



CHAPTER 2

First Pennsylvania Bank, N.A.

Name of Institution:	First Pennsylvania Bank, N.A.
Headquarters Location:	Philadelphia, Pennsylvania
Date of Resolution:	April 28, 1980
Resolution Method:	Open Bank Assistance Transaction

Introduction

One of the most notable institutions to receive open bank assistance (OBA) from the Federal Deposit Insurance Corporation (FDIC) was First Pennsylvania Bank, N.A. (First Penn), Philadelphia, Pennsylvania. First Penn was Philadelphia's largest bank and the 23rd largest bank in the nation, and its failure would have been the largest in U.S. history.

In 1980, the FDIC confronted the threatened insolvency of a large number of mutual savings banks. The institutions had generally much larger total deposits than the average commercial bank, and virtually all of their deposits were fully insured. No mutual savings bank had failed in the United States since 1939.

The FDIC faced an important issue: How to reconcile the situation with the large commercial bank and the mutual savings banks. FDIC Chairman Irvine H. Sprague summarized the dilemma as follows: "The savings bank problems . . . complicated our deliberations about First Pennsylvania. How could we save a big stockholder-owned commercial bank at the same time we were planning for the failure of all these mutual savings banks?"¹

General Description of the Bank

First Penn was the successor to the first U.S. private bank, which was established in 1782. As of April 28, 1980, First Penn had \$8 billion in total assets and \$5.3 billion in total deposits.² The deposits were in approximately 574,000 accounts. First Penn

1. Irvine H. Sprague, *Bailout* (New York: Basic Books, 1986), 78–79.

2. FDIC, *Historical Statistics on Banking: A Statistical History of the United States Banking Industry, 1934-1992* (Washington, D.C.: Federal Deposit Insurance Corporation, 1993), 617.

operated 69 U.S. offices, including 40 branches in Philadelphia County, Pennsylvania. It also operated branches in the U.S. Virgin Islands, London, and Nassau.

Background

During the 1970s, banks became vulnerable to high and rising interest rates. On February 16, 1971, the \$110 million Birmingham-Bloomfield Bank (BBB), Birmingham, Michigan (a suburb of Detroit), was the first \$100+ million failure handled by the FDIC.³ BBB had invested heavily in long-term municipal bonds, relying considerably on purchased deposits, in anticipation of expected interest rate declines. When interest rates rose, the bank incurred losses and found itself locked into low-yielding, depreciated securities. The experience of BBB did not prevent other banks from subsequently getting into situations in which they became vulnerable to high and rising interest rates.

The U.S. economy had broad-based weaknesses in 1980. Growth in real gross domestic product (GDP) was sluggish for the second consecutive year, and unemployment jumped to 7.2 percent from 5.8 percent in 1979.⁴ Home sales and housing starts were down sharply, but the market for office space remained tight. The Federal Reserve discount rate rose to 11.8 percent and the 30-year mortgage rate was up to 13.8 percent, resulting in higher interest rates for both loans and deposits. There was strong demand for oil around the world, with OPEC restrictions causing oil prices to rise. Substantial deposit amounts shifted from banks and thrifts to money market funds or to market securities, and depository institutions experienced both disintermediation and an increased cost of funds.⁵

The Problem

In the late 1960s and early 1970s, First Penn grew rapidly. From 1967 to 1976, assets increased from \$2.1 billion to more than \$6 billion, but many of the assets became non-performing loans.⁶ The bank resolved a substantial number of loans, but some problems remained. Beginning in 1976, the bank used short-term deposit liabilities to make large

3. FDIC, *Historical Statistics on Banking*, 608.

4. CB Commercial Torto/Wheaton Research, *The Office Outlook*, Bureau of Labor Statistics.

5. Disintermediation is the movement of funds from low-yielding accounts at traditional banking institutions to higher yielding investments in the general market—for example, withdrawing funds from a passbook savings account paying 5.5 percent to buy a Treasury bill paying 10 percent. As a counter move, banks paid higher rates to depositors (but they were regulated or limited), then charged higher rates to borrowers, which led to tight money and reduced economic activity. Since banking deregulation, disintermediation is not the economic problem it once was. John Downes and Jordan Elliot Goodman, *Dictionary of Finance and Investment Terms* (Hauppauge, New York: Barron's Educational Series, 1995), 143.

