CHAPTER 5

Open Bank Assistance

Introduction

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

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

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

Background

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

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

Statutory Basis and Policy Implications

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

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

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

Table I.5-1

Summary of Open Bank Assistance Transactions

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

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

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

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

Source: FDIC Division of Resolutions and Receiverships.

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

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

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

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

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

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

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

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

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

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

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

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

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

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

The FDIC completed the majority of OBA agreements (with 98 institutions) in 1987 and 1988.[10] Those transactions represented approximately 20.3 percent of the total OBA and failure transactions during those years. The first of several reasons for the increase in OBA transactions was the FDIC's policy to communicate to bankers the deficiencies of their assistance proposals and allow them to make adjustments to conform to the policy statement. If the proposal cost less than liquidation, staff would recommend the open proposal without requesting closed bank bids. The second reason for the increase in OBA transactions was the federal income tax benefits, including the relaxed rules for tax-free reorganizations, favorable rules regarding carry forwards of net operating losses, and favorable tax treatment of assistance payments received by the failing banks from the FDIC.[11] In 1989, however, with passage of the Financial Institutions Reform, Recovery, and Enforcement Act (FIRREA), many potential tax benefits associated with open bank assistance were repealed.[12]

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

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

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

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

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

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

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

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

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

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

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

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

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

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

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

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

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

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

Use of Open Bank Assistance

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

First Penn (1980)

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

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

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

17. For further details, see Part II, Case Studies of Significant Bank Resolutions, Chapter 2, First Pennsylvania Bank, N.A.

million of the warrants (half of the warrants that it held). On May 29, 1985, the FDIC sold its remaining 6.5 million warrants to First Penn for $30.1 million.[18] By using that open bank assistance strategy, the FDIC was able to resolve one of the largest troubled banks in the country (at that time), ultimately at no cost to the FDIC's insurance fund.

Mutual Savings Banks (1981 to 1983)

The FDIC completed 14 open bank assistance transactions between 1981 and 1983, all of which involved assisted mergers of mutual savings banks located primarily in the Northeast. The problem the FDIC faced with those savings banks was quite different from any faced earlier in its history. Asset quality was not the problem with MSBs; rather, it was the rising interest rates in the early 1980s. The FDIC's major concern was keeping the cost of resolving the failing MSBs at a reasonable level without undermining public confidence in the savings bank industry or in the FDIC.

The primary method the FDIC used was assisted mergers in which failing savings banks merged with healthier banks or thrifts. In most of the cases, to facilitate the merger, the FDIC would assume the interest rate risk by entering into an income maintenance agreement with the acquirer. The FDIC would pay the acquiring institution the difference between the yield on acquired earning assets and the average cost of funds to savings banks for some number of future years. Income maintenance agreements were used in 11 of the 14 assisted mergers during that period. In some cases, the FDIC also supplemented the assistance with an up-front cash payment, an additional dollar payment in the future, or purchased assets.

The FDIC handled the first MSB transaction through a mixture of bid and negotiation. In subsequent transactions, the FDIC defined certain bidding ground rules and then entertained bids in a variety of forms.

Because those savings banks did not fail but were merged into operating institutions, depositors and general creditors suffered no losses. In most cases, however, the failing bank's senior management was replaced and any subordinated noteholders received only a partial return of their investment.[19] Generally, the FDIC negotiated with noteholders, forcing them to take a lower interest rate and/or an extended maturity. In pursuing that policy, the FDIC weighed the cost of not wiping out the noteholders (by closing the bank) against offsetting considerations, including possible lawsuits to delay the transactions, greater flexibility for the acquiring institution in continuing leases and other contractual arrangements, cooperation from state supervisors, and the possible effect on deposit outflows in other MSBs.

18. Irvine H. Sprague, *Bailout* (New York: Basic Books, 1986), 105.

19. In a few cases, senior management was not replaced and, in each case, it was determined that the current management was not considered the cause of the problem. In some cases, the management that remained had been brought on to clean up an already troubled or failing institution.

