a given date, less any loss that may have been incurred for which there is no reserve, plus undivided earnings. Reserves are not considered part of surplus for purposes of this calculation.

<sup>15</sup> CUNA, *Credit Union Report*, 1988, and *Credit Union Magazine*, June, 1988.

<sup>16</sup> Credit unions generally have higher loan-to-asset ratios than either commercial banks or savings and loans, which had loan-to-asset ratios of 62 percent and 60.7 percent, respectively, at year-end 1988. The comparable figure for savings banks was 68.6 percent.

**Table 2**  
**Midyear 1989 Credit Union Balance Sheet:**  
**Items as Percent of Total Assets**

ASSETS	
Cash	2.18
Loans Outstanding	65.81
Allowance for Loan Losses	( 0.48)
Investments	29.52
Allowance for Investment Loss	( 0.04)
Fixed Assets	1.89
Other Assets	1.11
<b>Total Assets</b>	<b>100.00</b>
LIABILITIES AND EQUITY	
Borrowings	0.97
Other Liabilities	1.10
Savings	90.83
Regular Reserves	2.98
Other Reserves	1.00
Undivided Earnings	3.13
<b>Total Liabilities and Equity</b>	<b>100.00</b>

Source: CUNA, *Credit Union Operating Ratios and Spreads*, Midyear 1989.

assets, including prepaid expenses and accounts receivable, comprise the remainder of total assets.

Further information on the distribution of loans outstanding and types of investments is given in Tables 3 and 4, respectively. The distribution of dollar amounts of loans outstanding at midyear 1989 shows that loans to finance the purchase of new automobiles comprise about one-fourth of credit union lending. However, first-mortgage loans and other mortgage loans, together, now account for over 30 percent of outstanding loans at credit unions. (Other mortgage loans include any loan secured by a first or second lien on residential property and, therefore, outstanding balances on home-equity lines of credit.) Commercial loans, defined as loans over \$25,000 for business other than agriculture, account for only about one percent of credit union lending.

Table 4 shows the dollar volume of each type of investment, and of cash holdings, as a percentage of total surplus funds at all credit

unions. (Surplus funds are defined as cash plus investments.) The largest percentage of these funds, 26.7 percent, are invested in federally insured depository institutions, including banks, S&Ls and savings banks, although deposits in corporate central credit unions account for another 23.6 percent. Deposits in commercial banks, which comprise 8.3 percent of total investments, include Eurodollars, Yankee dollars, and bankers' acceptances, in addition to regular pass-book accounts and certificates of deposit. Federal government obligations, including Treasury bills, bonds and notes, account for 12.4 percent and federal agency securities (e.g., FNMA and GNMA) account for 17 percent, while only two percent of credit union investments are in mutual funds. (ICU and NIFCU are mutual funds organized for credit unions; they invest in very short-term government securities.) Finally, approximately five percent of credit union investments are in CUSOs, deposits at and loans to other credit unions, state and local government obligations, shares in NCUA's Central Liquidity Facility, and any other investments not listed above.

**Table 3**  
**Distribution of Dollar Amounts in Loans Outstanding,**  
**Midyear 1989**  
**(Items as Percent of Total Loans)**

Loan Type	Percent
Unsecured	19.6
New Automobile	24.5
First Mortgage	18.9
Other Mortgage	12.6
Agricultural	0.2
Commercial	1.1
Other Loans to Members	22.8
Other Loans	0.3
<b>Total Loans</b>	<b>100.0</b>

Source: CUNA, *Credit Union Operating Ratios and Spreads*, Midyear 1989.

**Table 4**  
**Distribution of Credit Union Investments, Midyear 1989**  
 (Items as Percent of Surplus Funds)

Investment	Percent
Cash	6.9
Federal Funds	6.1
Deposits in Corporate Central Credit Unions	23.6
Deposits in Commercial Banks	8.3
Deposits in S&Ls, Savings Banks	18.4
Government Securities	12.4
ICUs, NIFCU	0.6
Other Mutual Funds	1.4
Federal Agency Securities	17.0
Other Investments	5.2
<b>Total Surplus Funds</b>	<b>100.0</b>

Source: CUNA, *Credit Union Operating Ratios and Spreads*, Midyear 1989.

### *Regulatory Structure and Supervision of Credit Unions*

#### *Overview*

The NCUA regulates and supervises all federally chartered credit unions, while state-chartered credit unions are regulated by various agencies within their states. Forty-seven states and the Commonwealth of Puerto Rico have statutes pertaining to the organization and operation of credit unions; the majority of these statutes contain a "wild card" provision which generally allows state-chartered credit unions to engage in the same activities as federally chartered credit unions.<sup>17</sup> Additionally, there has been a tendency among state regulators to copy federal law and to ensure that state standards are not more lax than those of the NCUA. Thus, while most of the regulations discussed in this paper apply specifically to federal credit unions, they are true of a majority of state-chartered credit unions as well.

Prior to the 1970s, credit unions operated under a far less detailed,

albeit more restrictive, statute than those governing other financial institutions. Interpretation of the law tended toward paternalism: if the statute did not expressly permit an activity, then credit unions could not do it. The early credit union administrators also played a strong advocacy role, actively promoting the formation of new credit unions and in educating the public about the benefits and opportunities of credit union membership.

Credit unions have become subject to increasing amounts of regulation as permissible activities have expanded and as a result of the number of consumer-related laws passed in recent years, e.g., the Truth in Lending Act, the Real Estate Settlement Procedures Act, and the Equal Credit Opportunity Act. In another sense, however, the Federal Credit Union Act has become less restrictive. Recent NCUA Boards have tended to allow credit unions greater flexibility in managing their operations by simplifying rules and regulations. For example, in 1982, NCUA's regulation on share, share draft and share certificate accounts was reduced from six

pages to two sentences. Essentially, it states that a credit union's board of directors shall determine rates, terms and conditions of accounts, and that all advertising and agreements should be clear and accurate.

In the late 1980s, credit union regulators focused on the safety and soundness of the credit union system. Not surprisingly, a strong effort was made to improve the capabilities of examiners, consistent with the increasing sophistication of credit unions. This effort included expansion of the field staff, improvements in examiner-training programs, the use of on-site computers, and better coordination with state supervisors. During 1987, NCUA adopted the CAMEL rating system, which had been used by bank examiners, as a supervisory tool to evaluate credit union performance.

#### *National Credit Union Administration*

The NCUA was created as an independent agency in 1970. Previously, federal regulation of credit unions had been the responsibility of a number of agencies at different times, including the FDIC from 1942-1948. In its early years, the NCUA was headed by a single Administrator in conjunction with a seven-member advisory board. The agency was reorganized as a result of the Financial Institutions Regulatory and Interest Rate Control Act of 1978 (FIRA) which established a three-member board to manage NCUA. At the same time, the NCUA Board was given increased supervisory powers and charged with responsibility for creating and managing the Central Liquidity Facility (CLF), which is discussed below. FIRA also created the Federal Financial Institutions Examination Council with the newly designated Chairman of the NCUA Board as one of its five members.

The NCUA is funded by charges

<sup>17</sup> CUNA, *Comparative Digest of Credit Union Acts*, 1986 edition, 13-14.

to the NCUSIF (referred to as the "overhead transfer"), to cover the agency's insurance-related activities, and by fees received from credit unions for NCUA's other services. Prior to 1979, separate fees were assessed for examination, supervision, and chartering of federal credit unions. The agency now collects one annual operating fee from all federal credit unions, scaled according to asset size. In 1986, the overhead transfer rate was raised from 33 percent to 50 percent of the agency's budget, reflecting the proportion of NCUA's costs which are insurance-related. Operating fees also have been raised in recent years to meet NCUA's expenses.

The NCUA's powers are similar to those of the Federal Home Loan Bank Board, prior to enactment of FIRREA. NCUA is responsible for chartering, supervising, examining and insuring federal credit unions. State-chartered credit unions that elect federal share insurance are jointly supervised by NCUA and the respective state authorities. The NCUA Board has authority to issue cease-and-desist orders, to remove officers and directors for causes such as dishonesty or unfitness, and to suspend a federal credit union's charter or place the institution in involuntary liquidation in case of insolvency.

During the 1980s, NCUA was given increased authority to deal with troubled credit unions. The agency first sought and received temporary powers of conservatorship, which enable NCUA to take control of a failing credit union when it believes that the institution can be restored to health. Conservatorship also prevents dissipation of a credit union's assets in cases where a cease-and-desist order has been willfully violated, or when a credit union's records have been concealed from examiners. NCUA's conservatorship authority was made permanent in the Competitive Equality Banking Act of 1987.

The NCUSIF and NCUA also were granted increased supervisory and enforcement powers under Title IX, Regulatory Enforcement Authority and Criminal Enhancements, of FIRREA. In general, this section of the legislation grants federal banking agencies broader and more stringent enforcement authorities, such as provisions to increase civil and criminal penalties, to expand the universe of persons subject to enforcement, and to shorten the required period for notice prior to termination of federal deposit insurance.

Other enhanced supervisory powers included in FIRREA were directed to NCUA, in particular, as the result of the 1988 failure of Franklin Federal Credit Union of Omaha, Nebraska, the costliest credit union failure to date. The agency was given authority to investigate any substantive allegation of misconduct by a credit union or any institution-affiliated party; previously, NCUA had been restricted to investigating only those irregularities that were discovered during the examination process. Additionally, FIRREA strengthened the existing requirement that all federally insured credit unions have an annual audit conducted by the institution's supervisory committee, or by an outside certified public accountant.

As directed by FIRREA, NCUA adopted a regulation in late 1989, identifying the conditions under which an independent audit by a certified public accountant is required. These are: if the credit union's supervisory committee has failed to conduct the required annual audit; or, if that audit was incomplete or unsatisfactory; or, if the credit union has experienced serious and persistent recordkeeping deficiencies.<sup>18</sup> More importantly, FIRREA gave NCUA power to enforce the annual audit regulation by stipulating that a credit union's failure to comply will constitute an unsafe and unsound practice.

### *National Credit Union Share Insurance Fund*

The NCUSIF was established in 1970 as a fund in the U.S. Treasury under the management of NCUA. Legislation creating the NCUSIF directed NCUA to insure member accounts in all federal credit unions and in all qualifying state credit unions requesting insurance.<sup>19</sup> No start-up capital from the U.S. Treasury or Federal Reserve was used to launch the NCUSIF, and insurance premiums (1/12th of one percent) were the fund's primary source of income during its first nine years. Low insurance losses and operating expenses, combined with generally favorable economic conditions, permitted the fund to put 74 percent of its revenues directly into equity capital. As a result, the ratio of equity to insured shares rose to 0.32 percent by 1979.

This ratio began to decline the following year as credit union losses increased due to sudden plant closings, poor investment decisions, and the adverse effects of inflation and recession on credit union finances. During the 1980-83 period, fund equity stopped growing and contingent liabilities were used to conserve cash reserves.<sup>20</sup> However, these liabilities soon grew to a level almost equal to the fund's entire equity, forcing the NCUA to impose special assessments, which were permitted by statute. In 1982, the additional assessment was two-thirds of the regular assessment and in 1983, the regular assessment was

<sup>18</sup> *BNA's Banking Report*, Vol. 53, 11 December 1989, 880-881.

<sup>19</sup> NCUSIF insures approximately 96 percent of all credit union shares; the remaining four percent are insured by 11 state credit union or guaranty corporations, although six credit unions operated with no deposit insurance coverage in 1988. For a listing of the state laws governing credit union share insurance, see the NCUSIF's 1988 *Annual Report*, page 4.

<sup>20</sup> NCUSIF, *Annual Report*, 1984, 4-5.

effectively doubled. These additional funds arrested the decline in the equity-to-share ratio but did not help move the NCUSIF toward its mandated goal of a one percent equity ratio.

Legislation to capitalize the fund, approved by Congress in 1984, required credit unions to deposit one percent of insured shares in the fund. The amount of each credit union's deposit is carried as an asset on its books, and is adjusted annually in accordance with changes in the credit union's insured shares. These deposits are to be returned to individual credit unions in the event the fund's operations are transferred from the NCUA, or in cases where a credit union converts to insurance coverage provided by another source or voluntarily liquidates. A credit union's deposit is not returned if the institution is declared insolvent. The NCUSIF is authorized to use the deposit funds to meet insurance expenses, if necessary, although any amount used must be expensed and replenished by insured credit unions. Therefore, the NCUSIF is designed to have a capitalization floor of one percent.

The capitalization legislation also established a new "normal operating level," or level of fund equity to total insured shares of 1.3 percent. The fund is required to contribute sufficient amounts of net income each year to obtain and maintain that goal. This figure serves as a ceiling; any excess amount of equity is returned to insured credit unions as a dividend, as was done in 1985. The fund's equity-to-shares ratio stood at 1.26 percent as of June 30, 1988.<sup>21</sup> In the five years since capitalization, the NCUSIF has been able to pay all administrative and insurance costs from its investment income, thereby allowing NCUA to waive the annual insurance premium assessment and saving credit unions \$520 million in expenses through 1989.<sup>22</sup>

A recent proposal, contained in

the original Bush Administration's plan for the savings and loan legislation, would have required credit unions to write off their books the one percent deposit each is required to maintain in the NCUSIF, and to expense all future contributions. The current NCUA regulation, which instructs credit unions to record the one percent deposit as an asset, is consistent with generally accepted accounting principles.

The credit union industry argues that maintaining this deposit on their books as an asset is an important hedge against the type of moral hazard present under the premium-type of deposit insurance fund. That is, by maintaining an ownership interest in the fund, credit unions are subject to a form of market discipline in that they benefit from keeping industry losses to a minimum. Critics of this practice argue that the industry is overstating its capital by permitting this type of accounting.

### *Central Liquidity Facility*

The Financial Institutions Regulatory and Interest Rate Control Act of 1978 authorized NCUA to establish the Central Liquidity Facility (CLF), and to oversee its ongoing operations. The CLF was designed to be a central bank and lender of last resort for the credit union industry which, at that time, had no access to a government-sponsored liquidity facility such as the Federal Reserve System<sup>23</sup> or the Federal Home Loan Bank System. In the absence of such a facility, the industry had developed a series of state-chartered central credit unions and, beginning in 1975, federally chartered corporate central credit unions,<sup>24</sup> to manage industry liquidity by pooling available credit union investment funds, and making these funds available for loans to other credit unions.

The CLF was established to provide a back-up source of liquidity from *outside* the credit union in-

dustry, and hence, to provide financial stability during an industry-wide economic downturn. The CLF charges above-market rates for its short-term (30-90 days) adjustment credits, and for its seasonal credits, which are generally loans of 90-270 days' duration. The CLF prices these loans by setting the rate just above the average rate charged by corporate central credit unions.<sup>25</sup>

Income generated by the spread between its borrowing rate and that charged for its short-term and seasonal liquidity credits is used by the CLF to subsidize lending to troubled credit unions. These below-market-rate protracted adjustment credits (loans of one to four years), are collateralized loans granted to credit unions whose liquidity needs are expected to be of an extended duration, and which are the result of national, regional, or local difficulties. Unlike the Federal Home Loan Bank System, which may make advances for periods of up to twenty years for any purpose consistent with the promotion of home financing, the CLF makes no advances to credit unions for purposes of expansion.

The CLF, which began operations on October 1, 1979, is owned by its member credit unions and managed by the NCUA Board in Washington, D.C.. Unlike the Federal Reserve System and the Federal Home Loan Bank System, the CLF has no regional credit union liquidity facilities. Regular membership in the

<sup>21</sup> NCUSIF, *Annual Report*, 1988, 14.

<sup>22</sup> *BNA's Banking Report*, Vol. 53, 11 December 1989, 881.

<sup>23</sup> Pearce notes that, although some large credit unions now have legal access to the Federal Reserve's discount window, they do not really have a choice between borrowing from the CLF or the discount window because the Federal Reserve requires that credit unions first approach the CLF (p. 10).