6. Sprague, *Bailout*, 85.

purchases of long-term, fixed-rate U.S. government securities. Also, in an attempt to stabilize future income at what the bank thought would be high rates, First Penn bought its securities when those investments were earning interests of 7 to 8 percent. By 1979, it held more than \$1 billion in Treasury bonds. About half the portfolio of Treasury issues had maturities of more than 10 years; some 30-year bonds had maturities of 2007 and were paying 7.6 to 7.9 percent a year. But interest rates kept increasing, and First Penn was paying as much as 15.5 percent on deposits by May 1980.⁷ The income from fixed rates on the bonds could not keep pace with the cost First Penn needed to pay on its deposit funds, and the bonds became a burden. As interest rates climbed, the market value of the bonds fell to \$300 million less than their face value.⁸

Additionally, at the end of the first quarter of 1980, 6.3 percent of the bank's loans were not paying interest or were paying interest at a reduced rate. The 6.3 percentage rate was high in comparison to the rest of the industry.⁹ Questionable loans totaled \$328 million, which was \$16 million more than the bank's entire equity capital.¹⁰

The volume of the bank's nonperforming loans, combined with the problem in the securities portfolio, caused a lack of confidence among First Penn's customary sources of deposits and other funds.¹¹ Some of the bank's deposit customers, including regional banks and deposit brokers, began to move their deposits out of the bank, forcing First Penn to seek unusual amounts of credit from the discount window of the Federal Reserve Bank of Philadelphia (Federal Reserve). First Penn was in a poor position, because if it sold any substantial portion of the securities to gain liquidity and cut its interest rate losses, it would have had to recognize extraordinary losses caused by the securities' depreciated value.¹² By the first quarter of 1980, First Penn was paying short-term rates of 15.5 percent to fund \$1.2 billion of fixed-rate securities that earned only 8.7 percent.¹³

The Resolution

On Wednesday, March 26, 1980, representatives from the Federal Reserve and the Office of the Comptroller of the Currency (OCC) met with Chairman Sprague and other FDIC staff at the FDIC offices in Washington to discuss a possible resolution for First Penn. Four options were available: (1) The OCC could close the bank and the FDIC

7. Teresa Carson, "Interest Rate Decline Is Just What 1st Pennsylvania Needed," *American Banker* (May 27, 1980), 1.

8. Sprague, *Bailout*, 85–86.

9. Carson, "What 1st Pennsylvania Needed," 1.

10. Sprague, *Bailout*, 82.

11. "Regulators' Release on Assistance Plan for 1st Pennsylvania," *American Banker* (April 30, 1980), 3.

12. "Regulators' Release on Assistance Plan for 1st Pennsylvania," 3.

13. Carson, "What 1st Pennsylvania Needed," 1.

could arrange a purchase and assumption (P&A) transaction with another institution; (2) the FDIC could arrange an open bank assisted merger with another institution; (3) the OCC could close the bank and the FDIC could pay off the insured deposits; or (4) the FDIC could provide open bank assistance to First Penn itself.

Resolution Alternatives

Both a closed bank P&A transaction and an open bank assisted merger would have required one critical element: a healthy institution able and willing to take on First Penn's deposits and perhaps some or all of its assets. Only one other bank in Pennsylvania, Mellon Bank in Pittsburgh, was large enough to absorb First Penn, but the FDIC was reluctant to concentrate so much of the state's banking resources in one gigantic institution and create the potential for an antitrust situation. The FDIC was not able to look outside of the state, because no statutory authority existed for out-of-state acquisitions.¹⁴

As part of the Omnibus Budget and Reconciliation Act, the limit on deposit insurance coverage was about to be raised from \$40,000 to \$100,000 per insured account, effective March 31, 1980. A payoff of the insured deposits would have required a significant portion of the total FDIC insurance fund, which stood at \$9.8 billion at the end of 1979, and might have weakened public confidence in the FDIC's ability to handle any subsequent failures.¹⁵ Moreover, the FDIC would have had to acquire First Penn's \$8 billion in assets for liquidation, an amount that was more than four times the balance of \$1.9 billion in assets the FDIC already had in liquidation.¹⁶ Paying off First Penn's depositors, therefore, generally was not considered to be a feasible option. Still, a payoff had its proponents. FDIC Director William M. Isaac said, "How else do you maintain discipline in the marketplace?"¹⁷

The only option remaining was open bank assistance, but such a move was unusual and controversial. Although the FDIC had received OBA authority in 1950, it had used it on only four occasions before the crisis at First Penn. In section 13(c) of the Federal Deposit Insurance Act (FDI Act) of 1950, Congress gave the FDIC authority to provide assistance to an open bank, "when in the opinion of the Board of Directors the continued operation of such bank is essential to provide adequate banking service in the community."¹⁸ Specifically, section 13(c) authorized the FDIC to assist directly an operating insured bank when a bank was in danger of closing and its continued operation was essential to maintain adequate banking service in the community. The FDIC was autho-

