Resolution Strategies for Large U.S. Commercial Banks

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1: Introduction

Banking economists and the bank regulatory community justifiably have shown great interest in large bank failures. Several topics have received considerable attention and analysis. Economists have examined the extent to which a large bank failure might cause a systemic event in the financial system or the general economy. There has been extensive analysis about the best way to align the incentives of management at troubled banks and the bank regulatory community with the state of society as a whole. In addition, economists have sought closure rules that yield the best results (for the insurer or for society as a whole) and have noted the importance of providing adequate liquidity to depositors at failed banks. Economists have made numerous proposals that address one or more of these issues, generally from a birds-eye point of view.

While these discussions are extremely valuable, when a megabank\(^1\) failure is imminent other factors may place significant constraints on regulators’ ability to choose the best option based on economic factors. These factors include the political environment, the legal environment, and a host of operational complexities that could make it difficult or impossible for regulators to implement the most attractive policy from a theoretical viewpoint. It is the nexus of economic objectives and these other factors that produce the strategy that is adopted when a megabank fails. This paper fills the gap in the literature by examining the combination of these factors for large banks headquartered in the United States. After considering the economic, financial, and political costs and benefits of the various resolution strategies available to the

\(^{1}\) In this paper, we define a megabank as a bank with over $100 billion in assets, a very large number of offices, and at least one of the following: extensive international operations, a large derivatives portfolio, or extensive payment processing activities. Other terms used for such banks have more precise definitions. For example, see DeFerrari and Palmer (2001) for the Federal Reserve’s definition of a Large Complex Banking Organization (LCBO) or IMF (2002) for its definition of a Large Complex Financial Institution (LCFI). While the focus of this paper is on megabanks, the resolution strategies presented also apply to most smaller banking organizations.
FDIC, we conclude that some version of the bridge bank resolution strategy is likely the best alternative for resolving most large and complex banks.

An important source of information about operational and political issues is the FDIC’s experiences from earlier failures. While the FDIC regularly handles small bank failures, its experience with large banks is more limited and dated. Of the ten largest failures in the history of the FDIC, the most recent one was over ten years ago.² It has been over twenty years since the collapse of the largest bank handled by the FDIC.³ Much has changed since these failures. Since then, the largest U.S. banks have gotten substantially larger and more complex, and the rules under which the FDIC must operate have become considerably more restrictive.

Therefore, the FDIC should be proactive in planning for a possible large bank failure—even if none are expected in the near term. The risks of inadequate planning are too great and the future is too unpredictable. Well-prepared regulators are more likely to make wise choices in the midst of a crisis, and they would probably have a broader array of options available as well. Absent such efforts, the deposit insurer is likely to resolve a failure by providing direct assistance to the bank,⁴ because of its feasibility and its usefulness in facilitating financial stability in the short run. However, direct assistance would almost inevitably mean that the bank’s creditors would be made whole, and stockholders may also receive compensation. This would diminish market discipline imposed on megabanks. The loss of market discipline may encourage megabanks to take on more than the optimal amount of financial risk, thereby causing them to be less stable in the long run. If the deposit insurer develops ways to conduct an orderly failure resolution strategy.

² First City Bancorporation of Houston, Texas, failed (for the second time) in October 1992.
⁴ In the U.S. such a transaction can be implemented only after the Board of Governors of the Federal Reserve and the board of the FDIC recommend its use (by a two-thirds majority), and the Secretary of the Treasury, after consulting with the President, approves its use.
without providing direct assistance to the bank, it will be in a better position to strike a balance between short-term and long-term stability when a crisis arises. Pragmatic planning efforts on the part of the FDIC are necessary to reach this position.

In this paper, we discuss the resolution options available to the FDIC if a large bank were to fail. The next section sets forth major policy objectives to address when facing a potential failure. Section 3 discusses changes in the banking landscape that complicate the FDIC’s task, and Section 4 discusses legal and operational constraints under which the FDIC operates. Section 5 describes the transaction options available to the FDIC in light of the stated objectives and constraints. Section 6 concludes.

2: Major Policy Objectives

The FDIC’s objectives are to maintain confidence and stability in the U.S. financial system by protecting insured depositors in a large bank resolution. The FDIC seeks to accomplish these objectives by:

1. Minimizing the overall cost to the insurance funds, provided that systemic risk is avoided or mitigated.
2. Preserving market discipline.
3. Effectively managing the resolution and receivership process through:
   a. Timely pre-failure supervision and closure.
   b. Prompt access to liquidity.
   c. Effective management of resolution funding.
   d. Minimizing time institution is under government control.
e. Maximizing returns to creditors.

The overarching objectives are to protect insured depositors and to maintain confidence and stability in the financial system. These are general principles that have guided the FDIC’s actions since its inception. The three numbered objectives that provide more detail are discussed below. Unfortunately, they involve inherent and unavoidable conflicts.

**Objective 1 – Minimize the overall cost to the insurance funds, provided that systemic risk is avoided or mitigated.**

The FDIC has clear incentives to minimize resolution costs. Doing so not only protects the insurance funds (and minimizes assessments on the industry), but also importantly promotes market discipline (the second objective) by ensuring that uninsured creditors incur a portion of the bank’s losses. For the vast majority of bank failures—even very large bank failures—this approach is optimal. If, however, this approach would have serious adverse effects on economic conditions or financial stability and an alternative approach would avoid or mitigate such adverse effects, the FDIC may take a different course of action.

The failure of a megabank that imposes large costs on creditors could have profound implications for other insured depository institutions and elements of the economy. Systemic implications may include, but are not limited to, the following:

- The imposition of losses on uninsured depositors and general creditors could adversely affect the funding of other large depository institutions generally perceived as having financial difficulties.