<sup>24</sup> Technically, "corporate central" credit unions restrict membership to other credit unions, while "central" credit unions may, depending on state law, also accept certain individuals as members. For a history of central credit unions, see Donald J. Melvin, *et. al.*, pages 84-85. For a compilation of state laws regarding central credit unions and corporate credit unions, see the *Comparative Digest of Credit Union Acts*.

<sup>25</sup> Pearce, 10.

CLF is open to federal or state-chartered credit unions, insured or uninsured. Corporate central credit unions may join as agent members, thereby providing access to the CLF to their member credit unions. During 1988, the CLF had 266 direct credit union members and 42 agent members<sup>26</sup> (generally one from each state), representing another 15,500 credit unions.<sup>27</sup>

Each credit union wishing to join the CLF is required to subscribe to the latter's capital stock in an amount equal to no less than one-half of one percent of its paid-in and unimpaired capital and surplus; for agent members, the amount is based on the surplus of all member credit unions that are not themselves regular members of the CLF. Only one-half of the required subscription amount is actually remitted to the CLF; the remainder is required to be held in liquid assets by members, subject to call by the NCUA Board. Subscriptions are adjusted annually to reflect changes in the member credit unions' paid-in and unimpaired capital and surplus.

Dividends are declared and paid quarterly on members' required capital stock. Funds remitted by credit unions over and above the amount required for membership are called member deposits; these amounts receive interest payments equivalent to the dividend rate paid on capital stock. Members' equity in the CLF at the end of fiscal year 1988 was \$408.4 million (excluding unremitted subscriptions) and members received \$24.5 million in dividends and interest for the year. The NCUA reports that this figure represents a 6.4 percent return on members' capital and deposits.<sup>28</sup>

The CLF invests all capital in U.S. government and agency obligations, and in deposits at member credit unions or at federally insured financial institutions. The CLF funds all of its lending activities by borrowing from the Federal Financing Bank (FFB).<sup>29</sup> Unlike the Federal Home Loan Banks, which issue their own

debt instruments which must explicitly state that they are not guaranteed by the U.S. government, obligations of the NCUA, incurred on behalf of the CLF, are supported by the full faith and credit of the U.S. government.<sup>30</sup> Borrowing authority is limited each year to approximately twelve times equity and capital subscriptions on-call. Additionally, the CLF is authorized to borrow up to \$500 million from the U.S. Treasury to meet the liquidity needs of credit unions in an emergency. The CLF had outstanding loans at fiscal year-end, September 30, 1988, of \$120.4 million and it also had provided lines of credit totaling \$13.5 million for four private share insurance funds.<sup>31</sup>

### *Current Health of the Credit Union Industry*

Credit unions, like other thrift institutions, entered the 1980s under extremely unfavorable conditions. The effects of very high and volatile interest rates on the profitability of savings and loan associations and mutual savings banks at that time are well known. Credit unions also experienced disintermediation, liquidity pressures, and low earnings in the early 1980s, but the industry was perhaps more affected by a different problem: many credit unions were organized around an occupational common bond in industries that were particularly hard hit by the economic conditions of the time. Increased loan delinquencies and decreased rates of saving compounded the liquidity and earnings pressures at credit unions. Loss of sponsorship, lack of economic viability, or actual insolvency led many hundreds of credit unions to be merged or liquidated in the late 1970s and early 1980s.

### *Credit Union Failures in the 1980s*

As shown in Table 5, credit union failures peaked in 1981,<sup>32</sup> when

251 institutions were placed into involuntary liquidation and another 98 were merged with financial assistance from the NCUSIF; an additional 114 credit unions, although not technical "failures," received financial assistance to avoid liquidation that year. In 1982, involuntary credit union liquidations fell to 160, while assisted mergers rose to 167, and the numbers of active assistance cases and problem credit unions peaked at 124 and 1,192, respectively. By 1983, involuntary liquidations had dropped to 50, although assisted mergers hit a peak of 203 and the number of assistance cases was still high, at 113. This trend reflects the previously noted decline in the insurance fund's reserves during the early 1980s, which caused the NCUSIF to substitute alternative methods of credit union assistance for the more costly liquidation.

Since 1983, the behavior of interest rates has been more favorable for thrift institutions in general, and several regulatory changes have been favorable to credit unions, in particular. For example, several NCUA regulations governing

<sup>26</sup> As noted on page 3 of the NCUSIF's 1988 *Annual Report*, one of these was merged into another corporate credit union during the year, leaving a total of 41 corporate central credit unions.

<sup>27</sup> NCUA, *Annual Report*, 1988, 17.

<sup>28</sup> *Ibid.*

<sup>29</sup> The FFB, a corporation within the U.S. Treasury, was established in 1973 to coordinate the financing activities of federal agencies whose obligations are guaranteed by the federal government. The FFB borrows money at Treasury rates and lends the funds to designated agencies at one-eighth of an interest point higher.

<sup>30</sup> A special memorandum opinion concerning the full faith and credit status of the CLF was issued by the Attorney General on May 24, 1982.

<sup>31</sup> NCUA, *Annual Report*, 1988, 17.

<sup>32</sup> Although previous years' data are not given in Table 5, the number of involuntary liquidations were 168 and 169 in 1978 and 1979, respectively, according to the NCUSIF's 1987 *Annual Report*.

**Table 5**  
**Federally Insured Credit Union Failures and Problem Cases,**  
**Fiscal Years, 1980-1988**

Year	Involuntary Liquidations	Assisted Mergers*	Assistance Cases**	Problem Credit Unions
1980	239	NA	59	1018
1981	251	98	114	1174
1982	160	167	124	1192
1983	50	203	113	1124
1984	38	92	72	872
1985	31	63	45	742
1986	36	58	30	794
1987	33	55	16	929
1988	35	50	25	1022

Source: NCUSIF, *Annual Report*, 1988, 24-27.

\*Assisted merger cases were not separately identified until calendar year 1981; 1982 figure is for nine months ending Sept. 30, 1982; figures thereafter coincide with fiscal year.

\*\*Number of active cases of credit unions receiving assistance to avoid liquidation.

### *Recent Financial Performance of Credit Unions*

Selected performance measures for NCUSIF-insured credit unions are presented in Table 6. It is apparent that growth in credit union assets and savings has slowed dramatically, beginning in 1987. Credit union savings, which increased 24.3 percent during 1986, rose only 3.1 percent in the twelve-month period ending June, 1989. In contrast, loan growth has remained strong; loans outstanding at federally insured credit unions increased nearly 14 percent in 1988. Other credit union investments, which grew by nearly 38 percent in 1986, declined in 1988 and 1989.

The combination of slower share growth and brisk loan growth in recent years has increased the loans-to-savings ratio from 63.3 percent

<sup>33</sup> Leigh Gregg, "Problem CUs Undergo 'Intensive Care,'" *Credit Union Magazine* 55 (July 1989): 15.

<sup>34</sup> "Bank, S&L Failures Top Those of CUs," *Credit Union Magazine* 56 (January 1990): 54.

the common bond requirement for credit union charters were loosened, giving many credit unions facing liquidation more flexibility to either merge with other credit unions, or to expand their membership base.

As a result, credit union failures dropped dramatically after 1983. An average of 35 credit unions per year were placed into involuntary liquidation during the 1984-1988 period, while NCUSIF-assisted mergers, which declined steadily during that period, numbered 50 in 1988. Cases of active credit unions receiving financial assistance to avoid liquidation fell from 72 in 1984, to 16 in 1987, before rising to 25 in 1988.

A more disturbing trend is indicated by the increase in the number of credit unions on NCUA's problem list (defined as those with CAMEL 4 and 5 ratings), from 742 in 1985 to 1,022 in 1988. These credit unions have become the focus of increased supervisory oversight by NCUA examiners; the NCUA also has encouraged the industry's trade associations to offer assistance to troubled credit

unions.<sup>33</sup> In part as a result of these developments, the number of credit unions on the agency's problem list declined to approximately 900 in 1989.<sup>34</sup>

**Table 6**  
**Selected Performance Measures, 1986-1989**  
**Federally Insured Credit Unions**

	1986	1987	1988	1989*
Yearly Growth				
Savings	24.3%	9.0%	7.2%	3.1%
Assets	23.4	9.8	7.8	4.0
Loans	15.7	15.6	13.9	12.3
Investments	37.8	1.0	-3.0	-10.8
Capital	18.2	14.5	14.3	12.3
Net Income	6.1	6.4	13.0	8.8
Ratios				
Loans-to-Savings	63.3	67.0	71.2	72.9
Return on Assets	1.02	0.94	0.98	1.00
Capital-to-Assets	6.2	6.5	6.9	7.1
Loan Delinquencies	2.2	1.9	1.8	1.7
Net Loan Charge-offs	0.61	0.62	0.64	0.62

Source: Statement by Dr. Charles H. Bradford before the NCUA Board, *Credit Union Performance, First Six Months of 1989*, September 14, 1989.

\*Yearly growth is from June 1988, to June 1989; for ratios, income and expense items are annualized.

in 1986, to nearly 73 percent for the year ending June, 1989. This development has had a favorable effect on credit unions' net income, since loan yields tend to be higher than those of other traditional credit union investments, although this reflects their higher risk of default. Credit union net income (after dividend payments but before reserve transfers) has grown steadily in the past few years, and the annual return on average assets rose from 0.94 in 1987 to 1.00 at midyear 1989.

The remaining financial statistics also suggest that the credit union industry is generally healthy. Capital (reserves and undivided earnings) rose at double-digit rates throughout the 1986-1989 period, and the capital-to-asset ratio for federally insured credit unions rose from 6.2 percent to 7.1 percent during this time. Credit quality appears good; loan delinquencies (two months or more overdue) declined from 2.2 percent of total credit union loans in 1986, to 1.7 percent in June, 1989. Finally, net charge-offs remained steady at about 0.62 percent during the last four years. In contrast, net charge-offs at commercial banks have increased during the last four years, with an average rate of about 0.94 during that time.

### *Current Credit Union Issues* *Expansion of Common Bonds*

One of the primary areas of contention between bankers and credit unions in recent years has been NCUA's increasingly liberal interpretation of the common bond requirement for credit union charters. Although early credit unions were formed to serve small, closely-knit groups of individuals, many of these limited-membership institutions could not survive the changing economic structure of the last several decades, resulting in a number of voluntary and involuntary credit union liquidations.

In order to reverse the trend of credit union dissolutions, the NCUA Board amended its field of membership chartering and expansion policies in order to allow credit unions to attract new members, and to facilitate mergers between credit unions. In 1982, when the NCUA Board began to make these changes, its operating philosophy was one of deregulation and, hence, the agency noted that it was "returning to credit union boards the right and responsibility to determine whom the credit union would serve."<sup>35</sup>

Thus, federal credit unions were permitted, with the regional director's approval, to serve nearby employee and associational groups which requested credit union service. In the past, multiple-group credit unions were restricted to either occupational or associational groups with a similar common bond. This restriction had forced occupational credit unions in declining industries to either convert to community charters, or to liquidate. The multiple-group policy change allowed a number of financially-distressed credit unions to merge with healthier institutions, and also helped diversify the economic base of credit unions. Today, over one-half of all credit unions serve multiple employee groups.<sup>36</sup>

Other changes were designed to expand membership at individual credit unions. For example, the Federal Credit Union Act is silent on the eligibility of other family members to join the credit union along with a member whose eligibility is based on the common bond. Traditionally, credit union charters have contained "usual wording" clauses which provided eligibility to immediate family members; these generally were interpreted by NCUA to be the primary member's spouse and any children living under the same roof.<sup>37</sup> However, in 1983, the NCUA Board approved a standard bylaw amendment allowing each credit union to

define for itself the concept of family member eligibility.<sup>38</sup> Thus, some credit unions amended their bylaws to allow members to invite their parents, grandparents, stepchildren and other relatives to join the credit union.

Similarly, NCUA also looked for ways to expand membership for senior citizens. In November 1984, NCUA adopted a policy permitting federal credit unions to sponsor or assist in the formation of senior citizen and retiree organizations with the primary purpose of providing eligibility for joining a credit union.<sup>39</sup> Previously, organizations formed with the purpose of providing credit union eligibility were not defined as having a common bond. Although senior citizen groups, such as the American Association of Retired Persons (AARP), already were eligible to join credit unions, this new policy eliminated much of the paperwork, and hence, delay in extending credit union membership to seniors.

The AARP opened its own credit union in 1988; eligible members include the more than 28 million AARP members nationwide, and their spouses.<sup>40</sup> This fact did not go unnoticed by banks and S&Ls, which, in the past, have benefitted from the large deposits often transferred to their institutions by retirees, who find their credit unions inconvenient when they stop working.

The formation of a credit union on the national level has prompted

<sup>35</sup> NCUA, *Annual Report*, 1984, 11.

<sup>36</sup> Judy Weidman, "Members Still Deserve Personal Service," *Credit Union Magazine* 54 (November 1988): 15.

<sup>37</sup> NCUA, *Studies in Federal Credit Union Chartering Policy*, July 1979, 26.

<sup>38</sup> NCUA, Letter No. 73 (February 2, 1983), Washington, D.C.

<sup>39</sup> *Washington Financial Reports*, 26 November 1984, 846.

<sup>40</sup> According to AARP offices in Washington, membership in the AARP Federal Credit Union had grown to only 85,000 by January 1990, and the credit union's assets at year-end 1989 were about \$150 million. Subsequently, in April 1990, the credit union's members voted to cease operations and the institution was closed barely two years after formation.



many to accuse NCUA of taking field-of-membership expansion too far. Perhaps as a result of this criticism, the NCUA Board voted in November 1988, to rescind plans to let well-run credit unions open their businesses to occupational groups of 300 or less without getting prior agency approval; at the same time, the agency voted to tighten chartering procedures for large associations like the AARP. Previously, NCUA had allowed approval of a charter by the regional director in the region where a proposed credit union would be headquartered. The agency's new rule requires approval from a majority of directors in only the regions where the association has members, along with approval from the director of NCUA's Office of Examination and Insurance.<sup>41</sup>

A more recent rule, passed by the NCUA Board on July 20, 1989, states that the agency's policy is to grant "associational charters at the lowest level which is economically feasible."<sup>42</sup> Thus, a charter will only be issued at the national level after it is first determined that a local or regional credit union would not be economically viable. The ruling further specifies that to form an associational credit union, a group would have to: hold at least one annual meeting, open to its members; sponsor other activities that would allow its members to meet and mingle; and specifically define who is eligible for membership. Associations based on a client or customer relationship are not considered to have a sufficient common bond. Thus, groups such as the American Automobile Association, which have more of a client base than a membership base, would be barred from forming a credit union.

### *Tax-Exemption*

The federal income tax exemption for state-chartered credit unions dates to the Revenue Act of 1916, which provided tax-exempt status to domestic building and loan associations and cooperatives. In

1917, the U.S. Attorney General ruled that although credit unions were not explicitly mentioned in the Act, they were subsumed under that exemption, if found to be "organized and operated for mutual purposes and without profit."<sup>43</sup>

Federal credit unions, which were not chartered until 1934, are exempt from federal income tax by a 1937 amendment to the Federal Credit Union Act. While the Senate-passed version of the original 1934 bill contained a federal tax exemption, the House of Representatives not only eliminated this provision, but also voted to permit individual states to tax federal credit unions. In an effort to speed passage of federal credit union legislation, the Senate agreed to these provisions, "with the acquiescence of the credit union movement."<sup>44</sup> However, the General Counsel of the Farm Credit Administration (then the chartering agency for federal credit unions) immediately requested an opinion on the tax-exempt status of federal credit unions from the Commissioner of the Internal Revenue. Based on the tax-exempt status of state-chartered credit unions, the IRS ruled in June 1935, that federal credit unions also would be granted the exemption.

Moreover, it soon was discovered that state income tax laws placed an unusually high tax burden on credit unions. At that time, states commonly taxed depository institutions on the basis of share capital; since credit union savings are defined as member shares and not deposits, their capital represents a much greater proportion of total assets. As a result of this disparity, Congress amended the Federal Credit Union Act in 1937 to include exemptions for both state and federal income taxes.