14. Sprague, *Bailout*, 82.

15. Paul M. Horvitz, "Bending the Law With Good Intentions," *American Banker* (May 8, 1980), 3.

16. FDIC, *1980 Annual Report*, 20.

17. Sprague, *Bailout*, 91.

18. FDIC, *Federal Deposit Insurance Corporation: The First Fifty Years* (Washington, D.C.: Federal Deposit Insurance Corporation, 1984), 94.

rized to make loans to, purchase the assets of, or make deposits in the troubled banks. Section 13(e) of the FDI Act allowed the FDIC to provide financial assistance only to facilitate the absorption of a failed or failing bank by another institution without a finding of “essentiality.”¹⁹ The use of section 13(e), however, wasn’t really an option for First Penn, because there was no suitable merger partner.

Open bank assistance was first used on July 27, 1971, when the FDIC provided assistance to Unity Bank and Trust Company, Boston, Massachusetts, which had \$9.3 million in deposits. On January 18, 1972, the FDIC assisted Bank of the Commonwealth, Detroit, Michigan, which had \$1.5 billion in total assets. Both banks served inner-city neighborhoods that lacked other adequate banking services, and so were considered “essential” to their neighborhoods. The FDIC did not use OBA again until September 20, 1974, when it assisted American Bank and Trust (AB&T), Orangeburg, South Carolina, with temporary funding to provide time to arrange a P&A transaction. AB&T, with \$150 million in total assets, was acquired by another bank just 12 days after the FDIC gave it assistance. Because AB&T was the only source of banking services in 10 of the communities in which it operated, the FDIC could justify providing the assistance. In another situation, the FDIC gave OBA to Farmers Bank of the State of Delaware on March 15, 1976. The bank was partially owned by Delaware and was the state’s sole depository, with \$370 million in deposits. Because of Farmers Bank’s unusual arrangement with the state, the FDIC judged the assistance to be “essential.”²⁰

The FDIC used open bank assistance sparingly, because it was concerned that the assistance would benefit stockholders, materially erode market discipline,²¹ and keep afloat a weakened bank to the possible detriment of the local community.²² Moreover, the FDIC was not entirely satisfied with the results of its assistance to Bank of the Commonwealth, where depositors never reestablished the confidence in the bank that had existed before its troubles. The bank had failed to grow and prosper as projected, it had been sold more than once, its name had been changed, and at the time of First Penn’s problems, the loan provided by the FDIC had not been paid back.²³

First Penn’s Proposal

First Penn hired a Wall Street investment banking firm to put together its proposal for FDIC assistance. At the same time, First Penn looked for an investor to take over the

19. FDIC, *The First Fifty Years*, 95–96.

20. FDIC, *The First Fifty Years*, 95.

21. Market discipline is the depositors’ and bank creditors’ reaction to their perception of risk. There is no market discipline when depositors and other bank creditors perceive that their funds are only minimally at risk, and they place their money in those banks and thrifts that are paying the highest interest rates, without regard to the management or financial stability of the institutions.

22. FDIC, *The First Fifty Years*, 97.

23. Sprague, *Bailout*, 76.

bank, but none was found. The proposal for open bank assistance was presented to the OCC on April 2, 1980, and was then presented to the FDIC the following day. The major points of the plan were as follows:²⁴

- The FDIC would provide a \$300 million, 10-year loan at a concessionary interest rate tied to bank earnings. The bank would repay no principal for five years; after that, it would make payments in 10 percent increments with a lump sum payment due in 1990. The loan would rank on a level with other capital notes of the bank and would be subordinated to all other creditors.
- First Penn would offer the FDIC five million warrants to purchase common stock. The holding company would omit payment of dividends to shareholders for two years.
- The regulators would be allowed to impose certain limits on bank operations, but the bank was not to be unduly hampered by such restrictions.
- The regulators would use their best efforts to help First Penn obtain \$1 billion in lines of credit and term deposits from major banks. First Penn would sell its depreciated government securities and use its loan from the FDIC to cover the loss. The bank would shrink itself and return to being a quality regional institution, less dependent on money market sources of funding.
- With First Penn's shareholders' meeting scheduled for April 29, 1980, the bank would plan to announce the assistance plan at the same time it announced its first-quarter loss.

Upon being presented with an assistance request, the FDIC first looked to determine if the bank could qualify under the "essentiality" rule. The key to being able to provide OBA was determining whether there were grounds to declare the bank "essential" and reasons to hold that First Penn was unique from the dozens of troubled mutual savings banks around the country. The FDIC's legal staff determined grounds for the FDIC's Board of Directors to find First Penn "essential,"²⁵ based mainly on its size. The closing of such a large bank would have had serious repercussions, not only in the local market, but probably nationwide. The Federal Reserve and the OCC also expressed concern about the domino effect of closing First Penn. They argued that disruption of First Penn's business connections would affect U.S. and international banks.