The FDIC's use of assisted mergers and income maintenance agreements was designed to provide participating MSBs time to restructure their balance sheets and remain solvent until interest rates became more favorable. Although the cost savings of the program are difficult to quantify, the program did achieve those goals.

Continental Illinois National Bank and Trust Company (1984)

The term "open bank assistance" gained national recognition in 1984 when the FDIC provided assistance to Continental Illinois National Bank and Trust Company (Continental), Chicago, Illinois. At its peak in 1981, Continental was the largest commercial and industrial lender in the United States and had purchased energy loan participations from Penn Square Bank, N.A., Oklahoma City, Oklahoma. The loans contributed significantly to the more than $5.1 billion in nonperforming loans that Continental held, resulting in eroding confidence in the bank and, ultimately, in a rapid and massive electronic deposit run that began in 1984. On May 17, 1984, the FDIC gave its assurance to protect all depositors and other general creditors of Continental against loss. A temporary capital infusion of $2 billion was made to stabilize liquidity concerns and to halt the run on deposits until a permanent solution could be arranged. The FDIC's options in resolving Continental were to pay off the customers with insured deposits, merge the institution with a healthier bank, or provide direct open assistance.

Because of the negative consequences for other banks and the economy, the FDIC ruled out a payoff of customers with insured deposits. It was estimated that "almost 2,300 small banks had nearly $6 billion at risk in Continental; 66 of them had more than their capital on the line and another 113 had between 50 and 100 percent."[20]

The FDIC also did not view merging Continental as a viable option because prospective purchasers would need a significant amount of time to evaluate the bank. In addition, a merger would require significant FDIC financial involvement to protect against the uncertainties.[21] More significantly, perhaps, the FDIC saw little outside interest in acquiring Continental.

After ruling out the first two options, the FDIC elected to provide direct assistance to Continental. The permanent solution involved replacing senior management, purchasing $4.5 billion in problem loans for $3.5 billion, and injecting $1 billion in capital. In exchange, the FDIC received 80 percent ownership in the parent company, Continental Illinois Corporation.[22] As a result, the shareholders of the parent company suffered an immediate 80 percent dilution of their investments, and the shareholders

20. William M. Isaac, Chairman, Federal Deposit Insurance Corporation, "Statement on Federal Assistance to Continental Illinois Corporation and Continental National Bank Presented to Subcommittee on Financial Institutions Supervision, Regulation and Insurance of the Committee on Banking, Finance and Urban Affairs, House of Representatives," October 4, 1984, 3.

21. Isaac, 3.

22. Isaac, 4-5.

became subject to losing their remaining investment, depending on the losses suffered by the FDIC in collecting the problem loans.[23] In the end, losses on the problem loans would reduce their investment to zero. Bondholders of the parent company, however, were protected and did not lose any of their investment.

The open bank assistance agreement with Continental was controversial for several reasons. Some critics objected simply to the notion of a government agency acquiring a majority equity interest in a bank, often using the word "nationalization" to describe the assistance package. Others objected to the fact that the FDIC guaranteed all depositors and other general creditors, thus assuming their share of loss and removing the market risk. Still others objected to the bondholders of the holding company not suffering any loss and the apparent possibility that the shareholders might retain some of their investment as well. Finally, relating to all those issues and far outlasting the immediate aftermath, critics raised the issue of "too big to fail."[24] That issue would create resentment by many smaller banks because of their belief that the FDIC treated larger failing banks differently from smaller ones.