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5 This may happen only in the event of a systemic risk determination; it is discussed in more detail in Section 4
• The potential disruption of financial and capital markets resulting from market uncertainty associated with a megabank insolvency could cause major and widespread credit, liquidity and market disruptions. The selective placement of large amounts of qualified financial contracts (QFCs)—which include derivatives—in the hands of a receiver (thereby placing into question whether the contracts will be honored or creating other uncertainty regarding the contracts’ status) or repudiating such contracts could create significant economic disruptions. Liquidity shortages could be severe, resulting in distorted asset pricing.

• The suspension or significant curtailment of credit operations of a large insured depository institution could have substantial implications for businesses that rely on it for credit services, thereby exacerbating what could be a recessionary economic environment.

• The imposition of losses on uninsured depositors, and the potential disruption of transactions and settlement services, could adversely affect the payment system.

Objective 2 – Preserve market discipline.

Economists recognize that the discipline imposed by bank creditors and stockholders promotes efficient financial markets. When markets are working well, bank creditors monitor banks and either demand higher interest rates or exit banks that are too risky; stockholders prefer to invest in high-performing banks and penalize weak bank managers. Thus creditors and stockholders provide bank managers an incentive to avoid excessive risk and to fix problems promptly as they arise. If the FDIC were to avoid systemic risk by “bailing out” the creditors and stockholders of a failed bank, then the creditors and stockholders of other large banks may be less inclined to monitor and discipline bank management. This change could lead to a less
robust (and riskier) banking industry in future years. It may also give large banks a funding advantage over smaller banks that are not viewed by the markets as posing a systemic risk.\(^6\) Thus there is a natural tension between the desire to avoid disruption in the short term and the potential for a riskier industry in the long term.

**Objective 3 – Effectively manage the resolution and receivership process**

Obviously the resolution and receivership process should be managed in a way that minimizes disruption and costs. Timely action on the part of the FDIC and other banking regulators is an important component to a well-managed failure. Timely pre-failure supervision can mitigate costs and, in many cases, prevent failure. A timely closure avoids the ongoing costs associated with running an insolvent bank and gives the bank’s management fewer opportunities to take on excessive risk in a “gamble for resurrection.”

Another important aspect of an effective closure relates to funds management. To minimize disruption to the bank’s customers, the FDIC ideally should structure a transaction that provides the failed bank’s depositors prompt access to liquidity.\(^7\) This does not necessarily imply a structure whereby all depositors are made whole. If uninsured and unsecured depositors suffer a loss, the funds representing their expected recovery should be made available as quickly as possible. A transaction structure that unnecessarily causes service interruptions or denies uninsured depositors access to the majority of their funds may raise systemic risk concerns. On the other hand, the FDIC must manage the resolution funding in a way that preserves the

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liquidity position of the insurance funds.\textsuperscript{8} Since the assets and deposits of a megabank will be several times larger than the insurance fund’s financial resources, the FDIC will be limited to using a transaction structure that allows the FDIC to retain enough funds to stand ready to handle additional failures. Therefore, cash preservation techniques can and should be employed regardless of the transaction structure selected. Subject to certain legal and policy considerations, the FDIC can grant assurances to depositors and creditors, or guarantee Federal Reserve Bank borrowings as a way to preserve or extend the liquidity of the assisted institution, thereby minimizing the need for the FDIC to use its own cash resources to meet the need for working cash. The FDIC may even consider financing some or all of the losses of the insured depository institution by, for example, issuing a note to the assisted institution or bridge bank in lieu of direct cash assistance, assuming an existing liability, or borrowing from the Federal Financing Bank (“FFB”) or the U.S. Treasury.

The FDIC will also want to minimize the time that the institution remains under government control. Government-controlled banks tend to distort markets, and the FDIC will be interested in minimizing any such distortion.\textsuperscript{9} Additionally, since the final resolution of a bridge

\textsuperscript{8} The FDIC should address both the capital position and the liquidity position of its insurance funds. The resolution structure influences both. The capital position relates to minimizing fund losses, whereas the liquidity position involves cash flow and borrowing capacity. Prompt resolution can only occur if the insurance funds have sufficient capital and liquidity.

\textsuperscript{9} The FDIC currently strives to return assets to the private sector as quickly as possible (although without neglecting the appropriate due diligence and marketing activities) in order to maximize recoveries to the receivership. This policy arose from its experience in selling and managing assets during the banking and thrift crisis, and it is motivated in part by the belief that this optimizes asset recoveries and minimizes the FDIC’s cash flow requirements and risk exposure.

There are additional reasons why the FDIC would prefer to avoid running a bridge bank for a long time. First, the FDIC lacks experience in running large banks. Second, the FDIC’s government status gives it a funding advantage over the private sector, and the FDIC has no desire to distort capital allocation by exploiting this advantage.

This objective comports with the recommendations in Basel Committee on Banking Supervision (2002), p. 31. There is an extensive literature on government-owned banks, primarily addressing their role and effectiveness in emerging markets. Recent empirical evidence indicates that they tend to be less profitable than private-sector banks and subject to political influence; in addition, their government affiliation gives them an advantage in funding cost. See La Porta, Lopez-de-Silanes, and Shleifer (2002), Mian (2003) and Sherif, Borish and Gross (2003).
bank is unknown, as time passes customers and staff of the bridge bank would likely leave to establish more permanent relationships, causing the franchise value of the bridge bank to decrease. However, a brief period of government control may give the FDIC the chance to better formulate a marketing strategy and market assets to a larger number of potential acquirers, thereby maximizing asset recoveries and minimizing costs. If a large bank were to fail, we anticipate any FDIC oversight of banking operations would last for less than a year (although it may be handling certain problem assets or liabilities for quite some time afterwards).