24. Sprague, *Bailout*, 87–88.

25. Frank L. Skillern, Jr., Draft Memorandum to Irvine H. Sprague, "Analysis of the FDIC's Authority Under Section 13(c) of the Act," April 11, 1980; Frank L. Skillern, Jr., Memorandum to the FDIC Board of Directors, "First Pennsylvania Bank, N.A., Bala-Cynwyd, Pennsylvania, Application for Assistance under Section 13(c)," April 28, 1980; Sprague, *Bailout*, 91.

Terms of the Assistance Transaction

The FDIC rejected First Penn's plan as presented, but during the next few weeks, negotiated an assistance agreement. On April 28, 1980, the FDIC, the Federal Reserve, and the OCC jointly announced a \$500 million assistance package to assure the viability and continued strength of First Penn. The key elements of the agreement were as follows:²⁶

- The FDIC would provide a five-year subordinated note for \$325 million, which was interest free for the first year and had a rate for the remaining four years of 125 percent of the yield on the FDIC's investment portfolio, which at the time earned 8.54 percent. The FDIC's note was senior to all other subordinated debt except for the bank note (see below).
- A group of 27 leading banks in the Philadelphia area and the nation would provide a five-year subordinated note for \$175 million, at an interest rate equal to Citibank's one-year certificate of deposit rate (adjusted annually). The bank loan was senior to all other subordinated debt. The assistance from the other banks was deemed necessary to instill the confidence in First Penn that was lacking when the FDIC previously assisted the Bank of the Commonwealth in 1972 without any private-sector contribution.
- The Federal Reserve would provide a \$1 billion bank line of credit through access to the Federal Reserve discount window.
- Because the loans from the FDIC and the banks were intended to shore up First Penn's capital while it sold off the government securities with low interest rates, the FDIC would require First Penn to immediately sell off a first installment of those securities large enough to cause a \$75 million loss. That action would reduce the severe interest drain on the bank.
- The transaction would include 20 million warrants for stock purchases in the bank's holding company by the FDIC (13 million) and the 27 bank lenders (7 million to be split among the banks) at an exercise price of \$3 per share.²⁷ (The inclusion of the warrants became one of the most important aspects of the assistance package.) The warrants would be good for seven years, and First Penn would be required to invest proceeds from any exercise of warrants into equity capital of the bank. The warrants effectively would dilute shareholder interest in the bank and decrease any return the existing shareholders might receive as part of First Penn's recovery.

26. Sprague, *Bailout*, 94–97.

27. The exercise price was the price at which each warrant could be exchanged for one share of stock on any given date.

- First Pennsylvania Corporation, the holding company for First Penn, would be required to invest \$55 million in proceeds from the sale and liquidation of its finance and mortgage company subsidiaries into bank capital, dispose of or restructure its securities dealer subsidiary, and pay dividends only with specific FDIC approval.
- During the life of the loans, the bank and the holding company and affiliates would be subject to special reporting requirements, supervision, and FDIC approval of operating plans.
- Holding company shareholders would be required to approve the transaction.

The assistance agreement was approved and consummated on May 29, 1980.

After the Transaction

Regarding the warrants obtained in the First Penn transaction, a lawsuit was filed in August 1980 by one of the stockholders of the bank. The suit disputed the FDIC's authority to hold an ownership interest in the holding company. In June 1983, the court ruled that the FDIC's assistance powers under section 13(c) of the FDI Act were broad enough to allow the warrants.²⁸ The decision came at an opportune time; First Penn had recovered to the point where it wanted to pay off its assistance two years early. Paying off the loan early and terminating the assistance package would enable First Penn to operate independently without the restrictions in the assistance agreement and to pay dividends without the FDIC's approval.

First Penn also wanted the FDIC to sell back its warrants so a new common stock issue could proceed. On November 15, 1983, the FDIC sold back half of the warrants (6.5 million) to First Penn for \$2 per warrant. The bank then paid off its remaining FDIC loan with the proceeds of the stock offering (\$150 million), a new loan from the assisting banks (\$75 million), plus internal cash. Eighteen months later, on May 29, 1985, the FDIC sold its remaining 6.5 million warrants to First Penn for \$30.1 million (\$4.625 per share).²⁹

FDIC Resolution Costs

The First Penn open bank assistance transaction essentially was a zero cost transaction for the FDIC, with its financial exposure being its \$325 million five-year subordinated note. First Penn paid the principal and scheduled interest payments on the note in full.