Although the FDIC's decision was controversial, the open bank assistance provided to Continental accomplished the objectives of stabilizing liquidity, preventing Continental's failure, and restoring Continental's capital to an adequate level. The OBA also proved to be cost-effective for the FDIC. In 1991, the FDIC sold its remaining 26 percent equity holding in Continental, thus completing the return of Continental to private ownership and producing a net gain of $200 million on the $1 billion of capital originally provided. Dividend income on the stock amounted to an additional $202 million. The final resolution cost for handling Continental was about $1.1 billion, or 3.3 percent of Continental's assets at the time of assistance.[25]

BancTexas Group, Inc. (1987)
Alaska Mutual Bank and United Bank of Alaska (1987 to 1988)

In 1987, the FDIC provided open bank assistance to 19 banks, 11 of which were subsidiaries of BancTexas Group, Inc. (BancTexas), a $1.2 billion bank holding company headquartered in Dallas, Texas. The FDIC completed the OBA transaction with BancTexas on July 17, 1987. The transaction included a one-time FDIC cash contribution of $150 million to enhance the bank's capital, as well as an infusion of additional capital from a rights offering to shareholders and a standby pool of new private investors organized by The Hallwood Group, Inc., a New York-based merchant banking concern.

23. Isaac, 4.

24. Most of the institutions considered "too big to fail" were actually closed; however, certain troubled institutions were considered too large to be resolved by paying off only their insured depositors. A more accurate name would be "too big to pay off all depositors."

25. For additional detail, see Part II, Case Studies of Significant Bank Resolutions, Chapter 4, Continental Illinois National Bank and Trust Company.

The one-time FDIC injection of cash resulted in a fixed cost to the insurance fund and was a relatively simple transaction. The FDIC assumed none of the bank's problem assets and obligations; instead, the new investors and managers of the new holding company agreed to carry out their own strategies for dealing with the problem assets and for maintaining the bank's capital.

It was also 1987 when the FDIC gave preliminary approval for open bank assistance to merge Alaska Mutual Bank and United Bank of Alaska, both in Anchorage, Alaska. The resulting newly formed institution had about $1.3 billion in assets and represented the largest banking institution in Alaska. That transaction, completed in January 1988, was similar to the BancTexas transaction because it was also a fixed-cost transaction (a one-time-only FDIC cash contribution) and included new equity capital raised from a new private investor group organized again by The Hallwood Group, Inc.

In both the Texas and Alaska cases, however, the OBA proved to be insufficient to withstand the continued deterioration of the depressed regional economies. The newly formed Alaska institution remained open for about 15 months before closing in April 1989. BancTexas lasted a little more than two years before closing in January 1990. The resolution costs for those two institutions amounted to $77.4 million and $64.6 million, respectively.

Because of the failure of the Texas and Alaska banks, most of the later proposals for open bank assistance required the FDIC to protect an acquiring institution from losses of the failed bank's assets for a specified period.

First City Bancorporation of Texas, Inc. (1987 to 1988)

In 1987, the FDIC agreed in principle to provide open bank assistance to First City. At that time, the $11 billion bank holding company, with 60 bank subsidiaries, was in severe financial condition. The banks were heavily dependent on energy and real estate loans, and when their condition began deteriorating with the decline of those markets, First City approached the FDIC about providing open bank assistance.

Although the FDIC's standard practice with failing banks was to protect all depositors against loss, there was little interest in protecting holding company bondholders or shareholders or the bank's management. The problem with open bank assistance was the difficulty in treating bondholders and shareholders as if the bank had failed when those creditors and investors had to approve OBA. The FDIC and other bank regulators, however, were reluctant to close the First City banks, given their regulators' view that all of Texas's major banks were facing financial difficulties because of the region's economic difficulties and, thus, were susceptible to a loss of public confidence and deposit runs.

All of these factors resulted in a nine-month effort to carry out an OBA transaction that was acceptable to bondholders and shareholders, as well as to the FDIC. Although the FDIC wanted to minimize returns to those groups, the bondholders and shareholders wanted to maximize those returns. The FDIC's leverage in the negotiations was that the banks were failing and could be closed by the primary regulators. The bondholders' and shareholders' leverage was the knowledge that closing the bank was not the action taken with Continental.