As receiver, the FDIC has a duty to maximize returns to all the creditors of the bank—not just returns to the depositor class. This dovetails closely with the FDIC’s desire to minimize its costs, but it will be important even if no losses are expected to accrue to the depositor class.

### 3: The Changing Banking Landscape

Over the last 10–15 years, the largest banking companies have changed markedly. While every megabank is unique, all have changed in ways that introduce difficulties and complexities for a deposit insurer. This section discusses some of these features.

**Size.** The FDIC now insures twelve institutions that hold more than $100 billion in assets up from six just 10 years ago. The largest bank insured by the FDIC today (Bank of America, NA) has total assets of $1.05 trillion, about 31 times larger than Continental Illinois when it failed and 30 times larger than the BIF insurance fund.
**Complex technology.** Most resolution transactions require that the deposit insurer interact with the computer systems of the failed bank. Today’s banks have extensive and complex systems environments with numerous automated processes that may require changes at closure. The logistical difficulties related to technology are compounded if the failed bank had not completed systems conversions after purchasing one or more banks. As of December 2004, the holding companies for the 12 financial institutions referenced above were involved in 216 mergers of FDIC-insured institutions in the last five years (an average of 18 per company). Thus the failed bank may have several parallel systems and duplicate processes for handling a single type of activity at the bank. In addition, technology has increased the speed of transactions, allowing some creditors to exit a troubled bank more quickly. Thus, the pace of failure has probably increased, at least for banks that rely heavily on unprotected funding sources.\(^{11}\)

**Derivatives.** As of year-end 1993, as the banking crisis was winding down, the volume of off-balance sheet derivatives held by U.S. commercial banks was $11 trillion in notional value; as of September 2004, it was $88 trillion.\(^{12}\) The increase in volume amplifies the FDIC’s challenges associated with the closeout provisions in derivative contracts (described in Section 4).

**Geography.** All megabanks operate in multiple time zones, and most operate in multiple countries. This complicates the logistics and communications required at failure—particularly if the bank operates in several countries—since it will require co-ordination with a large number of banking regulators.\(^{13}\) This also causes problems in selecting the time of closure. Normally, the

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\(^{10}\) See Group of 10 (2001) for additional analysis about the effects of consolidation on systemic risk and the ability to effect an orderly resolution of a failure.

\(^{11}\) This affects transaction deposits, overnight borrowing, and other unprotected credits with contractual clauses designed to protect the lender if the bank experiences an adverse event.

\(^{12}\) See Folkerts-Landau and Garber (1997) for a more detailed discussion. See also McDonough (1998).

\(^{13}\) If a subsidiary of a U.S. bank failed, but the bank did not fail, the FDIC would probably not be involved. Instead, the failure would be resolved under the rules in place in the country where it is located. It is highly unlikely that a branch of a U.S. bank would fail unless the entire bank failed. If a U.S. bank with international operations failed due to problems in other countries, then the FDIC would have the same objectives and follow the same resolution
FDIC closes banks at the end of the business day, usually on a Friday. If the bank is closed when its head office closes, normal activity will be disrupted elsewhere. If the closing is delayed, critical bank staff may be unavailable to the FDIC. If all locations are not closed at the same time, an opportunity is created for unprotected creditors to withdraw funds after failure.

**Holding company structures.** In the U.S., bank activities are limited. To address these limits, or for other reasons, many large banking companies have created complex holding company structures. It is not unusual for non-bank affiliates to perform functions disallowed or limited for banks (such as insurance, securities transactions, merchant banking, and real estate brokerage). There can be literally hundreds of separate companies, with several tiers of ownership within a single banking organization. The holding company may be managed with little or no regard to the legal boundaries between its bank and non-bank subsidiaries, aside from meeting its regulatory requirements. This has the potential to cause problems when failure brings the legal boundaries to the forefront, with significant differences in the prospective bankruptcy regimes faced by the company’s bank and non-bank affiliates. The bank may outsource certain critical operations (such as data processing or its call center) to non-bank affiliates or the parent company.¹⁴ Unless these services continue unabated, it may be difficult to retain the value of the bank’s franchise or even process deposits without disruption. Since the bankruptcy regime for non-banks was not designed for quick action, achieving uninterrupted service could be quite a challenge if the parent declares bankruptcy. In addition, the structure could complicate the operation and marketing of business lines that cross bank and non-bank affiliates. These strategies regardless of the source of the bank’s problems. It would consider local market conditions and the legal situation when developing sales strategies (at least for countries where the government does not run a separate receivership for the assets and liabilities in its country), and the source of bank distress would certainly influence considerations about systemic risk.

¹⁴ For example, when NextBank failed in February 2002, it had virtually no staff or facilities. All bank functions were performed by holding company employees in holding company facilities. The FDIC negotiated with the leadership of the holding company to delay bankruptcy of the holding company and to allow the staff who were knowledgeable about the bank’s operations to assist in the resolution. The holding company declared bankruptcy in November 2002.
characteristics are likely to cause problems because the FDIC insures only the bank deposits and has no jurisdiction over the non-bank affiliates or the holding company(ies).