28. Sprague, *Bailout*, 103.

29. Sprague, *Bailout*, 105-106.

The only real cost to the FDIC was the foregone interest on the first year of the loan, which was part of the transaction as it was structured. If for that first year, the FDIC had charged First Penn a rate equal to 125 percent of the yield on its investment portfolio, matching the rate for the other years, the interest payment on \$325 million would have been about \$34.7 million. Offsetting any foregone interest is the \$43 million the FDIC received during 1983 and 1985 by selling its warrants back to First Penn and the 25 percent higher interest rate charged First Penn relative to the yield on the FDIC's investment portfolio.

Lessons Learned

The FDIC took a risk in allowing First Penn to continue operations. Because First Penn was a large institution, a continuation of losses in its securities and loan portfolios would have had a significant effect on the insurance fund if it had failed. Also, the failure of First Penn may have had a devastating effect on the regional and other large banks doing business with First Penn.

The FDIC reduced its risk in three ways. First, private-sector banks assumed a portion of the risk by extending part of the necessary recapitalization loan. Second, the FDIC obtained warrants for common stock in the holding company, effectively spreading the risk to include shareholders and providing itself with an upside potential. Third, during the life of the loans, the bank and its holding company and affiliates were subject to special reporting requirements and supervision, as well as the FDIC approval of dividend payments and operating plans.

Effect on Future Resolutions

Open bank assistance proved to be effective in the case of First Penn, and the transaction set a precedent for dealing with large failing banks. The FDIC's constraints in finding a buyer or merger partner probably influenced the Garn–St Germain Depository Institutions Act of 1982, which gave the FDIC more flexibility in dealing with failing or failed institutions, including the authority to seek out-of-state bidders for emergency acquisitions.

The effectiveness of the First Penn resolution no doubt influenced the FDIC's handling of the mutual savings banks that were in trouble at about the same time. From November 4, 1981, through October 15, 1982, the FDIC merged 11 mutual savings banks with other financial institutions. In the case of the mutual savings banks, the FDIC's resolution strategy was to force the weaker savings banks to find merger partners among the healthier banks or thrifts. To attract a merger partner, the FDIC guaranteed the acquirer a market rate of return on the acquired assets through the use of an income

maintenance agreement.³⁰ In a 12-month period starting November 1981, the FDIC provided income maintenance agreements nine times to complete such mergers. The distressed savings banks had more than \$13 billion in assets.

The size of First Penn and the mutual savings banks afforded the FDIC an opportunity to develop alternative methods for dealing with large failing banks. Because the failure of a large bank could have had a serious negative effect on the deposit insurance fund, the FDIC used open bank assistance to keep the banks open and allow them a chance to return to profitability. To assist troubled banks needing only temporary assistance, the FDIC developed other forms of assistance, such as net worth certificates.³¹ With the net worth certificates, the mutual savings banks no longer needed to be merged to prevent their failure.

All depositors were protected and senior management was replaced in the First Penn transaction. Those actions would prove to be common features of future open bank assistance transactions. In the First Penn case, shareholders experienced little negative financial effect, but then the FDIC did not experience any real cost, either. Future open bank assistance transactions would impose much larger losses on shareholders. Gradually, outside observers began to question the features of FDIC open bank assistance transactions. The issue was whether or not the costs imposed on participants in a failed bank's affairs were sufficient to obtain the benefit of market forces and the discipline those forces provide on individual behavior. Also, an issue was if market forces were being inhibited, what offsetting benefits justified such actions? The subsequent handling of Penn Square Bank, N.A., and the Continental Illinois National Bank and Trust Company open bank assistance transaction would bring those issues to the forefront.

30. Income maintenance agreements involved the FDIC's paying a merger partner (assuming institution) the difference between the yield on acquired earning assets and the average cost of funds for savings banks, plus spread to cover administrative and overhead expenses related to those assets. In effect, the FDIC guaranteed the acquirer a market rate of return on acquired assets with below-market rates. The FDIC entered into those agreements only if the resulting institution was viewed to be viable. In most cases the senior officials at the troubled institution were required to resign, and subordinated debtholders received only a portion of their investments.

31. For more details, see Part I, Resolution and Asset Disposition Practices, Chapter 3, Evolution of the FDIC's Resolution Practices.



'Many of you have asked why the FDIC chose to handle the Penn Square failure through a payoff of insured depositors rather than a merger, as we typically do. The answer is simple: we had no choice.'

—then-FDIC Chairman William M. Isaac