Congress reconsidered the tax-exempt status of cooperatives and other tax-exempt financial institutions in 1951, and voted to remove the exemption for all but credit unions, which were given a

separate Internal Revenue Code provision. The basis for this decision appears to have been the belief that credit unions remained true to their original purpose and characteristics, while mutual savings banks were found to be "in active competition with commercial banks ... for the public savings, and ... with many types of taxable institutions in the security and real estate markets."<sup>45</sup> Savings and loan associations, tax exempt since the Federal Home Loan Bank System was created in 1934, were declared "no longer self-contained cooperative institutions as they were originally organized."<sup>46</sup>

The tax-exempt status of credit unions has been challenged on a number of occasions since 1970, both by other financial institutions and those seeking to balance the federal budget. Banks and thrifts argue that relaxation of the common bond requirement and enhancements in credit union powers have eroded the traditional distinctions between their organizations and credit unions. The tax-exempt status of credit unions is seen by bankers as a federal subsidy, which permits them to price loans at 50 to 125 basis points below competing banks, and to offer free checking and certificates of deposit at rates from 75 to 150 basis points above area banks.<sup>47</sup> The American Bankers Association

<sup>41</sup> *BNA's Banking Report*, Vol. 52, 14 November 1988, 833.

<sup>42</sup> NCUA, "Final Rule and Final Interpretive Ruling and Policy Statement 89-1—Chartering and Field of Membership Policy," 54 *Fed. Reg.* 31,165 (1989).

<sup>43</sup> *Op. Att'y Gen.* 176 (1917).

<sup>44</sup> Statement of the Credit Union National Association, Inc. before the Committee of Finance, U.S. Senate, *Taxation of Financial Services Industry: Hearing before the Committee on Finance*, 98th Cong., 1st sess., 11 March 1983, 221.

<sup>45</sup> U.S. Congress, Senate, *Senate Report No. 781*, 82nd Cong., 1st sess., 18 September 1951, reprinted in *U.S. Code Cong. & Admin. News*, 1993.

<sup>46</sup> *Ibid.*, 1996.

<sup>47</sup> These figures were attributed to an independent group of bankers known as the Bankers Committee for Tax Equality. See Robert M. Garsson, "Credit Unions Ready to Defend Tax-Exempt Status," *American Banker*, 13 July 1987, 3.

has estimated that the subsidy resulting from tax exemption amounts to an 81 basis-point reduction in the average loan rate that credit unions charge their members.<sup>48</sup>

It should be noted that the credit union industry traditionally argues that its tax-exempt status plays only a small role in the ability to price loans and deposit products more favorably than banks. It acknowledges the value of sponsor subsidies, typically rent-free office space and employees' time, but also stresses the large proportion of volunteer staff. Although larger credit unions are usually staffed by salaried employees, credit union officers and directors at these institutions are primarily still volunteers, saving the credit union industry over \$1 billion annually, according to the National Association of Federal Credit Unions.<sup>49</sup>

The question whether credit unions "should" be taxed is beyond the scope of this paper. The answer will be determined, in part, by legal considerations, such as the degree to which credit unions fulfill their original purpose, and in part by whether credit unions are judged to pose a competitive threat to other taxable financial institutions. This determination is likely to be affected, as well, by the amount of federal budgetary benefits that would accrue as a result of taxation of credit unions.

In that regard, taxation of credit unions has been proposed in recent years by the Congressional Budget Office and by the Treasury Department. Estimates of the additional annual revenue that would be generated range from \$200 million to \$400 million, depending on the formula used.<sup>50</sup> Most of these proposals would limit taxation to larger credit unions in order to reduce the paperwork burden for small institutions. For example, taxing federal credit unions with over \$10 million in assets would leave nearly 80 percent of the in-

dustry in number, but only 15 percent of its assets, tax-exempt.

### Summary and Conclusions

The U.S. credit union industry has evolved from serving simple, short-term consumer saving and lending needs, to being full-service consumer banks. Much of this change has occurred only in the last decade, and coincides with a period of rapid change and increased competition for all financial institutions. However, important differences still remain between credit unions and commercial banks. Credit unions are limited to lending to their members and to other credit unions, and while loans are made for a greater variety of purposes, these do not include second homes or loans for investment purposes. Although credit unions are empowered to make business loans, this activity accounts for only one percent of credit unions' lending. Finally, the majority of credit unions are still small, with less than \$5 million in assets, and many continue to provide only the more traditional products and services to their members. Even with the rapid growth in credit union savings during the 1980s, by the end of the decade, total credit union assets were still not as great as those of the largest U.S. bank holding company.

Success has become a double-edged sword for credit unions. As a result of their profitability and increased market share, credit unions now face a variety of proposals designed to alter the structure and organization of their industry. However, while other financial institutions have pointed to the changing characteristics of the largest credit unions, many of the small, traditional credit unions have not welcomed some of these changes. For example, liberalized regulations governing the common bond requirement exposed credit unions to competition with each other for the first time. De-

regulation of interest rates in the early 1980s eliminated another traditional advantage of credit unions, who were allowed to pay seven percent on share accounts when banks and thrifts were limited to paying less than six percent. In addition, larger credit unions now are required to maintain reserves on transaction accounts. Finally, as previously noted, credit unions have been faced with increased competition for consumer lending from other financial institutions.

Financial statistics suggest that, in general, the credit union industry currently is healthy. However, recent events in the savings and loan and commercial banking industries, as well as several prominent credit union failures, underscore the need for quality examination and supervision by regulators. In this regard, the credit union system may prove to be fortunate, since it was able to increase both the number and training of its examination staff during a period when the industry was experiencing few problems. All credit unions now receive annual on-site examinations; those experiencing problems are visited more often.

Credit unions will be facing a period of legislative scrutiny at both the state and the federal levels. Legislative action on issues such as common bond regulations, tax-exemption, and the structure of their regulatory system and deposit insurance fund could alter substantially the economic and regulatory environment in which credit unions operate.

<sup>48</sup> Value of the Federal Income Tax Exemption Subsidy to Credit Union Members," *Hoozier Banker*, February 1990, 9.

<sup>49</sup> Rosenstein, 13.

<sup>50</sup> See, for example, Kevin J. Mullins and Anthony Pennella, "Pressure to Share Tax Burden Mounts for Credit Unions," *American Banker*, 14 February 1989, 8; Jay Rosenstein, "Tax Bite Getting Number-Crunched," *American Banker*, 12 September 1989, 13; and "Budget Watchers Ponder Credit Union Taxation," *Savings Institutions*, April 1988, 27.

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# Risk-Based Capital Requirements: Reshaping the Thrift Industry

by Peter J. Elmer\*

**R**ecent legislation enacted in response to the failure of hundreds of insolvent thrift institutions requires thrifts to hold substantially more capital. Estimates of thrifts' ability to meet the new capital requirements are presented in this paper. The estimates show that a substantial segment of the industry currently fails to meet the new standards. This group comprises 33 percent by number, and 44 percent by assets, of all thrifts not in conservatorship. Moreover, an even larger segment, comprising 46 percent of non-conservatorship thrifts by number, and 70 percent by assets, does not appear to meet the standards that ultimately will be required.

Given their current earnings performance, most thrifts estimated to fail the new standards will not be able to meet the standards in the near future solely through retained earnings. This suggests that policies soon will have to be developed to deal with large numbers of institutions that do not meet capital requirements. These include supervisory policies to limit high-risk behavior and inappropriate dividend payments, programs for thrifts that do not have acceptable plans to increase capital, and policies on when, if ever, to use open-thrift assistance.

The long-term ability of thrifts to raise capital will be affected by economic conditions, including the be-

havior of interest rates, real-estate markets, and other factors influencing the value of the thrift charter. However, without substantial improvement in earnings, the options available to most thrifts failing to meet capital requirements appear limited to some combination of shrinkage, raising capital from external sources, and mergers with healthy institutions. The activities of institutions actively seeking healthy merger partners and attempting to sell high-risk assets would be, to some extent, in competition with activities of the Resolution Trust Corporation (RTC) and could make its responsibilities more difficult.

## Capital Requirements

In compliance with the Financial Institutions Reform, Recovery, and Enforcement Act of 1989 (FIRREA), the Office of Thrift Supervision (OTS) set new capital standards for all federally and state-chartered savings associations insured by the Savings Association Insurance Fund (SAIF), effective December 7, 1989. These standards are based on standards developed in 1987 by an international group of bank regulators, the Basle Committee on Banking Regulations and Supervisory Practices. The initial standards were subsequently revised and adopted by the major industrialized countries (the "Group of 10") as a framework for measuring bank

capital adequacy. U.S. bank regulators soon adopted regulations consistent with the Basle standards. Although thrift regulations have included various forms of risk-based capital standards for a number of years, FIRREA mandated stricter enforcement as well as a revision of the standards to ensure that they were no less stringent than the standards applicable to national banks.

The requirements are considered "interim final" standards because they do not contain an interest-rate risk component that is currently under development. As such, they are almost entirely credit-based and are very similar to bank standards. The new requirements contain three components:

- **Tangible Capital Standard:** Tangible capital must be at least 1.5 percent of adjusted total assets.
- **Leverage Ratio Standard:** Core (Tier 1) capital must be at least three percent of adjusted total assets.
- **Risk-Based Capital Standard:** Core plus supplementary (Tier 2) capital must be at least 6.4 percent (80 percent of eight percent) of risk-weighted assets and supplementary capital can not exceed core capital.

Roughly speaking, the above terms are defined as follows: "tangible

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capital" is common equity less goodwill; "adjusted total assets" are total assets (net of specific reserves) less goodwill; "core capital" is tangible capital plus qualifying goodwill up to 1.5 percent of tangible assets; "supplementary capital" is preferred stock, subordinated debt and general loan- and lease-loss reserves; "risk-weighted assets" are the risk-weighted sum of on-balance-sheet assets and off-balance-sheet commitments.<sup>1</sup>

The above standards will be tightened considerably over the next several years. For example, the risk-based 6.4 percent standard will be increased to eight percent by the end of 1992 and the ability to include qualifying intangibles in core capital will be eliminated by the end of 1994.<sup>2</sup>

### Impact of the New Requirements

The impact of the new capital requirements is estimated from December 31, 1989 Thrift Financial Reports (TFRs), based on December 7, 1989 standards, for all SAIF-insured thrifts. Since the TFRs are not designed to measure the new capital requirements, numerous assumptions are needed to translate TFR data into capital-requirement estimates. Estimating tangible capital, tangible assets, core, and supplementary capital is relatively straightforward. The primary problem is estimating risk-weighted assets for risk-based capital purposes. In brief, TFR data are placed into one of five risk-weight classes (0, 20, 50, 100, and 200 percent) and, where necessary, assumptions are made regarding the distribution of line items among the risk-weight classes (see Box 2 in the Appendix for a more detailed discussion of the assumptions).

The impact of the December 7, 1989 requirements is shown in Table 1. Four points are of particular interest. First, a large number of thrifts fail to meet the new standards. In addition to the 290

**Table 1**  
**Financial Data for SAIF-Insured Thrifts Failing December 7, 1989**  
**Capital Requirements**  
(Data as of December 1989; \$ Billions; % of Total Assets)

	In Conservatorship		Not In Conservatorship But Fail Any Capital Requirement		All Thrifts Not In Conservatorship	
	(1)	(2)	(3)	(4)	(5)	(6)
Delinquent Loans	\$ 10.3	7.9%	\$ 21.2	4.2%	\$ 30.1	2.7%
Real Estate Repossessed or Held for Development	12.4	9.5	21.2	4.2	27.1	2.4
Construction and Land Loans	8.2	6.3	29.7	6.0	55.1	4.9
1-4 Family Mortgages	39.7	30.5	165.2	33.2	468.8	41.8
Multi-Family & Commercial Mortgages	15.6	12.0	70.3	14.1	147.3	13.1
Total Assets	130.3	100.0	497.4	100.0	1121.4	100.0
Net Income	(8.8)	(6.8)	(9.7)	(2.0)	(7.2)	(0.6)
Number of Institutions	290		845		2,588	
Number in Eastern Region	80		396		1,472	
Number in Central Region	74		210		669	
Number in Southwest Region	87		100		148	
Number in Western Region	49		139		299	

Note: The conservatorship list is as of March 20, 1990. Columns 1 and 2 show conservatorship data by dollar amount and as a percentage of total assets, respectively. Columns 3 and 4 show non-conservatorship SAIF-insured thrifts that fail any of the December 7, 1989 capital standards. Columns 5 and 6 show all thrifts not in conservatorship, i.e., the remaining thrift industry insured by SAIF. The regions shown in lines 9 through 12 are RTC regions that are defined as follows: "Western Region" contains California, Arizona, New Mexico, Colorado, Utah, Nevada, Oregon, Idaho, Wyoming, Montana, Washington, Alaska, Hawaii, and Guam; "Southwest Region" contains Texas and Oklahoma; "Central Region" contains Wisconsin, Minnesota, North Dakota, South Dakota, Nebraska, Kansas, Arkansas, Missouri, Iowa, Illinois, Indiana, and Michigan; "Eastern Region" contains all remaining states, the District of Columbia, Virgin Islands and Puerto Rico.

thrifts in conservatorship as of March 20, 1989, 845 thrifts, holding \$497 billion in assets, are estimated to fail the new standards. These 845 thrifts represent 33 percent in number, and 44 percent of the assets, of the 2,588 non-conservatorship thrifts. Total assets of all thrifts failing to meet the new standards plus conservatorships are estimated to be \$628 billion, or 50 percent of all thrift assets. The average thrift failing the new capital standards has \$589 million in assets, which is considerably larger than either the average conservatorship (\$449 million) or non-conservatorship (\$433 million) thrift.

Second, high-risk and problem assets held by RTC conservatorships as of March 20, 1990, represent a small fraction of comparable assets held by all thrifts estimated to fail the new capital standards. For example, non-conservatorship thrifts failing the standards hold \$42.3 billion of the

highest-risk assets (delinquent loans and real estate repossessed or held for development), which is almost twice the \$22.7 billion held by conservatorships. They also hold about four times more construction, multi-family and commercial mortgages.

The regional distribution of thrifts failing the new capital standards differs from the distribution of conservatorship thrifts. While the RTC's conservatorships are concentrated in the Southwest region, about 88 percent of the thrifts estimated to fail the capital standards are concentrated in the Eastern, Central and Western regions.<sup>3</sup> Table 2 provides more detail on the

<sup>1</sup> More precise capital definitions are given in Box 1 in the Appendix. A discussion of the risk-weights is in Box 2 in the Appendix.

<sup>2</sup> Other transition rules affect the amount of maturing capital instruments includable in supplementary capital, permissible equity investments, investments in subsidiaries, and general valuation loan and lease allowances.

<sup>3</sup> See Table 1 for a listing of the states included in each RTC region.

**Table 2**  
**State Rankings of Thrifts Either in Conservatorship or Failing Any December 7, 1989 Capital Requirement**

Rank	Conservatorship	Not in Conservatorship But Fail Any December 7 Capital Requirement
1	Texas	California
2	Illinois	Illinois
3	California	Texas
4	Louisiana	Florida
5	Kansas	Ohio
6	Florida	New Jersey
7	Arkansas	New York
8	Mississippi	Pennsylvania
9	Missouri	Virginia
10	Colorado	Oklahoma

Note: Rankings are based on the number of institutions in each state. If two states have the same number of institutions, the state with the most total assets is given the higher rank.

regional distributions. Texas contains the most conservatorships and all but three of the top ten conservatorship states are from the Southwest or Farm Belt. In contrast, the list of ten states with the most non-conservatorship thrifts estimated to fail the new standards is headed by California and includes only two states from the Southwest or Farm Belt.

Finally, the striking number and size of thrifts estimated to fail the new capital standards are primarily due to risk-based capital standards, not the tangible capital or leverage ratio standards. As shown in Figure 1, the risk-based standards are by far the most restrictive of the three new capital standards. The risk-based standards cause 48 percent more thrift assets to fail capital requirements than the next most stringent standard, the leverage ratio. Moreover, 98 percent of the assets of thrifts failing any capital requirement are in thrifts that fail to meet the risk-based capital standards.