**Role in key markets.** Megabanks play important roles in financial markets. For example, the bank may be a key player in the capital markets or derivatives markets, or it may have a significant role in the payments system. If the bank plays a role in ensuring that a market clears, then a disorderly failure is more likely to disrupt the market. Industry consolidation has increased the concentration of certain functions in the hands of fewer banks. If a bank has few competitors in a particular line of business, the FDIC may seek a resolution strategy that allows the affected business line to continue operating effectively.

### 4: Increased Legal and Operational Constraints

In addition to the increased size and complexity of large banks today relative to a decade ago, the FDIC also faces greater legal and operational constraints on the bank failure resolution process. Most significantly, the FDIC must adhere strictly to a cost test that it does not have the authority to compromise. Under the provisions of the Federal Deposit Insurance Corporation Improvement Act of 1991 (FDICIA), the FDIC must resolve failing insured depository institutions using the transaction, other than a payout and liquidation, that is the “least costly to the deposit insurance fund of all possible methods for meeting the Corporation’s obligation to provide insurance coverage” (emphasis added). Least cost refers specifically to the costs associated with an individual failure of a depository institution and does not include potential spillover costs, such as those associated with the possible failure of other unaffiliated depository institutions that may occur or be expected to occur as fallout from the initial failure. These

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provisions may increase the speed of failure because they give unprotected creditors a stronger incentive to exit troubled banks or seek collateral.

A failure resolution that does not meet the least-costly standard is permitted only if the least-costly resolution structure “would have serious adverse effects on economic conditions or financial stability”\textsuperscript{16} and an alternative resolution “would avoid or mitigate such adverse effects.”\textsuperscript{17} The determination that the least-costly resolution would have such consequences must be made by the Secretary of the Treasury, in consultation with the President, upon the recommendation of two-thirds votes of the FDIC Board of Directors and the Board of Governors of the Federal Reserve System. This is commonly referred to as a systemic risk determination. Since its implementation in 1991, no insured depository institution has been found to raise systemic risk implications. It is believed a systemic risk determination will be a rare event.

FDICIA also effectively prohibited the use of open bank assistance without a systemic risk determination, thereby substantially limiting the likelihood of its future use. The FDIC is prohibited from using assistance to an open institution “in any manner to benefit any shareholder or affiliate.”\textsuperscript{18} Further, the FDIC “may not . . . make any payment or provide any assistance, guarantee, or transfer . . . in connection with any insured depository institution which would have the . . . effect of satisfying . . . any claim against the institution for obligations of the institution which would constitute [foreign] deposits.”\textsuperscript{19} These provisions can be ignored only with a systemic risk determination.

\textsuperscript{16} Federal Deposit Insurance Act, Section 13(c)(4)(G)(i).
\textsuperscript{17} Ibid.
\textsuperscript{18} Federal Deposit Insurance Act, Section 11(a)(4)(B).
\textsuperscript{19} Federal Deposit Insurance Act, Section 41(a).
In 1993, a more subtle change to the FDIC’s environment occurred when national depositor preference was enacted. This effectively gives deposits preference over general creditor claims in a resolution transaction of any insured depository institution. The Federal Deposit Insurance Act excludes foreign deposits from the definition of a deposit. Consequently, foreign deposits—those not payable in the United States—have general creditor standing in a failure. Thus, in the absence of a systemic risk determination, foreign deposits will be exposed to loss rates that may be substantially higher than they would have been before the enactment of the national depositor preference legislation, and certainly higher than domestic deposits. Given that foreign governments have a strong incentive to protect local depositors and creditors, it is unlikely that they would voluntarily allow a resolution structure where deposits in their countries receive less than uninsured deposits in the U.S. Therefore, one or more foreign governments might marshal the assets of the failed bank in their countries and liquidate them to satisfy local depositor and creditor claims. Such action—typically referred to as “ring fencing”—could be used widely in the failure of a U.S. bank that has foreign operations. This complicates a megabank resolution and may create a greater potential for systemic risk.

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20 The change was enacted in the Omnibus Budget Reconciliation Act of 1993. Prior to 1993 certain states had legislated depositor preference that applied only to the state-chartered depository institutions operating in the respective state. At the time, depositor preference generally did not apply to large banks.

21 While there have been instances where countries have ring fenced (the liquidation of Bank of Credit and Commerce International is a visible example), no foreign country has ring fenced in connection with the failure of a U.S.-chartered bank.

22 A transaction that involves ring fencing will complicate several aspects of the resolution. The capital market activities of a megabank may be conducted in several countries, for example. Liquidating these activities separately may create more systemic risk than a single resolution effort. Further, multiple liquidations will result in vastly different treatment for depositors across different foreign countries, which may delay the availability of funds to depositors. See Marino and Bennett (1999), Curtis (2000), Contact Group on the Legal and Institutional Underpinnings of the International Financial System (2002), and Baxter, Hansen and Sommer (2004) for a more detailed discussion.
The FDIC also faces considerable operational constraints in handling the qualified financial contracts (QFCs) of a failed institution. If a bank fails and the FDIC immediately creates a bridge bank to assume its assets and certain liabilities, the FDIC as receiver has only three options in dealing with QFCs.

- The contract can be repudiated.

- The contract can be transferred to a third party (including a bridge bank), but only if all QFCs with the same counterparty, including affiliates, also are transferred and the receiver has taken steps “reasonably calculated to provide notice” to the counterparty to any such contract of such transfer by 5:00 p.m. on the business day following such transfer. A counterparty is precluded from terminating the QFC if it is transferred to a bridge bank on the business day following the appointment of a receiver.

- The contract can be held in the receivership. In this case the counterparty can terminate the contract and net its position after the close of business (New York time) on the business day following the appointment of the receiver.