In April 1988, the FDIC provided $970 million in capital notes to 59 of First City's subsidiary banks.[26] A new private investor group, which raised $500 million in new capital through a stock offering, assumed control of the holding company. The ownership of First City's existing shareholders was reduced to less than 2 percent of the total equity. In addition, the agreement required the transfer of approximately $1.7 billion in nonperforming and troubled assets to a separate entity created to service such assets; that transfer was funded by notes from the First City subsidiary banks. In the OBA transaction, the FDIC did not purchase any assets held by the assisted banks; it received warrants to purchase 5 percent of the common stock of First City and also purchased $43 million of junior preferred stock convertible into 10 percent of the common stock. Finally, most holders of First City's preferred stock and publicly held, long-term debt agreed to substantial concessions as a requisite to the transaction. However, as with the BancTexas and Alaska OBAs, the assistance was insufficient. All remaining First City banks were closed in 1992 at no cost to the FDIC.

The First City case marked the beginning of the end for open bank assistance transactions. The FDIC was dissatisfied with the difficulty involved in completing a transaction. It had been asking Congress for bridge bank authority that would give it far greater leverage in such situations, and by August 1987, Congress passed legislation that gave the FDIC that authority. With a bridge bank, the FDIC could simply leave all bondholders' and debt holders' claims behind in a receivership, while transferring a failed bank's assets and other liabilities to a bridge bank controlled by the FDIC until it could be sold or liquidated. With a bridge bank, bondholders and shareholders would have no bargaining power. Incidentally, the 1992 resolution of First City involved the establishment of 20 bridge banks.

Savings and Loans

In the early 1980s, the Federal Savings and Loan Insurance Corporation (FSLIC), like the FDIC, used income maintenance agreements and net worth certificates for institutions incurring a "spread problem." In a period of rising rates, institutions were not able to increase rates earned on assets to keep pace with the rising costs of deposits and borrowed funds. In the middle and late 1980s, because of increased credit quality problems and its own lack of liquidity, the FSLIC primarily focused on assisted mergers involving the merger of an unhealthy institution with a healthier institution. To

26. Of the 60 bank subsidiaries, 59 were in Texas and 1 was in South Dakota. One Texas subsidiary, McAllen State Bank, McAllen, Texas, was closed by the Texas Banking Commission on April 19, 1988. One day later, the FDIC Board of Directors approved the open bank assistance transaction. For further detail, see Part II, Case Studies of Significant Bank Resolutions, Chapter 5, First City Bancorporation of Texas, Inc.

facilitate the merger, the FSLIC would enter into longer term assistance agreements with the acquirer. Because most of the failing S&Ls were mutual in form (no stockholders), there were no windfalls for stockholders. When stockholders owned a failing S&L, the FSLIC resolved the institution with an assisted, whole institution purchase and assumption (P&A) transaction. Claims of existing shareholders were left with the receiver of the failed institution. In only a few instances did the FSLIC provide OBA to an institution that was owned by stockholders.

From 1989 through 1995, the RTC was responsible for handling failing and failed savings and loans. During 1990, the RTC considered using open bank assistance transactions to resolve well-managed, but undercapitalized, S&Ls; but Congress opposed the idea, and the RTC never completed any OBA transactions.

Conclusion

Open bank assistance has been used infrequently by the FDIC. From 1980 through 1994, the FDIC provided OBA transactions in only 65 cases. Those cases involved 133 institutions, or only 8 percent of the 1,617 institutions that failed or received assistance during that period. The FDIC used OBA to resolve failing institutions in a variety of different circumstances. Open bank assistance was most effective when it was used selectively to resolve a specific type of problem. In the early 1980s, although the FDIC used OBA transactions to assist the weakened MSBs, OBA use reached its pinnacle in stabilizing the liquidity crisis at Continental. In the mid- to late 1980s, the FDIC used OBA more frequently to keep open several larger banking institutions that were suffering from regional economic problems. Open bank assistance in those cases, however, was less successful, and several of those assisted institutions later failed.