Although the above statistics are unsettling, they nevertheless may understate significantly the ultimate (fully phased-in) impact of the new capital requirements. As an exam-

ple, consider the impact of phasing-in only two of the scheduled requirements: raising the 6.4 percent threshold to eight percent (required by the end of 1992) and eliminating the ability to use qualifying intangibles in core capital (required by the end of 1994). Assuming that

the December 1989, thrift balance sheets remain unchanged for five years, the number of thrifts estimated to fail capital requirements rises 41 percent, from 845 to 1,190, and the amount of thrift assets affected increases 57 percent, from \$497 billion to \$782 billion. The \$782 billion of assets affected represent 70 percent of all non-conservatorship thrift assets. Other restrictions scheduled to be phased-in can only increase the number of thrifts failing to meet the new standards.

It must be noted that institutions not currently meeting their capital requirements are not doomed to fail. Although some will fail, others will survive. Solvent thrifts not meeting the capital standards will doubtless come under considerable supervisory pressure to increase capital. However, a number of strategies may enable thrifts to improve capital. Options available include shrinking balance sheets, securitizing assets, merging with healthier institutions, attracting outside capital, and, in some cases,

**Figure 1**  
**Non-Conservatorship Thrifts that Fail December 7, 1989 Capital Standards**  
*(Data as of December 1989; \$ Billions)*

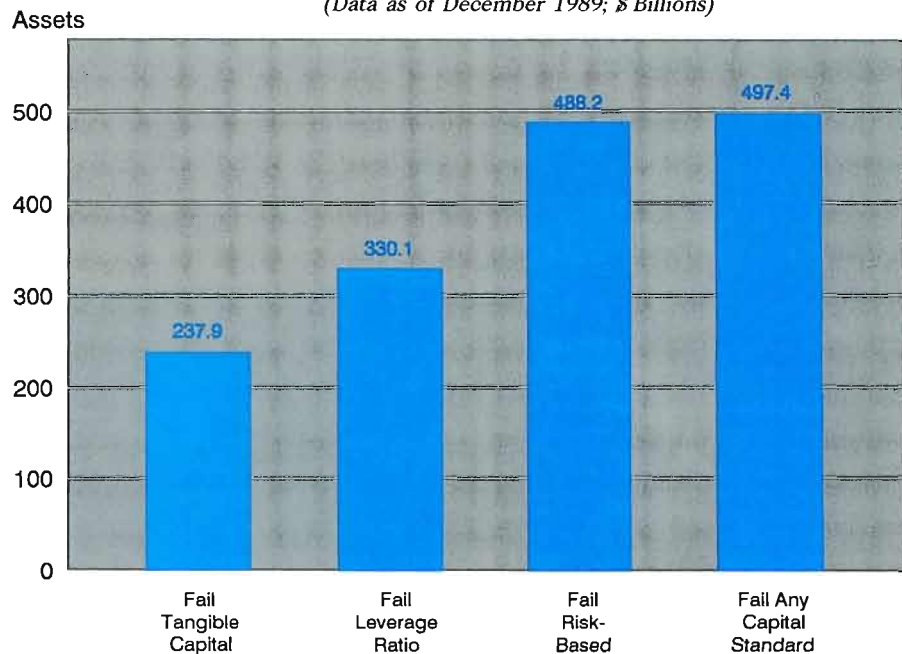
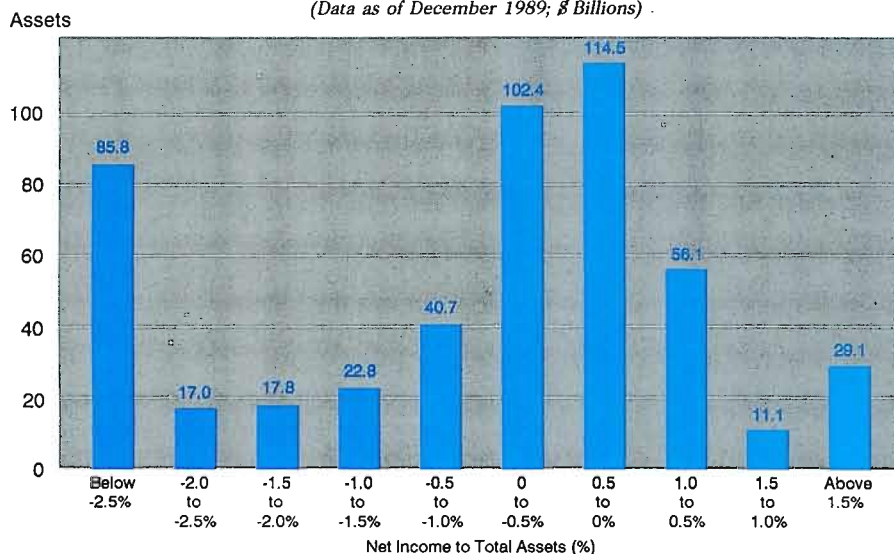


Figure 2  
Distribution of Annualized Net Income to Assets for Thrifts Failing  
December 7, 1989 Capital Requirements  
(Data as of December 1989; \$ Billions)



Note: Net income is total income less total expenses.

retaining earnings. This last possibility is discussed below.

### Can Earnings Solve the Problem?

Information on the earnings of thrifts estimated to fail the new capital standards are presented in Figures 2 and 3. These data show two measures of annualized return on assets for fourth quarter, 1989, earnings.<sup>4</sup> Although past earnings may not necessarily provide accurate predictions of future earnings, the most recent data available are especially useful for this analysis because the new capital requirements took effect on December 7, 1989, thus causing regulators to be-

gin assessing viability in the first quarter, 1990. Moreover, it is unlikely that the earnings trends of large numbers of institutions would change enough in the near term to alter the conclusions of this paper.

Figure 2 shows the distribution of net income to assets. While net income reflects the "bottom line" earnings available to be retained as capital, it can be heavily influenced by losses on, and reserves for, bad assets. In spite of this limitation, it is important to recognize that Figure 2 shows that over one-half (58 percent) of the assets of all thrifts failing the new standards were in thrifts that had negative net income. Twenty-nine percent lost at least 100 basis points on assets.

While about 23 percent of the assets were in thrifts that had modest positive earnings in the 0 to 50 basis points range, only eight percent were in thrifts that earned at least 100 basis points.

Figure 3 shows the distribution of an optimistic measure of earnings, net operating income.<sup>5</sup> Net operating income often overstates earnings because it omits losses on, and reserves for, bad assets as well as taxes. In spite of the more optimistic measure of earnings, the distribution of net operating income in Figure 3 tells largely the same story told by net income in Figure 2. Most important, over one-half (55 percent) of the assets of all thrifts failing the new standards have negative net operating income while only nine percent earned at least 100 basis points. Thus, the measure of earnings does not alter the conclusion that a large portion of thrifts estimated to fail the new capital standards have significant earnings problems.

The ability of thrifts to meet capital requirements through retained earnings can be estimated if we make a number of assumptions. In particular, the short-term impact of earnings can be estimated by assuming that the fourth quarter, 1989, balance sheets and net incomes continue for the next year and that all earnings are retained.

Given these assumptions, the results in Table 3 show that most thrifts will not be able to solve their capital problems with earnings in the

<sup>4</sup> The distribution of fourth-quarter earnings of thrifts failing to meet their capital requirements is very similar to the distribution of third-quarter earnings described in an earlier draft of this paper.

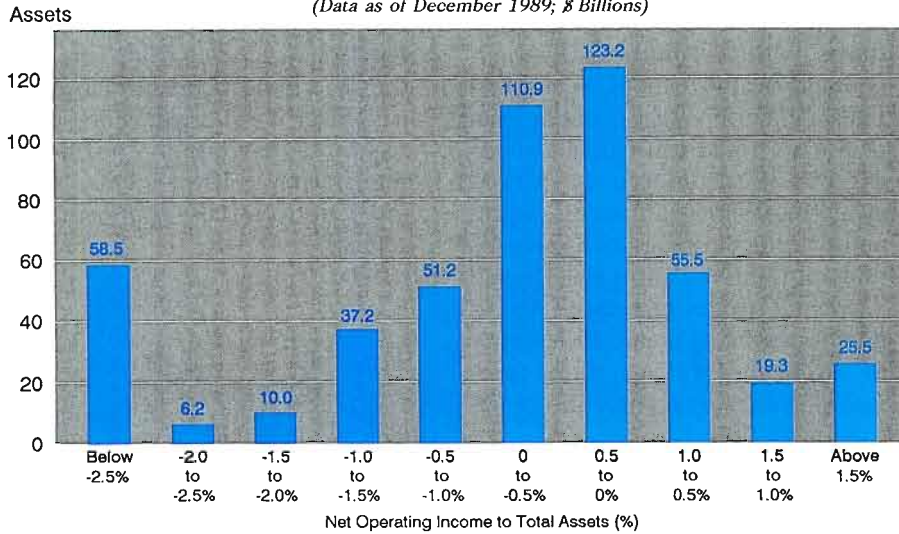
<sup>5</sup> Net operating income is operating income plus interest income, less operating expense and less interest expense. Operating income primarily includes servicing fees, loan origination fees, income from service corporations and income from real estate held for investment. Profits from the sale of foreclosed real estate, investment securities and many other assets are considered nonoperating income. Operating expense includes employee compensation, administrative expense and amortization of goodwill. Nonoperating expenses are net provisions (reserves) for losses on assets, losses on the sale of assets and taxes.

Table 3

	Number of Institutions	Total Assets (\$ Billions)
Currently Fail Any Capital Standard	845	\$497.4
Pass Standards if Retain One-Year Income	-88	-36.1
	757	461.3
Fail Standards if Losses Continue	+69	+16.8
Fail Any Capital Standard if Income Continues	826	\$478.1

## Risk-Based Capital Requirements

Figure 3  
Distribution of Annualized Net Operating Income  
to Assets for Thrifts Failing December 7, 1989 Capital Requirements  
(Data as of December 1989; \$ Billions)



Note: Net operating income is operating income plus interest income less operating expense and less interest expense.

near term. Specifically, retaining earnings for one year would enable only 88 thrifts failing the new standards to meet their requirements, while losses at thrifts currently passing their capital requirements would cause an additional 69 to fail the standards. Thus, it is unlikely that retaining earnings can change the basic impact of the new capital standards on the thrift industry over the short term.

A different set of assumptions is needed to project the long-term impact of earnings. It is assumed that assets remain constant, that net income for the next five years is equal to the fourth quarter, 1989, net operating income, and that all net income is retained for five years. Given this scenario, Table 4 shows that without substantial improvements in profitability and/or restructuring of balance sheets, long-term prospects for earnings to supply needed capital are not much better than short-term prospects. As noted earlier, 1,190 thrifts would fail the fully phased-in requirements if they were currently in effect. Table 4 shows that 386 of the 1,190 thrifts could meet future capital standards by retaining earn-

ings. The remaining 804 thrifts would not meet the fully phased-in requirements, and most of these (599) would be over two percentage points below the required capital ratio of eight percent. Therefore, approximately one-third of the thrifts projected to fail the fully

phased-in requirements may be able to retain sufficient earnings to meet future capital requirements, while two-thirds currently seem unlikely to do so.

### Implications

The existence of large numbers of undercapitalized thrifts over the next several years could have interesting implications for the thrift industry, its regulatory system, and the RTC. First, given that risk-based standards are the driving force behind capital deficiency, large numbers of thrifts may attempt to raise their regulatory capital ratios by either selling high-risk assets or reducing risk exposure through securitization. Since thrifts failing the new capital standards have a much larger volume of these assets than all RTC conservatorships combined, competition between the RTC and thrifts attempting to sell or securitize assets could make the RTC's job of selling assets more difficult.

Competition between the RTC and thrifts could extend to the market for whole institutions as

Table 4  
Impact of Retaining Five Years of Earnings for Thrifts Projected  
to Fail Fully Phased-in Capital Requirements  
(\$ Billions)

Projected Capital/Tangible Assets Ratio Shortfall	Number of Thrifts	Value of Assets
Over Two Percent Below Required Capital	599	\$378.5
Zero to Two Percent Below Required Capital	205	139.4
Meet Required Capital	386	264.3
<b>Total Failing Fully Phased-in Requirements if Currently in Effect</b>	<b>1,190</b>	<b>\$782.2</b>

Note: Fully phased-in required capital is assumed to equal eight percent of risk-weighted assets and permits no qualifying intangible assets in capital. Other fully phased-in requirements, such as those concerning permissible equity investments and maturing capital instruments, are not considered. The total (1,190 thrifts and \$782.2 billion in assets) reflects thrifts that fail fully phased-in requirements if they were currently in effect. The first three lines show the potential impact of retaining earnings on thrifts that would otherwise fail the fully phased-in requirements. Specifically, annualized fourth quarter, 1989, net operating income is used as a proxy for long-term annual earnings, then five years of annualized net operating income are added to the fourth quarter, 1989, balance sheet as retained earnings. The additional retained earnings enable 386 thrifts to meet the fully phased-in requirements.



well. Although the restructuring of assets may help some thrifts, others may nevertheless be seeking buyers and/or merger partners. Thus, potential purchasers of thrifts may have many options other than institutions in conservatorship, again making the RTC's job more difficult.

The RTC's activities may be affected in other ways. As discussed earlier, to the extent some thrifts not meeting capital requirements become insolvent, the resolution of insolvent thrifts could shift from the Southwest to other parts of the country. In situations where a thrift not meeting capital requirements appears headed for insolvency, there is likely to be debate over whether it should be put into RTC conservatorship or handled early in some way such as open-thrift assistance ("early intervention").

Certain provisions of FIRREA are designed to encourage thrifts to re-

turn to their traditional lending activities.<sup>6</sup> FIRREA's impact on lending activity could be reinforced by the new risk-based capital standards, which could tend to encourage thrifts to hold single- and multi-family mortgages, rather than commercial and construction mortgages, due to differences in risk-weightings.<sup>7</sup> In addition, the availability of securitization for single- and multi-family mortgages could encourage thrifts attempting to reduce assets to originate these types of mortgages rather than commercial and construction mortgages.

Finally, the existence of large numbers of thrifts that fail capital requirements, but are formally solvent, will put great pressure on the thrift industry supervisory system. If not restrained by supervision, there is a danger that some institutions might attempt to earn their way out of their problems by en-

gaging in aggressive lending, interest-rate speculation and direct investments. In some instances there may be great temptation for insiders to extract whatever value they can from the institution before it is taken by the regulators. Thus, regulators may find that thrifts failing the new capital standards require substantial supervisory resources.

<sup>6</sup>The following is a partial listing of many changes mandated by FIRREA: raised the percentage of portfolio assets held as qualified thrift investments (the "QTL" test) from 60 to 70 percent; limited nonresidential real-estate loans of federal associations to four times capital; prohibited many loan and investment activities of state associations if they are not permitted for federal associations; prohibited troubled thrifts from accepting brokered deposits; limited loans and investments with affiliates; disqualified low-rated (junk) bonds as permissible investments.

<sup>7</sup>Single- and some multi-family mortgages receive a 50 percent risk-weight whereas other mortgages are in the 100 percent bucket.

## APPENDIX

### Box 1 Capital-Requirement Definitions

The formal capital-requirement definitions are very complex and too lengthy to fully list here. The following are the primary components of the capital definitions.

**Tangible Capital:** Add common stockholders' equity (including retained earnings), noncumulative perpetual preferred stock and related earnings, minority interests in the equity accounts of fully consolidated subsidiaries, and non-withdrawable accounts and pledged deposits of mutual savings associations that have no fixed maturity, do not earn interest that can be carried to future periods, and can not be withdrawn at the option of the accountholder. Deduct goodwill and other intangible assets except purchased mortgage servicing valued at the lower of 90 percent of fair market value or original cost, and investments (both equity and debt) in "includable" subsidiaries, i.e., subsidiaries engaged in activities not permissible for a national bank.<sup>8</sup>

**Adjusted Total Assets:** Adjusted total assets are total assets reported under generally accepted accounting principles (GAAP), plus the prorated assets of includable subsidiaries for which a minority interest is held that is unconsolidated under GAAP, the prorated assets of non-includable subsidiaries acquired prior to April 12, 1989, qualifying goodwill resulting from prior regulatory accounting practices, and for risk-based standards, general valuation loan- and lease-loss allowances up to 1.5 percent of risk-weighted assets (reduced to 1.25 percent starting December 31, 1992); minus assets not included in the applicable capital standard, minority interests in includable subsidiaries, investments in subsidiaries that are subject to consolidation, and, for purposes of

determining core capital standards, supervisory goodwill.