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23 “The term ‘qualified financial contract’ means any securities contract, commodity contract, forward contract, repurchase agreement, swap agreement, and any similar agreement that the Corporation determines by regulation to be a qualified financial contract for purposes of this paragraph.” Federal Deposit Insurance Act, Section 11(e)(8)(D)(i). The constituent contracts defined as “qualified financial contracts” are themselves defined in section 11(e)(8)(D). These definitions include most derivative contracts to which the bank is a party as well as some agreements, like repos or securities sales agreements, that are not commonly considered to be derivatives.

24 A bridge bank is a temporarily chartered national bank “owned” by the FDIC. It is described in more detail in Section 5.

25 Federal Deposit Insurance Act, Section 11(e)(1).

26 Federal Deposit Insurance Act, Section 11(e)(9).

27 “The term ‘business day’ means any day other than any Saturday, Sunday, or any day on which either the New York Stock Exchange or the Federal Reserve Bank of New York is closed.” Federal Deposit Insurance Act, Section 11(e)(10)(B).

28 Federal Deposit Insurance Act, Section 11(e)(10)(A)(ii).

29 The holder of a QFC is afforded the “right to offset or net out any termination value, payment amount, or other transfer obligation arising under or in connection with 1 or more contracts and agreements . . ., including any master agreement for such contracts or agreements.” Federal Deposit Insurance Act, Section 11(e)(8)(A)(iii).
Thus, the FDIC must determine on the day following closure which (if any) derivative contracts will be transferred to the bridge institution; otherwise a counterparty can terminate the contract and net its position. For some institutions, the FDIC’s task is complicated by the structure of the company, because the derivatives portfolio may be spread across bank and non-bank affiliates.

In summary, the rules and procedures under which the FDIC must currently operate are far more restrictive than the environment in place during the 1980s and early 1990s. During that time, the FDIC routinely handled large bank failures without subjecting depositors and general creditors to a loss. Such transactions clearly are easier to structure, and they maintain the failed institution’s franchise value. Further, during much of this time the involvement of large banks in the derivatives area was fairly limited. If a large commercial bank were to fail today, the FDIC would face a much more cumbersome resolution process. It must adhere strictly to a cost test, which means that depending on the magnitude of loss, uninsured depositors and general creditors would likely suffer some degree of loss. Large outstanding derivatives portfolios at all of the megabanks are also a complicating factor.

5: FDIC Transaction Options

The FDIC has numerous tools at its disposal to resolve a failing insured depository institution. These broadly include a deposit payoff, a purchase-and-assumption transaction (P&A), a bridge bank structure, and open bank assistance. In this section, we briefly describe each of these transactions and discuss how well they might meet the stated objectives, and

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30 Losses at large failed commercial banks generally have been small as a percent of bank assets. Depending on the failed institution’s liability structure and the size of the potential loss, it is possible that all domestic depositors may receive full value for their funds under a transaction that is consistent with least cost.
explain why the bridge bank resolution strategy is likely the best approach for resolving large and complex banks.\textsuperscript{31}

There are many circumstances that could surround the failure of a megabank, and great variation between the business structures of these institutions. These factors make prognostication of the transaction options a hazardous proposition. At this point it is not possible to tell exactly how a future megabank transaction would unfold. It appears, however, that a bridge bank structure would be the FDIC’s most likely alternative.

**Payoff**

In a deposit payoff the bank is closed by its chartering agency (either federal or state) and all assets and liabilities are transferred to a receivership. The FDIC acts as receiver for virtually all insured depository institutions closed in the U.S. The FDIC will then arrange to pay insured depositors as quickly as possible—usually within three days of the bank’s closure. Payment can be made either by checks issued to depositors or through another depository institution that acts as a paying agent (insured deposit transfer). An insured-deposit transfer may generate, for the benefit of the receivership, a premium paid by the bank that acts as a paying agent.\textsuperscript{32} Uninsured depositors and other creditors are given a receivership certificate for the uninsured portion of their funds.

\textsuperscript{31} For a more detailed description of these transactions, see FDIC (1998).

\textsuperscript{32} However, it may be difficult to accomplish an insured deposit transfer at the time of failure because of the advanced planning that is normally required (as discussed in the next section).
After the receivership is established, the FDIC liquidates the assets. Depending upon the extent of ring fencing, the FDIC may be dealing with domestic assets only (if all foreign governments ring fence) or with assets from many countries. The FDIC or its contractors will handle the asset liquidation. Distributions are made on a pro rata basis to creditors (including the FDIC standing in place of insured depositors) from the proceeds of the liquidated assets.

A deposit payoff would run counter to several of the FDIC’s objectives concerning the failure of a large bank. Most importantly, it is unlikely to be the least-costly transaction. In a deposit payoff, the FDIC pays off insured depositors and liquidates the assets of the failed institution. The operational challenges and resulting costs associated with a deposit payoff could be considerable. For example, the logistics involved in cutting and mailing checks to such a large number of depositors would be very difficult. But, apart from that, megabanks—even those that are insolvent—have considerable franchise value as a going concern. This franchise value could stem from its deposit and loan generating operations, or from other business activities. A deposit payoff would destroy much (if not all) of this value.  

Leaving all assets of the failed institution with the receiver also may not be the most cost effective approach. While the FDIC could manage the collection of these assets or enter into collection agreements with third parties, these options may be less effective than other alternatives such as a bridge bank structure because the FDIC’s ability to maintain normal bank operations (such as extending credit or accepting deposits) is limited. Further, the deposit and

33 A payout is exempt from the least-cost provisions in FDICIA. However, as receiver, the FDIC has a duty to maximize recoveries to all creditors—not just to the insurance funds. If the bank has little or no franchise value, then a payout might be the best way to maximize recoveries.
loan relationships of many business customers are intricately intertwined. Severing these relationships contributes to the reduction in franchise value.