After the Continental transaction, many people perceived that open bank assistance was used only for larger banks. Although the FDIC has provided open bank assistance to failing banks of all sizes, it has played a more prominent role in resolving larger failing banks. Of the 65 cases in which OBA was used, 30 transactions, or 46 percent of the 65 cases, were for banks with total assets of less than $50 million. However, the average asset size of banks handled through OBA was $620 million, compared to an average asset size of only $148 million for closed bank transactions. Furthermore, although OBA was used for only 8 percent of the 1,617 institutions that failed or received assistance from 1980 to 1994, it was used for more than 24 percent of the $302.6 billion in failing or failed bank assets during that period.

In addition, OBA became synonymous with the phrase “too big to fail,” thereby heightening the controversy over whether large banks and small banks were resolved equitably. However, “too big to fail” was an inaccurate phrase. In reality, large banks did fail, shareholders lost their investments, and management was removed during that period. In practice, most large bank failures were handled by P&A transactions, in which uninsured depositors and creditors received 100 percent of their funds. P&A and

OBA transactions therefore treated uninsured depositors and creditors in a similar fashion. However, shareholders in an OBA did have a better chance of receiving some funds.

If some banks were truly too big to fail (or, more accurately, were too big for depositors to suffer any losses), the obvious corollary was that most banks were not too big to fail and that uninsured depositors could suffer losses. While recognizing the inequities of that practice, the FDIC also wanted to minimize local economic disruptions. Therefore, from the 1980s through the early 1990s, the FDIC often selected a resolution method that protected all depositors, even in smaller banks.

Another concern about OBA and the too big to fail issue was that OBA might lessen market discipline. However, in almost all OBA transactions completed by the FDIC from the 1980s through the early 1990s, the institutions were either mutual in form and had no shareholders, or the existing stockholders of the assisted institution suffered substantial losses of their investment. As part of the typical OBA transaction, the ownership position of existing shareholders was diluted to a minimal amount, typically about 5 percent. In some OBA transactions, shareholders did retain a higher percentage initially; however, the percentage was subject to decreases based on the ongoing financial condition of the bank. For example, at Continental, shareholders whose 100 percent ownership was initially diluted to 20 percent later received almost nothing because of additional losses suffered by the FDIC. For uninsured depositors and creditors, the FDIC generally believed that payoffs to ensure depositor discipline usually affected only unsophisticated depositors, whereas sophisticated depositors usually got out of failing institutions long before they failed.

The primary benefits of OBA transactions are listed below.

- OBAs were a cost-effective method for resolving failing institutions. The cost of OBA transactions (approximately 6.2 percent of the bank's assets at resolution) from the 1980s through the early 1990s was lower than that of other methods. However, because each failing bank situation was unique and because all but two of the OBA transactions were completed before the "least cost" requirement, one cannot conclude that OBA transactions were always the *most cost-effective* transactions.
- OBAs minimized disruption to the local community.
- New investors assumed some of the risk and typically brought new capital to the institution.
- Usually, OBA transactions kept a majority of the assets in the private sector.

The primary disadvantages of OBA transactions are as follows:

- Contingent liabilities remained with the troubled institution.
- Customers with uninsured deposits and general creditors were protected by

OBAs, thus potentially reducing marketplace discipline. Furthermore, although shareholders suffered substantial losses on their investments, they did receive some benefit compared to what they would have received in a closed bank transaction.

- The time necessary for a troubled institution to put together assistance proposals and to complete negotiations was sometimes outside the FDIC's parameters for resolving failing institutions.
- Weak institutions were allowed to remain open and compete with nonassisted institutions.

In 1989, the FDIC began moving away from providing open bank assistance and, from 1989 to 1992, entered into only seven OBA transactions. To date, there have been no OBA transactions since 1992. OBA transactions ceased because of problems experienced with some of the latter transactions, including problems in negotiating the transactions (for example, in the case of First City), and because of a series of legislative changes, which either restricted the use of OBAs (for example, the least cost provision) or broadened the alternatives available to the FDIC to resolve large bank failures (for example, bridge bank authority).