**Core (Tier 1) Capital:** Add common stockholders' equity (including retained earnings), noncumulative perpetual preferred stock and related surplus, minority interests in the equity accounts of fully consolidated subsidiaries, non-withdrawable accounts and pledged deposits of mutual savings associations that have no fixed maturity, do not earn interest that can be carried to future periods, and can not be withdrawn at the option of the accountholder, and the remaining goodwill resulting from prior regulatory accounting practices (FSLIC capital contributions). Deduct and/or phase-out a number of investments (both equity and debt) in subsidiaries, and intangible assets over 25 percent of core capital except qualifying supervisory goodwill up to 1.5 percent of adjusted total assets (phased-out to zero through December 31, 1994), and purchased mortgage servicing valued at the lower of 90 percent of fair market value or original cost.

**Supplementary (Tier 2) Capital:** Up to 100 percent of an institution's core capital, add cumulative perpetual preferred stock, mutual capital certificates, nonwithdrawable accounts and pledged deposits not included in core capital, general loan- and lease-loss allowances up to a maximum of 1.5 percent of risk-weighted assets (reduced to 1.25 percent after December 31, 1992), and most net worth certificates, income capital certificates, perpetual subordinated debt, mandatory convertible subordinated debt, and a number of maturing capital instruments such as intermediate-term preferred stock.<sup>9</sup>

**Risk-Weighted Assets:** The weighted sum of all assets plus consolidated off-balance-sheet items where each asset or item is multiplied by the appropriate risk-weight. Off-balance-sheet items must be converted to on-balance-sheet credit equivalent amounts be-

fore a risk-weight is assigned. Assets deleted from capital for capital-requirement purposes are also not included in risk-weighted assets.

### Box 2 Estimating Risk-Based Capital Requirements from Thrift Financial Reports

Estimating required capital is often very difficult for analysts because they are limited to examining standard Thrift Financial Reports (TFRs) that have not been designed to meet the needs of risk-based capital analysis. In particular, portions of many line items fall into two or more risk classes, making it necessary to make assumptions regarding the line-item components.<sup>10</sup>

Table A provides a summary of the risk-weights applied to TFR line items used to estimate risk-based capital in this paper.<sup>11</sup> Many of the risk-weights can be calculated directly from TFRs without any need for assumptions. This is true of one-to-four family mortgages ("1-4s") except FHA/VA insured loans, because 1-4s and FHA/VA loans appear as separate TFR line items.

In three cases, line items that contain more than one risk class of assets are broken apart based on reasonable assumptions regarding the distribution of assets in the line item.

- Mortgage pool securities guaranteed by Ginnie Mae are classified

<sup>8</sup> The subsidiary investment restrictions include a number of exceptions and special cases such as permissibility of certain mortgage banker subsidiaries and the phase-in of capital requirements for subsidiaries engaged before April 12, 1989 in activities that are not permissible for a national bank.

<sup>9</sup> Separate restrictions apply to the amortization of maturing capital instruments issued before versus after November 7, 1989.

<sup>10</sup> Assumptions will no longer be needed as thrifts begin reporting required capital on a separate section of the TFR, schedule CCR (Consolidated Capital Requirement), in March 1990.

<sup>11</sup> As a technical point, off-balance-sheet items must be converted to on-balance-sheet credit equivalent amounts before being assigned a risk-weight. The risk-weights shown in Table A include the impact of credit conversion for off-balance-sheet items.

with Freddie Mac and Fannie Mae securities. Given that Ginnie Maes are about one-third of the mortgage security market, a conservative 25 percent of all mortgage pool securities are assumed to be Ginnie Maes (zero percent weight).

- Since the majority of collateralized mortgage obligations (CMOs) do not have residual characteristics, one-half of all CMOs are assumed to have residual characteristics (100 percent weight) and one-half not to have them (20 percent weight).
- Stock in Federal Home Loan Banks is assumed to be 0.3 percent of assets due to statutory ownership restrictions.

While some line items can be broken apart, assumptions must be made regarding others. The following is a list of the more important assumptions made to complete the analysis.

- No assets are guaranteed by the FSLIC Resolution Fund, formerly the FSLIC, (guaranteed assets require a zero percent weight, whereas either a 100 or 200 percent weight would typically otherwise apply).
- No multi-family mortgages qualify for the 50 percent weight (non-qualifying multi-family mortgages receive a 100 percent weight instead of the 50 percent weight applied to qualifying multi-family).
- All preferred stock is cumulative (cumulative preferred stock does not qualify as core capital, whereas non-cumulative preferred stock is permitted in core capital).
- No 1-4s are held with loan-to-value ratios in excess of 80 percent (1-4s above 80 percent require a 100 percent risk-weight instead of the 50 percent weight applied to 1-4s below 80 percent).

- Subsidiaries do not hold substantial amounts of risk assets (while the net equity in service corporation subsidiaries is counted at 100 percent, subsidiaries that contain significant amounts of risk assets could easily require much higher capital if consolidated).

- All goodwill is supervisory goodwill (supervisory goodwill is permitted in core capital up to 1.5 percent of tangible assets).

The first three of the above six assumptions tend to overestimate required capital; the last three to underestimate it. On balance, it is not clear whether the overall net effect is to overstate or understate required capital. More accurate estimates of risk-based capital will be possible as more extensive 1990 TFRs become available showing thrifts on a consolidated basis.

Table A  
Summary of Risk-Weights and Assumptions for Estimating  
December 7, 1989 Capital Requirements

Risk-Weight	On-Balance-Sheet	Off-Balance-Sheet
0%	<ul style="list-style-type: none"> <li>● Cash and noninterest-earning assets.</li> <li>● U.S. government and agency securities.</li> <li>● Losses unrecognized pursuant to 561.12 (a)(3) and deferrals pursuant to 563c.14.</li> <li>● Ginnie Mae securities (assumed 25% of federally insured mortgage pool securities).</li> <li>● FHA/VA insured loans.</li> </ul>	<ul style="list-style-type: none"> <li>● All commitments to originate or sell loans.</li> <li>● Underlying principal of interest-rate swaps.</li> <li>● All options and futures positions outstanding.</li> <li>● Mortgage loans held for sale or serviced for others.</li> <li>● Letters of credit collateralized by deposits.</li> </ul>
20%	<ul style="list-style-type: none"> <li>● Non-Ginnie Mae securities (assumed 75% of federally insured mortgage pool securities) and non-residual CMOs (assumed 50% of CMOs).</li> <li>● Consumer closed-end loans on deposits.</li> <li>● FHLB stock (assumed 0.3% of total assets).</li> </ul>	
50%	<ul style="list-style-type: none"> <li>● 1-4 family mortgages except FHA/VA insured loans and delinquent 1-4s (assumed all 1-4s qualify for this risk class).</li> </ul>	<ul style="list-style-type: none"> <li>● Letters of credit collateralized by cash.</li> <li>● Principal amount of loans sold with recourse (assumed all recourse commitments are for 1-4s).</li> </ul>
100%	<ul style="list-style-type: none"> <li>● Construction, land, and commercial mortgages net of reserves, other contra assets except loans in process, and delinquencies.</li> <li>● Multi-family mortgages (assumed none qualify for 50% risk-weight).</li> <li>● Loans in process.</li> <li>● Non-mortgage loans, except consumer loans on deposits, net of reserves, other contra assets except loans in process, and delinquencies.</li> <li>● Real estate held for development, net of reserves (assumed none are guaranteed by FSLIC Resolution Fund).</li> <li>● Equity securities, except FHLB stock, and net equity in service corporations.</li> <li>● IOs, POs, and residual CMOs (assumed 50% of CMOs).</li> <li>● FSLIC capital contributions up to 1.5% of tangible assets.</li> <li>● Other assets, including goodwill (assumed all supervisory), loan servicing, and fixed assets, net of valuation allowances. FHLB stock (assumed 0.3% of total assets) deleted from "other" assets.</li> </ul>	<ul style="list-style-type: none"> <li>● Delinquent 1-4 family mortgages (assumed none are guaranteed by FSLIC Resolution Fund).</li> </ul>
200%	<ul style="list-style-type: none"> <li>● Repossessed real estate (assumed none are guaranteed by FSLIC Resolution Fund), net of reserves.</li> </ul>	<ul style="list-style-type: none"> <li>● All delinquent loans except 1-4 delinquents (assumed none are guaranteed by FSLIC Resolution Fund).</li> </ul>

# Recent Developments Affecting Depository Institutions

by Benjamin B. Christopher\*

## *Federal Legislation*

### *Financial Institutions Reform, Recovery, And Enforcement Act Of 1989*

President Bush on August 9, 1989 signed the Financial Institutions Reform, Recovery, and Enforcement Act of 1989 (FIRREA). The Act abolishes the Federal Home Loan Bank Board (FHLBB) and merges the Federal Savings and Loan Insurance Corporation (FSLIC) into the FDIC. It establishes a Bank Insurance Fund (BIF) and a Savings Association Insurance Fund (SAIF), both to be administered by the FDIC. The Act creates in the Treasury Department, The Office of Thrift Supervision (OTS), which succeeds the FHLBB as the primary federal regulator of thrift institutions. The Federal Housing Finance Board (FHFB) will oversee the Federal Home Loan Bank System.

The Act creates the Resolution Trust Corporation (RTC) which will manage the assets and liabilities of insolvent savings and loan associations that are closed between January 1, 1989 and August 9, 1992, and will terminate on December 31, 1996. The FDIC will direct the day-to-day activities of the RTC. The Oversight Board (OB) will be responsible for setting broad policies for RTC. The OB consists of the Secretary of the Treasury (Chair-

man), the Chairman of the Federal Reserve Board, the Secretary of the Department of Housing and Urban Development, and two independent members (of different political parties) to be appointed by the President.

The Resolution Funding Corporation (REFCORP) is established to provide funds for the RTC through the issuance of debt obligations, and is subject to the authority of the OB.

Among the many provisions of FIRREA are those providing capital standards for insured thrift institutions, phased-in increases in assessments for banks and thrifts, and stronger enforcement powers for bank and thrift regulators.

The Act requires that reports on several matters related to deposit insurance be provided to the Congress. Among these are reports by the FDIC on pass-through of deposit insurance, availability of directors' and officers' liability insurance, and risk-based assessments, and a report by the Treasury Department on reforms needed in the deposit insurance system.

## *Regulatory Agency Actions*

### *Federal Deposit Insurance Corporation*

#### *Capital Requirements*

The FDIC adopted capital requirements for newly formed state-

chartered nonmember banks and thrifts created as a result of RTC transactions. The FDIC will require a 4½ percent tangible capital-to-assets ratio for new applications for deposit insurance by such institutions. Capital in these cases would be defined by risk-based guidelines. It would include at least three percent Tier 1 capital and no more than 1½ percent from Tier 2. Loan-loss reserves would be excluded.

The FDIC Board emphasized that the policy is designed to expedite the thrift resolution process and does not affect long-term capital standards. Directors Robert L. Clarke and M. Danny Wall stressed that their votes approving the policy were intended to permit the RTC to go forward with case resolutions but did not indicate endorsement of the specific ratio set forth in the policy for institutions under their supervision. *Joint News Release, FDIC, RTC PR-188-89 (FDIC), 9/27.*

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Reference sources: *American Banker* (AB); *Wall Street Journal* (WSJ); *BNA's Banking Report* (BBR); *Federal Register* (FR); Commerce Clearing House, Inc., *Electronic Legislative Search System* (ELSS). All ELSS items have been enacted into law when included in this report.

### ***Cooperative Agreement With Office Of Thrift Supervision***

The FDIC and the OTS have formed an agreement to coordinate and cooperate on regulatory matters. FDIC Chairman L. William Seidman said the agreement, aimed at avoiding duplicate efforts by the two regulators, "recognizes the OTS is the primary federal supervisor of both federal and state thrifts. At the same time, it provides the FDIC with the flexibility necessary to address our mandated backup supervisory role."

Under the agreement, the two agencies will exchange databases, provide copies of reports of examination and relevant documents to the other agency, and notify each other of the receipt of applications in which both agencies have an interest. The agencies will cooperate in administrative hearings procedures by providing documents and personnel as necessary; also, they will exchange information about enforcement actions, and proposed changes in control and examination schedules involving thrift institutions. *PR-199-89 (FDIC), 10/13.*

### ***Brokered Deposits***

The FDIC issued an interim rule and request for comments under a section of FIRREA which prohibits the acceptance or renewal of brokered deposits by any undercapitalized insured depository institution (bank or thrift) after December 7, 1989 except on specific application to and waiver of the prohibition by the FDIC. The interim rule provides guidance and further detail on when an institution is considered undercapitalized, when certain deposits are considered "brokered" for purposes of the prohibition, and the circumstances under which a waiver from the prohibition may be granted. The rule specifically permits an undercapitalized insured depository institution to accept, renew or rollover brokered deposits

during a 60-day period from December 8, 1989 to February 5, 1990, if certain requirements are met.

The interim rule, effective upon publication in the *Federal Register*, will "sunset" in six months unless modified or replaced by a final rule prior to that time. *FR, 12/12/89, p. 51012.*

### ***Definition Of Highly Leveraged Transactions***

The FDIC, Federal Reserve Board (FRB), and Office of the Comptroller of the Currency (OCC) jointly adopted a common definition of highly leveraged transactions (HLTs) to be used by examiners in supervising HLT activities at all insured banks.

For supervisory purposes, a bank or bank holding company is considered to be involved in an HLT when credit is extended or investment is made in a business where the financing transaction involves the buyout, acquisition, or recapitalization of an existing business. In addition to this purpose test, to be considered an HLT the transaction must at least double the subject company's liabilities and result in a leverage ratio (total assets divided by total liabilities) higher than 50 percent, *or* must result in a leverage ratio higher than 75 percent, *or* must be designated an HLT by a syndication agent.

Where a credit meets the purpose test but is not covered by any of the above criteria, the bank supervisory agencies may nevertheless designate the credit as an HLT. It is anticipated that this would be done infrequently and only in material cases. *FIL-18-89 (FDIC), 11/20; FIL-14-90, 2/9.*

### ***Notice Of Rapid Growth***

The FDIC adopted a final rule which requires insured banks to give the agency 30 days' advance notice when planning to increase their assets 7.5 percent or more

over any three-month period through the solicitation, in any combination, of fully insured brokered deposits, fully insured out-of-territory deposits, or secured borrowings, including repurchase agreements. The final rule eliminates after-the-fact reporting of rapid growth, as originally proposed. *PR-61-90, 4/4.*

### ***Changes In Officials Of Nonmember Banks***

The FDIC issued an interim rule and request for comments under FIRREA which requires certain insured nonmember banks to notify the FDIC before adding or replacing a member of the board of directors or employing or changing the responsibilities of an individual to a position as a senior executive officer. The FDIC may disapprove any proposed board member or senior executive officer whose service is not considered to be in the best interest of the depositors of the insured nonmember bank or the public.

An insured nonmember bank which is covered by the requirement must notify the FDIC within 30 days before adding a director or employing any individual as a senior executive officer. A bank is covered if it (1) has been chartered less than two years; (2) has undergone a change in control within the preceding two years; or (3) is not in compliance with the minimum capital requirements applicable to it or is otherwise in a "troubled condition," as determined on the basis of the bank's most recent Report of Condition or Report of Examination or inspection. Effective December 27, 1989. *FR, 12/27/89, p. 53040.*

### ***Applications For Mergers***

The FDIC adopted a policy statement that redefines and clarifies product and geographic markets and the standards to be applied in assessing both the competitive effects and prudential concerns involved in proposed bank merger

transactions. The final statement is fundamentally the same as the proposal issued in October 1988 for revising the Corporation's policy on the approval of mergers.