A deposit payoff also would be the least advantageous from the standpoint of the FDIC’s liquidity management. The FDIC would generally have to generate enough cash to payoff insured deposits, an amount that could easily exceed the value of Treasury securities held in the fund. Liquidating these securities could have negative accounting and other implications for the FDIC. The FDIC has sufficient borrowing authority through the FFB that it could raise this money in most circumstances, but will want to avoid this approach when other viable, less costly resolution options exist.

**Purchase-and-Assumption Transaction**

In a P&A transaction, the FDIC places all of the assets and liabilities of the bank into a receivership, and then one or more acquirers immediately assume the insured and secured deposits (and perhaps other liabilities as well) and purchase some or all of the bank’s assets. Sound assets could be transferred at par or market value; troubled assets could be transferred at a discount or with a loss-sharing agreement. Any difference between assets and liabilities would be made up by the FDIC in the form of cash or a note.

A P&A structure for a large bank will require a considerable amount of preplanning. Before the failure, the FDIC starts the process by collecting information about the bank and developing an information package for potential acquirers. Then the FDIC solicits potential acquiring banks, requesting that they bid on the assets and insured liabilities of the failed
institution. In preparation for bidding, acquirers may want to conduct on-site due diligence before submitting bids. The FDIC typically receives a significant premium for the failed institution’s franchise value.

To encourage broad market participation and maximize franchise value, the FDIC groups similar assets and related deposits for sale. Bids can be submitted on a single group of assets or liabilities, all of the bank’s assets and liabilities, or any other combination. Right before the failure date, the FDIC evaluates the bids and accepts the least-cost bid or combination of bids. Thus the FDIC might sell the entire franchise to a single bidder, or the bank may be sold piecemeal to multiple bidders.\(^\text{34}\)

To minimize the assets that it must manage, to reduce working cash requirements, and to encourage more market participation, the FDIC may enter into loss-sharing arrangements for some or all of the troubled assets. Under the loss-sharing agreements, the bidder acquires, manages and liquidates the assets. Both the bidder and the receivership creditors (including the FDIC) share in the loss exposure and potential gains from liquidating the assets.

For a megabank, it may be impossible for the FDIC to conduct the preplanning activities in secret. The recent legislative and policy changes discussed earlier will make it fairly difficult for the FDIC to take the action necessary to negotiate a permanent solution prior to the failure of a megabank.\(^\text{35}\) Effective preplanning for a megabank failure requires that:

\(^{34}\) Selling the bank piecemeal to multiple bidders would also increase the pool of eligible bidders.

\(^{35}\) During the 1980s the FDIC successfully negotiated with large banks open bank assistance and P&A transactions, each of which involved a process that lasted months before its conclusion. Further, all of these negotiations eventually became public knowledge without severe consequences for the bank. These earlier transactions were facilitated by the public’s perception at the time that the FDIC always structured large-bank transactions that protected all depositors and creditors. Today, by contrast, such a transaction would require a systemic risk determination, and the FDIC: (1) has broad bridge bank authority, (2) is required to engage in a “least cost”
• federal regulators and/or the insured depository institution’s management recognize fairly early that the insured depository institution’s long-term viability depends on FDIC intervention, and

• either relatively lengthy resolution negotiations can be conducted in secrecy or the public disclosure of these negotiations will not result in a fatal liquidity crisis for the insured depository institution.

It seems unlikely that all of these conditions will be met for a troubled megabank. The necessary preplanning process of a P&A has a high likelihood of becoming public knowledge; in fact, disclosure may be required by the failing institution. Public knowledge of the FDIC’s involvement could well serve as a lethal blow to an already troubled institution.

Like a payoff, this transaction may result in extensive ring fencing, especially since foreign deposits stand behind domestic deposits. Ring fencing will probably affect the way that the FDIC calculates its cost test and structures the bank’s assets for sale to potential acquirers. Certain assets may not be offered for sale because of jurisdictional questions.

QFCs and other derivatives would be disposed of by the receiver based on an overall valuation of the portfolio or individual relationships. Many of these positions may be fully collateralized, implying that the respective counterparties are not exposed to loss. If most of the portfolio were collateralized, then the FDIC might be able to transfer the entire portfolio to an acquirer.

transaction, and (3) has established a considerable record of imposing losses on uninsured depositors and unsecured creditors of failed banks. These factors greatly diminish the potential success of assistance negotiations.
The FDIC’s experience suggests that in most cases a P&A transaction involving a very large bank could be difficult and expensive to structure in the time available, thereby raising cost test issues. When Continental Illinois collapsed the FDIC tried to find an acquirer and could have structured a P&A transaction. But the guarantees and assurances demanded by the potential acquirer likely would have been more expensive than the ultimate solution. Again, this solution may not meet the least-cost test and may not be possible if the failure unfolds quickly.