Table I.5-2

Open Bank Assistance Transactions (1980–1994)
($ in Millions)

Date	Institution Name	State	Number of Failed Banks	Total Assets	Total Deposits	Costs	Costs/ Assets (%)
04/28/80	First Pennsylvania Bank, N.A.	PA	1	$7,953.0	$5,300.0	$0.0	0.0
11/04/81	Greenwich Savings Bank	NY	1	2,529.9	1,881.2	465.1	18.4
12/04/81	Central Savings Bank	NY	1	918.6	675.7	127.3	13.9
12/18/81	Union Dime Savings Bank	NY	1	1,437.7	1,172.2	61.5	4.3
01/15/82	The Western New York SB	NY	1	1,022.0	890.2	30.2	3.0
02/20/82	Farmers & Mechanics SB	MN	1	980.4	789.4	52.4	5.3
03/11/82	Fidelity Mutual Savings Bank	WA	1	689.1	550.5	44.5	6.5
03/11/82	United States Bank of Newark	NJ	1	674.7	578.4	77.3	11.5
03/26/82	The New York Bank for Savings	NY	1	3,403.0	2,779.7	751.4	22.1

Table I.5-2

Open Bank Assistance Transactions (1980–1994)

($ in Millions)

Continued

Date	Institution Name	State	Number of Failed Banks	Total Assets	Total Deposits	Costs	Costs/ Assets (%)
04/02/82	Western Saving Fund Society	PA	1	$2,112.8	$1,956.8	$29.3	1.4
09/24/82	United Mutual Savings Bank	NY	1	832.9	777.9	33.1	4.0
10/15/82	Mechanics Savings Bank	NY	1	55.3	50.6	0.0	0.0
02/09/83	Dry Dock Savings Bank	NY	1	2,500.0	2,038.0	59.4	2.4
08/05/83	Oregon Mutual Savings Bank	OR	1	260.0	251.3	11.9	4.6
10/01/83	Auburn Savings Bank	NY	1	130.0	131.4	0.0	0.0
05/17/84	Continental Illinois	IL	1	33,633.0	17,450.4	1,104.0	3.3
09/28/84	Orange Savings Bank	NJ	1	514.9	494.6	7.3	1.4
05/31/85	Bank of Oregon	OR	1	106.3	93.7	18.8	17.7
08/16/85	The Commercial Bank	AL	1	89.0	76.0	0.0	0.0
10/01/85	Bowery Savings Bank	NY	1	5,278.8	4,938.4	334.5	6.3
12/31/85	Home Savings Bank	NY	1	421.8	402.3	5.7	1.4
04/16/86	The Talmage State Bank	KS	1	9.6	8.9	1.5	15.6
08/15/86	State Bank of Westphalia	KS	1	4.3	4.1	0.0	0.0
08/30/86	Mid Valley Bank	WA	1	40.2	38.2	0.2	0.5
11/24/86	Bank of Oklahoma, N.A.	OK	1	468.2	349.9	78.8	16.8
11/26/86	Bank of Commerce	TN	1	67.3	65.6	11.3	16.8
12/29/86	Bank of Kansas City	MO	1	118.8	108.2	5.2	4.4
12/31/86	Citizens Bank & Trust Co.	LA	1	10.4	10.7	0.4	3.8
02/25/87	American National Bank	OK	1	10.3	9.1	1.1	10.7
02/26/87	Central Bank & Trust Co.	LA	1	28.3	28.0	0.0	0.0
05/13/87	Syracuse Savings Bank	NY	1	1,200.0	1,100.0	0.0	0.0
06/05/87	Security Bank of Rich Hill	MO	1	12.9	12.7	0.2	1.7
07/17/87	BancTexas	TX	11	1,192.6	900.0	150.0	12.6
07/31/87	Valley Bank of Belgrade	MT	1	18.6	16.9	3.0	16.1