The Federal Deposit Insurance Act requires the prior written approval of the FDIC before any insured bank may merge, consolidate with or purchase the assets and assume the deposit liabilities of a non-insured bank, or in any merger or consolidation of two or more insured banks if the acquiring, assuming or resulting institution is to be an insured nonmember bank. The new policy statement was effective September 22, 1989. *FR*, 9/22/89, p. 39043.

### ***Loan-Review Systems***

In a letter to FDIC-supervised banks, the FDIC strongly endorsed institutions' internal loan-review and grading systems that are designed to highlight for management and the board of directors those loans which warrant special attention for reasons bearing on ultimate collectibility. The FDIC believes that every bank it supervises should have a loan-review system which, at a minimum, provides for: an identification or grouping of loans that warrant the special attention of management; for each loan identified, an indication of the reason(s) why the particular loan merits special attention; and a mechanism for reporting periodically to the board on the status of each loan identified and action(s) taken by management.

Examiners will encourage banks to establish and maintain systems that meet the minimum standards. *BL-27-89*, 6/29.

### ***Guidance On External Auditing Procedures***

The FDIC adopted a new policy statement recommending minimum procedures for annual external auditing programs of FDIC-supervised banks. The new guidance is in addi-

tion to an FDIC policy statement that became effective December 28, 1988, which strongly urges banks to have an audit by an "independent public accountant" but also identifies acceptable alternatives. Guidance is provided on specific auditing procedures, especially for banks that forgo an annual audit of their financial statements by an independent public accountant, in areas common to all banks that may prove to be high-risk. These areas include loans, the allowance for loan losses, securities investments, transactions involving bank officers, directors and other "insiders," and internal controls.

The new policy statement will become effective when it is published in the *Federal Register*. *PR-8-90*; 1/19.

### ***Independent Audit Requirement For Publicly Held Banks***

The FDIC amended its securities disclosure regulations issued under the Securities Exchange Act of 1934 to bring them into substantial similarity with those of the Securities and Exchange Commission (SEC). One of the amendments eliminates the use of verification statements and will require that financial statements of publicly held banks be audited by independent public accountants. Since 1964 most banks have generally had the option of using verification statements which express the opinion of a bank's principal accounting officer or internal auditor. Currently, only eight banks reporting under this regulation do not file certified financial statements. The amendment is effective for periods ending after December 15, 1990. *FR*, 12/29/89, p. 53571.

### ***Appraisal Standards***

The FDIC is seeking public comment on a proposal on uniform appraisal standards. A similar propo-

posal was approved by the RTC. The federal financial institution regulators and the RTC are required to develop uniform appraisal standards by FIRREA.

The proposed regulation, drafted by an interagency committee, identifies which transactions require an appraiser, sets forth minimum standards for performing appraisals, and distinguishes appraisals requiring the services of a state-certified appraiser from those requiring a state-licensed appraiser. The agencies specifically seek comments on definitions, the transaction amount below which a state-certified or licensed appraiser would not be required, the criteria that determine when a state-certified appraiser is required and when a state-licensed appraiser is required, and additional appraisal standards contained in the proposed regulation. *PR-21-90*, 2/13; *FR*, 2/22, p. 6285 (RTC).

### ***Savings Institutions' Activities And Investments***

The FDIC adopted an interim rule to implement provisions of FIRREA which (a) seek to establish parallel regulation of state- and federally chartered savings associations, and (b) would prevent state associations from exercising powers not authorized to federal associations or which the FDIC deems too risky. The interim rule also requires that savings associations provide the FDIC and the OTS with a notice of intent to establish or acquire a subsidiary, or to conduct a new activity through a subsidiary. In addition, it requires state-chartered savings associations to obtain FDIC approval before engaging, either directly or through service corporations, in activities not permissible for a federal association or at levels beyond what is permitted a federal association. The rule became effective on December 29, 1989. *FIL-2-90*, 1/10, *FDIC*; *FR*, 12/29/89, p. 53540.

### ***Real-Estate Lending Problems***

FDIC Chairman L. William Seidman expressed concern over real-estate lending problems developing around the country, citing in particular the emerging trends in Arizona, parts of Florida and certain Northeastern areas.

Over a 12-month period to the fall of 1989, real-estate loan growth accounted for nearly two-thirds of all bank asset growth across the nation, and comprised almost one-fourth of all commercial bank assets. Nonperforming real-estate assets constitute almost half of all nonperforming assets in the banking system, Mr. Seidman said. In the Northeast, the percentage of real-estate loans in nonaccrual status has almost doubled over the past year. Also, net charge-offs of real-estate loans, on average, were running 47 percent higher than the same period in 1988, and were expected to accelerate in the fourth quarter.

Industry indicators would be even less favorable were it not for the FDIC's assistance in removing billions of dollars in bad real-estate assets from the commercial banking sector, the Chairman noted. *PR-23-89, 12/5.*

### ***Insured Foreign-Currency Deposits***

The FDIC proposed amendments including a specific provision that would recognize that foreign-currency-denominated deposits are entitled to deposit insurance. Such deposits are foreign currency maintained in an account at a domestic office of a U.S. bank.

The Federal Deposit Insurance Act does not prohibit the maintenance of deposits in foreign currencies, and some banks have been accepting these deposits, and the FDIC has been insuring them, for years.

The FRB announced that, as of January 1, 1990, it would no longer object to banks' holding deposits

denominated in foreign currencies. This reverses the FRB's long-standing policy of discouraging banks from engaging in this activity. *Statement by FDIC official, AB, 2/13/90, p. 6.*

### ***Studies Required By FIRREA***

**"Pass-Through" Of Deposit Insurance:** The FDIC submitted to Congress a report containing its findings and recommendations concerning "pass-through" deposit insurance. The report addresses such deposit insurance provided to individual participants in pension and profit-sharing plans qualified under section 401 of the Internal Revenue Code and to individual investors in unit investment trusts. In addition, the report includes the FDIC's assessment of the potential effects of broadening deposit insurance coverage on the safety of the insurance funds and the operation of capital markets. *Findings and Recommendations Concerning "Pass-Through" Deposit Insurance, FDIC, 2/90.*

**Directors' And Officers' Liability Insurance:** The FDIC requested public comments on a study of directors' and officers' liability insurance and depository institution bonds, and the availability and terms of such insurance for directors and officers of insured depository institutions. *FR, 12/29/89, p. 53719; 1/30/90, p. 3102.*

### ***Federal Reserve Board***

#### ***Capital Adequacy Guidelines***

The FRB proposed transition capital standards for state member banks and bank holding companies through the end of 1990, and set forth its preliminary views on the appropriate leverage standard to be applied to banking organizations in conjunction with the risk-based capital framework after year-end 1990.

Under the proposal, a banking organization may choose until year-

end 1990 to conform to either the existing minimum capital adequacy ratios (5.5 percent primary capital and six percent total capital to total assets) or to the 7.25 percent year-end 1990 risk-based capital standard. In addition, the FRB is proposing to establish and apply during this period a minimum ratio of three percent Tier 1 capital to total assets (leverage ratio). For leverage purposes, Tier 1 would be defined consistent with the year-end 1992 risk-based capital guidelines. At the end of 1992, Tier 1 capital for state member banks will include common equity, minority interests in equity accounts of consolidated subsidiaries, and qualifying non-cumulative perpetual preferred stock, less goodwill. It excludes other intangibles and investments in subsidiaries as determined by the FRB on a case-by-case basis.

The proposed standards are minimum requirements, applicable to sound institutions rated composite 1 under the appropriate bank holding company rating system. Organizations experiencing growth, whether internally or by acquisition, are expected to maintain strong capital positions substantially above minimum supervisory levels, without significant reliance on intangible assets. *Federal Reserve Press Release, 12/29/89.*

#### ***BHC Acquisitions Of Savings Associations***

The FRB, as authorized by FIRREA, amended its Regulation Y to permit bank holding companies to acquire healthy as well as failed or failing savings associations, in any state, regardless of whether the holding company can operate a bank in that state. No operational or branching conditions are imposed on the savings associations except that they must conform their activities to those permissible for bank holding companies. Effective October 10, 1989. *Federal Reserve Press Release, 9/5/89.*



### ***Court Upholds Approval Of Powers For State Banks In Holding Companies***

Under a decision by a U.S. Court of Appeals, two Indiana state banks acquired by Merchants National Corp., Indianapolis, may resume insurance activities that are permitted by the state's law but are barred by federal law. The Court, accepting the FRB's interpretation of section 4 of the Bank Holding Company Act, ruled that the limitations on bank holding company activities, including the restrictions on insurance activities imposed by the Garn-St Germain Depository Institutions Act of 1982, do not apply to activities conducted directly by state banks owned by bank holding companies.

The FRB, in October 1986, approved Merchant National's purchase of the two state banks—Anderson Banking Co., of Anderson, and Mid State Bank of Hendricks County, Danville—and about a year later allowed the banks to resume their insurance activities. The Independent Insurance Agents of America sued the FRB to overturn the decision, arguing that allowing the banks to sell insurance violated the BHC Act. *BBR*, 12/4/89, p. 845; *AB*, 11/30, p. 1; 12/1, p. 2.

### ***Thrift's Merger Into Bank Approved***

The FRB granted approval for Southeast Banking Corp. to merge Southeast Bank for Savings—the former First Federal Savings and Loan, Jacksonville—into Southeast Bank, Miami. Southeast Banking acquired First Federal in 1988. Through the merger the thrift would be effectively converted into a bank. A provision of FIRREA permits such mergers if the resultant institution continues to pay premiums into SAIF.

As of late December, the FRB had approved four thrift-to-bank conversions under the SAIF continuing-premium provision of FIRREA. *AB*, 12/28/89, p. 2.

### ***Citicorp Allowed To Keep Insurance Subsidiaries***

The FRB permitted Citicorp to retain ownership of two nonbank subsidiaries in Arizona that sell insurance. The Garn-St Germain Act of 1982, which generally prohibits bank holding companies from selling insurance, provides for exceptions, including any insurance agency activity that a bank holding company or its subsidiaries engaged in on May 1, 1982. The FRB rejected the argument of insurance industry groups that the exception did not transfer when Citicorp purchased GWB Holding Co., parent firm of Great Western Bank and Trust, Phoenix, and two other firms that engage in insurance activities. *AB*, 12/19/89, p. 2.

### ***BankAmerica Can Acquire Bank Sellers Of Insurance***

The FRB granted approval for BankAmerica Corp. to acquire Bank of America State Bank, Concord, California, a newly chartered state bank that will engage in specialized community lending activities, cash management services for California corporate customers and public agencies, and insurance agency/brokerage activities. The application appears to be the first for a charter to take advantage of provisions of the state's Proposition 103 which removed prohibitions on the conduct of insurance activities by banks and bank holding companies.

The FRB also allowed BankAmerica to acquire a state bank in Oregon through which BankAmerica can conduct general insurance agency activities in the state. *BBR*, 2/26/90, p. 326; 3/5, p. 366.

### ***Dealing In Bank-Ineligible Securities***

The FRB modified its authorization for bank holding company subsidiaries to underwrite and deal in securities that member banks may not underwrite and deal in un-

der the Glass-Steagall Act. The limit on revenue which a subsidiary may derive from underwriting and dealing in ineligible securities is raised from five to ten percent of its total revenues. In addition, a subsidiary is permitted to underwrite and deal in securities held by affiliates if the securities are rated by a non-affiliated nationally recognized rating organization; or are issued or guaranteed by the Federal National Mortgage Association, the Federal Home Loan Mortgage Corporation, or the Government National Mortgage Association, or represent interests in such obligations. Effective immediately. *Federal Reserve Press Release*, 9/21/89.

### ***Approval To Underwrite Corporate Debt***

The FRB granted final approval for J.P. Morgan & Co. to underwrite and deal in corporate debt in the U.S. through its securities subsidiary. The bank holding company was the first to receive the FRB's final approval to engage in these activities. In January 1989 the FRB granted several major banking firms initial approval to underwrite and deal in corporate debt. Final approvals were delayed until the firms could show that they had enough capital to support the securities subsidiary and undergo an audit to indicate adequate management and systems to support the new underwriting activities.

The FRB also said it will consider giving bank holding companies permission to underwrite corporate equities in 1990. The Securities Industry Association has challenged in a pending lawsuit the FRB's January action. *WSJ*, 6/20/89, p. C1; *AB*, 6/20, p. 1.

The FRB gave final approval to Bankers Trust New York Corp. and Chase Manhattan Corp. to underwrite corporate debt through their government securities subsidiaries. The FRB's decision required the BHCs to raise additional capital within 60 days by issuing preferred stock. *BBR*, 7/31/89, p. 160.

### ***Bank Loans To Securities-Unit Clients***

A ruling by the FRB allows Morgan Guaranty Trust Company of New York, or its parent company, to extend credit to customers privately placing debt securities through Morgan's securities affiliate even if the loan is used by the customer to repay principal on its debt. A three-year period is required between the time the security was placed to the time the credit is extended. Previously, banks were permitted to extend credit to a company involved in a private placement managed by a bank's securities unit only if the loan was for another purpose. The decision is seen as a significant departure from the FRB's long-held policy requiring banks' securities affiliates to operate entirely separately from the banking affiliates, and is expected to enable banks to be more competitive with Wall Street firms.

The FRB's ruling follows its October 30 decision permitting Bankers Trust New York Corp. to transfer its private-placement business from its subsidiary bank to its subsidiary securities company. Also, lending to securities-unit clients was ruled an "eligible" activity, not included within the ten percent limitation on limited securities activities, and may be counted in the base for calculating that limitation. *AB, 11/27/89, p. 1.*

### ***Foreign Banks Permitted To Operate Securities Units***

The FRB granted approval for Canadian Imperial Bank of Commerce, Royal Bank of Canada, and Barclays Bank PLC to own and fund companies that will underwrite corporate debt, commercial paper and other securities which U.S. banks are not allowed to underwrite. The FRB would approve such activities for U.S. banks only if they were conducted by units of bank holding companies. Foreign banks, however, do not generally have

holding companies. Restrictions placed on the new powers are expected to prevent the foreign institutions from gaining a competitive edge over U.S. banks. The FRB rejected a request from the two Canadian banks for authority to underwrite corporate equity securities. *AB, 1/8/90, p. 1; WSJ, 1/5, p. A2.*

### ***West German Bank's Subsidiaries Approved As Investment Adviser, Broker***

The FRB granted approval for an asset management subsidiary of Dresdner Bank AG, Frankfurt, to acquire an interest in a Boston firm that provides portfolio investment advice and investment management services to institutions and individuals. Dresdner also owns a registered broker-dealer subsidiary which acts as a broker and specialist on the floor of the New York Stock Exchange—an activity not permitted for subsidiaries of U.S.-based bank holding companies. To forestall any unfair competitive advantage, or possible conflicts of interest, Dresdner agreed to separate completely the operations of the two subsidiaries. *BBR, 8/7/89, p. 200.*

### ***Japanese BHC May Broker Interest-Rate Swaps***

The FRB granted approval for a U.S. subsidiary of the Sumitomo Bank Ltd., Osaka, Japan, to act as originator, principal or broker in interest-rate and currency swaps and swap-derivative products. It was the FRB's first approval for a bank holding company to act in these capacities in such transactions. Previously it had approved similar activities for bank holding companies in foreign-exchange forward transactions.

Approval also was granted for the subsidiary to advise institutional customers about interest-rate and currency swaps and swap-derivative products. *BBR, 7/3/89, p. 7.*

### ***Approval For French Bank As Specialist On Stock Exchange***

The FRB granted approval for a subsidiary of Societe Generale, Paris, to become a specialist in deutsche mark options on the Philadelphia Stock Exchange. It will be the first bank to be a specialist on a registered securities exchange.