**Bridge Bank—Least Cost**

The bridge bank structure has two phases. At failure, the bank is closed, and all of the bank’s assets and liabilities are placed in a receivership managed by the FDIC. Virtually all assets, plus the insured deposits (and perhaps other liabilities) are then moved into a bridge bank managed by the FDIC. In the bridge bank, preparations are made for the second phase: executing the most cost-effective sales strategy. Figure 1 provides a graphic illustration of the process.
By placing the bank in receivership, the FDIC limits its obligation to pay uninsured creditors to the funds recovered from the receivership sales and operations. However, many types of bank activities are discontinued in a receivership because it is designed to be a vehicle for liquidating a financial institution. Therefore, to enable a broader array of bank operations to continue, the FDIC establishes a bridge bank as quickly as possible, and places virtually all of the bank’s assets, plus all domestic deposits that are identified as insured, into the bridge bank. If bank losses are estimated to be absorbed by the interests of shareholders, subordinated debtors and general trade claimants (resulting in no expected loss to domestic depositors), then the uninsured domestic deposits could also be transferred en masse to the bridge bank.

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36 If bank losses are estimated to be absorbed by the interests of shareholders, subordinated debtors and general trade claimants (resulting in no expected loss to domestic depositors), then the uninsured domestic deposits could also be transferred en masse to the bridge bank.
90 percent of each account) may also be transferred into the bridge bank (this is referred to as an advance dividend).

The bridge bank is a temporary national bank owned by the FDIC. As much as possible, normal banking operations continue at the bridge bank. Generally, the FDIC is likely to prefer a continuation of bank lending and other activities, both to preserve the bank’s franchise value and to minimize market disruption. However, the FDIC would probably discontinue any activities that pose too much risk to creditors.

The FDIC will seek to ensure reliable funding for the bridge bank in a way that minimizes funding costs and does not put too much liquidity pressure on the insurance fund. To accomplish this, the FDIC may guarantee all of the bridge bank’s deposits and some other credits—including any new deposits accepted after failure. The FDIC may also capitalize the bridge bank (although the bridge bank has no capital requirement) or provide working cash as needed.

The bridge bank’s operations may be complicated by several factors. For example, it may be that some parts of the bridge bank operations are performed by holding company affiliates; these companies may not be controlled by the FDIC, and their incentives may not align with the FDIC’s objectives. In addition, haircuts imposed on uninsured depositors might interfere with a smooth transition in processing the bridge bank’s transaction accounts.37

37 To ensure certainty in the payment system, there are strict timing requirements in place for payments processing. If the bridge bank fails to meet the requirements, the FDIC could be subject to substantial losses. The FDIC is considering new requirements for large banks to facilitate the successful and prompt imposition of haircuts in the event of failure, which in turn would improve the bridge bank’s ability to meet these timing requirements. See FDIC (2005).
After the bridge bank is established, the FDIC prepares the bank for sale. Information about the bank’s assets and liabilities is collected and shared with prospective bidders. The FDIC could choose to sell the bank via a P&A structure using the basic process described above, but with most or all of the marketing activities occurring after the failure date. Alternately, it could recapitalize the bank via a stock sale.

The entire sale process is expected to occur within one year of failure. Once most of the bridge bank’s assets and deposits are sold, the bridge bank is closed and the remaining assets and liabilities are placed into receivership. Normal banking operations cease at this point. The receivership continues to sell assets and pay dividends to creditors as funds become available. If the domestic depositors are paid in full, then the receivership uses the available funds to pay dividends to the general trade claimants.

Compared to a P&A or payoff, decisions about the QFCs and other derivatives may be a little more complicated for a bridge bank scenario. Some of the QFC transactions may be linked to important hedging or other functions of the failed bank.

Like the P&A and payoff, this transaction may result in extensive ring fencing. Such activity would probably occur during the failure phase. Therefore, the marketing phase could take ring fencing into account more easily than a P&A without a bridge bank. However, ring fencing will create uncertainties that may delay opening certain functions of the bridge bank.

Because losses can be imposed on third party creditors, the franchise continues operating during the bidding process, and the FDIC is able to perform due diligence and market the assets

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38 The life of a bridge bank is limited to two years, although extensions are permitted.
broadly, the bridge bank method is the likely option to minimize the FDIC’s resolution cost. It can provide both insured and uninsured depositors with prompt access to their funds. It allows the FDIC to conserve its liquidity by providing depositors access to funds without making direct payments for the entire deposit liability. However, these benefits can only be obtained by substantially increasing the complexity of the FDIC’s task, which in turn may involve offsetting costs and increased operational risk. Even so, the bridge bank structure has a great deal to offer the FDIC, and it has been used successfully for a number of large-bank failures in the past.

In some circumstances this method may not adequately address concerns about systemic risk. If the bank has a large and troubled derivatives book, some or all of the contracts might be left behind in the receivership or abrogated, potentially causing significant disruptions to the financial markets. If other banks are perceived as having problems similar to those of the failed bank, creditor losses at the failed bank might trigger deposit runs at other banks. If the bank has a significant role in the payment system or sizeable interbank loans outstanding, its failure might impose substantive losses on other banks or cause disruptions in the payment system. Operational difficulties might delay the opening of the bridge bank or access to funds for important creditors. In some situations, regulators might want to consider other alternatives.

**Bridge Bank—Non-Least Cost**

The Federal Deposit Insurance Act, and the FDIC, recognize the importance of a least-costly transaction in limiting losses to the deposit insurance fund, and in maintaining market

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39 Examples include costs associated with addressing holding company issues, increased returned item processing due to losses imposed on depositors, and excess advance dividend payments (if net recoveries to the depositor class are lower than the initial estimates).
discipline. However, the statute provides for a systemic risk exception to the least-costly transaction. If that were to occur, how would the resolution differ?

A systemic risk determination would greatly expand the FDIC’s options. There would still be a desire to control cost, but only in rare cases would it be a least-cost resolution.