Table I.5-2

Open Bank Assistance Transactions (1980–1994)

($ in Millions)

Continued

Date	Institution Name	State	Number of Failed Banks	Total Assets	Total Deposits	Costs	Costs/ Assets (%)
10/16/87	Commercial Bank, N.A.	OK	1	$23.8	$22.2	$4.5	18.9
12/03/87	Crossroads Bank	TX	1	26.0	26.1	1.3	5.0
12/29/87	The Falun State Bank	KS	1	3.1	3.0	0.1	1.6
01/07/88	The Peoples State B&T Co.	KS	1	40.6	40.0	5.5	13.6
01/13/88	The Jefferson Guaranty Bank	LA	1	287.4	270.0	57.5	20.0
01/27/88	Citizens State Bank	MN	1	30.1	29.3	0.8	2.6
01/28/88	Alaska Mutual Bank	AK	1	822.6	676.7	170.7	20.8
01/28/88	United Bank Alaska	AK	1	462.5	419.1	170.7	36.9
02/12/88	American National Bank	OH	1	27.2	24.7	0	0.0
03/15/88	Morehead National Bank	KY	1	8.2	7.8	1.0	11.9
04/15/88	Burns State Bank	KS	1	4.1	3.6	0.6	14.6
04/20/88	First City Texas	TX	59	11,200.0	9,400.0	1,100.8	9.8
04/20/88	Bank of Santa Fe	NM	1	101.2	93.7	22.3	22.0
04/25/88	Bond County State Bank	IL	1	6.6	6.4	0.6	9.1
04/28/88	Citizens Bank of Tulsa	OK	1	8.8	8.7	1.9	21.6
05/18/88	The American State Bank	SD	1	67.3	63.5	2.6	3.9
06/14/88	Bank of Imboden	AR	1	17.8	17.2	2.2	12.4
07/14/88	Texas Bancorp Shares, Inc.	TX	1	76.5	74.2	12.1	15.8
07/15/88	Oak Forest National Bank	TX	1	8.8	8.6	1.4	15.9
08/09/88	Security State Bank	IA	1	16.8	16.3	0.2	1.2
09/16/88	Guaranty National Bank	TX	1	22.0	23.0	4.2	19.0
11/16/88	Alliance Bank, N.A.	OK	1	9.6	12.0	4.1	42.7
12/21/88	Baton Rouge B&T Co.	LA	1	114.9	115.3	18.0	15.7
12/30/88	Tracy Collins B&T Co.	UT	1	206.0	191.0	17.4	8.5
01/31/89	Metropolitan National Bank	TX	1	5.7	6.4	2.3	40.7

Table I.5-2

Open Bank Assistance Transactions (1980–1994)

($ in Millions)

Continued

Date	Institution Name	State	Number of Failed Banks	Total Assets	Total Deposits	Costs	Costs/ Assets (%)
09/12/90	The Pawnee National Bank	OK	1	$15.9	$15.6	$2.4	15.1
09/16/91	First Bank and Trust	IL	1	29.7	28.8	0.6	2.1
10/02/91	The Gunnison B&T Co.	CO	1	22.3	21.4	1.5	6.6
12/04/91	The Douglass Bank	KS	1	31.9	30.2	1.0	3.1
10/16/92	Freedom Bank	TX	1	21.7	20.9	0.4	1.7
12/10/92	Citizens State Bank	TX	1	13.2	12.6	0.2	1.5
Totals/Average		**65**	**133**	**$82,457.0**	**$57,619.3**	**$5,074.3**	**6.2**

Source: FDIC Division of Research and Statistics.

PREVIOUS CHAPTER
NEXT CHAPTER
TABLE OF CONTENTS

When banks face a poor regional economy and a sudden or severe liquidity crisis, the bridge bank structure allows time to evaluate the bank's condition and address outstanding problems before the marketing and sale of the bank.