In 1986 the FRB denied a request from a French bank to become a specialist in French franc options. Reportedly the FRB has been concerned about conflicts involved in a major bank acting as a market maker in its own country's currency. The FRB noted that the deutsche mark market is more liquid than was the French franc market at the time of the earlier request, and that the market for foreign-currency options has broadened significantly on the Philadelphia Exchange. *AB, 6/28/89, p. 10.*

### ***Community Reinvestment Records Influence Regulators' Decisions On Applications***

The FRB granted approval for First Union Corp., Charlotte, North Carolina, to acquire Florida National Banks of Florida, Inc., Jacksonville, despite a less than fully satisfactory record of First Union's subsidiary banks in several states in meeting Community Reinvestment Act (CRA) requirements. Influencing the FRB's decision was Florida National's deteriorating financial condition. First Union agreed to improve its CRA performance. The FRB said First Union should not plan further expansion until it demonstrates a fully acceptable CRA record.

A provision of FIRREA requires public disclosure of CRA examinations and ratings for the first time. *AB, 7/24/89, p. 3; 11/1, p. 1.*

### ***Fees On Daylight Overdrafts***

The FRB proposed that beginning in 1991, banks pay a fee on their

daily intraday average of Fed Wire overdrafts above a deductible of ten percent of their risk-based capital. When fully phased in, the fees would be equivalent to \$6.85 per day per \$1 million of average overdrafts beyond the deductible. This is one of the proposed rules on overdrafts that, if adopted, will be phased in between 1990 and 1993.

Most banks will be able to incur small overdrafts free of charge because of the deductible. While an estimated 200 to 250 financial institutions would pay for overdrafts, about 90 percent of the fees would be paid by 15 banks.

The FRB proposed also to include government securities transactions in the calculation of daylight overdrafts. These so-called "book-entry" overdrafts account for 60 percent of all Fed Wire overdrafts.

In its previous efforts to control risk to the banking system from daylight overdrafts, in 1986 the FRB established debit caps limiting the daylight overdrafts banks may incur, and since then the caps have been tightened. The new proposals would require banks that regularly exceed their Fed Wire overdraft caps solely due to book-entry transfers to collateralize all of their Fed Wire overdrafts. *AB, 6/1/89, p. 1; 6/2, p. 3; FR, 6/21, pp. 26090, 26094, 26108.*

### *Office Of The Comptroller Of The Currency*

#### *Minimum Capital Ratio*

The OCC proposed to adopt a three percent minimum capital-to-assets ratio to supplement risk-based capital standards for national banks. Banks would be required, effective December 31, 1990, to meet both the minimum leverage ratio, and interim risk-based capital standards. Capital would be defined, for purposes of the leverage ratio, as Tier 1 capital, which includes common equity, noncumulative perpetual preferred stock (excluding auction rate issues), and minority interests that are held by others in a bank's consolidated sub-

sidaries. The agency specifically asked for comments on whether an overall six percent leverage ratio to include some Tier 2 capital would be more effective.

Risk-based capital standards are scheduled to be fully effective at year-end 1992. Between 1990 and year-end 1992, banks would be required to hold at least 7.25 percent capital to risk-adjusted assets, rising to eight percent at the end of 1992. Of the eight percent, four percent must be in Tier 1, and the other half in Tier 2, which consists of loan-loss reserves, cumulative and limited-life preferred stock, mandatory convertible securities, subordinated debt, and other forms of capital. *BBR, 11/13/89, p. 687; FR, 11/3, p. 46394.*

#### *Procedures For Receiverships*

The OCC specified certain factors which the agency may consider in determining whether to appoint a receiver for a national bank. A major change is the use of equity capital, rather than primary capital, in measuring a bank's net worth. The allowance for loan and lease losses (loan-loss reserve) is excluded from the calculation of net worth. This change is intended to bring the measurement of net worth more closely in line with generally accepted accounting principles (GAAP). The final rule does not alter the method of determining insolvency on a liquidity basis. Also, it does not limit the OCC's discretion to consider other factors in assessing the solvency of a national bank on a case-by-case basis. *FR, 11/28/89, p. 48851.*

#### *Highly Leveraged Transactions*

The OCC announced a policy starting late in 1989 for periodic monitoring of HLTs in all national banks with exposure to such transactions greater than two percent of assets.

Comptroller of the Currency Robert L. Clarke on November 14

said the agency had conducted recent detailed examinations of HLTs in 11 multinational banks. Much of the U.S. banking industry's exposure to HLTs is at 17 multinational banks, which have an aggregate \$79 billion in exposure. Mr. Clarke said that 12 of these companies had more than 100 percent equity exposure to HLTs, and nine had more than 150 percent equity exposure. At the 11 institutions given detailed examinations, criticized HLTs relative to total outstanding HLTs almost doubled from year-end 1988 to mid-1989, rising from nine percent to 17 percent.

*Statement by Robert L. Clarke, 11/14/89.*

#### *Banks Can Sell Fixed-Rate Annuities*

The OCC gave approval for national banks to sell fixed-rate annuities for insurance companies. Brokering fixed-rate annuities is not an insurance activity, the OCC said, but is more similar to the sale of a financial instrument like a certificate of deposit. National banks have been allowed to market variable-rate annuities since 1985. *AB, 2/26/90, p. 1.*

#### *Broader Powers For Bank Subsidiary Approved*

The OCC granted approval to Security Pacific National Bank, Los Angeles, for its subsidiary, Security Pacific Futures Inc., to buy and sell agricultural, petroleum, metal, and other commodity futures, and their related options. Previously, federal regulators permitted subsidiaries of banks to broker futures and options contracts only when the underlying items were financial instruments that are traded on financial exchanges, and not used as a way to buy and sell the underlying commodity.

The OCC's order specifically prohibits the bank from guaranteeing the futures subsidiary's obligations. It also limits the bank's investment in, or unsecured loans to the subsidiary, to 15 percent of

the bank's capital, and limits the total of secured and unsecured loans and investments to 25 percent. *AB*, 1/2/90, p. 1.

### ***Banks' Payment Of Dividends***

The OCC proposed regulatory amendments and clarifications which are intended to make the calculation of national banks' dividend-paying capacity consistent with GAAP. In this regard, the allowance for loan and lease losses would not be a part of either "undivided profits then on hand" or "net profits." A national bank may be able to use a portion of its capital surplus account as undivided profits, depending on the composition of that account. Also, some banks may be able to restore their ability to pay a dividend either through a quasi-reorganization or issuing preferred stock not subject to the dividend limitation, the OCC said.

Industry sources believe that the amendment could discourage banks' reserving for losses, including losses on less-developed-country (LDC) debt. However, reserves provisioned in 1987 would not be affected by the change if the final rule is adopted in 1990 as is expected. Under the rule, dividend-paying capacity would be based on profits for three years. *FR*, 8/16/89, p. 33711; *AB*, 8/29, p. 1.

### ***Disclosure Of CRA Decisions***

The OCC notified national banks that it will publish letters to applicants reporting on decisions for all cases in which applications from national banks have been conditionally approved or denied on CRA grounds. The decision letters will be disclosed, beginning with cases decided in July, 1989, in the OCC's monthly *Interpretations* publication and the decisions will be summarized in the OCC's *Quarterly Journal*. Decision letters for protested applications that have been

approved without conditions are available to the public upon request. *Banking Circular 238*, OCC, 6/15/89.

### ***National Bank Lending Limits To Foreign Governments***

The OCC amended its regulation to establish a noncombination rule when the central government or another central facility becomes the obligor for loans to a foreign government, its agencies, and instrumentalities, as a result of debt restructuring. Under the amendment, the loans will continue to be included under the lending limit for the original obligor on each loan and will not be attributed to the named central obligor in the restructuring. The amendment also imposes, in such cases, an overall limitation equal to 50 percent of a bank's unimpaired capital and surplus with respect to all loans, in the aggregate, to the foreign government, its agencies, and instrumentalities, including restructured loans. Effective January 10, 1990. *FR*, 1/10/90, p. 854.

### ***Resolution Trust Corporation And Oversight Board***

#### ***Status Of The RTC***

L. William Seidman, Chairman, and David C. Cooke, Executive Director, of the RTC, said that as of January 16, 1990 the RTC had resolved 40 failed cases of savings institutions, and had 293 institutions under conservatorship. Collectively, these 333 institutions reported \$136 billion in gross assets and \$148 billion in liabilities as of September 30, 1989. The estimated present-value cost of resolving these cases, based on FDIC loss experience, is approximately \$42 billion.

There were 225 to 295 more institutions with \$160 billion to \$200 billion in assets that may be categorized as "likely failures," according to preliminary estimates of the

OTS. In addition, there were 295 to 325 seriously undercapitalized institutions with assets of \$185 billion to \$205 billion that OTS expects to categorize as "distressed," and which it expected to resolve without government assistance.

OB staff have completed a Strategic Plan concerning the policies and activities of the RTC. According to the Plan, the RTC's mission is to manage and resolve institutions that come under its jurisdiction and to dispose of any residual assets in a manner that (a) maximizes return and minimizes loss, (b) minimizes the impact on local real-estate and financial markets, and (c) maximizes the preservation of the availability and affordability of residential property for low- and moderate-income individuals.

*L. William Seidman and David C. Cooke, Testimony, U.S. House Committee on Banking, Finance and Urban Affairs, 1/24/90.*

### ***Ethical Standards Relating To Independent Contractors***

The OB and RTC adopted ethics rules for independent contractors who seek to perform services for the RTC. The regulation addresses conflicts of interest, ethical responsibilities and use of confidential information. It establishes qualification standards, conflict-of-interest restrictions, certification requirements and other standards applicable to law firms, accounting firms, investment banking firms, real-estate brokers, appraisers, property managers and others who provide similar services under agreements with the RTC.

In part, contractors will need to certify that they and their related entities have not caused a substantial loss, defined as \$50,000 or more, to the federal deposit insurance funds. In addition, a contractor currently in default on an obligation to the FDIC, the RTC, or an insured depository institution under the jurisdiction of the RTC would also be deemed ineligible to contract with the RTC.

The RTC will establish a process for reviewing the disqualification of contractors to ensure that implementation of the regulation is equitable and consistent. *PR-46-90, 2/6, OB, RTC.*

### **Asset Inventory**

The initial inventory of real-estate assets that will be available for sale from the RTC was released. The comprehensive inventory includes about 30,000 real-estate assets that the RTC was managing on September 30, 1989. It includes commercial properties, land, and residential properties. FIRREA requires that an inventory of record be published every six months. However, the RTC soon will begin making asset information available on a more frequent basis. *News Release, RTC, 1/2/90.*

### **Buyer's Guide**

The RTC released *A Buyer's Guide*, a 20-page booklet containing information about doing business with the agency. The *Guide* will be updated as necessary to reflect any changes that might occur in the programs of the RTC. *RTC, 11/15/89.*

### **Office Of Thrift Supervision**

#### **Capital Standards**

The OTS issued new standards requiring savings and loan associations to have tangible capital totaling at least 1.5 percent of assets, core capital of three percent, and additional risk-based capital by December 7, 1989. The action conformed to provisions of FIRREA. See "Risk-Based Capital Requirements: Reshaping the Thrift Industry," *FDIC Banking Review*, this issue.

Institutions that fall below the new standards on December 7 must submit an acceptable capital plan to raise their capital levels or be subjected to operating restrictions including growth and capital distribution limitations and regulatory

approvals of changes in management and board of directors. The capital plan must be submitted to the OTS within 60 days after November 7, the date on which the capital regulation was adopted, or the date on which the institution fails to comply with the capital standards. *NEWS, OTS, 11/6/89; 11/8; 12/15.*

#### **Capital Forbearances Ended; Some Thrifts' Growth Is Limited**

OTS reminded thrifts that FIRREA eliminates capital and accounting forbearances previously granted by the Federal Home Loan Bank Board. The institutions were advised to eliminate such forbearances in calculating whether they comply with the new minimum capital standards.

Certain thrifts were advised that they may not increase deposits beyond the amount of net interest credited to the accounts, or may not increase deposits or borrowings more than needed to fund legally-binding loan commitments and loans in process. This applies to all thrifts that fail to meet their minimum regulatory capital requirements, and that are not operating under a capital restoration plan approved by OTS, as well as to institutions that receive a low composite rating from federal examiners (MACRO 4 or 5) or require more than normal government supervision. Some associations, defined in OTS' statement, are subject to greater restrictions and may not make any new loans or investments without prior approval from an OTS District Director. *NEWS, OTS, 1/12/90.*

#### **Single-Borrower Loan Limits**

Under new guidelines issued by the OTS, savings and loan associations have the same limits as national banks on loans to one borrower. The limitations were mandated by FIRREA.

A thrift, with certain exceptions, cannot have total loans to any one borrower of more than 15 percent of the institution's unimpaired capital and surplus. An additional ten percent of unimpaired capital and surplus can be lent to a single borrower if the loan is fully secured by readily marketable collateral. Prior to FIRREA the lending limit for thrifts and their subsidiaries was ten percent of withdrawable accounts, or regulatory capital, whichever was less.

FIRREA also provides that a savings institution can lend up to \$500,000 to any borrower for any purpose. If the loan is to be used to develop residential housing units, the aggregate lending limit is the lesser of \$30 million, or 30 percent of the association's unimpaired capital and surplus, provided the lender meets certain requirements. Up to 50 percent of an institution's unimpaired capital and surplus may be lent if the loan is to be used to facilitate the sale of repossessed property.

At any time, the OTS Director may impose more stringent restrictions on an institution's loans to one borrower if necessary to protect the safety and soundness of the association. *NEWS, OTS, 9/29/89.*

#### **Agency Offices**

The OTS will remove the current restriction banning federal savings associations from establishing offices to originate and service loans outside the same state as the home office of the savings association or the same state of any association's branch office. Additionally, the OTS will require notification in writing of openings and closings of these offices. The change in regulations is effective January 8, 1990.

Previously, a thrift would have to create a service corporation in order to operate loan production facilities in states where the firm did not already have a presence. *FR, 12/8/89, p. 50613; AB, 12/14, p. 2.*

### ***Equity-Risk Investments***

The OTS has delayed the termination of its equity-risk investment regulation until July 13, 1990. The regulation requires savings associations to obtain prior approval of their Principal Supervisory Agents (now District Directors), before making investments in equity securities, real estate, service corporations and operating subsidiaries above certain thresholds. These thresholds are tied to the regulatory and tangible capital levels of the savings association.

The OTS noted that FIRREA contains a number of provisions that will have a significant effect on investments covered by the current equity-risk investment regulation. Thus the OTS believed it prudent to again delay the termination date. *FR, 11/15/89, p. 47510.*

### ***Federal Thrift Regulator Accreditation Program***

Beginning September 1, 1989, only accredited individuals, designated by OTS as "federal thrift regulators," can conduct complete examinations and/or manage a supervisory caseload, conduct meetings with thrift institutions' directors, set the scope of an examination and recommend corrective action for thrift institutions. A regulator who has not yet been accredited can still perform examination and supervisory functions, but must do so in an "acting capacity" under the close supervision of a federal thrift regulator.

OTS had accredited about 1,100 examiners and supervisors by early September, 1989. To be accredited, a regulator must meet specific education and course-work requirements, and demonstrate proficiency over a two- to five-year period in certain designated capacities. This is an on-going program with continuing requirements for maintaining active status as a federal thrift regulator. *NEWS, OTS, 9/7/89.*

### ***Federal Financial Institutions Examination Council***

#### ***Call Report Changes***

The Federal Financial Institutions Examination Council (FFIEC) adopted changes to the Reports of Condition and Income (Call Reports) filed quarterly by commercial banks and FDIC-supervised savings banks. The changes will (1) provide the banking agencies with sufficient data to permit the monitoring of banks' risk-based capital levels, while basing the amount of information reported by individual banks on their size and capital level, and (2) provide other data considered necessary for bank supervisory purposes, particularly with respect to the nature and extent of banks' off-balance-sheet activities. There is a new risk-based capital schedule, a revised version of the current off-balance-sheet schedule, and modifications or new items in other schedules.