The first approach likely would be to see if using the bridge bank transaction just described could solve the systemic problem, but with the twist that some depositor or creditor classes are made whole or get more than they otherwise would. The FDIC has the legal authority to discriminate among depositor and creditor classes, as long as all creditors receive at least what they would have received in a payout and liquidation. This type of transaction need not result in all of the bank’s unprotected creditors getting something extra. If the systemic threat centers only on the derivatives portfolio, for example, these claimants could be made whole even if other creditors are limited to their value under a payout and liquidation. Or the FDIC could minimize ring fencing by providing foreign depositors with the same recovery as domestic uninsured depositors.

A variation of this approach would be to make all depositors and general creditors whole with potential losses accruing only to shareholders and subordinated debt holders. Because the FDIC would not need to impose losses on uninsured depositors or general trade claimants, and because ring fencing would probably not occur, this option would reduce the operational risk associated with other bridge bank options. This structure has a very low potential for generating systemic risk concerns and does not bail out bank capital, but it raises the overall resolution cost and exacerbates moral hazard concerns.
Open-Bank Assistance

At the extreme, a systemic risk determination affords the FDIC the option of using open-bank assistance. In an open-bank assistance transaction, the FDIC provides direct assistance to the bank, and the bank is never closed. This is viewed by the FDIC as the last-resort, least-desirable alternative, but certain circumstances may require it. Past experiences with open-bank assistance has made the FDIC well aware of its considerable pitfalls: cost concerns and the need to negotiate with shareholders and creditors. In addition, this structure may reduce the future effectiveness of market discipline.\textsuperscript{40} This is a transaction structure the FDIC would not look forward to implementing.

Initially, open-bank assistance is the easiest transaction to structure. Because the bank is not closed, depositors and general creditors are not subject to loss. The bank’s operations continue to function. The FDIC must take action that will restore confidence in the bank that could include a capital infusion and granting assurances to depositors and perhaps a select group of general creditors.

The complexity of open-bank assistance appears after the initial granting of assistance and assurances. The FDIC must then negotiate the appropriate concessions with the various bank stakeholders. Since all large banks in the U.S. are owned by a holding company, these negotiations likely will focus on holding company equity and debt. In the past, the FDIC has

\textsuperscript{40} Several studies have found that the acknowledgement of “too big to fail” after the failure of Continental Illinois yielded tangible benefits to large banks at the time. See, for example, O’Hara and Shaw (1990).
received warrants for holding company stock and has required certain holding company creditors to accept concessions.\textsuperscript{41}

6: Conclusion

Because of the increasing complexity of megabanks, the constraints imposed on the FDIC if a megabank should fail, and the economic importance of a megabank failure, the FDIC must always be prepared for such an event—even if it is considered unlikely in the near term. The risks of inadequate planning are too great and the future too unpredictable. One way to plan for a potential failure is to examine the FDIC’s ability to meet its objectives in light of the legal constraints and operational difficulties that might occur, as we have attempted to do in this paper.

We find that the FDIC has several tools available that would be useful if a large bank failed. The FDIC’s receivership management authority is cost-effective (compared to other bankruptcy proceedings in the U.S.)\textsuperscript{42} and it gives the FDIC sufficient authority to sell the failed bank’s assets. The FDIC’s bridge bank authority allows the FDIC to preserve a large bank’s franchise value during the marketing process. By avoiding lengthy bankruptcy provisions, the FDIC can move quickly to resolve a failed bank. The ability to reduce the liquidity costs of depositors (and possibly other creditors) by paying dividends in advance of selling the bank or the bank’s assets mitigates the indirect costs of failure. Because the FDIC can advance funds to depositors by providing access to funds at the bridge bank (rather than paying cash), liquidity can

\textsuperscript{41} See, for example, the case studies on Continental Illinois National Bank and Trust Company and First City Bancorporation of Texas discussed in FDIC (1998).

\textsuperscript{42} The ability to stay credits (available in general bankruptcy but not bank failure) would destroy the franchise value of the bank and damages asset values. In addition, the principal/agent problems associated with a standard bankruptcy are worse than those experienced by the FDIC. In addition, the FDIC is far more familiar with bank assets than a typical bankruptcy judge. The inefficiency of bankruptcy proceedings has been noted by several authors. See Bradley and Rosenzweig (1992) and Bris, Welch and Zhu (2005). See also Hupkes (2000).
be provided to depositors without excessive damage to the FDIC’s liquidity position. This type of transaction—one that exposes uninsured depositors and creditors to loss—limits the FDIC’s loss exposure and promotes market discipline. We expect that the FDIC will find some type of bridge bank resolution to best meet its objectives for most large bank failures.

Because of the size and complexity of megabanks, the FDIC may not be able to fully realize the benefits of a bridge bank structure. Some bridge bank structures might damage the economy, disrupt financial markets, or even cause a financial panic, depending upon the situation at hand. Some transactions may be theoretically available but operationally difficult or impossible. The systemic risk exception gives banking regulators a variety of options for handling a failing bank that has the potential to cause serious harm to the economy or financial instability. If the systemic risk exception were invoked, the FDIC could protect one or more classes of creditors within a bridge bank, or render open-bank assistance, as needed to reduce the systemic consequences of the failure. This provides the flexibility to develop a solution that balances the desire for market discipline and long-term financial stability against the short-term dangers. By being equipped for using either method, the FDIC can be ready to face the resolution of a megabank.

Market participants should be aware of the FDIC’s options and how it likely would approach a large-bank resolution. While twenty years ago it was generally understood that the likelihood of losses to uninsured depositors and general creditors was fairly small, this no longer is the case today. This knowledge has important implications for market discipline, considered an important factor in limiting bank risk taking.
Bibliography