Pending approval by the Office of Management and Budget, these changes will become effective on the March 31, 1990, report date, except for one new item that would be added as of June 30, 1990. *FIL-4-89, 8/28, FFIEC, and information from FFIEC, 1/30/90.*

#### ***States' Licensing Of Real-Estate Appraisers***

The FFIEC released guidelines for state certification and licensing of real-estate appraisers. Authorized under Title XI of FIRREA, the guidelines are intended to help states establish certification and licensing procedures for appraisers involved in federally related transactions.

The certification and licensing function, the FFIEC said, should be established as an independent regulatory agency answerable to the governor or a cabinet-level officer who has no regulatory responsibility for realty-related activities.

Those who appoint an agency head or appraisal board members should not be associated with an affected industry. Agency heads should not be actively engaged in the appraisal business or any other affected industry.

Among other guidelines are that all appraisers subject to the licensing or certification provisions must be qualified through appropriate testing and experience requirements established by state law. Also, no persons are to be exempt from meeting the requirements, or be otherwise "grandfathered" into the system. *FIL-11-90, 1/18, FFIEC.*

### ***Department Of The Treasury***

#### ***Study Of Deposit Insurance***

The Department requested public comments on a study the Department is conducting of the federal deposit insurance system. The Department intends to complete its study, which was mandated by FIRREA, by early 1991, and submit a final report of its conclusions and recommendations to Congress by early 1991. *FR, 12/6/89, p. 50469.*

### ***State Legislation And Regulations***

#### ***Investment In Real Estate***

**Iowa:** A new law allows state-chartered banks to invest directly in certain real estate after obtaining the approval of the Superintendent of Banking. A state bank's investment in real estate is limited to a total of 20 percent of capital and surplus. Effective July 1, 1989. *ELSS, 9/29/89.*

#### ***Real-Estate Appraisals***

**Maryland:** New legislation requires the Bank Commissioner, Director of the Division of Savings and Loan Associations, and Commissioner of Consumer Credit to develop and implement minimum safety-and-soundness standards for real-estate appraisals and appraisers. *ELSS, 9/29/89.*

### **Intrastate Branching**

**Colorado:** A federal judge ruled that the RTC is prohibited under Colorado's branching law from converting failed thrifts in the state into branches of national banks. As a result of the decision, Mesa National Bank, Grand Junction, agreed to acquire Valley Federal Savings and Loan Association, and Mesa Federal Savings and Loan Association, both of Grand Junction, as affiliates rather than branches. *BBR*, 2/19/90, p. 30.

**Georgia:** An appeals court ruled against a decision of the state Department of Banking and Finance allowing Bank Corp. of Georgia, Macon, to acquire four branches from two savings and loan associations. Under Georgia's law, to enter another county a bank must purchase another bank or an entire S&L. Excepted from this restriction are the state's two largest counties, Fulton and DeKalb, between which banks are permitted to branch. *AB*, 11/14/89, p. 2.

**Illinois:** A new law allows banks to buy failed or failing thrifts irrespective of previous restrictions on acquisitions. The law brings the state into compliance with the requirements of FIRREA. Effective November 30, 1989. *ABA Bankers Weekly*, 11/14/89, p. 7.

**Wisconsin:** The Governor signed legislation which, for one year beginning August 5, 1989, allows state-chartered banks to branch anywhere in Wisconsin. Existing law permits state banks to branch only countywide, with few exceptions, and forbids them from opening a branch within three-quarters of a mile of a branch, or 1.5 miles of the home office, of another bank. The OCC has given national banks unrestricted branching rights in the state. The OCC cited the authority of savings and loan associations to branch statewide in Wisconsin. *AB*, 7/5/89, p. 2; *Office of Commissioner of Banking, Wisconsin*, 1/30/90.

### **Interstate Banking**

**Iowa:** A new law, to become ef-

fective January 1, 1991, allows bank holding companies based in six bordering states to purchase banks in Iowa, if the other state allows entry to Iowa banks on a reciprocal basis. The states are Minnesota, Nebraska, South Dakota, Illinois, Missouri and Wisconsin. The new law provides that not more than 35 percent of Iowa's bank deposits may be controlled by out-of-state holding companies.

An Iowa bank is permitted, by adopting an appropriate resolution prior to January 1, to remove itself from consideration by an out-of-state holding company with respect to the purchase of more than 25 percent of its stock. *AB*, 2/5/90, p. 1; *BBR*, 2/19, p. 292.

**New Jersey:** Effective August 2, 1989, under the state's reciprocal interstate banking law that initially took effect on January 1, 1988, eleven states and Puerto Rico were added to those whose banking firms can acquire New Jersey's banks, and *vice versa*. The states are Colorado, Idaho, Illinois, Indiana, Louisiana, Nebraska, Nevada, New Mexico, Oregon, South Dakota and Vermont. *AB*, 8/10/89, p. 12.

### **Bank Subsidiaries' Activities**

**New Jersey:** Under a new law effective January 2, 1990, banks owned by the same holding company may accept deposits and conduct other activities for each other. *ELSS*, 1/17/90.

### **State Prohibits Sale Of Uninsured Bonds At S&Ls**

**California:** Thrift regulators are banning California's 108 state-chartered thrifts from sales in their branches of subordinated debentures, which have low payment priority in event of bankruptcy. Reportedly the state's savings and loan department also is considering a rule to prohibit the sale of all uninsured securities in retail offices.

The action comes in the aftermath of the failure of Lincoln Sav-

ings and Loan Association, which sold retail customers the uninsured bonds issued by the parent company, American Continental Corp., bonds that became almost worthless. *AB*, 12/29/89, p. 3.

## **Bank And Thrift Performance**

### **Banks' Earnings Down In 1989**

Commercial banks in the U.S. had net income in 1989 of \$16.3 billion, down by more than 35 percent from the level of 1988. Net earnings in the first two quarters of 1989 totaled over \$14 billion, but were followed in the third quarter by a loss of \$740 million, the decline resulting mainly from increases in provisioning for international loan losses. In the last quarter larger allowances for domestic credit losses held down the results, as earnings recovered to \$2.7 billion.

Five of the ten largest banks in the U.S. reported full-year losses due mainly to higher reserving for losses on loans to LDCs. One-quarter of all U.S. banks with assets over \$10 billion also had net losses for the year, as many regional banks experienced problems in their real-estate loan portfolios. Smaller banks, particularly those in the Southwestern U.S., continued to show a recovery in profitability.

In 1990, money-center institutions generally are likely to reduce their reserving for loan losses and their earnings should improve. Regional banks in various sections of the U.S. are expected to experience higher losses on real-estate loans. The outlook for the smaller banks is for improved earnings. *The FDIC Quarterly Banking Profile, Fourth Quarter, 1989.*

### **Bank Failures In 1989**

A total of 206 FDIC-insured banks failed in 1989, six more than in 1988. Texas accounted for nearly two-thirds of all bank failures in the

U.S. in 1989. It had 133 cases, up from 120 in 1988. In Louisiana there were 21 failures in 1989, compared to 11 in 1988, while in Oklahoma the number declined by 11, to 12 failures in 1989.

Most insured-bank failures are handled by the purchase-and-assumption method, in which a healthy institution assumes the deposits and other liabilities and purchases a portion of the assets of the failed bank. There were 174 P&As in 1989. In addition, insured-deposit transfers were used to resolve 23 failed-bank cases in 1989, and there were nine deposit pay-offs.

#### **Most Thrifts Were Profitable While Industry Losses Increased In 1989**

Seventy percent of the 2,597 savings and loan associations not in conservatorship at year-end 1989 had net earnings of \$1.3 billion in the fourth quarter of 1989, according to the OTS. However, losses of \$3.4 billion by the other 30 percent caused a net loss of \$2.1 billion. Also in the fourth quarter, the 281 thrifts in conservatorship at year-end lost \$4.4 billion, and 84 thrifts transferred to the RTC since January 1, 1990, lost \$1.8 billion.

For the year 1989, the profitable portion of the non-conservatorship group earned \$5.1 billion, while the remainder of the group lost \$10.3 billion. The consolidated industry lost \$19.2 billion, compared with \$13.4 billion a year ago. Most of the losses in the fourth quarter and for the full year reflected non-operating losses, an official said, as institutions sold assets at a loss or made provisions for losses. *NEWS, OTS, 3/26/90.*

#### **Banks' Purchases Of S&Ls**

Banks have agreed to buy 55 thrifts under the provisions of FIRREA, enacted in August 1989. These thrifts have assets of around

\$20 billion, or 1.6 percent of the industry's total assets. The largest of the S&Ls, First Federal Savings and Loan Association, Pittsburgh, has assets of \$3.1 billion, and five others are in the \$1 billion-or-over class.

Almost half of the deals have involved banks' agreeing to buy healthy thrifts. Most of these transactions are still pending. Reportedly most banks have not decided whether to continue the acquired institution as a thrift or merge it into the banking operation.

It is expected that acquisitions will speed up as banks become more familiar with thrifts, and the OTS completes its guidelines for banks' purchases of mutual thrifts. *AB, 1/16/90.*

#### **S&Ls Edge Ahead Of Banks In Home-Loan Originations**

Savings and loan associations had 36 percent, and commercial banks 33 percent, of home-mortgage originations nationally in December 1989, according to the U.S. Department of Housing and Urban Development (HUD). Banks led S&Ls in such originations in June for the first time in the 19 years that HUD has collected these data.

Growing numbers of commercial banks in many sections of the U.S. are emphasizing home mortgages as part of their consumer-services strategy. Analysts say also that banks were especially aggressive in 1988 in originations of longer-term loans, and fixed-rate loans which increased in popularity when interest rates declined. At the same time, many thrifts have had to slow their growth—or even become smaller—to meet regulatory capital requirements. Some thrifts, however, may be planning to increase their mortgage lending to meet the 70 percent (up from 60 percent) qualified-asset guidelines for thrifts contained in FIRREA. *AB, 9/29/89, p. 1; 11/6, p. 3; 12/22, p. 6; 2/2/90, p. 8; 4/9, p. 9.*

#### **ATM Systems In Southeast To Merge**

Three southeastern electronic banking systems—Avail in Georgia, Honor in Florida, and Relay in the Carolinas—agreed to merge. The merger would link about 7,000 automated teller machines and 4,400 point of sale terminals in five states and the District of Columbia, creating the nation's third-largest network of ATMs. The largest ATM system, New York Cash Exchange, has 8,800 ATMs, and the second largest, Star System in California, has 8,600. The merging networks are expected to sign a definitive agreement in early 1990. *AB, 12/19/89, p. 1.*

#### **Recent Articles And Studies**

##### **Deposit Insurance Reform**

A study ("Can the Market Evaluate Asset Quality Exposure in Banks?", Richard E. Randall) of the effectiveness of market discipline evaluates the success of investors and security analysts in identifying and evaluating the problems of large bank holding companies. The study includes 40 BHCs, each with assets exceeding \$2 billion, that developed serious problems in the 1980s through mid-1987. It is concluded that market discipline cannot be relied on to limit banks' credit risk. The evidence from this study is that the underperformance of stock prices and downgrading of bond ratings came at a late stage, only after excessive damage had occurred. This is not unexpected, because market analysts do not currently have, and are unlikely to ever have, the means to accurately identify and evaluate changes in asset quality at an early stage.

The author does not favor a reduction in deposit insurance coverage because there would be little or no benefit from market discipline while the greater depositor sensitivity could make banks much more vulnerable to runs. *New England Eco-*



*omic Review, Federal Reserve Bank of Boston, July/August, 1989, pp. 3-24.*

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This article ("A Plan for Reducing Future Deposit Insurance Losses: Puttable Subordinated Debt," Larry D. Wall) presents a plan for a no-deposit-insurance environment for banks without reducing insurance coverage for depositors. A new mechanism, puttable subordinated bonds, would both discipline excessive risk-taking and identify failing banks. The bonds under the plan would be subordinated to all other liabilities. However, bondowners could request redemption.

It is suggested that large banks be required to issue the debt and that small banks have this as an option. Banks operating under the plan would not be permitted to redeem the puttable bonds if redemption would violate regulatory standards. A bank would have 90 days to meet a redemption request by issuing new debt, or reducing its subordinated debt needs, for example, by selling assets. Any bank that could not honor the redemption requests on its puttable subordinated debt at the end of 90 days without violating the regulatory requirements would be deemed insolvent and would be closed.

Holders of the subordinated debt would have a strong incentive to have a bank closed before its capital became negative. The system would discourage bank risk-taking because the subordinated debtholders would bear most of the consequences of failure, and would demand compensation to reflect the degree of riskiness.

A risk that the put option may be exercised on solvent institutions could be reduced by issuing bonds with rates that vary with the market and the bank's riskiness, and by pricing the bonds to sell above par.

The role of the regulators under the plan, while substantially reduced, would not be eliminated be-

cause (a) of a continuing potential risk to the deposit insurance system, and (b) the existence of small banks that could not join the plan because of the lack of a satisfactory market for their subordinated debt.

*Economic Review, Federal Reserve Bank of Atlanta, July/August, 1989, pp. 2-17.*

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Based on the experience of state-level deposit insurance programs, several of which are reviewed in detail, this article ("Deposit Insurance: Lessons From the Record," Charles W. Calomiris) suggests a system in which banking industry self-regulation would perform an essential role. Banker participation in the enforcement of regulations was successful in state programs in the past. One reason is that bankers were adept at restricting risk-taking. Also, they were more skillful than the regulators in identifying "the least-cost regulatory structure," which involves the "optimal combination of reserve requirements, risk-based insurance premiums, capital and subordinated debt requirements, etc."

There could be a two-tier regulatory system of deposit insurance in which the government provides national protection, but relies on local incentives to monitor risk. By making insurance premiums for banks in any region depend on the failure experience of their neighbors, for example, the government can make monitoring incentive-compatible. Some regulations governing banks (including the geographic limits on bank groups) could be determined at the national level, while other regulations might be allowed to vary at the level of the individual groups. *Economic Perspectives, Federal Reserve Bank of Chicago, May/June, 1989, pp. 10-30.*

### *International Debt Insurance Proposal*

FDIC Chairman William Seidman

proposed the creation of an International Debt Insurer (IDI) to provide a flexible coinsurance system of debt guarantees for commercial bank loans to heavily-indebted developing countries. It would be managed by a multinational board appointed by capital contributors, or the International Monetary Fund and World Bank.

The IDI would be funded with initial contributions from creditor banks, and callable capital from multilateral development agencies (IMF, World Bank), premiums paid by banks, and possibly contributions from creditor governments. Capital contributions and accumulated premiums would be refunded as covered debt is retired.

IDI would coinsure new loans only if the developing country had made certifiable economic progress entitling the country to insurance coverage for the year involved. To be insured, new loans would require additional capital contributions, and only certain types of new loans, for example, project financing, could be insured.

In return for insurance coverage, commercial banks would agree to debt-reduction plans that would focus on reducing annual debt-service burdens, setting the amount and timing of debt-service reductions at reasonable levels given the situation in each debtor country. Generally, debt would be restructured with lengthened maturities and reduced payments. IDI insurance would cover only a portion of the restructured debt-service payments. The greater the reduction in claims that banks are willing to accept, the greater the percentage of restructured payments that would be insured.

Debtor countries, if they are to qualify for the insurance program, must agree to undertake economic reforms that will lead to the restoration of their creditworthiness. *Statement by Chairman Seidman, July, 1989.*

***Multiproduct Costs In  
Large Banks***

Deregulation of bank products is often justified based on the contention that cost savings can result from joint production of a variety of financial services. This study is concerned with whether multiproduct production in large banks does in fact reduce their costs. It attempts to measure the costs of a single bank against the sum of the

costs of two "competing" banks in producing a given output mix. The data are taken from Reports of Condition and Income submitted to the Federal Reserve during 1986 by a sample of over 300 of the largest banks in the U.S.. The study concludes that for large banks generally no appreciable cost savings seem to result from multiproduct production.

The model does not, however,

explicitly incorporate convenience to customers, and banks may be reducing consumers' transactions costs through the array of services offered. Banks also may engage in multiproduct production as a means of diversification to reduce risk even though the resulting scale of output or product mix is not optimal when viewed strictly from a production perspective. *Economic Review, Federal Reserve Bank of Atlanta, May/June, 1989, pp. 2-11.*